SIFMA Insights

Equity Market Structure Conference Debrief

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Contents

Executive Summary

Recently, we hosted our annual Equity Market Structure Conference. With almost 200 people in attendance for panels and speeches, we gained insights into top-of-mind topics for market participants.

The U.S. equity markets are largest in the world – nearly two and a half times the next largest, the EU – representing around 38% of the $85 trillion in global equity market cap. On average, around 7.3 billion shares are traded on U.S. equity markets every day. The U.S. equity markets continue to be among the deepest, most liquid and most efficient in the world, with investors enjoying narrow spreads, low transaction costs and fast execution speeds.

That said, one can always strive to improve. Efficient and resilient market structure is key to sustaining investor confidence and participation underpinning the equity markets. The goal of regulators and market participants is to promote market resiliency and ensure the equity markets continue to benefit investors and play an essential role in capital formation.

Inside this note, we recap what was seen and heard at our conference, including: where are we in reviewing Reg NMS; when will the CAT meow; what should the modern SRO structure look like; and we can't not discuss capital formation.

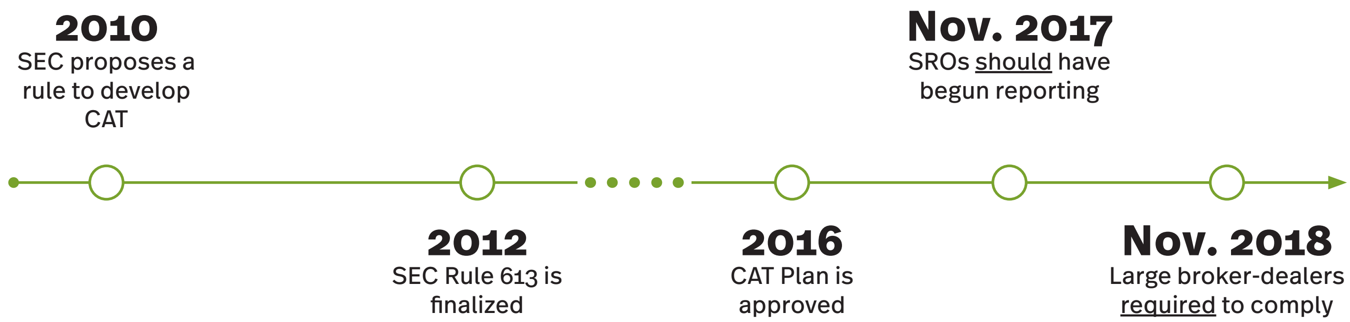
Where Are We in Reviewing Reg NMS?

SEC Commissioner Hester Peirce kicked off the conference by stressing that regulators must review the underlying assumptions of regulations, not just the regulations themselves. We must stop and ask if market inefficiencies equal market failure to the point they require more regulation to correct? And could more regulation just exacerbate any inefficiencies in today's markets? Peirce went on to note NMS is not a goal to be achieved. It needs to be dynamic to match markets, changing as the industry changes. The big question discussed was, "Should we continue to focus on forcing market structure via the order protection rule?" Almost everything in the equity markets can be traced back to this rule, meaning any review of Reg NMS must take a holistic approach.

Historically, the SEC utilized pilot programs to test changes to market structure. SEC Director of the Division of Trading and Markets, Brett Redfearn, indicated he is reviewing all 17 active pilots, five of which apply market-wide, as opposed to a single exchange. Since pilots come with real costs to market participants, they need a solid structure, a clearly defined program, a set end date and an assessment system to measure success. Redfearn noted they need good data to determine if the proposed change helps markets or if it could it be leading to a suboptimal solution. The following are a few of the SEC's test programs:

- **Tick size pilot** – Many believed a wider tick increment might improve liquidity for smaller cap stocks, potentially increasing the number of market makers trading the stocks, research analysts covering the stocks and overall trading in these names. The pilot is set to expire October 2. Not only does the SEC not expect to extend it, the SROs voted to end the pilot on this date. SEC's Redfearn indicated increasing tick sizes "may not make sense for the long haul," but we might learn the relative changes in trading costs associated with wider spreads and the costs/benefits associated with a trade-at provision, via the collected data.
- **Transaction fee pilot** – This pilot – currently in the proposal stage – aims to assess the impact of rebates on order routing behavior and both execution and market quality. While the SEC's proposal arose out of a recommendation by the EMSAC, the inclusion of a test group ending rebates diverged from the EMSAC. Yet, the SEC believes it would be missing an opportunity to fully evaluate exchange pricing models without this feature. At the end of the pilot, the SEC intends to also assess the appropriate role of regulators in setting market pricing – could competitive market forces cap fees without the government setting caps? Some market participants have expressed concerns about the size of the test buckets: 1,000 stocks in each of three groups, totaling over one-third of all NMS stocks. SEC's Redfearn requested comments from market participants on this and all pilots.
- **Roundtable on market structure for low volume securities** (<100,000 ADV) – 50% of NMS stocks are low volume, as are ~30% of U.S. corporate stocks. The low volume corporate stocks represent 15% of total NMS stocks, but <1% of total NMS volume (low volume ETPs equal 18% and <0.5% respectively). Low volume stocks are illiquid "for a whole bunch of reasons", but SEC's Redfearn indicated it is worthwhile looking into market structure changes that could make it easier to trade these stocks, allowing exchanges to innovate to serve issuers and investors and repatriate liquidity back onto exchanges.
- **Roundtable on access to markets and market data** – Market participants have access to products and services providing a range of entrances to markets and market data. This roundtable will explore costs, speed and transparency around data, including the amount of SIP money collected and how much is reinvested in improving the SIP.
- The third roundtable will address **regulatory approaches to combat retail fraud.**

When Will the CAT Meow?



We're just going to put this right up front. When asked directly, SEC's Redfearn said, "I have no definitive answer on the CAT deadline extension…but we are working on it." As shown above, large broker-dealers are required to begin reporting to the CAT in November of this year, but the CAT has not yet been born (completed). **This leaves market participants in limbo.** It did not, however, leave panelists with nothing to talk about. We summarize the long CAT journey as:

Objective: Provide FINRA, the SEC and the exchanges the data necessary to enable a view of the whole market, including granularity at the customer account level.

Concern: As originally designed, the CAT would become essentially the largest database in the world for personally identifiable information (PII). The industry and SROs are now coalescing around a concept that would protect investors' PII, where it would only be shared with regulators after anomalous activity has been detected. The PII would then be held in a secure sand box and used for the purpose of investigation into the questioned activity, analysis meant to benefit markets and protect investors. The industry awaits the SEC's decision on this concept.

Concern: What if the same surveillance red flag goes off in multiple systems – will a firm be hit with 22 different SROs each requesting the same information? It is very costly – money, time and personnel – for firms to respond to regulatory inquiries, and to perform this same task 22 times does not seem efficient. Panelists indicated regulators should follow the insider trading model, where there is one inquiry across all markets.

Concern: There were also concerns expressed on data integrity. One panelist indicated smaller firms typically have one person tasked with monitoring all the data processes. Larger firms often task a junior member of the compliance team to ensure the integrity of entering and confirming data. If the regulators are going to be so reliant on the data in the CAT, the industry needs to make sure the integrity of the data is at the highest level. On the CAT side, one panelist indicated they can verify authenticity once the data is submitted, as it is stored in its raw format before being pulled into reports. However, the CAT cannot ensure that the data was sent in correctly (the garbage in, garbage out phenomenon).

Many questions remain, with one panelist saying, "The CAT, it's a mess." (Hopefully you've watched The Campaign to get this reference!) The CAT was envisioned to be a cooperative process, but some market participants are concerned implementation is straying from this objective and the end result may increase costs to market participants.

What Should the Modern SRO Structure Look Like?

Currently, there are 21 securities exchanges in the U.S., under seven parent groups (please see the next page). All of those exchanges are SROs under current law. While we held a panel at the conference titled “The Modern Era of SRO Structure”, one panelist was quick to point out that we are not really in the modern era, we are “still in 1975”. Market structure has evolved significantly since then, but the SRO rules remain the same. These rules were set when the SROs were owned by broker-dealers and other market participants, who also sat on the boards of these exchanges. Exchanges are now private, for-profit entities reporting to their shareholders. Yet, they maintain authority for their own and other stock exchanges.

The original idea was that exchanges were broad industry utilities for the public benefit, meaning incentives would be aligned to promote efficient and fair markets. Now, market participants see a shift to SROs leveraging their responsibilities for their commercial interests. These are topics discussed in the EMSAC Trading Venues Subcommittee, to mixed reviews. Some market participants see limited progress, indicating that without a vote the advisor’s role does not mean much. They suggest there should be a cross-section of representatives on the committee.

On the exchange side, they noted: the advisory committee size expanded, the number of released minutes increased, less material is marked confidential, and they released information on the SRO formula and latency statistics – all driven by advisor recommendations. The questions remain, what is achievable and what are SROs willing to do in these meetings?

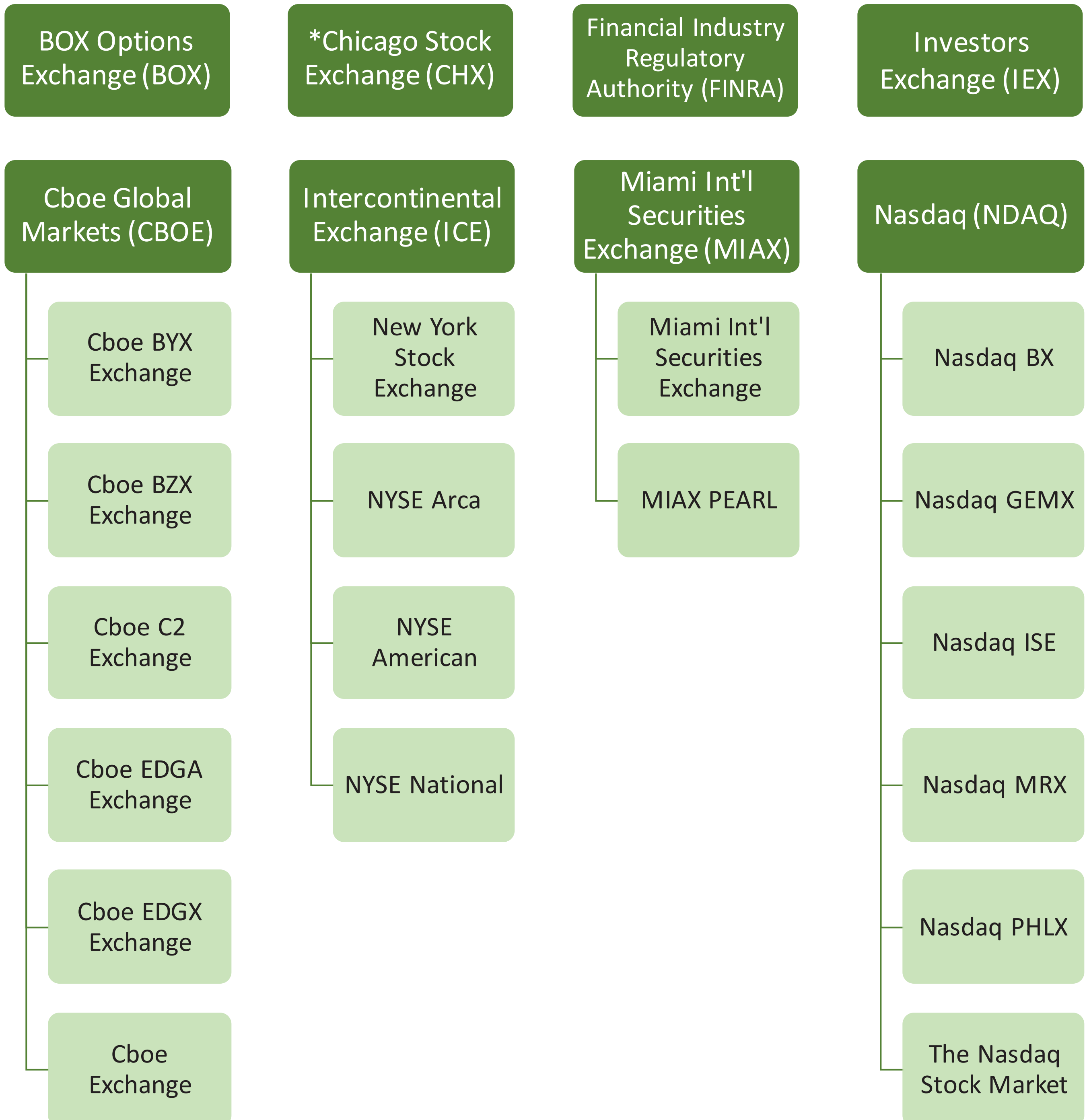
Concerns also arose over the issue of SRO regulatory immunity from liability. EMSAC did not reach a consensus on how to approach this. Market participants want defined what falls under the “regulatory” label and the activities included. Exchanges receive immunity from lawsuits only when they are acting as a regulator (investigating a firm, enforcement actions, etc.). As immunity is governed by the courts, not the SEC or the Exchange Act, when exactly are exchanges standing in the shoes of the government? And what is purely commercial activity?

On the immunity topic, the City of Providence lawsuit was an important case. The court ruled that immunity covers regulatory activities, not an exchange’s commercial activities, which in that case were proprietary data feeds, co-location services, and complex order types.

Our conference did not solve all the problems, and the SEC indicated they do not have the answers right now either. SEC Commissioner Peirce noted SROs can play a role, but the SEC needs to think about that role. Times have changed, and this role has too.

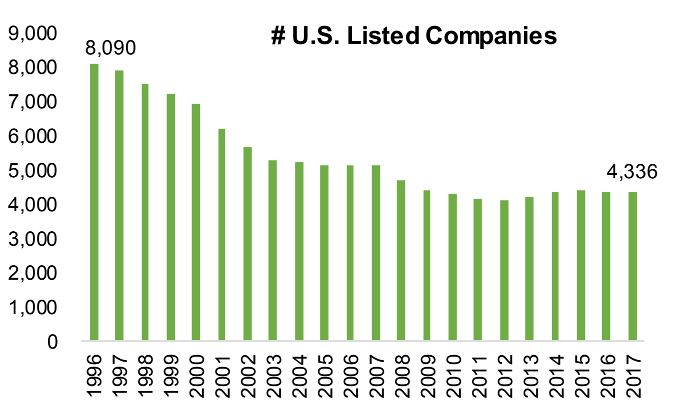
Current SRO Landscape

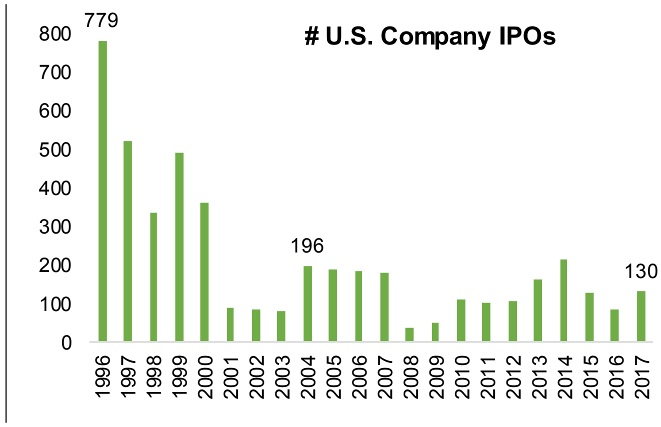
*Of note, in April, ICE announced it entered into an agreement to acquire CHX, pending regulatory approval.



Source: https://www.sec.gov/rules/sro.shtml

We Can’t Not Discuss Capital Formation





Source: # companies = World Bank; # IPOs = Dealogic

Note: All exchanges, U.S. firms only; # companies excludes investment funds and trusts; # IPOs excludes BDCs, SPACs, MLPs, CLEFs, REITs

SEC Chairman Jay Clayton has expressed concerns about the shrinking number of public companies in the U. S. As shown above, the number of public companies declined 46% (-3% CAGR) from 1996 to 2017, while the number of IPOs declined 83% (-8% CAGR, albeit from the tech bubble peak). One panelist indicated the “the stats are not good, but the sky is not falling.” For example, the New York Stock Exchange had over 50 U.S. IPOs in 1Q18, indicated as their best quarter since 2008.

There are many reasons why a company might stay private longer, including various macro conditions such as: low interest rates; litigation concerns; time and cost associated with compliance and regulations to list; continued trend to passive investing; etc. Private markets try to decrease some of these frictions, and private investment dollars have been readily accessible and growing since the financial crisis. U.S. private equity deal flow has come in over $500 billion the last four years, nearing $600 billion in 2016[1].

From a market structure viewpoint, one panelist indicated the decision to list can “get complicated quickly.” Issuers need to wrap their heads around what it will be like to enter the public markets (earnings reporting, working with investors). They have choices as to where to list, and they will need to gain an understanding of all of the trading venues. Further, smaller companies indicate it is difficult and takes time to adjust to public life. Many small cap stocks barely trade, with some not even trading for weeks (and when they do trade it is in smaller amounts; we listed stats for thinly-traded stocks earlier in this report).

Market structure experts expressed concerns that changing market structure to boost IPOs may not be the right answer. For example, one panelist indicated people have not been able to correlate changes to tick sizes to IPOs. Also, if the U.S. is simply lowering listing standards to generate more IPOs, it needs to be made clear to investors which companies operate which way. “We do not want to go to the lowest common denominator.” As mentioned above, some stocks are illiquid for a reason. While it is a good concept to test changes to market structure in relation to capital formation, we need to be careful in design and aware that structure may not be the panacea.

[1] Source: PitchBook

Appendix: Terms to Know

ADV	Average Daily Trading Volume
Best Ex	Best Execution in Trading
CAT	Consolidated Audit Trail
EMS	Equity Market Structure
ETP	Exchange-Traded Product
IPO	Initial Public Offering
NBBO	National Best Bid Offer
PII	Personally Identifiable Information (associated with CAT)
Tick Size	Minimum price movement of a trading instrument

FINRA	Financial Industry Regulatory Authority
SEC	Securities and Exchange Commission
SRO	Self-Regulatory Organization

EMSAC	Equity Market Structure Advisory Committee
NMS	National Market System
Reg NMS	Regulation National Market System
SIP	Security Information Processor

SIFMA Insights

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