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On behalf of the Securities Industry and Financial Markets Association

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Committee on Financial Services

Subcommittee on Capital Markets, Securities, and Investment

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"

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Chairman Huizenga, Ranking Member Maloney, and distinguished members of the Subcommittee, thank you for providing me the opportunity to testify today on behalf of the Securities Industry and Financial Markets Association (SIFMA) and to share our views on the history and current state of our equity markets. SIFMA represents a broad range of financial services firms active in the capital markets and is dedicated to promoting investor opportunity, access to capital, and an efficient market system that stimulates economic growth and job creation. This Committee's review of the dramatic evolution in our markets over the past few decades is very much welcome by SIFMA's diverse membership.

My personal testimony is rooted in three decades of securities markets experience, beginning in 1981 as an options trader on the floor of the Philadelphia Stock Exchange, later serving on its Board of Governors. Roughly a decade later I joined the staff of the Securities and Exchange Commission, where I served as Senior Counsel in the Division of Market Regulation. Upon leaving the Commission, I led a U.S. project to assist the Government of Romania in creating their emerging securities market before taking a position as General Counsel at the Cincinnati Stock Exchange and chairing the Operating Committee of the National Market System Plan governing NASDAQ securities. In 2003, I joined Schwab as general counsel of Schwab Capital Markets.

With this experience, I would suggest that today's equity market structure is the result of regulatory changes, technological advancements and competition, which in turn has provided investors, including individual investors, with a market that is easy to access with highly transparent and extremely low transaction costs. This capital markets system helps Americans achieve financial security and provides companies with the access to capital they need to grow and create jobs. The United States has the largest percentage of individual investor participation and the deepest and most liquid markets in the world. As stakeholders and policymakers debate possible changes to our market structure, it is critical to remember how efficient and resilient our markets are to the benefit of retail investors that Charles Schwab and others serve every day. That being said, the evolution we have seen has created odd incentives and antiquated systems and everything should be on the table for review.

Evolution of the U.S. Equities Markets

Congress mandated the establishment of a National Market System in 1975 and since then, the U.S. equities markets have undergone significant evolution. In 1975, most equity trading took place in-person on the trading floor of a single exchange. Today's market is fully electronic and automated with a vibrant ecosystem of interconnected but competing market venues, including more than a dozen exchanges and numerous Alternative Trading Systems (ATSs).

The true beginning of the modern market we know today, from both a regulatory and business model perspective, can be traced to 1998 when the Securities & Exchange Commission (SEC or Commission) adopted Regulation ATS. The regulatory structure put in place through Regulation ATS allowed competitive order matching services to operate as alternative trading venues to exchanges subject to a robust SEC regulatory scheme plus the full complement of broker-dealer regulations, which include comprehensive requirements on net capital, supervisory controls, and reporting. When the Commission adopted Regulation ATS, it sought to encourage the introduction of new markets and at the same time ensure investor protection.[1] ATSs had operated in the market prior to the 1998 rulemaking, but they were not fully integrated into the national market system. This lack of integration raised concerns about gaps in market access and fairness, systems capacity, transparency, and surveillance. The net result of Regulation ATS has been the growth of trading venues that offer varying business models and compete for order flow to the benefit of investors.

In the mid-1990's, at the same time it was examining ATSs, the Commission started examining the impact of fractions as pricing increments for securities. Today, of course, the minimum pricing increment for equities is one penny. Yet for nearly 200-years, equities traded in increments of 1/8th of a dollar. In 1994 the SEC published a report regarding the equities markets, in which it expressed concern with pricing in 1/8th of a dollar, or 12 ½ cents. Trading in "eighths" was causing artificially wide spreads and hindering quote competition.[2] Subsequently, the SEC and the exchanges changed the pricing increment to 1/16th of a dollar, or 6 ¼ cents, believing that this reduction would provide multiple benefits, including better pricing and enhanced liquidity. Several years later, Congress introduced legislation to direct the Commission to adopt decimal pricing for all equity securities. In response, the Commission mandated in 2000 that the exchanges implement decimal pricing by April 2001.[3]

In 2004, the Commission began a process of evaluating market structure that included public hearings and culminated in the proposal of Regulation NMS. The Commission adopted Regulation NMS in April 2005, stating that it sought to modernize and strengthen the regulatory structure of the equities markets. Regulation NMS was predicated on the need to foster more efficient markets by promoting fair competition among individual markets, while at the same time assuring that the markets were linked together to encourage the interaction of – and competition between – the orders of buyers and sellers.

The centerpiece of Regulation NMS is Rule 611, the Order Protection Rule (OPR), which provides intermarket price protection to "protected quotations." In conjunction with the OPR, Rule 610 addresses fair access, access fees, and locked and crossed markets. Reg. NMS also implements Rule 612, the Sub-Penny Rule, to address concerns related to the practice of "stepping ahead" of displayed limit orders by trivial amounts. In addition, the SEC revised the market data revenue allocation formula, and made changes to the governance structure of the consolidated market data Plans by establishing non-voting Advisory Committees.

These key provisions of Reg NMS were in response to specific policy goals that the Commission wanted to achieve. Specifically, the OPR sought to address market inefficiencies by further automating the markets and providing strong intermarket price protection in order to promote the display of limit orders, as well as to assure that those investors who submit market orders receive the best price available. Further, in adopting Rule 610, the Commission recognized the importance of interlinking in a manner that provided market participants with the ability to efficiently and fairly access a trading center's protected quotations. Additionally, by revising the

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[1] *See* https://www.gpo.gov/fdsys/pkg/FR-1998-12-22/pdf/98-33299.pdf

[2] *See* https://www.sec.gov/news/studies/2012/decimalization-072012.pdf

[3] *See* Commission Notice: Decimals Implementation Plan for the Equities and Options Markets (July 24, 2000), available at http://www.sec.gov/rules/other/decimalp.htm.

market data revenue allocation formulas and increasing NMS Plan transparency, the Commission sought to preserve the integrity and affordability of consolidated market data.

In the midst of these regulatory changes, and in light of competitive pressures from ATSs, the markets underwent an additional shift. In the early to mid-2000's, the national securities exchanges began to demutualize and become for-profit companies instead of member-owned utilities.[4] Today the largest exchanges are owned by publicly-traded corporations. As such, the exchanges are no longer expected to provide trading services to their members, but instead they have an obligation to deliver profits to their corporate shareholders.

Current State of U.S. Equities Markets

The net result of these changes, both regulatory and technological, is that today's market is certainly much different than it was in 1975 and is even unrecognizable from the market of 10 years ago when Regulation NMS went into effect. For the most part, these changes have been positive for investors and market participants. The markets today are highly automated and efficient, providing near instantaneous, low-cost executions. Additionally, the market is incredibly competitive and dynamic, which, in turn, has provided market participants with a diverse range of venues to place and execute their orders. Individual investors in particular have benefited substantially from the evolution of the markets.

Yet, amidst this evolution, there are aspects of our market structure that could be improved. For more than a decade, SIFMA has been a leading voice on equity markets analysis, and today we see at least five areas of focus for market structure and the future of Regulation NMS:

Order Protection Rule. With the OPR having now been in effect more than a decade, this is an ideal time for the SEC to conduct an analysis of its impact on the equity markets and whether it should be refined to address market evolution. To address market fragmentation and complexity, the Commission should evaluate the 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 Commission also could consider an elimination of the OPR coupled with enhanced best execution principles, maintaining the status quo or enhancing price protection by protecting multiple levels of liquidity. In any of these cases, the markets would benefit greatly from a result based on analysis using current market conditions.

Access Fees. Since Reg NMS was adopted, spreads have narrowed and commissions have decreased, making the existing cap of access fees outsized relative to today's market realities. To address this, the Commission again has several different paths for possible reform: (1) reducing the access fee cap to no more than $0.0005 for all securities; (2) implementing the Commission's Equity Market Structure Advisory Committee's access fee pilot recommendation; or (3) eliminating rebates and linkages between passive posting of limit orders and transaction pricing. In any of these cases, the resulting access fee and rebate regimes would reflect an updated analysis based on the impact of current market practices.

Market Data. To assure that market data is timely, comprehensive, nondiscriminatory, and accessible to all market participants at a reasonable cost, the Commission should consider: (1)

[4] *See e.g.* https://www.sec.gov/rules/sro/nyse/34-53382.pdf

enhancing the SIP feeds with bid and offer quotes beyond the top of book data and providing that as the sole source of consolidated market data to meet regulatory obligations; and (2) replacing the single-consolidator SIP model of market data dissemination with a competitive construct, such as a Competing Market Data Aggregators model. These results would improve the ability of all market participants to use SIP data for the benefit of investors and decrease the need for market participants to rely on the exchanges' increasingly unaffordable proprietary market data products.

NMS Plan Governance. To address conflicts of interests and enhance the NMS Plans, the Commission should provide broker-dealers and asset managers with meaningful direct voting representation on the NMS Plan Operating Committees. Including industry expertise in the direct governance of NMS Plans would enhance the operation of these important utilities and help to ensure they are operated for the benefit of the entire market, not just the commercial interest of the exchanges.

SRO Status. SIFMA supports effective regulation of the securities markets, and we believe that, properly structured, strong self-regulation must continue to be an integral part of the oversight of the market and its participants. However, the current self-regulatory structure is outdated and in great need of rethought and reform. In this context, SIFMA believes that Congress and the SEC should consider whether exchanges should continue to be subject to the full responsibilities and obligations of being SROs, or enjoy the protections and benefits that flow from that status. An overhaul of the self-regulatory model would address the significant conflicts of interest in having one group of for-profit commercial entities – the exchanges – act as regulators of the commercial competitors – broker-dealers.

While we understand and appreciate that the Committee intends to evaluate policy solutions at a later date, we would like to highlight two issues that are relevant to today's topic and are examples of where market evolution has created inefficiencies or worse: market data and NMS Plan governance.

With demutualization, exchanges that were once operating as public utilities are now for-profit entities with a legal fiduciary duty to maximize profit to shareholders. Yet exchanges still are Self-Regulatory Organizations (SROs), with the authority to regulate their own markets, and the securities markets in general. This has resulted in significant conflicts of interest, as for-profit companies now act as regulators of the very market participants that they directly compete with.

Further, with the exchanges acting as SROs, they also retain the ability to set market policy through NMS Plans, a regulatory device that the SEC has leveraged frequently in recent years in lieu of formal rulemaking. However well-intentioned, the NMS Plan structure has resulted in policies that are designed to benefit the exchanges' business interests or mitigate their regulatory obligations at the expense of broker-dealers. This outcome is largely due to the lack of direct representation by the industry (both broker-dealers and asset managers) on the Plan Operating Committees that are tasked with setting market policy.

Market data is at the core of equity market structure and Regulation NMS. Broker-dealers today are required to report their bids and offers and last sales for securities to SROs, which in turn are required to participate in a NMS Plan for consolidating and distributing that data. When Regulation NMS was adopted, the SEC acknowledged that one of its most important responsibilities was to preserve the integrity and affordability of the consolidated data stream. Additionally, the SEC stated that one of the strengths of the current consolidated market data model was that it benefited investors, particularly retail investors, by enabling them to assess the best market prices and evaluate best execution of their orders by obtaining data from a single, consolidated source that is highly reliable and comprehensive.

Unfortunately, the consolidated data feed today is not usable for any kind of sophisticated or competitive trading platforms. Rather than improving the underlying infrastructure of the Securities Information Processors (SIPs) responsible for distributing the consolidated market data and enhancing the associated content, the exchanges have largely focused on their own market data offerings at sharply escalating fees. These proprietary feeds are distributed directly through upgraded connections (rather than via the consolidated market data infrastructure) and contain much more detailed information about the exchanges' trading books, including depth of book information, thus providing substantially enhanced views of the market to any market professional.

Consequently, the lack of depth of book data in the SIP feeds and the general inferiority of the SIPs' infrastructure have rendered the SIPs' consolidated core data effectively useless for accurate price discovery. They are now used primarily for informational purposes, administrative messages and to provide stale (from the perspective of computerized trading) price information to individual investors who rely on the SIPs as their primary market data source.

Nevertheless, market participants continue to be required to consume market data consistent with their best execution and other regulatory obligations and trading objectives. As market data fees continue to increase, market participants are offered little competitive recourse. This evolution has not only resulted in costs that are squeezing smaller broker-dealers out of being able to offer competitive trading platforms, but is also resulting in a multi-tiered landscape where some market participants are receiving trading information before others. It remains unresolved whether competitive forces alone can actually set a fair and reasonable price for market data.

Conclusion

The U.S. equity markets are dramatically different than they were just a few years ago. As we have for decades, SIFMA and its members are dedicated to engaging in the public debate over the health and fairness of our equity markets. We appreciate the interest of this Committee in evaluating the state of our markets and look forward to working with you in the coming months and years on this important task.