MEMORANDUM

TO: Equity Market Structure Advisory Committee (EMSAC)

FROM: EMSAC Customer Issues Subcommittee

DATE: July 25**,** 2016

SUBJECT: Recommendations Relating to Customer Issues

The Customer Issues Subcommittee was formed to consider initiatives to protect investor interests and promote investor confidence. The Subcommittee is charged with making recommendations to the full Committee that would support more granular information to investors and enhance transparency. Topics include issues around meaningful execution quality and review of order routing disclosures (Rules 605 and 606), payment for order flow, as well as processes to educate retail customers on order types and market volatility.

The primary focus of the Customer Issues Subcommittee has revolved around four topics: (1) understanding the retail investor perspective on equity market structure, (2) use of stop order types by retail customers, (3) review of execution quality statistics from a retail perspective, and (4) payment for order flow.

We note that with respect to the use of stop orders, FINRA has already issued Regulatory Notice 16-19 relating to the use of stop orders in periods of extreme market volatility. The guidance provided is consistent with the Subcommittee's recommendations presented in the April 2016 Customer Issues Subcommittee Status Report. With respect to payment for order flow, the subcommittee has not come to any specific recommendations. Discussions spanned several topics including prohibiting the use of payment for order flow, managing conflicts of interest and opportunities for enhancing existing or requiring new disclosures. The subcommittee notes that the Commission has recently released a proposal on order handling disclosures including new disclosures related to payment for order flow. The subcommittee believes comment on these disclosures is appropriate.

As part of its deliberations, the Subcommittee considered input from market participants including retail broker dealers, industry groups and members of the SEC's Investor Advisory Committee. Statistical information reviewed by the subcommittee demonstrates that retail execution quality has improved over the last several years. While the Commission's recent order handling proposal recognizes the need to modernize Rule 606 disclosures in light of changes to market structure, the Subcommittee recommends additional modifications to Rule 605 and Rule 606 related to retail order flow as outlined below. [1] Additionally, the subcommittee recommends that the Commission perform surveys in order to benchmark and monitor investor confidence as described below.

Recommendation #1 – Benchmark and monitor investor confidence in U.S. equities market structure.

- The SEC should always have an informed and current view of the state of individual investor confidence in our equity markets. The SEC should periodically sponsor or conduct surveys of individual investors to establish benchmarks and trends over time for investor confidence in the U.S. equities markets.
- Existing academic and industry studies on confidence, stock market participation levels and investor trust in the markets should inform the SEC's view. Partnerships and coordination of efforts to extend and enhance the knowledge of these issues should be considered and undertaken.
- The SEC should use the survey information and other indications to examine views on market structure, disclosures and volatility and the implications of these views on investor behavior, asset allocation decisions, readiness for retirement, and perceptions on the advisability of and risk associated with investing in equities.
- Results of the surveys and the SEC's understanding of individual investor perceptions and behaviors should be used to inform rule-making and educational efforts. Testing the usability, clarity, and effectiveness of disclosures on a representative sample of individual investors, including those recommended below, should be undertaken prior to implementation and revised in response to the testing results. In addition, disclosures or investor educational materials to improve investors' understanding of different business models and market structure should also be tested and revised if needed.

Recommendation #2 – Modify Rule 605 and Rule 606 to provide meaningful execution quality and order handling disclosures from a retail perspective.

- Improve the accessibility of Rule 605 and 606 reports
  - Leverage the SEC's existing Market Structure Data and Analysis website as a central repository Rule 605 and 606 reports.
  - Incorporate Rule 605 and 606 data into the SEC's Data Visualization Tool.

- Expand the scope of Rule 605 by requiring every broker-dealer to report with an exemption for broker dealers with de minimis order flow, aligning scope of Rule 605 reporting with Rule 606.
  - Today, Rule 605 requires market centers[2] to publish reports. Broker-dealers who route order flow to other execution venues only produce Rule 606 reports.

[1] Recommendations will be updated to reflect the SEC's recently issued proposal on order handling disclosures after the Subcommittee reviews the proposal.

    - While there would be compliance and implementation costs, the use of third party vendors may mitigate some of these concerns.
    - By having all broker dealers provide Rule 605 data, there would be an opportunity for market participants, academics and the press to evaluate these statistics in a consistent manner.

  - To further improve standardization and the consistency of reporting, the SEC could consider centralizing report creation in an unbiased and trusted source such as FINRA.

  - For market data driven calculations in Rule 605 and Rule 606, require that calculations to be based on either SIP or proprietary feeds depending on what feeds were used for routing and execution. Include disclosure identifying type of market data used in report.

  - Modify Rule 605 to reflect changes in market structure since the rule was initially adopted:
    - Include odd-lots
    - Segregate Immediate or Cancel (IOC) orders
    - Include the following new data elements: "quoted spread[3]" and "enhanced liquidity[4]"
    - Expand execution time buckets to include more granular measurements including: less than 50 milliseconds, 50 milliseconds – 500 milliseconds; 500 milliseconds to 1 second
    - Revise FAQs regarding methodology to assign an NBBO for orders received in the same second as a quote change such that all firms reference the NBBO from the closest millisecond prior to the receipt of a covered order.

- Expand the scope of Rule 606 reporters to include exchanges and ATSs that route orders.

- Modify Rule 606 enhancements to reflect changes in market structure since the rule was initially adopted:
    - Instead of dividing data by listing markets, divide by S&P 500 and Other NMS equities
    - Include a new section for OTC Equity Data
    - Segregate data currently in the "Other" category with separate columns for market open/close orders and stop/stop on quote orders. Based on order attributes, odd lots would fall into the market, limit, market open/close, stop/stop on quote, or other category

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[2] As defined by Regulation NMS, market center means any exchange market maker, OTC market maker, alternative trading system, national securities exchange, or national securities association.
[3] Quoted spread would be the prevailing National Best Bid or Offer ("NBBO") at the time a market center receives an order.
[4] Enhanced Liquidity would indicate for the proportion of shares greater than the available shares displayed at NBBO that were executed at or better than the NBBO.

- Segregate marketable limit orders from non-marketable limit orders
- Consistently identify routing destinations across Rule 606 reporters
- Include plain English descriptions, definitions and FAQs
- Include execution quality statistics by routing destination, e.g., effective spread /quoted spread.