RESEARCH

Insights

Debrief: Equity Market Structure Roundtable

Perspectives & Key Themes from Market Participants

May 2023

While supportive of reviewing existing regulations, market participants are concerned about unintended consequences to a system that currently works well – no/low costs for investors, firms can route orders in the most efficient way for their business. This was top of mind when SIFMA hosted our second Equity Market Structure Roundtable to discuss the four SEC proposals released last December. The event brought together viewpoints from the buy-side, sell-side, exchanges, academics, and others, as well as an update from the SEC's Chief Economist and Director of Division of Economic and Risk Analysis (DERA). Inside this note, we recap just some of what was seen and heard, including:

- **The SEC Viewpoint**: "The economic perspective is very important at the SEC." The guidance drives the economic analysis, a process that is "highly collaborative" with the rule writing division. Economists fill in the pieces of the baseline (current state) and then add in the cost-benefit analysis to reach a conclusion.
- **The Market Viewpoint**
    - Overall: Prefer a staggered gradual approach, with an updated Rule 605 the baseline. Doing all proposals at once could bring unintended consequences.
    - Disclosure of Order Execution Information: Proposal could create confusion for investors. Panelists pondered two reports – one simple form for investors and a deeper dive for the industry.
    - Tick Sizes, Access Fees, & Transparency of Better Priced Orders: Be conservative, take a narrow approach. The more complex you make the system, the more you could erode investor trust.
    - Regulation Best Execution: Proposal could negatively impact market efficiency and resiliency. Panelists do not see the need for a second best ex rule when the current rule works.
    - Enhancing Order Competition: Proposal could increase costs to the industry and investors, as well as degrade the customer experience for both retail and institutional investors.

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Debrief: Equity Market Structure Roundtable

On December 14, 2022, the U.S. Securities and Exchange Commission (SEC) issued four proposals to completely rewrite the regulations governing the structure of U.S. equity markets. Taken together, they total over 1,650 pages of proposed rulemaking, representing the greatest overhaul of equity markets since Regulation National Market System (Reg NMS) in 2005. The four proposals, in brief, are:

- Disclosure of Order Execution Information[1] – to update the disclosure required under Rule 605 for order executions in NMS stocks by:
  - Expanding the scope of reporting entities subject to the rule;
  - Modifying the definition of covered orders;
  - Modifying the information required to be reported under the rule;
  - Modifying reporting requirements for non-marketable limit orders;
  - Eliminating time-to-execution categories in favor of average time to execution; and
  - Enhancing the accessibility of the required reports by requiring all reporting entities to make a summary report available.
- Tick Sizes, Access Fees, and Transparency of Better Priced Orders[2]
  - Adopt variable minimum pricing increments for the quoting and trading of NMS stocks;
  - Reduce the access fee caps; and
  - Enhance the transparency of better priced orders.
- Regulation Best Execution[3] – new rules relating to a broker-dealer's duty of best execution (best ex).
- Enhancing Order Competition[4] – to promote competition as a means to protect the interests of individual investors and to further the objectives of NMS (retail order auctions, or auctions).

In addition to the significance of each of the proposals on their own, market participants are concerned about the interconnectedness of the four proposals. SIFMA's second Equity Market Structure Roundtable brought together market participants, policy makers and observers to discuss the SEC proposals and these concerns.[5] Inside this report, we recap what various market participants and observers are saying about the proposals, as well as a review of the SEC's economic analysis of the proposals.

[1] https://www.sec.gov/news/press-release/2022-223
[2] https://www.sec.gov/news/press-release/2022-224
[3] https://www.sec.gov/news/press-release/2022-226
[4] https://www.sec.gov/news/press-release/2022-225
[5] SIFMA Comment Letter on the SEC's Equity Market Structure Proposals: https://www.sifma.org/resources/news/sifma-comments-on-the-secs-equity-market-structure-proposals/#:~:text=Commenting%20on%20the%20proposals%2C%20SIFMA,reaching%20and%20raise%20serious%20concerns.

The SEC Viewpoint

Economic Analysis Methodology

We sat down with Jessica Wachter, SEC Chief Economist and Director of the Division of Economic and Risk Analysis (DERA), to discuss the economic analysis performed for the four proposals. She began by noting that the guidance[6] informs their process. In brief, this guidance states that the basic elements of a good regulatory economic analysis are:

- A statement of the need for the proposed action;
- The definition of a baseline against which to measure the likely economic consequences of the proposed regulation;
- The identification of alternative regulatory approaches; and
- An evaluation of the benefits and costs – both quantitative and qualitative – of the proposed action and the main alternatives identified by the analysis.

As the SEC needs to demonstrate the need for regulation, Wachter indicated they rely on this guidance to identify the reason behind the rulemaking. The guidance lists sources to draw on to justify rulemaking, such as Congressional mandate or a market failure, further noting that a market failure can include asymmetric information or a failure for the market to coordinate around an issue on their own. After identifying the need, SEC economists move through the remaining steps, ending with a cost-benefit analysis. These steps are to be performed regardless of the reason behind the rulemaking.

Putting this into practice, Wachter indicated that their process is highly collaborative with the rule writing division. At the start, the project discussion focuses mainly on policy. Then the economic analysis is performed, further informing the policy. The groups continue to go back and forth until reaching a final proposal. She further indicated that this collaboration occurs at all levels, from staff to directors, across divisions. “The economic perspective is very important at the SEC.”

As to the economic analysis, economists first outline the plan. Next, in line with the first principle – to break down complicated problems into basic elements and then reassemble them from the ground up – SEC economists fill in the pieces of the baseline – current environment, or steady state – and then add in the cost benefit analysis. Wachter noted that she and her team combine economics and data, understanding where the data comes from and what it can or cannot tell them. When it comes to analysis of non-data topics, she noted that the process is similar because they establish the baseline first. “Rules all have economic effects, even if there are no numbers in it.”

Finally, Wachter discussed how the SEC incorporates comment letters from the public, including stakeholders. She noted that they consider this process very important, looking at all comments and evaluating if the SEC needs to change its approach accordingly. She noted that they carefully evaluate the data in comment letters and marry it up with their own analysis.

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[6] https://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf

The Market Viewpoint

We note that all commentary assumes the four proposals are enacted as written.

As one panelist noted, to say that there was a strong reaction from market participants to the proposals is a bit of an understatement. It is also interesting to note that all types of market participants – broker-dealers, buyside, retail brokers, exchanges – have come together to express concerns around the potential impacts of the rules and justifications for the rulemakings. We do not typically see these participants on the same side of an argument.

To begin with, market participants fail to see the justification for the proposed regulatory changes, particularly changes of this magnitude. As SEC Chair Gensler himself has noted, U.S. capital markets remain the “gold standard” and the “largest and most innovative capital markets in the world.” If he believes that – as we do – then what problem are we trying to solve? There was no market failure. Over the past few years U.S. equity markets have been tested with several periods where volatility spiked, with the VIX peaking at: 82.69 during the height of the COVID-driven market turmoil in 2020; 37.21 at the top of the meme stock event in 2021; 36.45 at the start of the Fed rate hikes in 2022; and 26.52 at the beginning of the regional bank turmoil this year. Yet, markets remained open and functioning. Market participants just do not see the justification for making foundational changes of this magnitude.

The scale of the proposals is staggering. As stated earlier, this would be a massive overhaul of equity markets, to a level not seen since Reg NMS in 2005. There are over 1,650 pages in the proposals together, with no individual rule totaling less than 340 pages. Beyond just the volume, the proposals would directly reverse some aspects of Reg NMS, the existing regulatory structure. Additionally, the four proposals are all interconnected, yet no economic analysis was done to assess the potential impacts of implementing all four of the proposals together. There is a scientific principle that says extraordinary claims require extraordinary proof. Market participants just do not see the proof.

Market participants across the trading ecosystem are concerned that these proposals could harm markets and create confusion for investors. The auctions, best ex, and tick size proposals could take well-functioning parts of the market and introduce latency, decrease transparency, and increase costs. How does this create a better outcome for investors?

Market participants are generally supportive of improving markets through greater disclosure and increased transparency. As such, they are onboard with updating Rule 605 disclosures, subject to certain changes and clarifications. This should be done first and then used in the analysis of the other proposals.

To summarize, the high level takeaway from market participants is that the SEC should take a staggered gradual approach to any potential changes, with an updated Rule 605 the foundation of any further rulemaking. Otherwise, market participants fear doing all four proposals at once could bring unintended consequences, including decreasing the level of retail investor participation.

Disclosure of Order Execution Information

The area with the most consensus among market participants is updating Rule 605. SEC Chair Gensler has said that the "measuring stick is broken". As such, market participants believe this key metric – the measuring stick – needs to be fixed first. Market participants agree the disclosure rules need to be modernized, adding more information and making it more readily available. This would increase transparency and could lead to better investment decision making for institutional and retail investors, as well as better post-trade analysis by firms.

Standardized reports could help investors compare brokers to assist them in making informed investment decisions. While summary reports can be useful, will this leave investors with a report that does not tell the full story? Panelists caution that the reports need to be constructed in a way customers can do something with them, and the updates need to be done carefully and accurately. Panelists do not believe the current proposal gets us there.

Execution quality statistics are difficult to analyze, as brokers have different clienteles. Different business models attract different investors with different risk tolerances. As such, unless designed well, any summary report would imply an apples to apples comparison. Yet, the proposal would not capture differences in order flow across brokers. As such, the comparison is actually apples to oranges, which could create a misleading picture for investors.

Panelists were concerned about this single summary report concept if it was meant to assist retail investors in making investment decisions. These reports show statistics on all stocks across all brokers and customer types. Yet, stocks have different liquidity levels and trading patterns. Brokers have different business models and therefore customer bases. Customers have different investment objectives and risk tolerances. A single summary report would not capture these nuances.

For example, you walk into a big box retailer and ask them what their average price is across all products sold. One store says $83, another says $200. On paper, this could lead a customer to simply choose the cheaper store price. However, these were averages across all products. It is not an accurate indicator of the individual product you are trying to buy. That decision includes multiple factors – brand, delivery, customer support, etc. – in addition to item price.

To bring that to a markets example, we look at average time to execution metric considered in the proposal. As an average, this is an indicator of what all customers are doing. How do investors look at that average? If there is a broker with a high level of cancelled orders, their statistics will show a shorter timeframe. This could be misleading to investors. Further, it could also cause firms to attempt to attract customers that cancel orders to pad their statistics.

Market participants believe the proposal as written could create more confusion for investors. Panelists pondered the creation of two reports – one simple form for investors and a deeper dive for the industry.

Tick Sizes, Access Fees, and Transparency of Better Priced Orders

We have seen this story before, with the SEC's Tick Size Pilot Program[7] from 2016-2018. This was a study to assess the impact of wider minimum quoting and trading increments – tick sizes – on the liquidity and trading of stocks of certain small-capitalization companies. The program was viewed as a failure by many, curtailing trading volumes of the included stocks and increasing investors' trade costs an estimated $900 million. Despite the history, market participants have some consensus that changing tick sizes and access fees would benefit markets.

There has been a consistent theme among some market participants that a one size fit all approach may not be the optimal way to look at markets. While a multifactor approach has been recommended as a better approach, panelists noted that the impact on liquidity must be considered as well. Regarding the current proposal, there is growing consensus among market participants around going to half a penny in tick constrained stocks. After this high-level consensus, the questions and diverging opinions begin. Even on the consensus for changing to half a penny in tick constrained stocks, there are questions around how to define constrained.

Market participants wonder where to draw the line of how to bucket stocks. Panelists indicated that the market already has a "bunch" of stocks with too many ticks. Some less liquid stocks already have increments too small and could benefit from wider ticks – with a reminder that wider ticks do not necessarily equate to wider spreads for all stocks. One panelist pondered if two to four ticks would be optimal, using this range to back into buckets.

As a panelist noted, we know what we do not know, and we do not know what the optimal tick size should be for each and every stock – liquid versus illiquid; small, medium, or large cap – and we do not know the corresponding optimal access fees by stock. There is a correlation between tick sizes and access fees. If we take ticks to half a penny for tick constrained stocks, the access fee needs to come down accordingly. Reducing quoting increments without changing access fees could have a negative impact on markets. Some market participants have noted that the current 30 milliseconds (mils) is too high for some stocks and could support going to 10 or 15 mils. One panelist idea was for penny wide increments go to 10 mils, tick constrained to 5 mils, and others stay at 30 mils. As mentioned above, the optimal buckets remain unknown.

Equity markets are already complex. Market participants are concerned that making too many changes under this proposal could increase complexity, as well as increase operational risk. For example, while ticks would be changed – and therefore updated in systems – quarterly, round lots and access fees would be monthly. This creates a lot of technology changes for both sellside and buyside firms. Everything in this proposal is interconnected – making significant changes all at once increases the risk of a technical glitch or failure. The proposed changes will also substantially increase the amount of market data, which will increase costs across the industry, costs which could be passed down to investors.

The overarching recommendation for this proposal was to be conservative and take a narrow approach. After all, the more complex you make the system and the more you constantly change buckets, the more you erode trust with investors, particularly retail investors. Additionally, on access fees, market participants are opposed to regulators setting prices. If it is determined that prices need changed again at a later date, it would take a lengthy rulemaking process to make the change.

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[7] There were three test groups compared to a control group, which continued to quote and trade at the current tick size increment of $0.01 per share: (1) quoting at $0.05 per share, trading at $0.01; (2) quoting & trading at $0.05 per share; & (3) quoting & trading at $0.05 per share, with a trade-at prohibition (prevents price matching by a trading center that is not displaying the best price unless an exception applies).

Regulation Best Execution (Best Ex)

Best ex is foundational to the health of markets. Market participants noted that the Financial Industry Regulatory Authority (FINRA) framework – which was developed over decades – is very solid. FINRA actively enforces the regulation, and when enforcement actions are announced it sends signals to the market as to how to abide by the rule. The SEC oversees FINRA, has jurisdiction over the FINRA rule and enforces it too, including issuing enforcement actions. In fact, all FINRA rules, including the FINRA Best Execution rule (and the contemporaneous Municipal Securities Rulemaking Board Best Ex rule) were reviewed and approved by the SEC.

While market participants are supportive of examining and potentially enhancing the current FINRA and MRSB rules, they see several flaws in the SEC proposal. Today's principles-based best ex rule accounts for multiple factors, not just price. However, under the proposal, best ex would become only about price execution versus all the factors considered today.

Additionally, panelists noted that a key element of today's best ex rule would be undermined – broker-dealer judgement and discretion. The proposed rule is overly prescriptive – mostly on prevailing price and disregarding all other factors – restricting broker-dealers' actions. Today's best ex rule is multi-dimensional and requires broker judgement. Broker-dealers advise clients on transactions, such as how to move a large stock position with little price impact. This is what brokers do. They know their clients and use judgement – backed by experience and information on the current market environment – to meet best ex criteria for their clients.

Further, there is a stark contradiction between the best ex and order competition proposals. The order competition rule says brokers must route orders to auctions if they do not get midpoint execution. Assume a broker can get $0.25 of price improvement at the auction but $0.50 elsewhere outside of the auction. The order competition rule says the broker must route to the auction, but the $0.25 less earned in price improvement at the auction means the broker has not achieved best ex. Panelists indicated that there is no way to comply with both proposals at the same time. One will be violated when conforming to the other.

To look at it another way, if a stock has a $0.12 spread and trade and quote sizes are harmonized, the amount of price improvement would be limited to the permissible increment. If this stock trades with a ½ cent tick size, it could only be improved by $0.06 to be consistent with the quote and trade increment. Under the new rule, the investor would only get either midpoint execution or cross the spread. If the stock does not receive a midpoint execution, the investor could be worse off than they are today.

Panelists believed this proposal is a backdoor way to eliminate payment for order flow (PFOF). However, PFOF is largely attributed to enabling $0 commissions. In the fall of 2019, commissions dropping to $0 drove the start of the increase in retail participation. Execution quality has improved under the current regulatory environment – best ex, competition for retail order flow – and the prescriptive nature of this proposal could decrease broker-dealer discretion to make routing decisions. Panelists noted that broker discretion made this market, driving competition. Changes to the existing rule could, therefore, negatively harm retail investors and retail participation levels.

Further, this proposal is being portrayed as just a broker-dealer rule. While technically correct, panelists noted that, in practice, there really is no such thing as a broker-dealer only rule. The buyside cannot access markets without broker-dealers. The impact of this rule will, therefore, flow to them and then their clients as well. And let us not forget

that the clients of many asset managers are also individual investors, via their retirements accounts and pension funds (among others).

For these reasons, market participants do not support this proposal. They support efficient markets and market resiliency, which they believe this proposal will negatively impact. And they do not see the need for a second best ex rule, especially when the current rule works well.

Enhancing Order Competition (Auctions)

Under the current system, brokers reward venues with the best execution statistics. Brokers have best ex obligations to route to venues with the best execution statistics. Under economic theory, fully effective competition can arise on ex ante basis. With this proposal, the SEC looked at ex post competition. They assumed that if you add stages at the end of the system, you can change behaviors at the beginning, enhancing best ex. Market participants are not sure that is the case and are concerned that auctions will, instead, increase costs to the industry and therefore investors.

Today's markets guarantee timely execution by brokers. The auction proposal would force brokers to go to auctions with a duration of 100-300 milliseconds. That is a lifetime in trading and a lot can happen in that time span – the quote can change multiple times. Today's retail investor gets a simple, efficient, and explainable experience. They see a quote on screen. They push a button. Almost all of the time their trade is executed at the price on screen or better. Retail investors are happy with their experience, which is why FINRA has had essentially no complaints about execution quality.

Under the auction proposal, this could change. For example, an investor sees $12 for their stock on screen. In the current system, the order will be executed at or better than $12. Going forward with auctions, the $12 order for 100 shares goes to the auction and is broadcast to other market participants. Another 100 share order then comes in at $12, followed by a third order to the auction. Auction participants may choose to fill the second or third orders before the first. The retail investor will see others buying up stocks at $12, yet they do not get filled at $12. How does a retail broker explain this to a retail investor?

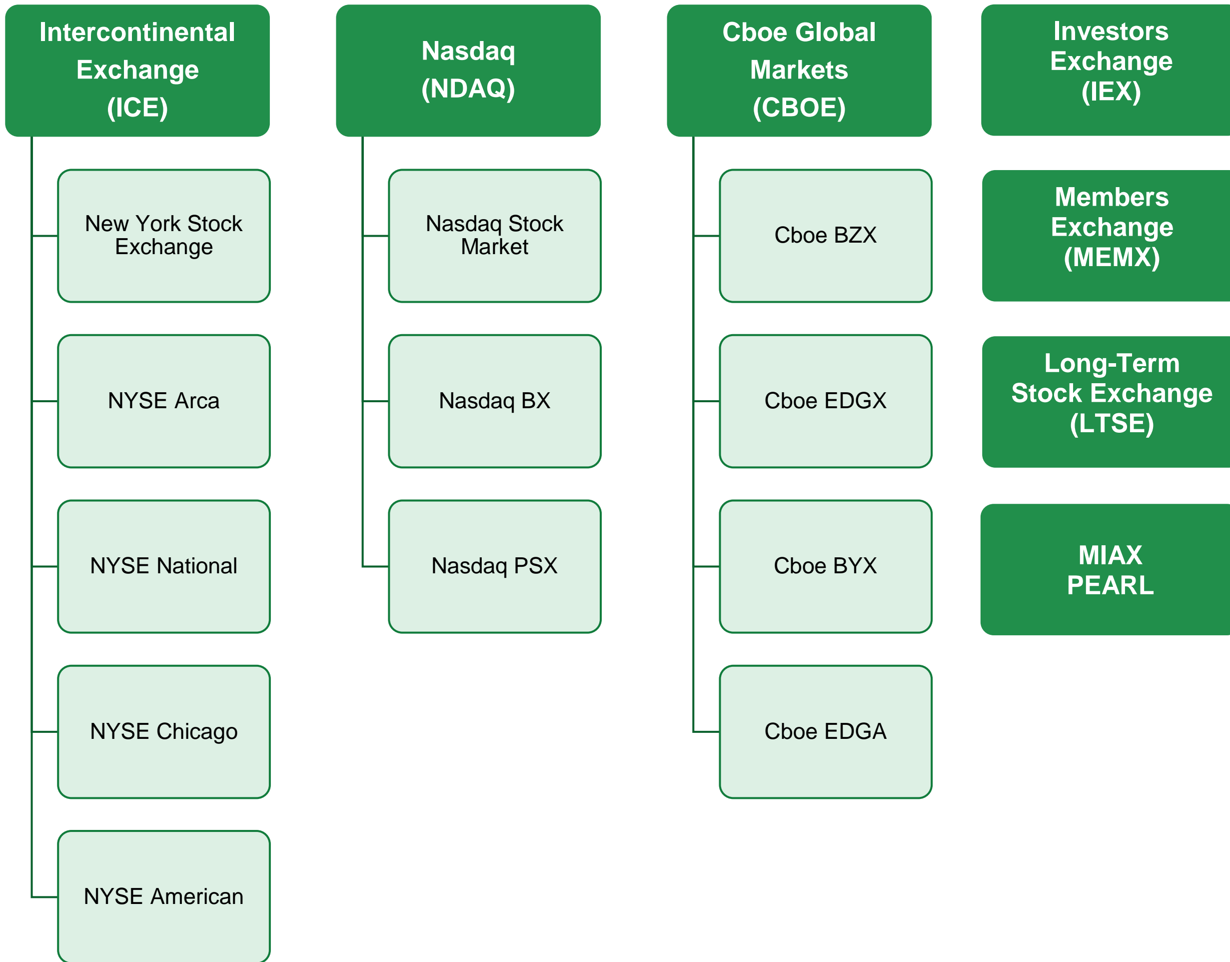
As to institutional order flow interacting with retail flow – SEC Chair Gensler's objective behind this proposal – the prevailing view is that asset managers are lining up to provide liquidity. That is not their role – they are not market makers. This is not to say institutional investors would not be willing to access the auctions, but they must make tradeoffs on liquidity and costs. Information leakage is the most important factor to institutional investors. As such, anonymity is key. There will be a greater risk of information leakage if brokers are forced to wait the 300 milliseconds in auctions. Institutional investors are trading 2 million shares, as compared to the 200 shares traded by retail investors. They are not going to go to auction and transact 1,000 times over a few days, as the information leakage – which can negatively impact final execution price – would be too great.

There could also be increased opportunity costs of unfilled orders. Currently, brokers are held to a very high bar. They have to execute well on every stock for every client – they guarantee trade execution. If brokers had their choice, they would prefer to cherry pick more profitable order flow. They are not allowed to do that today. Auctions would shift this picture, allowing cherry picking and therefore removing guaranteed trade execution in each stock for every client. This could potentially increase the number of unfilled orders, which would be a negative for investors.

The auction proposal could also increase operational risk. Market participants estimate that on a busy day we could end up seeing 100-200 auctions occurring at the same time. The messaging traffic would be "unbelievable". The scale of messages and surge of orders as brokers respond could increase operational risks, and no market participant wants to see a technology glitch take down the system.

Given these concerns, market participants believe the auction proposal could increase costs to the industry and investors, as well as degrade the customer experience for both retail and institutional investors.

Appendix: Equity Exchange Landscape



Appendix: SIFMA Insights Research Reports

SIFMA Insights: www.sifma.org/insights

- Ad hoc reports on timely market themes
- Market Structure Compendium (annual report)
- COVID Related Market Turmoil Recaps: Equities; Fixed Income and Structured Products

Monthly Market Metrics and Trends: www.sifma.org/insights-market-metrics-and-trends

- Statistics on volatility and equity and listed options volumes
- Highlights an interesting market trend

Market Structure Primers: www.sifma.org/primers

- Capital Markets Primer Part I: Global Markets & Financial Institutions
- Capital Markets Primer Part II: Primary, Secondary & Post-Trade Markets
- Global Equity Markets
- Electronic Trading
- US Capital Formation & Listings Exchanges
- US Equity
- US Multi-Listed Options
- US ETF
- US Fixed Income
- SOFR: The Transition from LIBOR
- The Evolution of the Fintech Narrative

Conference Debriefs

- Insights from market participants into top-of-mind topics
- Pre-Conference Survey Comparison, compares survey results across various conferences

Equity Market Structure Analysis

- The ABCs of Equity Market Structure: How US Markets Work and Why
- Analyzing the Meaning Behind the Level of Off-Exchange Trading, Part II
- Analyzing the Meaning Behind the Level of Off-Exchange Trading
- Why Market Structure and Liquidity Matter

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