

Treasury Chimes in on Equity Market Structure

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The Treasury Department's recent [report](#) on capital markets regulation includes a robust discussion of equity market structure issues. The report does not break new ground or raise issues that have not been debated previously at length, including by the SEC's [Equity Market Structure Advisory Committee](#) ("EMSAC"). That said, the report adds the Treasury's influential voice to the dialogue, and may further spur the SEC to take action on some issues. Reflecting the difficulty of reaching consensus on such complex matters, however, many of Treasury's comments on market structure appear tentative—such as suggestions that the SEC study an issue, consider an action, or finalize a proposed rule or other action that SEC officials have already publicly noted the agency plans to take.

Below, we highlight a number of the topics addressed by Treasury, followed by our comments.

Consolidating Liquidity for Less Liquid Stocks. While competition among trading venues has resulted in lower transaction costs, the fragmentation of liquidity among multiple trading venues may make it more difficult to trade less-liquid stocks without significant market impact. In order to consolidate trading to fewer venues, which Treasury believes would increase available liquidity, the report recommends that issuers of less-liquid stocks be permitted to partially or fully suspend unlisted trading privileges (known as "UTP"), thereby limiting the ability of exchanges other than the listing market to offer trading in a stock.

- *As with a number of Treasury's recommendations, this indicates a concern about how market structure may more broadly contribute to the challenges facing smaller companies – rather than simply how market structure impacts trading and investment activities. One risk of allowing issuers to decide whether to suspend UTP is that it could disadvantage smaller, non-listing markets.*

Dynamic Tick Sizes. Treasury recommends that the SEC evaluate allowing issuers, in consultation with their listing exchange, to determine the tick size for trading in their stocks (i.e., the minimum price increment for trading of the stock on all exchanges) in order to improve liquidity, particularly for smaller cap stocks which would have larger tick sizes.

- *We would expect the SEC to wait until it has completed its analysis of the existing [Tick Size Pilot](#) before taking any further action in this area. There has been skepticism in the brokerage industry regarding whether wider tick sizes actually increase liquidity, and in [recent testimony](#) to the Senate Banking Committee, SEC Chairman Jay Clayton characterized the preliminary analysis of the Tick Size Pilot's impact on market quality as "mixed." As with the ability to suspend UTP on a stock-by-stock basis, dynamic tick sizes selected (and potentially changed) by issuers would likely also present implementation hurdles for brokers and exchanges.*

Maker/Taker and Payment for Order Flow. Treasury expressed concerns about the conflicts of interest that arise both from maker-taker arrangements—where a venue charges a fee to broker-dealer members who execute trades that "take" displayed quotations while paying rebates to broker-dealer members who "make" liquidity by posting those displayed quotations—and from payment for order flow arrangements where a broker-dealer may receive a payment for routing orders to a particular venue or market maker. While Treasury makes a number of recommendations noted below, it cautions that to avoid harming liquidity for less-liquid stocks, the SEC should exempt less-liquid stocks from any potential restrictions on maker-taker rebates and payment for order flow.

- *We note that these are age-old issues. The SEC has traditionally chosen to address the conflicts of interest that are inherent in these practices through disclosure, such as the payment for order flow disclosures required on Rule 10b-10 transaction confirmations and the order routing disclosures required by Rule 606 of Regulation NMS.*

- **Enhanced Disclosures.** The report recommends that the SEC adopt its 2016 proposal to require new and enhanced order handling disclosures, which would require broker-dealers to provide customers with specific disclosure related routing and execution of their orders, such as the net aggregate amount of any payment for order flow received, and payment from any profit-sharing relationship received.
 - The [enhanced disclosures](#) that the SEC proposed in 2016 have received very broad support and are not controversial. Chairman Clayton recently indicated in his Senate Banking Committee [testimony](#) that he supports the proposed rules and has asked the SEC staff to prepare a final rulemaking.
- **Access Fee Pilot.** Treasury supports a pilot program to study the impact that reducing access fees—the fees charged to “takers” that primarily support the rebates paid to “makers”—would have on investors’ execution costs or available liquidity. If a pilot program shows that reducing access fees does not have a materially negative impact on market quality, the SEC should consider restricting the use of rebates and payment for order flow arrangements.
 - *An Access Fee Pilot already has broad support. It was [recommended](#) by the EMSAC and appears on the SEC’s [regulatory agenda](#). Chairman Clayton also noted his support for an Access Fee Pilot in his Senate Banking Committee [testimony](#) and indicated that he expects the SEC to consider a proposal in the near future. Of course, reducing access fees would reduce the funds available to exchanges to pay rebates to “makers,” potentially reducing their incentive to provide liquidity. This would upend the business models of a number of the exchanges that rely upon market/taker programs to attract trading.*
- **Further Payment for Order Flow Restrictions.** Treasury also recommended that the SEC “consider” requiring broker-dealers acting as agents to refund rebates and payments for order flow to their customers.
 - *The possibility of requiring a refund of rebates to customers or restricting rebates and payments for order flow is likely the most controversial market structure proposal, as many business models, such as discount brokerage, are in part supported by the revenue stream from payments for order flow. The SEC has considered this issue for decades and declined to take action. Among other concerns is that payment for order flow could not be restricted without also addressing internalization practices, which reduce transaction costs. Also, refunds of rebates and payments for order flow would create significant operational challenges.*

Market Data. Treasury noted concerns regarding the high cost of proprietary market data of the exchanges, and the differences in quality between proprietary feeds and the less comprehensive and slower consolidated Securities Information Processor (“SIP”) feeds.

- **Best Execution Guidance.** Noting that many broker-dealers believe they are compelled to purchase each exchange’s proprietary data feeds in order to ensure that they obtain best execution for customers, the report recommends that the SEC and FINRA issue guidance or rules clarifying that broker-dealers can satisfy the best execution obligations by relying solely on SIP data, if they do not otherwise subscribe to or use proprietary data feeds.
 - *We believe the SEC and FINRA will not find the need for further clarity particularly compelling. FINRA provided [guidance](#) substantially as Treasury now requests as recently as 2015, stating that “a firm that regularly accesses proprietary data feeds, in addition to the consolidated SIP feed, for its proprietary trading, would be expected to also be using these data feeds to determine the best market under prevailing market conditions when handling customer orders to meet its best execution obligations.”*
- **Exchange Fees for Market Data.** Treasury stated its view that “the market for proprietary data feeds is not fully competitive,” and therefore recommended that the SEC affirmatively scrutinize whether the fees that exchanges charge for their proprietary market data are fair and reasonable, non-discriminatory, and equitably allocated, as required under the Exchange Act.
 - *It is somewhat surprising that the Treasury expressed a view on the extent to which the market for proprietary market data is competitive, in light of the decade-long NetCoalition litigation on this issue (background on the case is available [here](#)) and the fact that the matter is currently being considered by the SEC on review of an [SEC ALJ decision](#) to the contrary. The ALJ decision found that the exchanges have shown their market data*

fees are constrained by competitive forces. While broker-dealers and their trade association likely will celebrate Treasury's support for their position, exchanges are likely to be concerned.

- Pending final adjudication on the NetCoalition matter, we would not expect the SEC to engage in a closer review of exchanges' market data fees. Exchange fee filings are generally filed with the SEC in reliance upon a rule that permits them to become automatically effective without formal SEC approval. If the SEC were to instead undertake to review and affirmatively approve these filings, a recent [D.C. Circuit decision](#) indicates that the SEC would be required to meet a high burden to justify its approval.

- **Competing Consolidators.** Treasury recommends that the SEC consider amending Regulation NMS as necessary to allow for competing consolidators—new market entrants that would ingest all the exchange data feeds consolidate them, and compete with the SIPs to provide the public with consolidated market data.
 - The competing consolidator concept is not new, having been recommended in the Report on the Advisory Committee on Market Information in 2001 (the “Seligman Report”) and again by some commenters in connection with Regulation NMS. While facilitating competition to the SIPs has regained some support as the divide has increased between the SIPs and the proprietary exchange feeds, recent improvements to the SIPs and the focus on changes to SIP governance may supersede this recommendation.
 - Also, having competing consolidators could be difficult from an operational point of view as latencies could introduce anomalies. Also, given the significance of market data fees for both exchanges and brokers, it is unclear how the multiple consolidator model could produce a better (or even neutral) economic outcome for the exchanges and brokerage business.

Order Protection Rule. A frequently expressed concern regarding the Order Protection Rule is that it may encourage the proliferation of markets by essentially requiring brokers to connect to every venue to enable them to access the best quotes, regardless of whether the venue generally has meaningful liquidity or frequently offers the best prices. Treasury suggests that the SEC amend the Order Protection Rule and give protected quote status only to exchanges that meet certain liquidity thresholds and offer opportunities for price improvement and only if the cost of connecting to the market offsets the burdens on the market. To avoid creating barriers to entry, Treasury suggests that orders on new exchanges have protected status for some period of time before being required to meet the minimum thresholds.

- To the extent that Treasury is concerned about the costs of linking to each market, requiring that brokers link to every new exchange for at least some period of time would not seem to address this concern. In addition, although Treasury notes that a minimum volume test could inhibit competition, its proposed solution of providing some initial time to reach the threshold would only address new entrants. Exchanges that fail to meet the threshold within the allocated timeframe and lose protected quote status could find it difficult compete through innovation and attract new market share. Like the dynamic tick size and UTP suspension recommendations, this recommendation could disadvantage smaller, non-listing markets.

Order Types. Treasury is concerned that the proliferation of order types has contributed to market complexity. As a result, it recommends that the SEC review whether exchanges and ATSs should “harmonize their order types,” and whether particular order types “sustain sufficient volume” to merit continuation.

- We find this recommendation surprising, as the Treasury report generally seeks reforms that are “guided by free-market principles,” and the SEC approved the order types as exchange rules. While market complexity is a legitimate concern, market venues compete with one another by offering different and in some cases innovative order types. It is not clear that the SEC will act on this recommendation.

Regulation ATS. Treasury voiced concern with the opaque nature of some ATS operations, particularly as compared to exchanges. As a result, Treasury recommended that the SEC adopt the amendments to Regulation ATS that the SEC [proposed](#)

in late 2015 “substantially as proposed,” but also paring back some of the proposed disclosure obligations where the information “is unnecessary and unhelpful to investors deciding where to send their orders” and modified so as to simplify the disclosures to reduce the compliance burden for ATSs.

- As with other pending rules that the Treasury supports, Chairman Clayton has likewise [previously indicated](#) his support for the proposed rule and his expectation that the SEC will move toward adoption. While supporting the rules, Treasury's recommendation takes somewhat inconsistent positions, first suggesting that the SEC adopt the rule “substantially as proposed,” before implying that, as proposed, the rule would require the unnecessary disclosure of confidential information, in an unnecessarily complex manner, and impose an undue compliance burden.

Although the Treasury has no formal role in setting the SEC's agenda, we expect that the SEC will consider seriously Treasury's views in formulating its plans for market structure reform.

Law Clerk Brooklynn Moore contributed to this post.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

Annette L. Nazareth

+1 202 962 7075

annette.nazareth@davispolk.com

Zachary J. Zweihorn

+1 202 962 7136

zachary.zweihorn@davispolk.com

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