

MEMO# 31660

March 15, 2019

SEC Outlines Equity Market Structure Priorities for 2019

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TO: Equity Markets Advisory Committee RE: SEC Outlines Equity Market Structure Priorities for 2019

SEC Chairman Jay Clayton and Brett Redfearn, Director of the Division of Trading and Markets, addressed the SEC's equity market structure agenda in a speech on March 8, 2019. The speech described the principles that guide the Commission's approach to equity market regulation, summarized three equity market structure initiatives that the Commission completed in 2018, and laid out three areas of potential equity market structure reform that the SEC will focus on in 2019: (1) thinly-traded securities; (2) market access and market data; and (3) efforts to combat retail fraud. A copy of the speech is available on the SEC's website.[\[1\]](#)

Key Principles Guiding the SEC's Market Structure Agenda

Chairman Clayton explained that the Commission's approach to each topic—as well as other market structure matters—is guided by the following five principles:

1. Maintaining fidelity to the SEC's mission to protect investors, to maintain fair, orderly, and efficient markets, and to facilitate capital formation;
2. Focusing on the long-term interests of Main Street investors;
3. Facilitating transparency that can energize competitive forces to benefit investors;
4. Reviewing Commission rules to assess whether they are functioning as intended, particularly as technology spurs new market mechanisms and trading practices; and
5. Coordinating and communicating with other regulators and stakeholders in the markets that the SEC oversees.

Equity Market Structure Initiatives Adopted in 2018

Chairman Clayton reviewed the three equity market structure rules the SEC adopted in 2018: (1) amendments to Regulation NMS concerning alternative trading systems (ATSs) that trade exchange-listed equity securities; (2) amendments to Rule 606 under Regulation NMS requiring greater transparency of broker-dealer order handling practices; and (3)

adoption of Rule 610T of Regulation NMS which establishes a transaction fee pilot program.^[2]

Director Redfearn provided an update on how these three rules will impact equity market structure. He explained that each ATS that facilitates trading in listed equity securities filed a new initial form ATS-N, which provides a much greater level of detail on the ATSs than was previously available. Those ATS-N forms will be made public later in 2019 and, for some of the ATSs, will mark the first time information about their operations will be fully public. Increased disclosure concerning broker order routing and payment for order flow arrangements will provide market participants with more information that should ultimately help them assess how well brokers are complying with best execution requirements. Lastly, the transaction fee pilot should help the Commission better understand how exchange transaction pricing structures affect equity market quality.

Equity Market Structure Agenda for 2019

Chairman Clayton emphasized the “monumental transformation” of US equity markets over the last decade due to advancements in technology. He noted that the US regulatory framework must evolve alongside these developments in technology as applied to financial markets. The Chairman suggested that the Commission should reassess Regulation NMS and the meaning of “best execution” in today’s marketplace. Chairman Clayton stated that there are many areas of Regulation NMS that the Commission “got right,” some that “may have missed their mark,” and some that were “positive in 2005 but may no longer be so.” He noted that it is possible that “[s]ome of the challenges we face today may . . . be consequences of Regulation NMS and other rules” considering that today’s market is very different from when Regulation NMS was adopted in 2005. Chairman Clayton and Director Redfearn outlined three areas for potential reform in 2019 and beyond: (1) thinly-traded securities; (2) market data and market access; and (3) combatting retail fraud.

Thinly-Traded Securities

Chairman Clayton expressed concern that the one-size-fits-all nature of equity market structure regulation works better for liquid securities than for illiquid ones. He has asked the SEC’s Division of Trading and Markets to recommend steps that could improve market structure for illiquid securities.

Director Redfearn noted that compared to actively traded securities, securities with lower trading volumes have wider spreads, less displayed size, and higher transaction costs for investors. He also stated that the lack of liquidity is apparent in the difficulties faced by institutional investors attempting to trade in the large quantities needed to make investing in a smaller company worth their efforts. Furthermore, illiquidity tends to be self-reinforcing because investors may be deterred from purchasing a stock in the first place if they know there are higher implementation costs involved in accumulating a position.

Director Redfearn explained that his staff is considering whether to recommend that the Commission publish a policy statement on this topic, addressing possible innovative market structure solutions such as periodic auctions or manual market-making. The staff also is evaluating whether changes to unlisted trading privileges could improve market quality for thinly-traded securities by aggregating liquidity in one location.

Market Data and Market Access

Chairman Clayton and Director Redfearn addressed the bifurcated system of market data and market access in the US equity markets, specifically: (1) the “core data” that is

distributed through consolidated public data feeds (known as “securities information processors” or “SIPs”) operated pursuant to national market system plans jointly administered by the exchanges and FINRA and (2) an array of proprietary data products and access services that the exchanges and other providers sell to the marketplace. They stated that the latter are usually faster, provide more detailed information, and cost more than the data available through SIPs. Chairman Clayton stated that the SEC should explore whether core data needs to be upgraded to better meet the needs of investors and market participants in today’s modern markets. Director Redfearn identified seven areas that the staff intends to explore:

1. **Speed.** There are growing concerns among market participants about latency differentials between SIPs and the direct feeds. Staff will consider whether to recommend changes to ensure that core data is timely by today’s standards.
2. **Content.** For stocks priced over \$500, an odd-lot quote is the best bid, best offer, or both approximately 75% of the day, compared to approximately 5% of the day for stocks priced under \$100. Staff will explore whether the round lot size of more expensive securities should be adjusted and whether odd lot information should be included in core data generally.
3. **Order Protection and Best Execution.** Staff will consider whether a best execution-based approach is the optimal way to proceed vis-à-vis odd lot displayed liquidity as opposed to the current order protection requirements of Regulation NMS.
4. **Depth.** Staff will examine whether core data should be expanded to include liquidity beyond the top of each market’s order book.
5. **Governance.** Staff will consider whether the governance of SIP NMS plans should be updated to address conflicts of interest, confidentiality policies and transparency, and voting representation on the operating committees overseeing the SIP plans.
6. **Transparency.** Staff will explore new disclosure requirements related to the costs and revenues associated with the operation of the SIPs and other exchange businesses. Staff also will explore whether changes should be made to the fee filing process for filings related to core data.
7. **Fair and Efficient Access.** Regulation NMS was intended to avoid a result where payment of exchange fees would be practically mandatory to have access to complete market data. Staff will consider whether market participants have fair and efficient access to such data under the current regime.

Combating Retail Fraud

Chairman Clayton expressed interest in reviewing the SEC’s disclosure and registration rules to reduce the opportunity for retail fraud. Director Redfearn outlined three steps that he expects the Division of Trading and Markets to take to advance this objective.

1. **Updating Rule 15c2-11.** Rule 15c2-11 under the Exchange Act requires a broker-dealer, among other things, to review certain issuer information and have a reasonable basis for believing such information is accurate in all material respects and from a reliable source before the broker-dealer initiates quotations for an over-the-counter security. For continuous quotations, there is an exception from the information and review requirements—known as the “piggyback exception”—which can lead to opportunities for retail fraud since investors may have little or no relevant information about a company. The Division of Trading and Markets is working on a

rulemaking to update Rule 15c2-11.

2. Definition of “Penny Stock”. The Commission’s penny stock rules require a broker-dealer to complete a number of steps before it allows a customer to engage in penny stock trading. Among other things, the broker-dealer must approve the account for penny stock trading, provide the person with a penny stock disclosure document, and receive from the person an agreement to the transaction setting forth the identity and quantity of the penny stock to be purchased. As a practical matter, these protections apply only in very narrow circumstances to transactions involving relatively new customers of a broker-dealer or customers with limited experience with penny stocks, and when the broker-dealer has solicited the customer to engage in a penny stock transaction.

SEC staff plans to re-examine the current exceptions from the definition of “penny stock” with a view of providing heightened protections for retail customers. Staff also plans to examine the current penny stock sales practice requirements under Rule 15c-9 to determine whether the Commission should provide additional protections for retail investors. Staff plans to examine whether the Commission should consider amendments to narrow the existing exemptions from the sales practice rules and otherwise strengthen the protections under the rules.

3. Transfer Agent Reforms. Director Redfearn discussed a gap in protection for retail investors relating to transfer agents. If a transfer agent improperly or inappropriately removes a legend from restricted securities, it could facilitate an illegal public distribution of securities and harm investors. The Division of Trading and Markets is working on an update to the transfer agent rules and is considering whether a rule that would specify transfer agent obligations with respect to the tracking and removal of restrictive legends would reduce opportunities for retail fraud.

George M. Gilbert
Assistant General Counsel

Nicholas Ersoy
Legal Intern

endnotes

[1] <https://www.sec.gov/news/speech/clayton-redfearn-equity-market-structure-2019>.

[2] See ICI Memorandum No. 31344 (Aug. 22, 2018), *available at* https://www.ici.org/my_ici/memorandum/memo31344 (summarizing the enhanced disclosure regime for ATSS); ICI Memorandum No. 31488 (Nov. 19, 2018), *available at* https://www.ici.org/my_ici/memorandum/memo31488 (summarizing the amendments to Rule 606 under Regulation NMS); and ICI Memorandum No. 31547 (Jan. 4, 2019), *available at* https://www.ici.org/my_ici/memorandum/memo31547 (summarizing the transaction fee pilot program).

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