

HOUSE FINANCIAL SERVICES SUBCOMMITTEE HEARING

OVERVIEW

For questions on the note below, please contact [Graham Harper](#) or [Daniel Austin](#) at (202) 547-3035.

Yesterday, the House Financial Services Subcommittees on Capital Markets, Securities, and Investment held a [hearing](#) entitled “U.S. Equity Market Structure Part I: A Review of the Evolution of Today’s Equity Market Structure and How We Got Here.”

Key Takeaways

- Tom Farley, NYSE, said proprietary market makers are hugely important, and NYSE does what it can to attract them. He also said that the Securities and Exchange Commission (SEC) should not delegate rulemaking authority to the Equity Market Structure Advisory Committee’s (EMSAC) Subcommittee on Regulation NMS (Reg NMS), and should instead undertake the traditional rulemaking process.
- Joseph Saluzzi, Themis Trading, said that the consolidated audit trail (CAT) does not include futures, so the SEC should work with the Commodity Futures Trading Commission (CFTC) to incorporate futures data into CAT.
- According to Ari Rubenstein, Global Trading Systems, if you remove rebates from the market, you remove liquidity for mid- and small-cap companies.

PANEL ONE SUMMARY

Opening Statements and Testimony

Subcommittee Chairman Bill Huizenga (R-MI)

Equity markets are essential to Main Street and companies all around the world. Many American rely on capital markets to save for college tuition and retirement.

Equity market structure has evolved and has been shaped by SEC rules. Much of the trading is now done by automated computer algorithms, and market activity is measured in milliseconds and microseconds.

Investors have benefited from more competitive equity markets and improved electronic trading. A truly comprehensive review of equity market structure is long overdue.

Subcommittee Ranking Member Carolyn Maloney (D-NY)

The U.S. has the deepest, most liquid capital markets in the world, but we can always look at ways to improve them. Reg NMS fundamentally overhauled U.S. market structure, but after 12 years, it makes sense to ask what the SEC got right, wrong, and what can be improved in Reg NMS.

I believe that improvements can and should be made to our equity markets. Competition has increased because the number of trading venues has expanded, but there is a fine line between too many trading venues and too few.

Subcommittee Vice Chairman Randy Hultgren (R-IL)

Congress has a responsibility to ensure U.S. equity markets are structured to maximize capital formation for job creators and protects the interests of investors saving for retirement.

It is important we are all on the same page in terms of our objectives as we review the equity market structure.

No aspect of market structure should be debated in a silo because they are all too interconnected.

Matt Lyons, Senior VP and Global Trading Manager, The Capital Group

Although the equity markets function well, they have changed greatly since the SEC adopted Reg NMS, so it is time to examine and improve equity market structure.

The SEC should conduct a pilot program to evaluate how access fees and liquidity rebates impact trading in highly liquid stocks and whether regulated funds and other investors would benefit from a market structure that significantly reduces the incentives of brokers to route orders based on the level of fees and rebates at trading platforms.

NMS plan governing bodies should include market participants as voting members, including representatives of regulated funds.

The SEC should increase transparency of order handling of broker-dealers (BDs) and require alternative trading systems (ATSs) to disclose key information about their operations and operators.

Joseph Saluzzi, Partner, Themis Trading LLC

While the SEC believed Reg NMS would create competition among stock exchanges to provide the best prices for investors, market fragmentation has increased and regulations have resulted in a high-speed competition to trade against long-term investors.

We do believe that exchanges provide a valuable service by helping to match buyers and sellers and deserve to be compensated for this function. However, we recommend that exchanges charge a flat rate for both the addition and removal of liquidity from their exchange.

Market participants do not want to rely on the public SIP for their pricing information; therefore, exchanges should only provide order information on an aggregated basis.

The numerous flash crashes we have seen since the adoption of Reg NMS have proven that the liquidity buffer provided by market makers often disappears when needed most.

We recommend the SEC and CFTC create a permanent task force that can quickly share data in the event of a market disruption.

Ari Rubenstein, CEO, Global Trading Systems

The recent BATS proposal to offer an alternative closing auction for securities listed on other markets will fragment order flow and rob issuers of the right to choose which exchange manages the closing auction of their shares.

We need a greater focus on cybersecurity to prevent hacking and cyberattacks.

Regulators should consider proposals to upgrade SIP because the perception that SIP feeds disseminate information at a significant disadvantage to direct feeds will eventually drain investor confidence.

Jeff Brown, Senior VP, Legislative and Regulatory Affairs, Charles Schwab, on behalf of SIFMA

To address market fragmentation and complexity, the SEC should evaluate the Order Protection Rule (OPR) and consider whether modifications or exemptions are needed, potentially including a volume threshold for protected quotation status and a block exemption for orders of significant size.

The SEC should replace the single-consolidator SIP model of market data dissemination with a competitive construct, which would decrease the need for market participants to rely on the exchanges for proprietary market data.

BDs and asset managers should be provided with direct voting representation on the NMS Plan Operating Committees.

Panel One Discussion

Market Rebates, Maker-Taker, and Order Handling

Maloney: EMSAC has recommended the SEC conduct a pilot program to assess whether market quality improves with lower rebates – should the SEC proceed with this program? What modifications should the SEC make to its proposed rule on the order-handling rule, and what additional disclosures would the proposed rule require? *Lyons:* The proposed rule should be acted on immediately; *Saluzzi:* The exchanges should not structure the pilot program. There should be a no-rebate bucket, and a flat-fee model is better than a maker-taker model.

Lynch (D-MA): Have you reviewed my legislation that would require a pilot program on the maker-taker scheme? Comment on Citadel's behavior in dark pools that led to its fine by the SEC earlier this year, and how we can increase transparency for that type of conduct. *Saluzzi:* I have reviewed that legislation, but we must not make it too complicated. We can match buyers and sellers, and we need less intermediation. The Citadel situation was based on two sets of data, and Citadel was seeing one price but charging another.

Foster (D-IL): Do your retail investors get a better deal because people are willing to pay for their order flow? *Lyons:* When we look at data, we attribute the reduction in explicit costs to decimalization and electronic access to the market; *Saluzzi:* The Citadel case shows that there are two sets of data, so retail investors are not getting the best price in every trade; *Brown:* Yes, they do pay for that order flow to attract those types of orders. Our clients, on average, receive a quarter of the spread on price improvements. Further disclosure is a good idea to help clients better understand the process.

Emmer (R-MN): Can you provide an example of the conflicts of interest you refer to in your statement?

Lyons: It is important for us to know who sees our orders, where there is information leakage, and how ATSS operate. Disclosure is a good way to avoid potential conflicts of interest; *Brown:* Payment for order flow could cause a potential conflict, but we must take steps to mitigate that conflict. We monitor our execution quality so that our clients receive best execution.

Equity Market Structure's Problems, Benefits, and Improvements

Huizenga: What is working well in the current equity market structure? What should Congress review considering the technological advancements made in U.S. equity markets? *Lyons:* Technology has empowered the buy-side to have more control over the order and the direction of the order. The closest to a consensus I have seen in the industry is for a pilot reviewing the maker-taker scheme; *Rubenstein:* The amount of intermediation has gone down tremendously, which is why the data says we have the most efficient markets in the world. While we have a great electronic market, there are areas of disclosure and

transparency that need to be improved; *Brown*: Reg NMS has improved the cost of trading and execution quality for retail investors.

Scott (D-GA): How should Congress prioritize changes to market structure? *Lyons*: Congress can encourage the SEC to continue to look for opportunities to improve our market structure. Conflicts of interest in the markets can be addressed, and the proposals the SEC has made related to broker disclosures are important to monitor and evaluate the execution quality we get; *Saluzzi*: Proper surveillance is missing. The SEC has proposed CAT, but it only applies to securities and options. The SEC should work with the CFTC on incorporating futures data into CAT.

Wagner (R-MO): In what ways have institutional and retail customers benefited from advancements in equity market structure? Are technological advancements attributable to Reg NMS? Describe how market structure impacts capital formation. *Lyons*: Reg NMS removed a lot of market friction, which provides more control over the order process and gets us better results for our investors; *Brown*: Retail investors have instantaneous access. Reg NMS has led to the deepest, most liquid markets in the world. However, it is time to modernize our market data system.

Poliquin (R-ME): Walk us through a large institutional trade that would be conducted on behalf of one your funds, and point out any problems in that process. *Lyons*: For us to maximize returns for our investors, we need to minimize information leakage. To minimize market impact, we will look to passively interact with the marketplace to avail ourselves of the liquidity available at that time.

Hill (R-AR): Talk about the impact that public policy that encourages ETF investment has had.

Rubenstein: ETFs bring many benefits, and there has been a huge adoption of them. There has not been a tremendous amount of volatility because of all the assets that have gone into ETFs.

Budd (R-NC): What are some of the features that make our equity markets unique, and what can we do to improve their structure? What are some practices that have stopped because of technology? *Lyons*: Eliminating unnecessary intermediation will benefit our markets. There is a need for market makers to provide liquidity, but market makers should survive on the spread; *Rubenstein*: Technology and computing power will increase efficiency and accuracy. Because of computers, so much information can be analyzed, which leads to a tighter spread; *Brown*: We must remain focused so that we do not create disincentives for individual investors to remain in the marketplace.

Reg NMS Committees and Market Data

Huizenga and Hill: What are the benefits of having asset managers and BDs represented on NMS Plan Operating Committees? *Lyons*: Non-SRO members and their views would bring added benefits to Committee discussions. When you have for-profit exchanges who are controlling the pricing mechanism, it is a perfect example of why having someone outside the SROs on the Committees would help; *Brown*: The introduction of BDs and asset managers would broaden the Committees' expertise.

Foster: Who would be against SIP improvements? *Brown*: When the SIP fails, all trading ceases. Exchanges are never going to make the SIP great because it would cannibalize their proprietary data feeds.

Hill: What does market data modernization mean to you? *Brown*: Modernization would mean more information for retail investors. We have been advocating for data modernization for many years; a public feed that we must purchase should be better maintained.

IPOs and Liquidity

Davidson (R-OH): Comment on the liquidity issues small-cap firms face. *Saluzzi:* All stocks are not equal. The tick size pilot seeks to encourage liquidity providers to support small-cap firms. You have to change traders' behavior; *Rubenstein:* The number of IPOs have gone down tremendously. If you remove rebates from the market, you will remove liquidity for small-cap companies. Attacking the maker-taker process runs contra to the tick size program.

Hollingsworth (R-IN): What concerns do most companies have about market structure as they look to go public? *Rubenstein:* They recognize how innovative technologies have made markets more efficient and transparent. The most important thing is that their closing auction is conducted by their primary listing venue; they do not want to see their closing auction fractured.

Disclosures and Conflicts of Interest

Hultgren: Can you explain why ATSS should be required to disclose how they operate? How does that relate to requiring BDs to provide more order routing granularity? *Lyons:* We go through a great deal of scrutiny, examining to whom our brokers route orders through. There are benefits for us for unlit ATSS, but our clients are better served if we have information about how they operate. Disclosure is not any more of a burden than what the SROs do today. The order-handling disclosure rule would show how and where orders are being routed, which are the missing components currently not available in a digestible format.

MacArthur (R-NJ): What are some areas of conflict between SROs and market participants, and how can we fix this conflict? *Lyons:* SROs and exchanges play an important role in market monitoring. The SEC needs to take a leading role and advocate for additional participants, besides SROs, to be members of the NMS Committees; *Saluzzi:* Exchanges enjoy many benefits from being SROs and also for-profit businesses; *Brown:* Exchanges have a duty to make money for their shareholders, but they operate under this mantle of being an SRO, granting them the right to regulate their participants. When they compete with market participants, they are both a regulator and a competitor. I would urge Congress to look at this issue. FINRA could absorb exchanges' regulatory function.

EMSAC

Hultgren: Thoughts on EMSAC? *Brown:* EMSAC is a valuable tool, but we were disappointed in its initial composition. I hope its composition is reassessed this fall.

Cybersecurity

Hultgren: Explain how stakeholders share information on cybersecurity. *Rubenstein:* The industry has been hesitant to work together to share sensitive information on cybersecurity.

PANEL TWO SUMMARY

Testimony

[Thomas Farley, President, New York Stock Exchange \(NYSE\)](#)

Since Reg NMS, equity markets have grown intensely competitive and innovative, leading to increased fragmentation, lack of obligated liquidity provision, and a decrease in displayed liquidity.

NYSE believes that regulation needs to be better designed to protect and reward displayed liquidity, and that any changes to equity market structure should emphasize increased transparency to listed companies and investors.

Dark pools do not contribute anything positive to price discovery, and their aggregate impact will continue to degrade the public price discovery process.

The SEC should curtail its use of SRO-proposed NMS Plans to achieve its policy goals and instead conduct data-driven SEC rulemaking subject to robust economic analysis and public review and comment.

Brad Katsuyama, CEO, The Investors Exchange

If the equity markets are not adequately serving the interests of investors and public companies and advancing the principles of fairness, transparency, and trust, then action must be taken to re-focus the markets on these tenets.

The most significant and detrimental exchange-generated conflict involves the practice of paying rebates to brokers for orders. These rebate practices cause clear and significant harm to investors.

National stock exchanges' motivation for profits drove them to sell advantages on their own markets in a way that benefits the fastest traders at the expense of all other participants.

Because there is a basic lack of transparency about exchange market data revenues, it would be appropriate for the SEC to require disclosure of the amount of exchange revenue from the sale of market data products.

Chris Concannon, President and Chief Operating Officer, Chicago Board of Options Exchange

Reg NMS contributed positive results to markets, including tighter spreads and efficiency; however, it has also created a complex and fragmented market. Benefits that may result from additional exchanges can be offset by increased costs and complexity relating to the required connectivity to an additional market.

Reg NMS was materially flawed in its one-size-fits-all approach to our markets. This is not an ideal design for the largest, most diverse equity market on the planet.

We recommend a comprehensive review of Reg NMS to promote Congressional objectives while modernizing Reg NMS to address the unintended consequences and significant changes to the marketplace since its implementation.

John Comerford, Head of Global Trading Research, Instinet

Reg NMS has been successful in its goals of enhancing market efficiency and supporting fair and vigorous competition. However, steps should be taken to reduce some of the unintended complexity and to more actively encourage the display of limit orders.

A one-size-fits-all tick size engenders unnecessarily disorderly trading behavior by creating unbalanced incentives between market participants for many stocks.

Any regulatory or statutory changes would be well served to retain the primary principle behind the design of Reg NMS, namely promoting fair competition among markets and orders.

Thomas Wittman, Executive VP and Global Head of Equities, NASDAQ

Nasdaq believes concentrating liquidity for small- and medium-growth companies onto a single exchange will allow investors to better source liquidity because, currently, liquidity is fragmented across an increasing number of trading venues.

Reg NMS lead to an explosion of ATSS and exchanges, leading to the current environment with more than 50 active trading venues.

Small- and medium-growth companies should have the ability to trade on sub-penny, penny, nickel, or even dime increments because the current one-size-fits-all approach to tick size is sub-optimal.

Panel Two Discussion

Equity Market Structure's Problems, Benefits, and Improvements

Lynch: Has your speed bump accomplished its goal? *Katsuyama:* It accomplishes the goal we sought to accomplish. It has minimized a certain segment of high-speed trading and latency arbitrage.

Budd: Should Congress review the regulatory framework of equity markets? *Wittman:* Yes.

Hollingsworth: Comment on order fragmentation. Do high-frequency traders (HFTs) provide benefits to the markets? *Farley:* Proprietary market makers are hugely important, and we do what we can to attract them to NYSE; *Katsuyama:* There are HFTs that benefit the market and some that do not. Those that add liquidity are positive, but those that remove liquidity are not; *Wittman:* Fragmentation spurs the ability to start new exchanges. Reg NMS costs are beginning to outweigh their benefits because of increased fragmentation.

Loudermilk (R-GA): What are some regulatory challenges your non-exchange businesses face? *Farley:* The SEC can determine what is and is not a "facility" of the exchange, giving it a nexus for regulation. "Facility" needs to be refined.

Reg NMS Committees and Market Data

Huizenga: Address adding new members to NMS Committees and transparency. *Farley:* NYSE has pushed for broad representation on advisory committees. The SEC has been using the NMS Committees to structure policy, which is not a positive development; *Concannon:* We are willing to consider additional participation on NMS Committees. Delegating rulemaking authority to the NMS Committees is quicker than the SEC promulgating rules; *Wittman:* When you look at the NMS Committees' governance structure, there are BDs that provide input, although they do not have voting rights.

Maloney: What are exchanges' costs to produce market data, and how much lower would fees be if they charged only the costs of producing that data? *Katsuyama:* You do not just pay for the data, but you also pay for the infrastructure to receive the data. When you are required to buy market data, it begs the question whether the costs for the data reflect the costs to produce that data.

Sherman (D-CA): Why do you not charge for market data? *Katsuyama:* Costs to produce and distribute market data are built into a trading fee. A competitive market should not allow for kickbacks.

Hill: Do BDs and asset managers belong on the NMS Committee? *Farley:* Yes.

Davidson: Can you add some clarity to CAT and market data? *Farley:* There was a CAT decision to include personally identifiable information (PII) of all market participants, which gives us great concern, because one entity would have valuable information of everyone who trades in equity markets;

Concannon: CAT was crafted in response to the flash crash. FINRA currently sees all our data, and they also have the entire OTC database. There is a vibrant system of surveillance, and CAT is the next step in surveillance's evolution in the U.S.

Market Rebates, Maker-Taker, and Order Handling

Maloney: Should the SEC proceed on a pilot program that examines market rebates, and if so, who should design it? *Farley:* We feel strongly that the SEC should engage in a rulemaking instead of delegating the pilot design to the exchanges.

Hultgren: Comment on banning rebates and Mr. Katsuyama's remarks about rebates. *Concannon:* The notion of banning rebates lacks understanding of how our markets work. Liquidity rebates go to dealers who are market makers. The rebate size should be modified as a company becomes more liquid, which is one problem of Reg NMS's one-size-fits-all approach. When brokers receive rebates, they are still subject to best execution. There will always be a conflict of interest because there are so many markets to route through.

Hill: Comment on rebates and conflicts of interest. *Farley:* I think BDs are conscientious actors, and they acknowledge there is an inherent conflict of interest regarding rebates, but there is not a clear solution.

IPOs and Liquidity

Sherman: What are the benefits of public markets and exchanges, and what do we do to get more companies to go public? *Wittman:* We are very focused on this issue. There are more companies looking to stay private. I think changes can be made to the IPO process to make it easier to go public.

Scott: Why is trading at the NYSE declining? *Farley:* Our trading volume is not declining. We are the market leader in absolute number of shares.

Poliquin: Why do you think fewer companies are going public? What do you think about short selling and its impact on companies going public? *Farley:* There have been many shareholder class action lawsuits over the past several years, which can discourage companies from going public. The data-driven realities show that short selling is good for capital formation. Our companies want more transparency on short selling.

Emmer: Tell us about the current liquidity for the top 100 stocks listed on Nasdaq? *Wittman:* There is a tremendous amount of liquidity for the top 100 stocks.

Tick Size Pilot Program

Emmer: Comment on tick size. *Concannon:* The one-size-fits-all approach clearly does not work. At the top of our market, there is tremendous liquidity. The tick size pilot is only adjusting in one direction, so there is more work we can do on how Reg NMS treats each stock; *Comerford:* Large cap companies have the wrong tick size, so we need to look at liquidity and the stock's price; *Wittman:* We have taken a one-size-fits-all approach and divided it between three buckets. The tick size pilot has both good and bad features.

Cybersecurity

Scott (D-GA): Thoughts on cybersecurity issues facing the industry? *Farley:* We are concerned about physical terrorist attacks and cyberattacks; *Concannon:* The ability to partner on cyber is critical, but it

is difficult for a cyber threat to penetrate our markets; *Comerford*: One benefit of fragmentation is that we have tremendously resilient markets and many places to trade.