WILLIAMS & JENSEN, PLLC

Fr: Alex Barcham

Re: Security Traders Association Annual Market Structure Conference – Day 1

Dt: September 30, 2015

Summary

On September 30, the Security Traders Association (STA) began its 82st Annual Market Structure Conference. The conference will continue on October 1-2.

STA President and CEO Jim Toes said in the past two years there has been a tremendous improvement in coordination amongst market participants. He raised concerns with the funding mechanism for the SEC, as 100 percent of the SEC budget is financed through transaction fees on the equity markets, but the SEC's oversight goes far beyond the equity markets. He said the STA is urging consideration of alternative funding mechanisms.

Keynote Speaker: Commissioner Kara Stein, U.S. Securities and Exchange Commission

Commissioner Stein said the 1975 Securities Act Amendments began the push to create the National Market System. She said the goal of this legislation was to improve the transparency of market information, improve efficiency of the market, promote fair trading, and ensure that investors get the best price. While acknowledging the progress toward these goals, she suggested that the markets have become darker and more opaque. She said the proliferation of trading venues has made the market stronger and more resilient, but also make it more complex. She said the interconnections in the market are often not well understood by regulators or investors. **Stein** emphasized that the markets have evolved and cannot return to their earlier state. She stressed the need to enhance the transparency of the market. She said transparency is about verification, in addition to disclosure.

Stein said additional transparency is needed at alternative trading systems (ATS), or dark pools. She said the speed of transactions makes asymmetries more likely to arise. She stated that dark liquidity has been around for decades, but expressed concern with the continuing growth of the "dark marketplace" and whether dark pools continue to perform the functions that they were originally intended. She noted that the size of the average dark pool trade now involves less than 200 shares. She expressed concern with repercussions of trades moving into dark markets, suggesting that opacity may make conflicts of interest less apparent and price discovery distorted. **Stein** pointed to several recent cases brought against dark pools by the SEC. She said in one case the ATS was running a secret proprietary trading desk and exploited confidential information from subscribers. She said in another case the ATS used order types that prioritized certain subscribers over others. She noted that in a third case a broker-dealer dumped a large variety of order types into the market, violating trade-through rules. She raised concerns that how ATSs operate is largely kept secret. **Stein** urged the SEC to adopt dramatic reforms to bring transparency to dark trading venues, suggesting that ATSs should compete on a level playing field. She said more execution and order data needs to be available to the public. She stressed the need to move forward with modernization of disclosures rules for order execution and routing.

Stein said she has championed the creation of the Consolidated Audit Trail (CAT). She said the CAT can promote confidence in the integrity of the marketplace. She said the Flash Crash showed the need for a robust and consolidated audit trail, and the events of August 24, 2015 reinforced the need for the CAT. She said effective oversight cannot happen without the CAT. She said the SEC issued that a final rule mandating that FINRA and the exchanges build the CAT, but that little progress has been made. She expressed disappointment that the SEC has largely outsourced its responsibility for the CAT. She noted that she has called for the SEC to designate a CAT project manager, but this has not happened. **Stein** said extreme volatility recently led to the limit up-limit down rules being triggered. She expressed the need to study how the limit-up/limit-down rules operated, particularly with exchange traded funds (ETFs). She suggested that a CAT would be valuable in understanding the recent volatility.

Stein stressed the need to restore investor confidence in the market. She questioned who is responsible when an algorithm goes awry. She said there needs to be clarity regarding roles and responsibilities in electronic markets. She emphasized that all of the people working in the markets need to understand the rules of the road. She suggested that certain employees, such as those creating algorithms, may need to be licensed.

Toes asked about Stein's views on the SEC Equity Market Structure Advisory Committee (EMSAC). **Stein** said she would like to see the Committee meet more often, noting that they have only met once thus far. She suggested that the Committee should take control of their agenda and tell the Commission what they should be looking at.

An audience member noted that the CAT does not include the commodities or futures markets. **Stein** said the CAT should eventually include the commodities markets, but that the SEC does not have jurisdiction over those markets.

Panel: SEC Equity Market Structure Advisory Committee

Moderator:
John McCarthy, KCG

Panelists:
Eric Noll, Convergex
Jamil Nazarali, Citadel
Joe Mecane, Barclays
Kevin Cronin, Invesco

John McCarthy (KCG) asked what issue the EMSAC should be most focused on. **Jamil Nazarali (Citadel)** emphasized that the markets are better, stronger and faster than ever before and stressed the need to make data-driven decisions. He suggested that the Committee should look at the role of exchanges in the market, including the self-regulatory organization (SRO) status and ability to charge for market data. **Joe Mecane (Barclays)** said the EMSAC should choose a topic it can make progress on; suggesting that access fees could be one such topic. He said the Committee should make clear what areas they believe are working well and they will not address. **Eric Noll (Convergex)** said there are widely diverging priorities amongst the EMSAC members. He stressed the need for the EMSAC to narrow its focus. **Kevin Cronin (Invesco)** said the EMSAC should focus on liquidity, trust and confidence in the market. He suggested that things are "generally very

good" in the market, but there are some areas which could use improvement. He stressed the need to take a data driven approach. He said there is some agreement that access fees would be a good issue for the EMSAC to start with. He said the EMSAC should also look at conflicts of interest.

McCarthy asked how transparency regarding order routing can be improved. He questioned whether this issue should be addressed through SEC rules or through industry best practices. **Cronin** said there is a lack of transparency in the market. He commended FINRA for its activities regarding ATS transparency. He emphasized the potential benefits of additional transparency, but stressed the need to strike an appropriate balance. **Mecane** recommended that any requirements or standards be very prescriptive, in order to avoid having different firms interpreting data differently. **Nazarali** said Rules 605 and 606 have helped improve execution quality for retail investors. He suggested that analogous rules could be created for institutional investors.

McCarthy said Noll recently wrote an Op-Ed for the Washington Post in which he recommended changing the order routing model to place retail investors ahead of institutional investors. He asked Noll to elaborate on this idea. **Noll** said markets "exist for the end investor," not for intermediaries. He said end user interests could be prioritized by ensuring that customers go first in the market. He acknowledged that some issues need to be worked out to allow for this to happen. He suggested that this could likely only be accomplished through a mandate under Regulation NMS. **Nazarali** suggested that this proposal would not work well in the equity markets, noting that it does not work well in the options market. He said the customer first rules in the options markets are subject to significant abuse. **Mecane** said some ATSs prioritize institutional orders over other orders. He raised concerns with the operational complexity of implementing a customer first rule. He said in the options market spreads were tighter on the maker-taker exchanges than on the customer first exchanges. **Cronin** said there are complicated dynamics in the market. He suggested that a customer first model would be challenging to implement.

McCarthy asked what issues the SEC should focus on in response to the August 24 event. **Mecane** said this event was the first "stress test" of limit-up/limit-down rules. He suggested that for the most part limit-up/limit-down worked in this case, but that the SEC should reexamine the mechanisms regarding the first 15 minutes of the day. He said ETFs are derivatives and will behave like derivatives, and thus should be reexamined. He questioned whether other factors, like stop orders, contributed to the issues on August 24. He said the market should consider how it handles ETFs, such as by tracking how ETFs are pricing compared to their indicative value. **Cronin** noted that many ETFs deal with international securities, so they will not open at the same time as U.S. markets. He suggested that there is a "knee jerk reaction" to blame ETFs. He suggested that it is not a surprise that market-makers left the market when they did not have good data. He questioned whether market orders should have collars on them at the market open. He stressed the need to examine stop orders, suggesting that they are "highly gameable." He said the market should look at order types which contributed to the issues on August 24. He said the mechanism needs some adjustment at the opening. **Noll** said there are very low levels of participation in reopening auctions, after a stock hits a halt. He questioned what would be needed to get market participants to participate in reopening auctions. **Nazarali** agreed that there are very low levels of participation in reopening auctions. He noted that there are different opening processes at different venues.

McCarthy asked about the IEX exchange applications. **Nazarali** said he has concerns with IEX's exchange applications, particularly regarding the speed bump. He said the IEX router will not be subject to the speed bump, which creates fairness issues. **Mecane** questioned how much

differentiation is desirable in the market structure. **Cronin** said while there are concerns about the speed bump, said he applauds IEX for searching for value outside of speed. He suggested that IEX could potentially create better outcomes for investors. **Noll** noted that when NASDAQ launched the Price Size Exchange (PSX) it asked the SEC if it could include a speed bump, but was told it would not be approved. He said the IEX filing will lead to questions about an exchange slowing down the market.

Interview: David Franasiak, Williams & Jensen, by John Donahue, Fidelity Capital Markets

John Donahue (Fidelity Capital Markets) asked about Franasiak's views on Commissioner Stein's speech. **David Franasiak (Williams & Jensen)** commended Stein's understanding of the market. He suggested that exchanges are not "100 percent lit" and ATSs are not "100 percent dark." He questioned who should build the CAT, and also whether the Securities Information Processor (SIP) should be run by a market participant or by a technology firm. He suggested that it may never be fully possible to determine causality during a market disruption. He noted that the SEC is currently fully funded by Section 31 transaction fees on the equity markets, suggesting that this is a potential problem down the road. He said there are elements of Stein's licensing proposal in existing regulatory proposals. He expressed concern that it may be difficult to bring in technology personnel if they are worried they will be subject to liability.

Donahue asked why the regulators are focusing on equity markets as opposed to other markets, such as derivatives and fixed income. **Franasiak** said there is much greater focus on securities than on bonds. He said there could be more transparency regarding bonds. He suggested that the regulators should not be focused solely on equities. He stated that equities are one of the most highly regulated markets in the world. He noted that the Dodd-Frank Act (DFA) created swap execution facilities (SEFs), which are meant to make swap trading more transparent. He noted that the energy trading industry converted many of their derivatives to futures, which are also regulated, suggesting that this has worked well. He said oversight is necessary, but must be done in the right way.

Donahue asked about the EMSAC. **Franasiak** noted that there is no retail investor representative on the EMSAC, but several Committee members have reached out to retail firms. He questioned the timing of the EMSAC, noting that there will be a new President and a new Congress in 13 months. He suggested that the roll out of the tick size pilot program is going slowly, and may not be up and running before the next President, who could potentially appoint a new Chair of the SEC.

Donahue asked how the regulators and Congress view retail investors. **Franasiak** said mutual funds and retail firms sometimes have different views because of the differences in how they are compensated, but both represent retail investors.

Toes asked for Franasiak's views on Speaker of the House John Boehner's resignation. **Franasiak** pointed to the rise of outsider candidates in the 2016 presidential election. He suggested that similar events are occurring in the UK. He said the lethargic economy is pushing voters to look at different candidates. He said Speaker Boehner had to deal with the growth of the Tea Party, who could have challenged his role as Speaker. He noted that the election for a new speaker will be held soon, and that Speaker Boehner and Senate Majority Leader Mitch McConnell will be talking with President Obama about a two year budget.

Donahue asked about former Secretary of State Hillary Clinton's use of a private email server. **Franasiak** said it was generally known that government employees used their own email accounts for some work related emails. He suggested that this is a larger issue for Clinton due to her role as Secretary of State and the type of information she had access to. He suggested Clinton made a mistake, which she has acknowledged.

Donahue asked about the political climate in Washington. **Franasiak** suggested that the increasing length of the election cycle makes it harder to get things done. He suggested that it will be more difficult to pass an extension of the Export-Import Bank as the election gets closer. He suggested that there may be a brokered convention for the Republicans. He said people may be underestimating Donald Trump's chances in the Republican race.

Panel: The Retail Perspective

Moderator:
Peter Haynes, TD Securities

Panelists:
John Standerfer, S3
Matt Billings, Scottrade
Todd Lard, Charles Schwab

Peter Haynes (TD Securities) asked whether the panelists agree there is not a direct retail perspective on the EMSAC. He asked if the Advisory Committee Members have reached out to the retail side. **Todd Lard (Charles Schwab)** said he appreciates the outreach of Citadel, but that retail firms should be able to participate directly in the EMSAC. He noted that the EMSAC is looking at creating Subcommittees, but he expressed concern with the transparency of these Subcommittees. **Matt Billings (Scottrade)** said the creation of the EMSAC is a positive development. He stated that some EMSAC members have attempted to reach out the retail side. He said Scottrade's average order size is 1,000 shares. He stated that it would make sense to have direct retail representation on the EMSAC.

Haynes said the EMSAC will eventually address the issue of payment for order flow (PFOF). He asked for the panelists' views on this issue. **John Standerfer (S3)** said the wholesale model has been very valuable to retail firms, as it allows them to navigate the complex market structure. **Billings** said the wholesale model is key for retail firms. He stated that Scottrade receives payment for order flow, but it uses these payments to finance its business model, including multiple platforms, research and education for customers. He said Scottrade's PFOF relationships are disclosed through Rule 606. **Lard** suggested that PFOF should not be a "dirty word." He stressed the need to take a holistic view of the market and look at fees, as well as PFOF.

Haynes said statistics frequently emerge regarding PFOF about the number of orders which are price improved. He suggested that one concern that is raised is that while price improvement occurs it is often nearly de minimis. **Lard** said on an individual order basis price improvement could be perceived as de minimis, but on a larger basis the savings are in the millions of dollars. He said retail firms are looking at new ways to review orders, such as through average savings per order. **Billings** suggested that what some describe as de minimis savings results in millions of dollars of savings. **Standerfer** emphasized the benefits to customers from price improvement.

Haynes asked about the reaction in Washington to PFOF and Flash Boys. **Lard** stated that retail investors have "never had it any better." He said retail firms have worked to get information out to consumers in an understandable form. He said there has been an improvement in disclosures. **Standerfer** suggested that Flash Boys was primarily focused on the institutional side.

Haynes pointed to the concerns with the opening process after the August 24 event. He asked about the experience of retail firms on August 24. **Lard** said the biggest issue he saw was around ETF dislocation. He said stop orders may have had an impact on the market, suggesting that the event was a result of a confluence of many issues. He said ETFs are a derivative and should be approached differently than other products.

Haynes asked what retail firms learned about the queuing up of orders ahead of the opening. **Billings** said the August 24 event was the result of multiple issues intersecting. He said firms are reexamining their opening processes and working to ensure that they are as efficient as possible.

Haynes said market orders and stop orders are frequently criticized order types. He asked if it would be practical to require overnight orders to have a limit, rather than just being straight market orders. **Standerfer** responded in the affirmative. He said these limits may be helpful in cases where market events lead to prices being different from what was expected. He suggested that protections should be implemented on a firm-by-firm basis, allowing sophisticated investors to opt-out if they desire. **Billings** said there would be some issues with changing the terms of orders, but that there should be discussions in this area.

Haynes asked about the use of stop orders and what can be done to prevent them from causing cascading market events. **Lard** said a degree of education is necessary to ensure clients understand how stop orders work. He suggested that stop orders should not be banned outright. He stressed the need to avoid making quick conclusions based on one market event.

Haynes asked about market data issues. **Billings** expressed support for improving transparency regarding market data. **Lard** said market data is an issue which EMSAC should examine and stressed that there should be a retail voice on the EMSAC. He said there is a conflict of interest in selling proprietary market data products and being the SRO in charge of the SIP.

Haynes said a significant portion of retail order flow is in the options market. He asked if the industry is focusing on options market structure. **Lard** noted that Section 31 transaction fees also apply to options. He suggested that options are sometimes forgotten as regulators focus on equity market structure and ETFs. He said there is a lack of understanding regarding ETFs, noting that they are derivatives. He stated that he would like to see more discussion on how the SIP can be improved. **Billings** said the options industry has spoken with Department of Labor regarding the fiduciary duty rule.