MEMORANDUM

TO: Equity Market Structure Advisory Committee (EMSAC)

FROM: EMSAC Regulation NMS Subcommittee

DATE: April 3**,** 2017

SUBJECT: Framework for Rule 611 & 610 Discussion

Introduction – Current Market Issues

The adoption of Regulation NMS had a significant impact on the U.S. equity markets – leading to greater automation, improving access to quotations and improving connectivity between markets. However, the trade-through and locked and crossed market provision of NMS were highly controversial in their adoption, and the industry largely remains divided in its view on both the success and the continued need for these rules. Given the complexity of Regulation NMS, while observations can be made, the industry (and we) has struggled to produce conclusive evidence that would drive a clear or compelling future direction.

Critics of the Regulation NMS trade-through and locked and crossed market rules primarily highlight (i) the complexity of our marketplace, including fragmentation and the proliferation of order types designed to aid in compliance, (ii) the burden of NMS compliance, (iii) the limited evidence that NMS has succeeded in its mission to encourage the display of limit orders, and (iv) the relatively homogenized form that venue competition has undertaken.

Supporters of Regulation NMS highlight (i) the difficulty in quantifying either a defined "problem" or measures of success, (ii) the "backstop" protection to displayed limit orders, especially to retail, and (iii) the additional compliance burden that would fall on the industry from its removal.

Both sides of the argument have merit, and cannot be quantitatively resolved in a definitive way. The purpose of this memo is to outline a framework for a potential pilot, should the SEC choose to prioritize such an initiative, which could gather data for a quantitative assessment of the impact and effectiveness of Regulation NMS. In particular, we look to expand on some of the efforts previously proposed by EMSAC's "Access Fee Pilot," and broaden consideration to the other interrelated components of Regulation NMS.

Strawman for a Potential Pilot Recommendation

1. A pilot to repeal Rule 611 for all NMS stocks; in this case the pilot structure is specifically meant to both facilitate measurement and an ability to reinstitute 611 for unexpected, unintended consequences. Note that because we believe the behavioral impact of a 611 repeal would not be effectively measured with security control groups, our discussion of a pilot in this context is meant to be a market-wide pilot. This is in contrast to EMSAC's

previously suggested Access Fee Pilot, which recommends security-specific pilot groups and a control group.

2. A pilot could also remove the Rule 610 prohibition on locked/crossed markets, but only if there is a removal of rebates and/or a lower access fee cap (as outlined in the Access Fee Pilot) in order to restrict the rebate-centric behavior that led to the implementation of the original prohibition. Possible alternatives are for a:

    1. 611 pilot <u>without</u> removal of the locked/crossed prohibition.

    2. 611 pilot <u>with</u> removal of the prohibition on locked/crossed markets, but (i) subsequent to the Access Fee Pilot, and (ii) instituting a $.0002 (or less, or no rebate) access fee cap, subject to conclusions from the Access Fee Pilot.

    3. 611 pilot <u>with</u> removal of the prohibition on locked/crossed markets, <u>simultaneous</u> to an Access Fee Pilot but with a $.0002 (or less, or no rebate) access fee cap. Note that this configuration would change two significant variables simultaneously, which may impact data measurement efficacy.

    4. *Note that for 2. and 3. above, ensuring that both the rebate and access fees are addressed is essential in ensuring that there is no economic motivation to lock/cross the market.*

3. No immediate change on tick sizes, but a more graduated regime can be a future project.

4. Enhanced best execution guidance is needed for execution and routing activities, understanding that much of the burden would fall on retail firms who would have to enhance their current monitoring procedures.

    1. More routing disclosure requirements would help firms to assess best execution performance in instances where such routing is performed on their behalf.

<u>Goals</u>

1. Reduce excess complexity in the marketplace - as demonstrated by venue fragmentation, order types and routing complexity - as a means of reducing operational complexity in the marketplace.

2. Test hypothesis that Rule 611 has not created an incentive for posting visible liquidity.

3. Should removal of Rule 611 result in at least status quo market quality, but without the burden of trade-through maintenance, this would be positive for the marketplace in reducing trading frictions.

4. Open the markets to competition and innovation over a longer time horizon, which is currently constrained due to the proscriptive nature of Regulation NMS.

Other Concepts Considered:

1. Trade-at
2. Block exemption
3. Do nothing
4. Minimum market share requirements for protected quote status
5. Pass-through of rates to investor as a specific way to address the conflict of rebates

Supporting Arguments/Evidence for Removal:

1. Using the Nasdaq market as a proxy, NMS did not seem to succeed in its mission to increase the display of limit orders in the marketplace. We have seen an increase in dark liquidity, smaller trade sizes, similar trading volumes, and a larger number of "small" venues.

2. We have seen a de minimis benefit from decreased trade-through rates, coupled with a relatively high cost of trade-through compliance. There has been a meaningful contribution to the creation of new venues, complex order types, and a need to focus on speed and other market complexities as a requirement to manage queue priority.

3. From a fairness/open access standpoint, setting the NBBO in active stocks without sophisticated use of "price-sliding" order types and ISOs is difficult for non-HFT firms that aren't trading proprietarily.

4. While there has been an increase in the number of market centers, nearly all of them are owned by three large exchange groups. Competition post-NMS is significant, but is largely along the dimensions of pricing and speed. Differentiated market structures have failed to gain significant traction.

5. The world has changed through the advances of technology, the conversion of manual markets, increased connectivity, innovation such as through inverted venues, and more advanced execution quality monitoring. Observing other non-Equity and non-US markets, we do not believe that these advances would revert without Rule 611.

Arguments Against Removal:

1. There is a concern, especially for individual investors, about removing the best execution "back-stop" of a trade-through rule. Especially when Rule 611 has served as one of the few examples of an explicit best execution rule.

    a. However, we believe that if 611 is intended to be a best execution rule, it is too prescriptive. Concerns about best execution would more effectively be addressed through enhanced guidance and procedures.

2. Similarly, there is concern that individual investors non-marketable orders will lose trade-through protection.

3. A concern as to the amount of effort that could be required to further monitor order routing behavior by agents. Many buy-side participants advocate that without the removal of the conflict of rebates, this is not a manageable requirement.

4. Many (including this Subcommittee) have highlighted the risk of continuous pilots. Understanding this introduces a significant delay, we would advocate that a Rule 611 pilot should be sequenced after Tick Pilot and any potential Access Fee Pilot and not be run concurrently. We would also offer that revocation of Rule 611 WITHOUT a pilot would be contrary to running a data-driven exercise, which has been an underlying premise for any significant permanent market structure change that is advocated.