WILLIAMS & JENSEN, PLLC

Fr: Rebecca Konst and Hana Laver

Re: SEC Equity Market Structure Advisory Committee

Dt: May 13, 2015

Summary

On May 13, the Securities and Exchange Commission's (SEC or Commission) Equity Market Structure Advisory Committee (EMSAC or Committee) convened its first meeting to discuss Rule 611 of SEC Regulation NMS, known as the "Order Protection Rule" or "Trade-through Rule."

Opening Remarks:

Steven Luparello (Director, Division of Trading and Markets) explained he is the designated officer for the Committee.

Chair Mary Jo White stated that she would summarize her written statement. She stated maintaining and enhancing the high quality of the equity market structure is a main priority of the SEC and this Committee will play an important role in that. She stated the U.S. equity markets have experienced a "sweeping" transformation with the use of electronic and algorithmic trading. She explained the SEC has taken a series of important steps to improve equity market structure. She noted concerns over extreme volatility in the markets and explained those have been addressed with steps such as circuit breakers, clearer rules for breaking trades, and banning stub quotes. She noted the adoption of Regulation SCI to improve the resilience of the markets. She stated the consolidated audit trail (CAT) proposal will also help with monitoring the markets, and that she anticipates "the plan will be published for public comment later this year."

White stated that in March the SEC proposed a rule for proprietary traders to be members of FINRA. She noted the issue of market complexity, suggesting it can be both better and worse for market participants. She explained "constructive" complexity can help smaller companies. She noted the tick size pilot is intended to provide data that will help the SEC make changes to the markets to help smaller entities. She stated many concerns with the market are that it is unnecessarily complex. **White** stated that the unneeded complexity can created instability, lead to unfair outcomes, can cause confusion, and can make the task of regulators more difficult. She stated these issues can undermine investor confidence. She stated the SEC must look at rules to see how they contributed to complexity but also industry practices that have contributed to market complexity as well. **White** stated it is fitting that this Committee will begin their role by discussing Rule 611. She stated the SEC is conducting a review to optimize the markets and Rule 611 plays an important role. She noted suggestions that Rule 611 has resulted in further market fragmentation. She noted a memo by staff on this issue. She noted topics such as maker-taker, access fee caps, the lock cross restrictions and the SEC's regulatory approach to trading venues as possible topics of additional memos from SEC staff.

Commissioner Luis Aguilar stated on May 11 he released a statement that discussed in detail equity market structure issues. He stated the equity market has undergone "tremendous" evolution. He stated this evolution has made it difficult to oversee the markets. He stated the current market structure benefits some participants over others. He stated as the Committee conducts its deliberations he asks the members to remember that the markets have to be structured to benefit investors and issuers. He stated an analysis of the needs of issuers and investors is the proper place to start this Committee's work. **Aguilar** noted there are no investors and issuers on the Committee and the Committee members should "check their personal gains at the door." He suggested there are portions of the market which need immediate attention such as: monitoring whether the fragmentation of the markets has "hit a tipping point," providing guidance on best execution, the importance of defending the order protection rule, the importance of updating rules on disclosure of order routing practices, and the need for a pilot program on whether a limited trade-at rule would improve market functioning.

Commissioner Daniel Gallagher stated the task before the Committee is to provide views on equity market structure issues. He stated this issue permeates each aspect of the SEC's mission. He noted the last equity market review was 20 years ago and it has been three years since he began calling for an equity market structure review. He expressed hope that the SEC will be able to avoid the typical "pitfalls" of holistic review such as attempting to solve each little issue in a vacuum. He stated this is exacerbated by the view that market participants are the source of each problem. He stated blanket assumptions need to be avoided and an understanding is needed on the role of regulations in the markets. **Gallagher** stated there cannot be any "sacred cows" and the Committee must be willing to review all regulations, rules, and market practices. He suggested that some regulations were written for a vastly different market and others such as Regulation NMS were "doomed" from the outset. He stated Regulations NMS was a series of unnecessarily complex non-market based rules. He expressed pleasure the Committee is beginning their review by looking at Rule 611. He stated the trade-through rule creates distortions in the markets. He encouraged the SEC to look at alternatives to the trade-through rule and look at FINRA rules on best execution for broker-dealers. He also asked the Committee to revisit whether national exchanges should continue to be SROs. He stated the status of exchanges matter because ATSs are not subject to the same restrictions as exchanges. He stated as exchanges continue to move away from self-regulation the differing regulation of ATSs becomes more important. **Gallagher** stated the "utility" mindset of security regulation needs to be challenged. He stated any holistic review of the markets should result in recommendations to Congress to update these provisions.

Commissioner Kara Stein stated this is an impressive group of individuals. She stated this Committee has been a long time coming. She noted this Committee is large and each member has an important perspective and voice. She urged each member to focus on improving the operation of the markets for all individuals. She noted there is no representative from public companies that issue stocks and there is no representation from retail brokerage. She stated these interests need to also be considered moving forward. **Stein** discussed the history of amendments to the securities regulations that culminated in passage of Regulation NMS. She noted concerns that the markets have outpaced regulations. She suggested it is time to consider whether the regulations need to evolve to better represent the markets. She noted the ongoing debate over the effectiveness of Regulations NMS. **Stein** stated the volume and order flow in the securities markets is unprecedented. She suggested that the market has its strengths and weaknesses and all issues need to be "on the table" for consideration. She expressed hope that the discussion of Rule 611 is a good starting point. She asked for the Committee to consider whether the SEC's regulatory approach continues to make sense, what incentives are working, what incentives drive off-exchange trading, how would better disclosure and transparency help all market participants, how should conflicts of interest be addressed, and how would consolidated audit trails be helpful for regulation.

Commissioner Michael Piwowar stated each Commissioner has been highlighting for some time the need for a comprehensive equity market structure review. He noted the importance of Rule 611 and suggested it is a reasonable starting point. He stated in the future rather than the SEC dictating a topic the Committee members should be allowed to prioritize topics to be discussed. He stated this is a diverse group of individuals and the SEC should not limit their focus. **Piwowar** suggested the collective experience of the members should drive the discussion of the Committee. He stated it is important that the discussion is grounded in the appropriate historical framework. He stated the means by which the SEC sought to achieve the goals of Regulation NMS were controversial at the time. He stated the benefits of Regulations NMS need to be balanced against the concerns raised when it was proposed.

Luparello stated the Committee intends to have quarterly meetings and the Committee will provide recommendations as they are created rather than creating an overall report.

Self-Introduction of Committee Members

Mathew Andresen (Headlands Technologies LLC) noted Headlands issued a report on Regulation NMS at the time of proposal. He stated these important issues deserve to be debated thoroughly.

Reginald Browne (Cantor Fitzgerald & Co.) stated execution quality has never been better for investors. He stated nevertheless, a review of market structure is necessary. He stated the most prudent rulemaking is based on careful empirical data. He stated evidence of how equity markets are currently operating and cost-benefit analysis are needed. He noted Rule 611 has ensured investors receive the best price on their buy and sell orders. He suggested several topics of discussion such as ETFs and improving liquidity and market security; market-maker obligations; and amendments to Regulation SHO.

Kevin Cronin (Invesco Ltd.) stated he has been with Invesco for about twenty years. He stated during that time he has participated in a number of the debates on market structure including Regulation NMS. He explained his view that Regulation NMS would help market operation. He stated Rule 611 was an important rule to be put in place. He stated while Rule 611 has been a "lynch pin" for debate the markets are certainly operating more efficiently. However, he stated there is "way too much" fragmentation in the markets and there is room for improvements. He stated transparency has been lost in many aspects of the markets. He suggested it would be "one dimensional" to blame Rule 611 for all of the problems. He suggested access fees have skewed the markets.

Brad Katsuyama (IEX Group Inc.) stated IEX is an alternative trading system. He stated they expect to file an application as an exchange in the near future. He expressed his hope to provide viewpoints from both the broker and dealer side of the markets. He stated the trade-through rule is a logical place to start the discussion of this Committee. He noted the interconnection of all the market issues. He stated Rule 611 is linked to many other issues. He suggested given the complexity of the markets the Committee should first look at the intended purposes of Rule 611, consider whether current concerns could be addressed through modifications, and whether issuers and investors would be helped through changes to the rule.

Ted Kaufman (Duke University Law School) stated he spent 22 years on the staff of Senator Joe Biden. He stated he had been a market investor since receiving his MBA. He expressed concern when the uptick rule was eliminated and jointed with a bipartisan group to reinstate the uptick rule. He stated during this debate he began looking in to the speed of the markets. He suggested regulations are not keeping pace with the markets. He noted his suggestions led to the proposal of the consolidated audit trail (CAT) that has yet to be implemented. He stated the Flash Crash increased his concerns.

Richard Ketchum (FINRA) stated FINRA is a self-regulatory organization (SRO) under the Exchange Act. He stated FINRA conducts market surveillance and looks particularly at cross-market abuses. He stated FINRA has rulemaking responsibilities that have resulted in many rules to enhance transparency of the markets, improve the current audit trail, and improve firm supervisory responsibilities. **Ketchum** noted the "dramatic guidance" of the SEC encouraging competition, transparency and best execution. He stated it is clear that the markets are complex and certain strategies need to be considered.

Manisha Kimmel (Thomson Reuters) stated while implementation is borne by the industry the ultimate costs are borne by issuers and investors. She stated her goal is to look at the impacts of technology on the markets.

Mehmet Kinak (T. Rowe Price Group) stated T. Rowe Price has a firm commitment of always trading on the best interest of investors. He stated they are focused on serving the needs of long-term investors. He expressed support for efforts to make markets fairer and more level for investors. He noted the complexity of the markets and suggested the best remedy remains transparency. He urged the Committee to always enhance transparency.

Andrew Lo (MIT and AlphaSimplex Group) stated the complexity of the markets has created jobs for MIT students. He stated this is an enormous task the SEC has set about to discuss. He noted technology has created benefits and unintended consequences for investors. He stated as technology develops investors will make use of it. He stated regardless of regulations investors and market participants will take advantage of the markets. He suggested simplifying the markets will be a benefit to all concerned.

Joseph Mecane (Barclays PLC) stated his diverse experience has allowed him to see market structure from a variety of viewpoints. He stated the markets function fairly well; therefore the Committee should be deliberate in making any changes. He suggested discussions on market quality become "circular" because there is no standardized framework. He stated the markets are complex and interrelated and the SEC must look holistically before making any rule changes.

Jamil Nazarali (Citadel Securities, LLC) stated this Committee will be a great mechanism for collecting differing viewpoints. He stated Citadel has actively engaged with their clients and those clients have actively expressed support for Rule 611. He stated today on average it costs a retail investor 4 basis points to do a "round-trip" trade. He explained that same trade in corporate bonds would cost far more. He stated the last thing that is needed is a removal of the protections of the trade-through rule. He suggested there is a fundamental simplicity of the rule, that executions have to be at or better than the best price. He stated the SEC should not "jettison" these fundamental protections.

Eric Noll (Convergex Group) stated now might be the time to change the nature of order priority in the marketplace. He suggested replacing the time schemes with one that grants priority to customers. He stated the change would put customers "front and center" and may drive trades back into the lit markets. He stated there would still be many questions to be addressed. He also asked the Committee to consider other secondary effects such as impacts on the equity options markets.

Maureen O'Hara (Cornell University and Investment Technology Group Inc.) stated she has done a lot of research on market structure and was also a part of the Flash Crash Commission. She suggested the Committee should look at what the markets should do. She noted in the high frequency world the nature of information has changed. She expressed the importance of market data and the proper way to structure that environment. In addition, **O'Hara** noted the nature of regulation has changed. She suggested that nothing is a "silo" anymore. She stated in the Flash Crash they learned that regulation has to be forward looking. Finally, she stated Regulation NMS is the "rules of the road" and the simpler the better. She stated the rules have to be clear and apply to everyone. She stated there needs to be a market that works for everyone. She stated looking at Rule 611 and 610 is appropriate because the markets have changed since those rules were implemented.

Joe Ratterman (BATS Global Markets, Inc.) stated the adoption of Regulation NMS served to further enhance the trend towards the automation of the markets. He stated BATS had a unique view of the impacts of Regulation NMS. He stated the automation of the markets has served to mitigate risk that serves all investors. He stated U.S. equity markets are considered the most open fair and transparent in the world. He noted there are provisions of Regulation NMS that have created increased complexity in the markets. **Ratterman** stated the Flash Crash highlighted some fragility in the markets. He noted the impactful measures that have been taken to eliminate the possibility of a reoccurrence of the Flash Crash. He suggested the benefits of regulations need to be considered, pilot programs need to be run before making changes, and the efficiency of the markets needs to maintained.

Nancy Smith (AARP Inc.) stated investors need to be put first, complexity needs to be considered, everything needs to be on the table, and outdated regulations need to be considered. She explained AARP has a broad social mission to meet the needs of those ages 60+ and protecting financial security is a large part of that mission. She stated the views of retail investors are extremely important.

Chester Spatt (Carnegie Mellon University) stated he served as the SEC's Chief Economist during the time that Regulation NMS was adopted. He stated he started studying electronic markets in the 1990's. He stated Regulation NMS has had many effects such as moving markets forward in terms of "fast markets," creating more competition, leading to dramatic declines in the cost of trading for small investors, and impacting the trading process. He stated Regulation NMS has led to more market fragmentation. **Spatt** suggested Regulation NMS could be seen as a sort of substitute for best execution. He stated he is currently looking at the consequences of access fees, conflicts of interest, and related issues such as the costs of fixed income trading and the impacts of lending fees.

Gary Stone (Bloomberg Tradebook LLC) stated he hopes to provide a multi-asset point of view. He stated the U.S. equity markets are among the best in the world but a holistic review is long overdue. He noted Rule 611 is a good starting point but is only that, a starting point. He asked the SEC to use the Committee members to set the ongoing agenda. He noted institutions have suggested a need for recognition of what their orders represent and feel Rule 611 is limiting a key driver of block negotiations. **Stone** noted clients have asked for a review of limit up limit down and a review of Rule 610. He stated the U.S. needs to consider Rule 605 and 606.

Review and Consideration of Proposed Bylaws

Luparello asked for a motion to consider the bylaws. He asked whether there are any concerns related to the bylaws and seeing none asked for a vote on the bylaws. The bylaws were approved by a unanimous vote.

Presentation on Rule 611 by SEC Staff

Dan Gray (Division of Trading and Markets) stated the Division has prepared a memo on Rule 611. He highlighted some points from the analysis and data in the memo on the effects of Rule 611. He stated it is important to understand the effects of the rule in the past. He suggested it is easy to overstate the importance of Rule 611. He noted prior to Rule 611 the NYSE floor "dominated" and two years after Rule 611 their market share was down to 30 percent and there was a move to automated trading. He explained the memo looks at other forces that were also in play during this time. He stated for NASDAQ the story is fairly different, when Rule 611 was adopted NASDAQ had already evolved into more electronic venues and there was significant trading at dark venues. **Gray** suggested it is difficult to attribute those changes to Rule 611. He stated NYSE had been subject to a trade-through rule prior to Rule 611 that creates a difficult problem of determining causation. He suggested NASDAQ is a better market to look at to assess the impacts of Rule 611. He noted the primary targets for Rule 611: trade through rates and prompting the display of limit orders. He suggested the rule "hit the target" for declining trade-through rates but it is less clear whether it was successful for promoting display of limit orders. **Gray** stated on dark fragmentation the rule does not require trading on dark venues. He noted the number of lit venues has increased.

Discussion

Cronin stated the point on dark pools is important but there are other pieces of Rule 611 which could be contributing to dark orders such as intermarket sweep orders (ISO) orders. He asked whether there are pieces like ISOs that need more focus. **Gray** stated Rule 611 has contributed to some of the complexities of dealing on lit venues.

Stone asked whether the staff looked at the depth of the markets. **Gray** stated depth has increased and spreads have decreased. He stated there are incentives to display limit orders because the metric of limit orders have not declined. **Stone** asked whether the staff considered going back and looking at the "assumptions of the day." **Gray** stated they never reran the trade-through studies.

O'Hara asked when the staff was calculating the trade-through percentages did they look at what happened when the window was "shrunk". **Gray** stated they did do that and it did not make a difference.

Luparello noted the memo also includes critiques of Rule 611. He stated what they hope to do is see whether the SEC got that list of critiques correct.

Mecane stated the category people use to justify why Rule 611 is unnecessary is the overhead costs versus the benefits of Rule 611. He asked how the SEC defines excessive complexity and how they measure the implications of that complexity. He asked how the SEC is thinking about complexity. **Luparello** stated these critiques were raised for further discussion. He stated that question is the right one to ask. **Noll** stated without order protection rules no lit market has a chance of success. He stated it is a "pre-necessary" condition. He stated it is a pre-condition for existence but not for success. **Cronin** stated the rule is clear, protecting the best bid and offer. He stated Rule 611 is a contributing factor to fragmentation but so are a number of other factors He stated the rule is not complex but the market has become complex. He stated the question is whether some protections for those willing to put forth a bid are needed. He stated exceptions for block trades should be considered but the rule itself is an important concept. **Nazarali** stated a lot of the complexity would not go away if Rule 611 was eliminated. He stated the different order types are a contributing factor and investor protection should not be eliminated just because it leads to some complexity in order types. **Ratterman** stated there was a monopoly prior to Rule 611. He stated BATS would not exist without Rule 611. He stated the markets may continue to promote competition without Rule 611 today but there was no competition before the rule. **Katsuyama** stated complexity is considered bad because there is not enough transparency. He suggested what needs to be "nailed down" are the disclosures which are needed to "play the game." He stated complexity has become a scary thing because there is not appropriate transparency.

Andresen stated in the 1990's there was a single exchange protected through a trade-through rule. H stated it was the implementation of Regulation NMS that "upset that apple cart." He stated Regulation NMS is a benefit to the markets. He stated in a competitive market there is not a need to stimulate markets to have Rule 611. He stated no one who is sophisticated in the marketplace will avoid those prices. He suggested the question is what the Rule is solving in 2015.

Spatt stated Rule 611 sets up some challenges. He highlighted that because Rule 611 provides protections at the top of the book and not all the way down there is an artificial incentive to enter. He stated Rule 611 directly leads to fragmentation because it provides incentive to enter the market. He stated with the nature of access fees, they potentially direct trades to a certain business model.

<u>Presentation and Q&A on Rule 611</u>

Jamie Selway (ITG) stated ITG clients benefit materially from sound market structure. He stated ITG is active in the continuous dialog between market participants and regulators on market structure issues. He noted following Regulation NMS the costs of participating in the markets has fallen. He stated it is important to regularly review the impacts of regulations. He explained the core goal of the trade-through rule is sound, namely that the best price wins. He noted that NASDAQ stocks were not subject to a trade-through rule prior to Rule 611. **Selway** stated "best price wins" works best in "frictionless" markets. He stated Rule 611 attempts to accommodate certain factors in the markets but cannot always do so. He stated the lack of ability to innovate has led to a "sameness" in the markets. **Selway** stated Rule 611 is a de facto requirement that all venues use a minimum tick size but does not allow for competition among them. He suggested the SEC can improve or replace Rule 611. He suggested the SEC should: create a de minimus exemption from Rule 611, create a block exemption from Rule 611, repeal the prohibition of locked markets under Rule 610, or remove Rule 611 all together. He stated if Rule 611 were removed best execution standards would become critical. In addition, he stated the message to retail investors would be important. **Selway** stated the tick size pilot is also an important discussion. He stated the tick size pilot further complicates the issue as the pilot is a Regulation NMS plan.

Thomas Farley (NYSE Group) stated the trade-through rule had several objectives one of which was to reduce the number of trade-throughs. He stated in terms of trade-throughs it was fairly successful. He stated another objective was to reward those who would put their price on a public market and in that regard it fell short. He stated the amount of dark orders has increased because there were not enough incentives to reward those who would contribute to public price formation. He stressed the importance of this discussion on Rule 611. **Farley** stated NYSE would have had a third objective to contribute to a safe and sound equity market characterized through transparency. He stated there was a lot of fragmentation following adoption of the trade-through rule. He advocated that more trust in the market will bring more buyers and sellers into the market. He suggested that can be accomplished with some "tweaks" to the trade-through rule. **Farley** noted the fragmentation of the markets and dark trading. He discussed several charts, one of which shows that most dark trading occurs close or at the NBBO. He suggested Rule 611 "fell short" on providing incentives to providing price discovery. **Farley** stated Rule 611 was an incremental step forward in policy but there is more to be done to promoting public price discovery.

Thomas Wittman (NASDAQ OMX) stated based on his 28 years in the industry he can state that the industry continually evolves and so too must regulation. He stated if the regulations are not given enough focus the markets will fail to remain the lead in the world. He noted NASDAQ runs a large public listing platform and supports emerging high growth companies that bolster the U.S. economy. **Wittman** suggested Rule 611 is the wrong focus of the Committee. He stated the current market structure is not well suited to serving investors and emerging companies. He stated evaluating Rule 611 as a stand-alone rule is not the best use of the Committee's time. He addressed issues such as the proliferation of exchanges and the differing rules for ATSs as more important issues. He suggested the U.S. markets can operate more efficiently. He stated foreign markets have used the U.S. markets as examples of changes needed in the markets yet the U.S. has not followed suit making changes. He applauded the Tick Size Pilot but suggested a faster way to implement rules which focus on issuer size is needed. **Wittman** stated exchanges should be free to experiment with the markets as they evolve. He stated the SEC must give more leeway for experimentations. He noted the focus of the JOBS Act on growth stocks but suggested a focus on addressing problems for active stocks is also needed. **Wittman** stated complex order types exist to avoid access fees. He suggested a tiered structure for fees and rebates is needed rather than the current one size fits all structure. He encouraged the SEC to allow for experimentation and to allow tick size to be determined by the listing exchange. He reiterated that a one-size fits all approach to regulation of the equity market is not working.

Discussion

Noll asked what the expectation would be in how persistent locked markets would be without Rule 611. **Selway** stated it would be substantial but would not be a problem. He stated the locked market is suggesting the increment of a penny is too "coarse." **Noll** asked how the market would respond to an order that never gets filled. **Selway** stated that would need to be addressed.

Cronin stated it would be a step backwards to allow locked markets and cross-markets.

Stone asked whether locked markets are a result of volunteered access fees. He asked whether a flat rate would result in markets not locking. **Cronin** stated the access fees figures prominently in this. **Stone** asked what the regime which can actually be charged on access fees is. **Cronin** stated the institutional community would say that transparency would be good and there is agreement that the access fees are too high. He stated allowing a crossed market does not sound like a good idea. **Stone** stated in 2004, Tradebook was "dead set" against access fees. He stated transparency is a big deal and if the maker-taker regime is eliminated then a lot of that decision-making will be taken into the "back room." **Ratterman** noted a proposal they put forth this year that access fees could benefit from "one size does not fit all." He stated there are excessive incentives related to the fees. He suggested a tiered approach based on the liquidity profile of the stocks. **Stone** asked whether eliminating volume tiers would be helpful. **Wittman** stated that is still a one size fits all approach.

Stone stated it would be tiered by stock. **Nazarali** stated that only works if you allow sub-penny. He stated if sub-penny pricing is allowed this opens up questions of harming displayed liquidity. **Wittman** stated intelligent tick sizes should be looked at. **Luparello** asked about the costs of this. **Selway** stated the cost of the front run is decreased. He stated institutions were hesitant to consider a sub-penny tick size because it is confusing outside well-known names. **Cronin** stated the risk is getting "jumped in front of" by a tenth of a penny or less. He stated there is no incentive to make a market in that stock. **Stone** agreed that sub-penny pricing is bad. He reiterated that if the access fee is added into the equation the investor can see the fee and that is passed through. **Andresen** expressed skepticism for adding that in. He stated the SEC is considering the incentives to quote. He stated there will be thin markets if there is no incentive to get there first. He expressed a preference for flexibility to incent behavior the exchanges like.

Noll asked about allowing locked markets. He asked whether this changes the complexity in the markets. **Ratterman** stated a vast percentage of their time is spent thinking about the matching logic and considering regulations. He stated they have to measure complexity versus the benefits. He stated the systems would get easier if they did not have to consider the other markets. **Wittman** stated the logic has been built into the match logic. He stated the complexity does not matter. **Farley** stated it adds complexity that the market would be more confusing. He stated the complexity in allowing locked markets is not huge. He stated the reason they have it is maker-taker pricing. He stated this is a conversation worth having. **Selway** stated price improvement rates are higher than zero. He stated a retail order would not be allowed to be locked.

Ketchum asked about a block exemption or a different best execution definition. **Selway** stated it would be healthy to relook at this. He stated Rule 611 is a rough proxy for best execution. He stated uniform institutional disclosure would be helpful. He stated from an intuitional standpoint Rule 611 does not do much. He stated more flexibility for the larger trade and the less liquid stock would be helpful.

Stone asked if the threshold is lowered would that help with dark trading. **Farley** stated it would help. He stated providing more incentives for those offering public prices would also be helpful. **Stone** stated he would be less supportive of prescriptive measures. **Farley** stated the real way is to figure out how to reward the person making a public price.

Kinak noted the exchanges all have their own dark books. He asked how they justify that. **Farley** stated NYSE is unique in that they disclose all the order types they use including those that are not displayed. He suggested their volume off exchange is very small. **Ratterman** stated the answer is not all lit and no dark. He stated the markets need different types of liquidity so a mix is needed. He suggested most posting on the lit markets are also posting on the dark. He suggested more research needs to be conducted on who is really being harmed. **Farley** stated NYSE supports dark trading as an important portion of the marketplace. He stated the key is to reward those who are actually making lit prices. **Wittman** stated they execute about 50 million shares a day at midpoint and dark but those are matched by lit. **Ratterman** stated a vast majority of trades occur at the midpoint and cannot be posted.

Nazarali stated in their analysis of retail limit orders, the vast majority get filled when there is a trade at that price. He stated Citadel is a big supporter of lit venues but there is a balance in that a lot of the benefits in the market result from the competition and innovation.

<u>Presentation and Q&A on Rule 611 (Continuation)</u>

Dave Lauer (KOR Group) asserted Reg NMS "has been a transformative force in U.S. market structure." He contended that Reg NMS has achieved its purpose of democratizing trading. He called for updating the rules without "scrapping the entire framework." He asserted Rule 611 has its benefits and it is currently the only protection investors have to force their brokers to conduct best execution. He contended conflicts should have much stronger standing. However, he declared Rule 611 is a terrible proxy to ensure best execution. He observed Rule 611 is accused of increasing fragmentation, market complexity, costs and systemic risk. He disagreed, saying the order protection may not have resulted in increased fragmentation. He agreed there are some established causal relationships, noting Rule 611 may play a role in sustaining increased fragmentation. He asserted market participants need information. He asserted that when brokers act like exchanges, it leads to conflicts of interest. He called for more critical review of order handling. He said broker fees do not help the markets, but act as taxes borne by brokers and ultimately by investors. He asserted market structure reform should protect investors and incentivize displayed liquidity. He made several recommendations, including: the Commission should update Rules 605 and 606, including ensuring investors get a full order audit trail; modernizing best execution rules; Rule 611's order protection responsibility should be borne by brokers not exchanges; reduce or eliminate market revenue sharing; and stop subsidizing non-performing exchanges. He also recommended ways to reduce conflicts of interest, including: eliminating maker-taker, exploring price improvement for non-block executions, and examining the propriety of major brokers owning and preferencing their own ATSs.

Jeffrey Brown (Charles Schwab) noted Rule 611 has its problems, but asserted "there are a lot of other issues we want to get to first." He noted there are concerns at having a trade-through rule in the marketplace. He said it is beyond the scope of the Commission to inject itself into micro market structure. He contended competition needs to drive the market. He said with such a massive change, there will be unintended consequences. He said one of the biggest unintended consequences has been the growth in off-exchange volume, which has been a boon to retail investors. He said this is driving execution quality to get better and better, which is what the market ought to do and the exchanges are reacting to that. He asserted "we cannot ignore the fact that this system gives us better execution quality than we have ever had." He urged caution, saying "we need to test things." He commended the SEC for the tick size pilot, noting Charles Schwab opposed it, but "at least it's being tested," so decisions can be made about its broader application. He suggested similar testing of SRO rules to address lock/cross. He called for examining NMS structure and the market data system, saying "there is so much more we can do to offer our investors more information."

Brandon Becker (TIAA Cref) asserted "the rainforest of order types is basically fertilized by rebates," calling for specific guidance on that issue. He recommended a reduction on the de facto cap on rebates that is currently in place. He called for addressing the economic incentives, saying the economics should be changed to fit the behavior. He noted the Commission has been reluctant to engage in rate making, but expressed concern that once the Commission starts setting rates, it must be actively engaged, pointing to "the gamesmanship of order types." He called for lowering rebates materially. He admitted this would be problematic, particularly for investor confidence, but emphasized the importance of addressing the underlying economics. He said infrastructure issues continue to be important, encouraging dark pool transparency. He said the Advisory Committee has an important role to play, saying it should focus on "one to three things the Commission could actually do." He asserted it is important to address equity market structure.

Bill Baxter (Fidelity Management and Research Company) said he supports the Commission's ongoing equity market structure review and would also like to see an agreement on the right metrics to view market quality. He said Rule 611 has fostered competition and forced automation across market venues as well as reducing trade-throughs. He said Fidelity welcomes competition in the market place, which adds to market complexity. He said the order protection rule requires all venues to do business with all brokers. He suggested Reg NMS' definition of trading venues be revised to confer protection for a finite period of time. He said Rule 610 of Reg NMS requires fair and nondiscriminatory access to quotations, expressing concern that access fees and liquidity rebates have increased conflicts of interest. He recommended the SEC reevaluate the need to reduce or cap access fees. He expressed support for a maker-taker pilot and increasing market capitalizations. He contended the order protection rule has led to an increase in dark trading and has reduced trade-throughs. He acknowledged many investors believe Rule 611 has led to an increase in trades on non-displayed venues, asserting trading in those venues lowers costs. He said any proposed changes to equity market structure should be carefully reviewed and tested.

Discussion

A committee member asked for more specifics about recommendations concerning metrics. **Baxter** replied the industry does not have a uniform measurement of market quality. He said trading strategies are based on an assessment of market quality. He said markets should focus on liquidity and volatility.

Joe Ratterman (BATS) asked if execution quality has improved overall. **Lauer** replied that has been his experience, expressing support for developing metrics and establishing transparency. He said institutions are pooled retail, so market structure cannot separate retail and institutional investors. **Becker** replied many brokers work very hard to get best execution right and their procedures are examined carefully. **Lauer** said a retail broker recently admitted to the Senate Permanent Subcommittee in Investigations (PSI), that it routes nearly all of its orders to the highest rebate venue, expressing concern that practice is considered best execution. **Brown** disagreed that is wider industry practice and Schwab works very hard on disclosure to clients.

Maureen O'Hara asked about problems in retail. **Lauer** replied he is not trying to single out retail. He again pointed to the example of the retail broker who routes all orders to the highest rebate venue, questioning how that can be considered best execution. He said order routing decisions based on fee structure cannot be considered best execution, pointing to the need for concrete data. He said this information should be distilled to retail investors so they can make better decisions.

Mehmet Kinak agreed it is true broker dealers do not have to disclose execution data, but said many are choosing to do so voluntarily. He said aggregate price improvement is in the "hundreds of millions of dollars a year" range. **Brown** expressed particular concern at dictating trade-at. **Lauer** added as off-exchange has increased and wholesale and internalization has increased, toxicity and order fragility have increased. **Brad Katsuyama** asserted "disclosures solve a lot of issues." He said the market structure debate has evolved so the market can "sort out a lot of nuanced outcomes," and the market should deliver the data to people who want to make use of it.

Richard Ketchum asked from the standpoint of low volume exchanges, how much does Rule 611 really save. **Lauer** replied the reason he likes moving complexity from dealers to brokers as part of enhanced disclosure is because it could dramatically simplify market structure. He called for addressing the underlying problems of excess complexity and order mediation. **Katsuyama**

cautioned against punishing brokers for making disclosures and "being too transparent." **Brown** agreed, saying no one knows the unintended consequence of changing Rule 611. He expressed particular concern those consequences could harm clients. He cautioned against institutionalizing an unleveled playing field. **Ratterman** said Rule 611 allows brokers to look an investor in the eye and say "you will get the best price, guaranteed by law." He contended the increased complexity comes with a large benefit. **Matthew Andresen** replied when complexity increases, the likelihood of a negative outcome also increases. **Jamil Nazarali** agreed that eliminating the best price guarantee would be bad. He asserted brokers should already be focused on best execution and getting the best price available for customers. **Lauer** emphasized that he is not calling for a simple repeal of Rule 611. **Ratterman** again stated he thinks it is a benefit that brokers can say best execution is guaranteed by law. **Baxter** called for a more enhanced, principles based standard.

Gary Stone pointed to fragmentation, asking if the problem is that there are too many venues or too many exchanges. **Mecane** replied it is a good question, but suggested "dealing with economic problems in an economic way." **Eric Noll** expressed support for allowing exchanges to be eliminated if they are not performing, but cautioned against prescribing a set number of exchanges. **Reginald Browne** said investors care about price and liquidity, asserting if venues are flattened and allowed to compete fairly, the market will take care of itself. He asked for retail firms' views on economic costs and risks to the system posed by pilots. **Brown** replied there is a cost-benefit analysis of the importance of the rule being tested versus the true cost to the industry. He pointed to the tick size pilot, noting the majority of comments to the initial proposal expressed concern as to the rule's complexity. **Manisha Kimmel** noted "changing fees is a lot easier than changing order routing." **Katsuyama** noted none of the large Canadian banks have their own ATSs, which has eliminated the need to fragment. **Lauer** also noted Canada does not have payment for order flow, which pushes the order flow down to the U.S. **Stone** questioned whether there should be breathing room in Rule 611 for lower traded stocks. **Nazarali** asserted Canada is not a market Citadel wants to emulate, pointing to the trade-at rule, saying it had a negative impact on bid-ask spreads. **Brown** asserted Rule 611 does not have a differential impact between low and high ADV securities.

<u>Discussion of Next Steps</u>

Luparello asked Committee members for their thoughts on next steps for the Committee. **Noll** expressed concern that the Committee will end up as a discussion group unless something concrete is accomplished. He suggested creating a Subcommittee structure to report back to the full Committee in order to accomplish things. **Ketchum** agreed. **Stone** also agreed and suggested "tackling" lock/cross, access fees, and trade-through together. **Luparello** agreed, saying the staff also suggested the idea of Subcommittees. He asked what the "natural adjacencies" are from a Rule 611 conversation, pointing to maker-taker and lock/cross. **Ratterman** suggested changing maker-taker to access fees. **Nancy Smith** asked if what he meant by transparency was getting more disclosure into the market. **Ratterman** said yes. **Luparello** said the issue is being discussed at the staff level and with the Commissioners and suggested having a conversation as to whether it is being sufficiently discussed, or if it is ripe for Advisory Committee action. **Nazil** asked for more information to be circulated and considered between meetings. He also asked for bringing industry participants in to discuss issues such as block orders for institutions, and maker-taker order routers, among others. **Mecane** said data coming from the Commission is very helpful. He said to the extent market quality metrics can be broadened, that would be helpful, particularly in relation to potential pilots. He also suggested looking at competition and how it plays into the benefits and artificial incentives driving competitive behavior, such as rebates, Rule 611 and market data. He asserted it would be helpful to separate market competition from competition that was intentionally created.

Stone suggested examining off-exchange trading. He also asked to what extent the Committee's data can be shared with outside academics, noting this is an opportunity to explore that. **Luparello** said the formation of the Subcommittees would be undertaken when the Committee next got together, but stated they are open to making progress sooner (such as by conference call open to the public).

Advisory Committee Members

Matthew Andresen- Headlands Technologies LLC
Reginald Browne- Cantor Fitzgerald & Co.
Kevin Cronin- Invesco Ltd.
Brad Katsuyama- IEX Group Inc.
Ted Kaufman- Duke University Law School and former U.S. Senator from Delaware
Richard Ketchum- FINRA
Manisha Kimmel- Thomson Reuters
Mehmet Kinak- T. Rowe Price Group
Andrew Lo- MIT and AlphaSimplex Group
Joseph Mecane- Barclays PLC
Jamil Nazarali- Citadel Securities, LLC
Eric Noll- Convergex Group
Maureen O'Hara- Cornell University and Investment Technology Group Inc.
Joe Ratterman- BATS Global Markets, Inc.
Nancy Smith- AARP Inc.
Chester Spatt- Carnegie Mellon University
Gary Stone- Bloomberg Tradebook LLC