WILLIAMS & JENSEN, PLLC

Fr: Rebecca Konst

Re: Security Traders Association Annual Market Structure Conference – Day 3

Dt: October 2, 2015

Summary

On October 2, the Security Traders Association (STA) concluded its 82st Annual Market Structure Conference. Participants on the first panel focused on dark pools and the second panel focused on unbundling. Charlie Cook from the Cook Report spoke about the upcoming presidential election.

Panel: "Dark Pools: A new beginning or a return to the past?"
Moderator: **Adam Sussman**, Liquidnet

Panelists
Jatin Suryawanshi, Jefferies
Dave Weisberger, RegOne Solutions
Mehmet Kinak, T. Rowe Price
Venu Palaparthi, Virtu Financial

Discussion

Adam Sussman (Liquidnet) asked how many dark pools are in the U.S. equity markets. **Venu Palaparthi (Virtu Financial)** stated there are about 45 dark pools to which **Jatin Suryawanshi (Jefferies)** agreed. **Mehmet Kinak (T. Rowe Price)** stated the official count for ATS is 36. **Dave Weisberger (RegOne Solutions)** stated depending on the definition, there are around 70, a few hundred, or thousands. He stated if a dark pool is where information goes then every time the trade goes to a sales trader it is in the dark. He stated the issue with dark is it should never have been called dark. He suggested it should instead be called "quiet." **Weisberger** stated price transparency is an academic good.

Sussman stated there are some number of ATS and dark pools. He asked whether the execution on an ATS different from one on an exchange. **Kinak** stated when trafficking in dark pools they look for unique liquidity, trust, and the level of liquidity. He stated most dark pools have similar liquidity. He suggested if there is unique liquidity then the dark pool does not open it up. He stated there is no need to have 36 or thousands of pools. He suggested 15 would be a better number. **Suryawanshi** stated Jefferies looks at the quality of the fill, where they are getting a fill, and that the mean stays at the same level. He stated they look at the frequency of the lots and then they look at the quality of the liquidity. He explained they use that information to conduct the transaction. He stated 36 pools are not needed but there should be enough pools to provide liquidity. **Palaparthi** stated every venue is important. He stated Virtu tries to put the quote out across all dark pools. He stated they look at transparency, economics, performance, matching logic within the pool, and segmentation. He stated when there are 36 different pools they end up having to process a lot of information which leads to inefficiency. **Palaparthi** stated if things expand farther then they will have to reconsider whether they want to be in all of those places.

Sussman noted Commissioner Stein discussed the amount of off exchange transactions. He asked whether this is a fair criticism. **Weisberger** stated it is not. **Sussman** asked what the experience is that is different in dark than on exchange. **Weisberger** stated the rules in the market have really not changed much. He stated they are still based on the notion of humans and cherry picking. He stated in the early part of the last decade when matching engines were created it ended up morphing into dark pools. He suggested dark on the NYSE is actually less than it was back then. **Weisberger** stated Regulation NMS has no block exemption and the rule is such that instead of having one algorithm they have thousands of them.

Sussman asked whether they would change their structure if the rules allowed block exceptions. **Suryawanshi** stated what needs to be considered going forward is a dark pool execution exception. **Weisberger** stated these changes are not possible in this regulatory landscape.

Sussman pointed to reports over the "vagaries" in dark pools. He asked how T. Rowe Price is approaching some of these findings. **Kinak** stated they have been looking at this "forever." He stated at the very least those reports have started to help standardize the data. He suggested getting data is a "painstaking" process and it is not standardized. He stated a lot of the buy side will reap some benefit from this attempt at standardization. **Kinak** stated they have seen from the data some behavior which was not optimal for their execution. He noted he is not always so focused on the mid-point fill.

Sussman asked about linking fees within dark pools. **Palaparthi** stated he cares about latency but it is not a primary concern. He stated they too get "picked off" when a pool is using a feed that is not "synced up." **Palaparthi** suggested there is a wide disparity in the amount of time to get an action among the dark pools. **Sussman** asked whether they avoid those pools. **Palaparthi** stated they do not avoid them but they do track performance. He stated if there is any predictability then they account for that. He stated they do not like getting stale prices.

Sussman asked how Weisberger helps firms deal with these issues. **Weisberger** stated spread capture is important. He stated the buy side cares about liquidity and whether the fills are good. He stated there are multiple problems for how pools accomplish fills. He explained the real issue is how dark pools use the SIP. He stated this is a problem and all matching engines should have the best information from direct feeds. **Weisberger** stated markets are in equilibrium and generally makers lose to the takers. He suggested the issue is whether anyone should care. He explained in a locked market scenario it is hard to see the "foot prints", and by opting out, one is actually hurting oneself.

Sussman noted the talk on transparency. He asked what it would be if there were one piece of data to add to the FINRA ATS report. **Palaparthi** stated if the identity of the counterparty is important then they would support revealing identities of counterparties. **Suryawanshi** stated order types should be disclosed. He stated what would be important is knowing how many counterparties are co-located and the pricing structures. **Kinak** stated FINRA can add additional disclosures. He stated the size of market share for each pool would be "nice to know," or the block size, or how often executed at mid-point, or the number one counterparty for the pool. **Weisberger** suggested disclosing more data on what is fully hidden or on the reserve sizes. He stated rules 606 and 605 need to be updated.

Sussman stated that given the number of ATSs, it is "striking" the number of new entrants. **Kinak** stated he is not sure why there are new entrants. He suggested there should be more consolidation

rather than new entrants. He noted the only new entrant which is needed is the block cross entity Luminex. **Weisberger** stated that any good innovation started with people asking "why are you doing that?" He stated it will come down to value add.

Sussman asked whether people are excited about new entrants. **Suryawanshi** stated in general they are agnostic. He stated if it provides value they will connect to it. He stated the problem is there will always be some arbitrage. He explained anyone who has faster access to data will have an advantage. **Palaparthi** stated he supports and applauds innovation, and he would support more standardization.

Sussman asked whether there will there be more dark pools in three years. **Weisberger** stated there will be more. **Kinak** and **Suryawanshi** stated there will be less. **Palaparthi** stated there will never be an end to pools but many will consolidate.

Questions and Answers

A question was asked about Canadian style venues. **Suryawanshi** stated they are "grappling" with this. He stated there is no right answer yet for when to trade through those. **Suryawanshi** expressed concern it could lead to liquidity staying within pockets. **Kinak** stated it is a lot easier to trade in Canada in block than in the U.S. He stated the one issue is the use of the "anonymous." He stated he is unsure whether that would be helpful in the U.S. He explained the volume is displayed, but they might not know what pool it is taking place in. **Weisberger** stated more information is always good. He expressed concern that all market structure conversations are focused on large-cap issues. He stated Canada cannot be compared to the U.S. on "so many issues."

A question was asked if Luminex is a success, whether it will force the industry as a whole to get to the same point where they all distribute the same information. **Weisberger** stated there is momentum to get more standardized information, which is in the best interests of the firms. **Sussman** stated he is not certain what data is being requested that Luminex might provide. He stated it will be interesting to see what data Luminex gives out.

<u>Panel: "Unbundling: Value & Institutional Transparency"</u>

Panelists

David Choate, CAPIS
Joe Wald, Clearpool Group
Timothy O'Halloran, Westminster
Nanette Buziak, Voya Investment Management

Discussion

Timothy O'Halloran (Westminster) explained the timeline of how things got where they are today. He stated the big question is whether commissions will be available to pay for research in Europe. He stated in December of 2014, the European Securities and Markets Authority (ESMA) issued their draft advice which recommended that research payments should not be linked to the quality and volume of transactions. He stated they also suggested creation of research payment accounts. He added they also outlined some "onerous" budgeting requirements which were "walked back" quickly. **O'Halloran** stated research was seen as an inducement which led to a lot of controversy in the marketplace. He stated the Financial Conduct Authority (FCA) released guidance that stated commissions cannot be used for research at all. He noted in June a letter was provided by a member of Italy's Parliament that noted concerns over the clarity of this. **O'Halloran** noted a

letter from the International Organization of Securities Commissioners (IOSCO) stated they liked the process being used. **O'Halloran** noted a letter from Representative Dennis Ross (R-FL) suggesting this will harm Emerging Growth Companies (EGCs). **O'Halloran** stated in September, Germany, France and the UK wrote a letter noting concerns with the process and stating it will result in a ban on research. He explained on Monday, ESMA released their final technical advice which did not address research or inducements, although those are expected in November. **O'Halloran** stated there will be a period of review and laws that will go into effect in January 2017 when MIFID II goes into effect. He suggested the tenor has changed in relation with this and some are cautiously optimistic.

Nanette Buziak (Voya Investment Management) stated they have been monitoring this closely. She expressed concern over the repercussions in that global asset management firms will need to work out processes. She stated the SEC does not seem like they will re-examine Rule 28(e) of the Securities Exchange Act of 1934 so companies might have to comply with the European rules *de facto*. **Buziak** explained there will be more scrutiny going forward as the sell side will have to change their processes and the buy side will have to disclose what they pay for research and why. She expressed concern from a buy side perspective that boards will "push back" on the price of research.

O'Halloran asked whether Choate has heard any complaints. **David Choate (CAPIS)** stated the buy side is very concerned over this and the lack of transparency. He stated the concern of the client sponsor community is there. He noted the unintended consequences if the most dramatic version comes to pass. He stated if research has to be paid from cash from the investment management shop, it does not seem workable.

O'Halloran noted a big concern over the lack of research availability in the small- and mid-cap space. He stated the concern is that orphan companies will have a high beta and higher cost of capital so they will not grow. He stated if this is a rule rather than a directive then the jurisdictions cannot interpret it differently.

Joe Wald (Clearpool Group) stated this has been around for a decade. He stated the challenge is that ultimately there are the "haves and have nots" in terms of technology. He stated that led to looking for different ways to pay for that technology.

O'Halloran stated if MIFID II creates an "all cash market place" there is a risk of creating an oligopoly. He stated trading has changed and firms are transacting more commission sharing arrangements (CSA) to pay for research. He stated Greenwich points out that a majority of what the buy side is paying for is access and conferences. **Buziak** stated the CIOs across the asset management firms are going to need to address this. She suggested portfolio managers are still living in the 1990s and think everything is free. She stated the portfolio managers and analysts have to consider their value and not give information for free. She stated there will have to be a "re-education" about what is important, corporate access or research. **Buziak** stated there could be a change in the research model in terms of the names that are covered.

O'Halloran stated one concern is that buy side were "careless" with their commissions; however, he suggested that there is not carelessness in the marketplace. He stated the average client of every brokerage firm is concerned with optimizing their commission flows and there is a movement towards different brokerage tools. He suggested there should be a movement to better brokerage voting tracking. **Choate** stated the buy side is not agnostic and the budgeting process is tight. He

stated third party research is easy because it has a price. He stated where more scrutiny may come in analyst meetings and corporate access. **Choate** suggested the question about the ability to pay research with commissions is unanswered. **O'Halloran** stated there are a number of possibilities, namely remove the clause to deal with it later, amend it to reflect that commissions are important, or issue it as a directive so jurisdictions can interpret it differently. He expressed hope that change to a complex system should come incrementally and suggested moving to an all cash market would be damaging. **Wald** asked whether this is the right question. He stated this movement started out very differently than where it is now. He stated the ultimate goal of transparency is not being served by this. **O'Halloran** stated the U.S. model seems to be the right model. He noted the SEC created a safe harbor and has taken a measured approach to review this periodically. He stated unbundling is becoming more the norm in the U.S. as research has evolved.

O'Halloran asked whether there is sometimes too much research. **Buziak** stated portfolio managers and analysts have a lot "coming at them." She stated they have embraced CSAs and the challenge is making payments and aggregating them. She explained the unbundling of research from sell side is like the *a la carte* options for cable. She stated this is evolving quickly and she does not see the "bus turning around." **Buziak** suggested the industry needs to be focused on what comes out in the next few months and issuing comments.

O'Halloran stated there is a lack of understanding about the economics of the business. He explained that investment managers need discretion to put in the processes to perform. He stated there is no right mix of third party versus proprietary research. He noted the SEC has acknowledged that independent and proprietary research is on a level playing field. **O'Halloran** stated there is still an information gap between the industry and regulators. He stated the system is starting to become more unbundled, and the buy side is setting the prices anyways.

O'Halloran asked whether brokers understand unbundling better. **Choate** stated the term "soft dollar" was focused on third party research only. He stated that definition is widely used in the industry. He stated there is still a lot of confusion in the marketplace.

O'Halloran noted the concerns that an all cash market would put brokers in violation of the Investment Act of 1940. He stated U.S. brokers could lose the commission stream from foreign companies and that global managers will have difficulties navigating two regulatory environments. **Buziak** stated this is a grey area. She stated there are questions whether her firm will *de facto* fall under this. She asked whether they will fall under these rules if they manage a London pension plan. She stated it is not always clear where the companies are based.

O'Halloran asked whether there is a technology solution. **Wald** stated this will spur technology. He stated from a technology standpoint there will be solutions but the question will be what they are trying to solve. **O'Halloran** stated the industry wants transparency and competition.

Questions and Answers

In response to a question, **Buziak** stated the industry tends to give resources without being paid for it. She applauded efforts to better track what fund companies actually value.

A question was asked how other services will be impacted. **O'Halloran** stated there is ability to pay for research and/or brokerage. He stated that whether it is strategy or fundamentally driven, "it is all over the map." He stated new research crops up every day. He suggested in the U.S. there is a

process that recognizes there is not a proscriptive list of what research is, but a more flexible approach that can change over time. **Buziak** stated it is important if the resource is value added.

A question was asked about different views on how commissions can be used and what clients should do to prepare themselves. **O'Halloran** stated there is no answer yet to what MiFID II will look like. He stated he has not heard that the SEC has any desire to change their rule. He stated it is the global advisers that will be impacted. **Choate** stated global advisers already have differing commission structures depending on domicile. **O'Halloran** stated some have already suggested they will simply pay cash, which does not help asset owners.

Speaker: Charlie Cook, Editor and Publisher, The Cook Report

Charlie Cook (The Cook Report) stated this is one of the "weirder" election cycles that have been seen. He some things explaining the oddities include: ideology; populism; and fear of the future. He stated the Democratic Party is more liberal than even when Clinton was President, and the Republicans are moving more to the right. He noted there used to be a substantial ideological overlap between the parties but now that overlap is gone. **Cook** stated those that overlapped tended to be the "glue" that made the political process work. **Cook** noted many Americans do not see the nation as being in a recovery, and the public is very nervous about the economy which is creating "turmoil." He explained these concerns have led to a rise in populism that is creating divisions within the parties. He stated there is also a fear of the future. He explained there is a segment of voters that feels "deeply threatened" by the changes in society. He noted that when asked, Democrats support a president promoting progress and Republicans support protecting "what made America great." **Cook** stated there is a real frustration and anger that is "spilling" into candidate selection.

Cook stated Bernie Sanders is not Hillary Clinton's problem. He suggested he cannot beat Hillary Clinton. He stated the only person who can beat Clinton is Clinton. He stated neither party will nominate someone older than Reagan when he was elected. **Cook** stated Sanders has served 23 years in the Congress and has not impacted legislation. He stated there will always be a certain percentage of voters that support the "outlier/anti-establishment" candidate. **Cook** suggested Hillary Clinton's ratings drop is in part due to some statements she has made and the e-mail story. He stated there is about a 75 percent chance that the email issue remains a political issue that "zaps" the strength of the campaign into early next year and a 25 percent chance this goes legal which would be a bigger issue. He suggested the only other candidate that could take advantage of Clinton's plight is Martin O'Malley. **Cook** noted there has been a lot of speculation over Joe Biden running for president; however, he suggested the "emotional turmoil" over the death of Biden's son is a big factor. He suggested for "better or worse" Clinton seems to be the candidate for the Democrats.

Cook stated on the Republican side a view developed that Governors have a better mindset for being President. He stated the Republican Party tends to have two sides: the traditional side and the more "exotic" side. He stated for the conventional side many would have figured Jeb Bush would have locked up the nomination. He explained that is still possible but it is not going as well for him. **Cook** suggested that Bush might be "appalled" at what is going on in the party which is why he has sort of "fallen off." In terms of Senator Marco Rubio, **Cook** suggested he has not been as visible as needed and has not had enough fund raising. For Governor John Kasich, **Cook** stated he is closer to the true center but he is too unfocused which gets in the way. For the "exotic" side, **Cook** stated Donald Trump is winning that side. He stated Trump is tapping into the "anger" against career

politicians. He suggested there is a limit to which this approach can be used before people start getting alienated. **Cook** suggested Ben Carson does not have enough "content." He stated that leaves Carly Fiorina and Ted Cruz. He stated Carly Fiorina is very smart and is a quick study. He stated the potential problem for her is how her background is couched: corporate victim; or failure. Cook suggested Ted Cruz will dominate this "exotic" side. He stated Cruz has positioned himself to inherit those supporting Trump and Carson right now.

Cook stated in the general election there are two forces: time for change versus demographic change. He stated the Republican Party is not changing with the demographics of the nation. He stated Republicans are doing so poorly with minorities that they cannot win. He suggested who each side nominates really does matter going forward. He stated the key states are largely the same as last time. He stated $896 million was spent on TV ads for the last election and $84 million was spent in 7 states. **Cook** explained in the Senate, Democrats need a 4 seat gain to win the majority and five if they do not keep the White House. He stated there are 24 Republican seats up for election and 7 are in states that President Obama carried.

Questions and Answers

A question was asked whether the demographic issues make Bush more electable. **Cook** stated there are a lot of moving parts and ways to look at this. He stated Bush is fluent in Spanish and married to someone born in Mexico which is helpful. He stated Rubio "skews" young and has that ethnic "card" as well. **Cook** stated Kasich/Rubio would be the strongest ticket for the minorities.