

Written Testimony of John Comerford, Managing Director, Head of Global Trading Research,  
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before the U.S. House of Representatives

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"

Tuesday, June 27, 2017

Chairman Huizenga, Ranking Member Maloney and members of the Subcommittee.

Instinet appreciates the invitation to participate in this important hearing. We believe that Instinet, an agency broker founded in 1969, can bring a unique perspective to this process. For nearly 50 years, Instinet has provided institutional investors with electronic agency trading services and technologies - services including the first electronic trading platform, the first U.S. crossing network and some of the market's earliest examples of direct market access, smart order routing and algorithmic trading strategies. Instinet has also been a leader in offering robust transparency to its clients with some of the first transaction cost reporting and analysis tools in the industry. At its core, Instinet has been guided for nearly half a century, by one primary goal - providing best execution to its customers.

Throughout the history of stock trading, the push and pull of regulation and technology has driven the evolution of markets and market structure. Regulators push for level playing fields, and participants leverage technology to best compete within the regulatory framework. Regulation has also driven innovation. For instance Regulation Alternative Trading Systems (ATS) has both strengthened the public markets and also facilitated innovative trading models, providing a path for some of those models to become national securities exchanges. Representatives from some of those success stories share this panel with me.

Specifically looking back at over 10 years of Regulation National Market System (NMS), I believe we can unequivocally say that it has been successful in its goals of enhancing the efficiency of the market and supporting fair and vigorous competition. However, that doesn't mean that we should or plan to rest on our laurels. For instance, we applaud the proposals to further improve transparency by enhancing Rules 605 and 606. I believe there are additional steps we could take that would simultaneously reduce some of the unintended complexity and more actively encourage the display of limit orders.

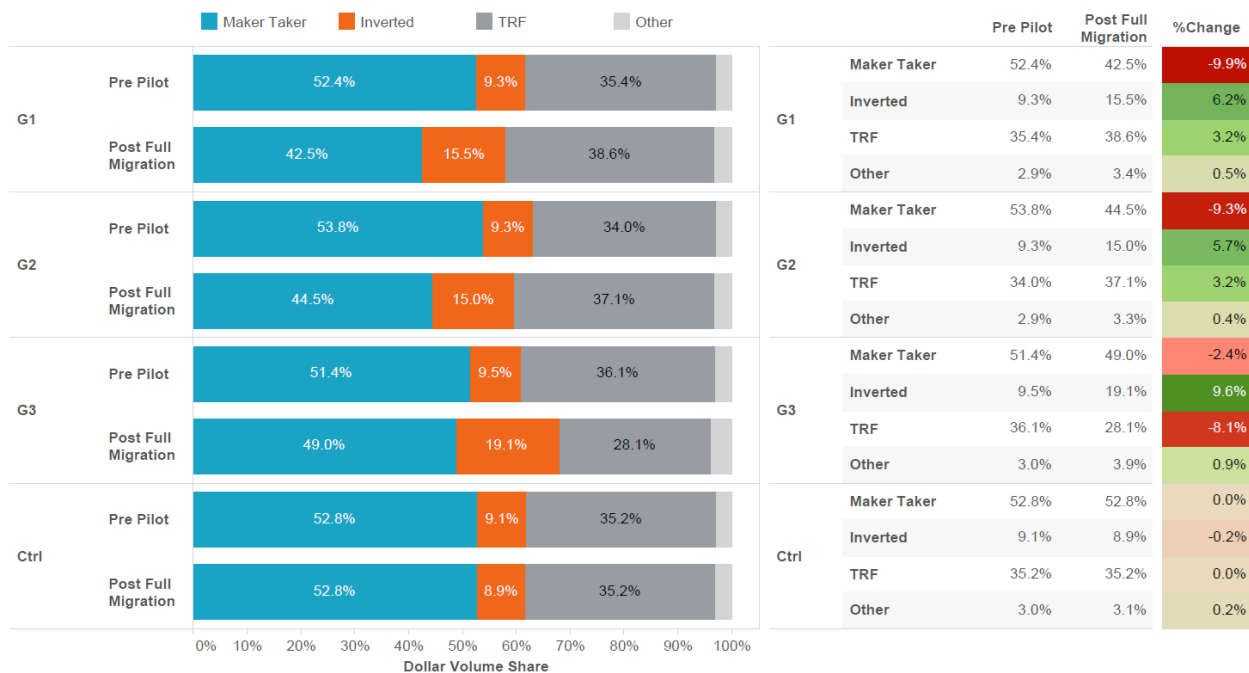
Others on the panel will likely cover the regulatory path to NMS and share their insights into Rules 605, 606, 610 and 611. I'd like to discuss a less discussed, but no less critical component of Regulation NMS, namely Rule 612, the Sub-Penny rule.

The minimum pricing increment of US equities began its decline in 1997, dropping from  $\frac{1}{8}$  of a dollar to teenies, or  $\frac{1}{16}$  of a dollar, mostly driven by competition from the Electronic Communication Networks (ECNs). That move was quickly followed in 2001 by full decimalization. It is worthy to note that it was decimalization more than Regulation NMS that drove average spreads down to the levels we currently experience. Regulation NMS set a floor on tick size compression with Rule 612, setting the minimum pricing increment for both quotes and orders to a penny for all stocks trading over a dollar.

At the time, a penny seemed more than reasonable - not too big, not too small. However, we now better understand that our one size fits all tick size engenders unnecessarily disorderly

trading behavior by creating unbalanced incentives between market participants for many stocks.

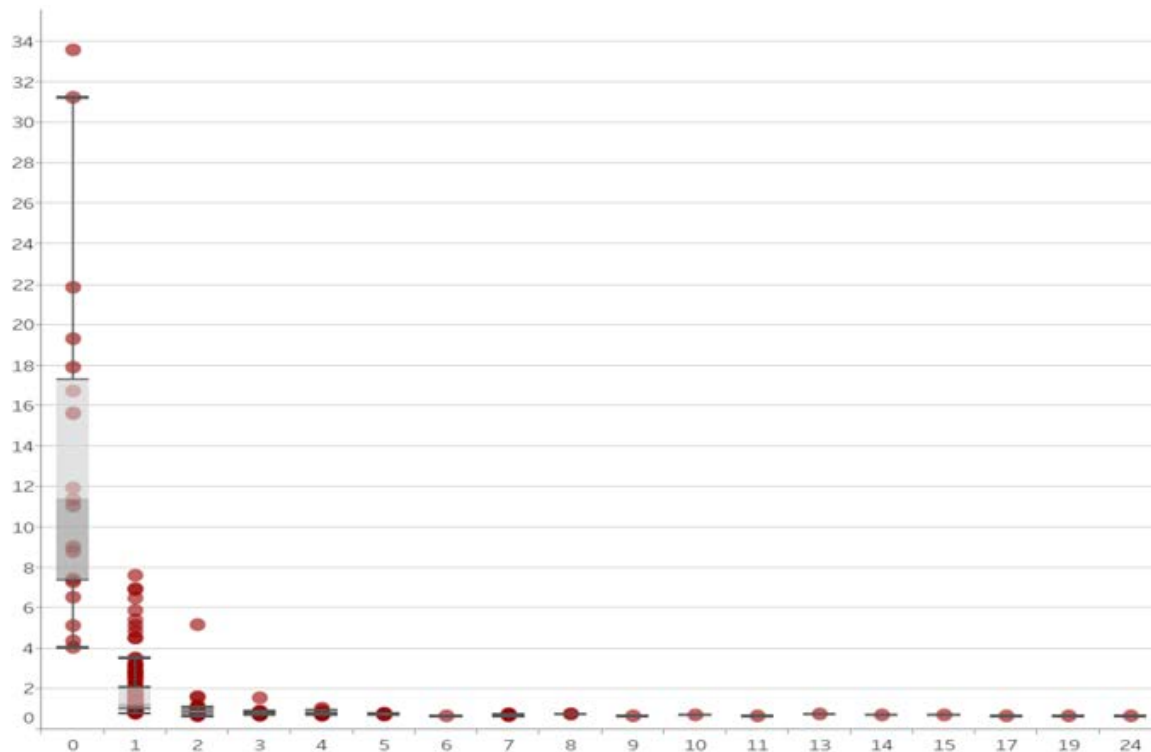
For instance, capturing a penny spread on a lower priced, more active stock is quite attractive for a liquidity provider. For these names, we see extreme competition at the public bid/offer, leading to quote fragmentation and volume being pushed towards dark pools and inverted destinations. Some early results from the Tick Size Pilot demonstrate the effects of widening tick sizes. Notice Groups 1 and 2 below where liquidity has shifted significantly from the maker-taker pools towards the inverted pools and Trade Reporting Facilities (TRF).



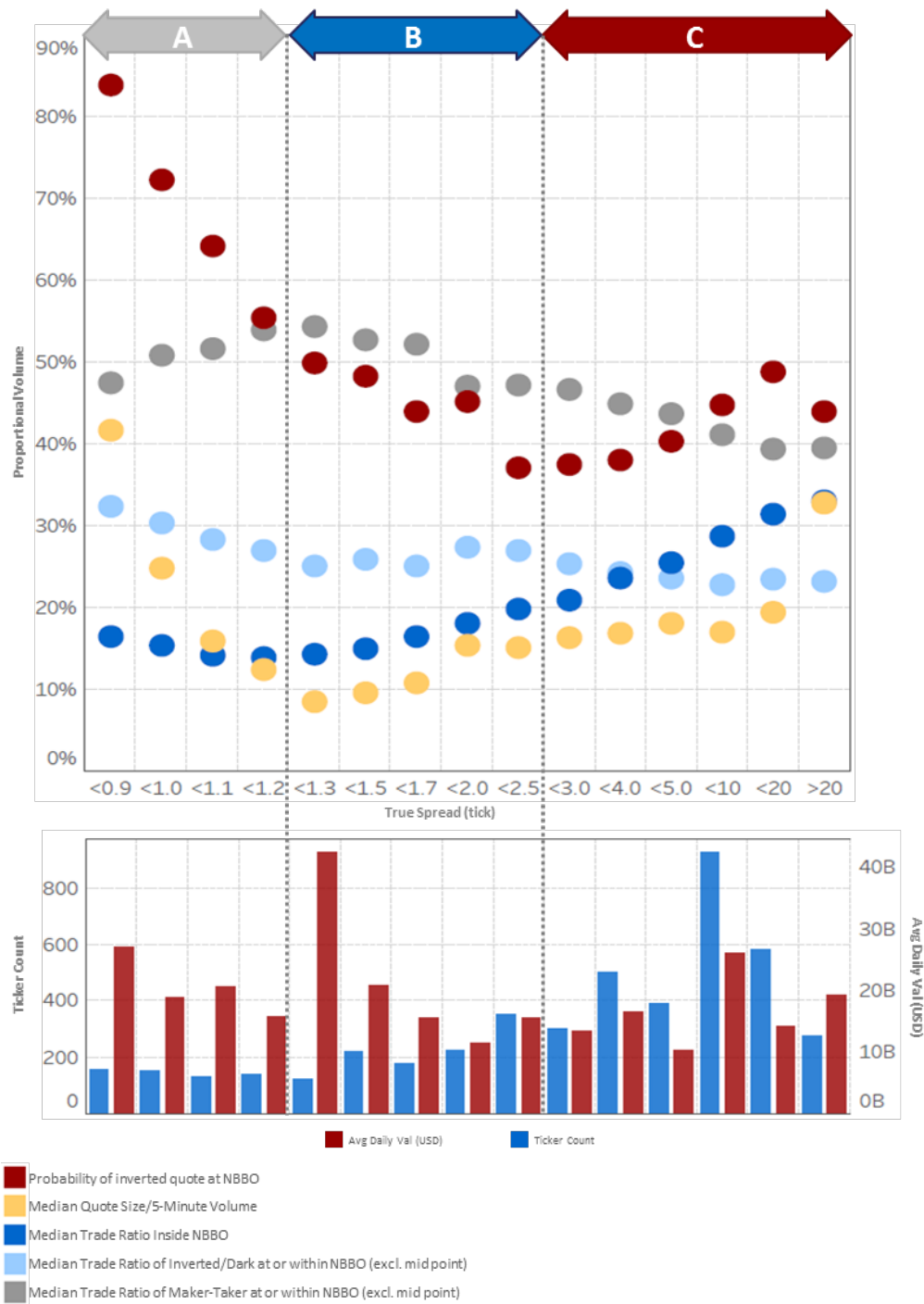
As much of the recent market structure dialogue revolves around the distortions created by the extreme competition in these larger percentage tick size names, it is somewhat forgotten that Rule 612 was designed to ensure that tick sizes did not get too small. The rule was intended “to promote greater price transparency and consistency, as well as to protect displayed limit orders” and address “the practice of ‘stepping ahead’ of displayed limit orders by trivial amounts.” We now know that, for higher priced and lower liquidity names, one penny is not a large enough minimum price increment to support these goals.

Consider the following chart. This is a histogram of the top 350 US stocks by average traded value displaying the ratio of their effective spread to their tick size. The x-axis is a penny tick size in basis points. For stocks with tick sizes greater than 5 bps, that is stocks trading under \$20, the effective spread was materially the same as their tick size. In other words, the spread is

constrained by the tick size. When the tick size drops to 2 bps (\$50 stocks) the average effective spread increases to about 1.5x the tick size. But for stocks over \$100, the effective spread of the stock averages 12 times the tick size. These are large volume stocks, like GOOGL and AZO. For these names Rule 612 and the penny increment are not encouraging the display of limit orders.



So, how pervasive are these issues? At Instinet, we consider only  $\frac{1}{3}$  of all U.S. stocks to have a “right-sized” minimum price increment, in which the costs and incentives of liquidity providers and liquidity takers are balanced. The following diagram illustrates some of our findings. Group A contains “tick constrained” names, where the true spread (defined as the average quoted spread including all exchange fees and rebates) is less than 1.2 cents. Group B contains the moderately constrained names, where the true spread is less than 2.5 cents. Group C contains the unconstrained names where the average spread is greater than 2.5 cents wide. Each group represents about 30% of the US stock market.



In Group A, one can see that:

- inverted pools, represented by red circles, become an important part of the NBBO
- the quote size relative to volume, represented by yellow circles, increases
- the volume, ex mid-point, in inverted and dark pools, represented by light blue circles, increases

In Group B, representing the stocks with a “right-sized” price increment, one can see that:

- stocks don’t exhibit the extreme fragmentation and fierce competition at the NBBO seen in Group A
- the tick size is still wide enough to attract liquidity providers to display limit orders

In Group C, where the tick size is small relative to the spread, one can see the effects that Rule 612 was designed to address:

- traditional maker-taker exchange volume at the touch, represented by gray circles, decreases
- there is a material increase in volume traded inside the spread, represented by the dark blue circles
- as we saw in the previous diagram, this behavior is not constrained to illiquid stocks

Regulation NMS redefined equity trading and strengthened the leading position of our equity markets globally. The foresight of the regulators and commenters a decade ago should be applauded. Any regulatory or statutory changes would be well served to retain the primary principle behind the design of Regulation NMS, namely promoting fair competition among markets and orders.

Finally, I would like to note that, while I focused on Rule 612, market structure issues are complex and interrelated. Any potential changes, whether tick sizes or access fees or order protection are best considered holistically and comprehensively, rather than independently. Everyone in this room shares the same goal - healthy secondary markets. We at Instinet thank you again for the opportunity to share our thoughts and opinions.

I look forward to answering any questions you might have.