The SEC May Soon Propose Changes to Equity Market Structure: What Traders Should Know

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On October 14, the Securities and Exchange Commission (SEC) released its report regarding the GameStop event of January 2021. The report does not fault the actions of any market participants. Instead, it outlines the U.S. market structure and regulatory framework, and then simply describes what happened in GameStop.

But the other foot may be about to fall. After GameStop, SEC Chair Gary Gensler asked his staff for recommendations regarding potential changes to equity market structure. On several occasions since then, he has outlined specific concerns about equity market structure and stated he wishes "to freshen up the SEC's rules to ensure that our equity markets reflect our mission: to maintain fair, orderly, and efficient markets, while ensuring we protect investors and facilitate capital formation."

Any staff recommendations that emerge from Gensler's request may become rulemaking proposals. If that occurs, there will be public notice and time for traders and their firms to submit comments for consideration by the SEC before the proposals become final.

What should traders know about the potential changes to market structure?

Let's take a look at Gensler's concerns:

In testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs on September 14, Gensler stated his staff is focusing on two key questions about equity market structure and conflicts of interest:

· How can the SEC facilitate greater competition and efficiency on an order-by-order basis when people submit orders to the marketplace?

· How can the SEC address alleged conflicts of interest in the market, including conflicts associated with both payment for order flow (PFOF) and exchange rebates?

In addition, Gensler previously expressed concerns about pricing and transparency issues associated with the PFOF trading model. Significantly, on August 30, Gensler stated that banning PFOF is “on the table.”

Market Structure Concerns

Segmentation in the Equity Market

Gensler has often expressed concern that the equity market structure is segmented. There are the public exchanges, off-exchange wholesale market makers, and alternative trading systems or dark pools. Segmentation means that different rule sets apply. Gensler’s view is that such segmentation creates an uneven playing field and may affect the width of the bid-ask spread. Other critics say it not only results in a transfer of liquidity away from the exchanges but also in a reduction of liquidity across the entire market.

Segmentation of the markets, however, allows traders and investors to direct order flow to whichever segment is most appropriate for them, and thus the existence of different rule sets is likewise appropriate. For example, retail investors may wish to obtain price improvement by routing to a wholesale market maker, while institutional customers with large blocks of stock to trade may prefer a dark pool. Segmentation, in other words, offers choices and efficiencies to traders and investors with different needs. It does not reflect an uneven playing field; rather, it reflects several different playing fields, each featuring a different game.

Further, the effect of segmentation on overall liquidity in the markets is not clear. More liquidity generally means narrower bid-ask spreads and thus better prices for buyers and sellers. Critics argue that less segmentation in the markets may add liquidity and narrow spreads, ultimately resulting in better prices overall. But where would this extra liquidity come from? There appears to be no hard data to support the proposition that liquidity would increase if the markets were less segmented.

On the other hand, a study published by the Financial Research Network found that reducing retail order flow segmentation would improve liquidity on the exchanges but that retail investors, in return, would receive less price improvement, while high-frequency traders would earn higher revenues from trading fees. As Larry Tabb of Bloomberg Intelligence explains, the present model keeps separate the smaller retail orders that are less likely to impact supply and demand and that wholesale market makers can execute those orders at tighter spreads than offered on the exchanges. He asks, “Why should an investor sending an order that has no effect on supply and demand pay the same price as those that do move the market?”

Further, as venture capital firm Andreessen Horowitz has stated, “[t]he fragmentation of trading venues combined with the cutthroat pricing pressure placed on market makers actually works to give consumers good pricing.” Indeed, market makers can show that the current PFOF model has resulted in billions of dollars in price improvement for retail investors over the national best bid and offer (NBBO) in 2020 alone.

Thus, the available research does not support that liquidity would increase if the markets were not segmented. What is clear is that traders would lose the ability to choose the venue that works best for them and their customers in return for a “one-size-fits-all” approach. There also is a good chance that retail investors would pay more.

Concentration in the Wholesale Market Maker Segment

While Gensler has expressed concern that the equity market is segregated, he also has expressed concern, somewhat paradoxically, that the wholesale market maker segment is concentrated. Just seven market makers handle the vast majority of all trading in that segment. Gensler’s concern is that such concentration deters healthy competition and innovation and increases systemwide risks in the event of a failure by one participant. In addition, the firms with the greatest market share tend to reap the profits from that concentration, he argues. Gensler has questioned whether both segmentation and concentration promote “fair, orderly, and efficient markets.”

Such concentration, however, has only been achieved at great expense and risk to market makers in the pursuit of efficiencies. Free markets reward efficiency and innovation and punish inefficiency and lack of foresight. If there were evidence that the dominant players engaged in fraudulent, unethical, or bad faith conduct to achieve their success, then action to right that wrong would be appropriate. But no such action has been pursued or is warranted. More to the point, the “concentration” in the wholesale market making segment has not deterred healthy competition and innovation; it is the result of it. And while there is some traction to the argument that concentration increases systemwide risks in the event of a failure of a single significant participant, here there are numerous other wholesale market makers who, it appears, could handle the additional order flow without much disruption to the markets generally.

Aggregation of Data by Market Makers

Gensler has also expressed concern that the concentration of trading leads to the aggregation of data by certain market makers, which may provide those market makers with a competitive advantage over other market makers with less order flow and over the exchanges, which see only their own data. It appears that Gensler is referring to market makers aggregating their own proprietary data reflecting order flow to the market maker, not data the market maker may obtain from the exchanges, because that is available to all. But the same argument applies as before: the aggregation of data by wholesale market makers has not deterred healthy competition and innovation; it is the result of it. Thus, absent some evidence of fraudulent, unethical, or bad faith conduct in aggregating their proprietary data, it is hard to see a legitimate basis to challenge what market makers do with their own information.

Conflicts of Interest

Gensler has expressed concern that there is a potential conflict of interest for broker-dealers when choosing to route order flow between venues that provide the most PFOF for the firm and those that provide the best execution for the customer.

But FINRA has a long-standing rule requiring firms to provide best execution to customers and has issued regulatory notices reiterating the requirement. And both the SEC and FINRA have brought actions against firms for alleged best execution violations where the firm received PFOF. Notably, only one SEC enforcement action

involved allegations that best execution actually suffered as a result of PFOF. In addition, firms are required to disclose PFOF arrangements. Under the Securities Exchange Act of 1934, firms must provide written notification to customers at or before completion of a transaction that the firm will receive PFOF and that the firm will furnish the source and nature of the compensation upon request. Under Regulation NMS, firms must make publicly available each quarter a report on the firm's order routing practices to include the aggregate amount of any PFOF received, both as a dollar amount and per share, and a description of any arrangement for PFOF.

It also is relevant that potential conflicts for broker-dealers are not limited to those involving PFOF. For example, potential conflicts may exist where retail brokers routing limit orders to exchanges in return for rebates make routing decisions based on maximizing the liquidity rebates generated from their limit order executions rather than execution quality for their customers. And potential conflicts may exist where alleged rule violations include, say, best execution, interpositioning, suitability, trading ahead, churning, markups, outside business activities, or fraud. The industry deals with such conflicts by enforcement of the relevant rule, and public disclosure and mitigation of such conflicts, if possible. This approach is clearly reflected in recent enforcement actions for violations of Regulation Best Interest, which also requires disclosure and mitigation, if possible, of potential conflicts.

Some critics, however, argue that the potential conflicts with PFOF cannot be adequately mitigated by disclosure and the requirements for best execution. Nevertheless, the SEC's long-standing view, after studying the problem for several years, has been that disclosure alone can adequately address the potential conflicts — that "sunlight is the best disinfectant" — and that a broker-dealer does not necessarily violate its best execution obligation merely because it receives PFOF. This leaves open the possibility, however, that the SEC will further amend Regulation NMS to increase disclosures related to PFOF.

It is unclear whether Gensler will continue to adhere to the SEC's historical view. He appears bent on overhauling market structure in ways that he thinks will make it fairer for retail investors. But given the dearth of enforcement actions where best execution quality has been shown to suffer as a result of PFOF, it appears the potential conflict of interest associated with the PFOF model is manageable under the current regulatory structure.

Pricing Concerns

Gensler has expressed concern that PFOF may benefit market makers more than investors. According to Gensler, when markets are opaque and customer orders are processed differently, prices are affected. And the "best price" in one trading venue may not be the best overall price.

But no hard data has been presented to support a better alternative. And the lack of such data presents the SEC with a challenge not only to define the exact problem with PFOF but also to propose a specific solution. In fact, the alternatives to PFOF may be worse. For example, just banning PFOF without moving the trading to the exchanges may result in wholesale market makers simply buying retail broker-dealer firms. Or retail firms could work out trade-service agreements with market makers or internalize the flow themselves to accomplish the same thing. And even if PFOF were banned and all trading moved to exchanges, it is not clear this would provide any tangible price improvement to retail customers, for the reasons discussed above. Indeed, redirecting all order flow to multiple exchanges offering different rebates as a form of PFOF may not eliminate alleged conflicts of interest, segmentation, and concentration concerns. It may just move them to the exchanges.

Finally, the likely consequence of banning PFOF may be a return to commission-based trading. As former SEC Commissioner Michael Piwowar testified:

The markets have evolved within this framework into a highly interconnected system. As a result, any change to market structure policy in one area will likely affect other areas. For example, if payment for order flow were restricted or banned, zero-commission trades would likely disappear. This is one tradeoff that the Commission will have to weigh when deciding whether and, if so, how to make any changes in existing regulation of payment for order flow arrangements.

Transparency Concerns

Gensler has expressed concern that there is a lack of transparency in the markets, citing opaque segments of the market and trading data that reflects an imperfect NBBO. In addition, SEC Commissioner Caroline Crenshaw's December 9, 2020, "Statement on Market Data Infrastructure" sets forth more granular concerns about the availability of market data.

Unlit Segments and the Imperfect NBBO

Gensler has expressed concern that certain segments of the markets, i.e., dark pools and wholesale market makers, are opaque. The NBBO does not capture the orders in those segments, which is almost half of all trading, nor does the NBBO capture odd-lot orders or non-displayed orders on the exchanges. Instead, the NBBO only comprises orders from "lit" markets (e.g., the exchanges) in "round lots" (100 shares and more), which means that purchases in any market of fewer than 100 shares are not reflected in the NBBO. By April 2021, 70% of all trades in high-priced stocks were odd-lot trades, 47% of all trades in mid-priced stocks were odd lots, and 28% of all low-priced stocks were odd lots. The phenomenon is even more acute with high-priced stocks, since they are less likely to trade in round lots. As such, Gensler has stated, the NBBO does not accurately reflect the prices on all parts of the exchanges, let alone the unlit segments.

Two-Tiered Market for Data

In addition to Gensler's concerns, Commissioner Crenshaw has stated that there is a two-tiered market for trading data for traders, one for those who can afford faster and better quality proprietary feeds and one for those who cannot. And because the exchanges provide both feeds, she has argued, there is a potential conflict of interest working against bridging the gap in speed and quality because doing so may reduce demand for the exchanges' more expensive feeds.

Such data has value because it reflects the price discovery created by the exchanges. "The existence of real-time quote data gives market participants information about the likely prices and quantities available in the market before they make their trading decisions." Specifically, the exchanges sell "top of the book" quotation and market data to securities information processors (SIPs) that consolidate and make the information (e.g., "SIP data") publicly available to market participants. But the exchanges also sell proprietary market data products, including "depth of book" market feeds. Thus, the exchanges compete with each other in selling their various products at different price levels, for different types of market participants with different needs. Wholesale market makers and other market participants can purchase both the SIP and proprietary data from the exchanges, develop algorithms to process it, and use it to inform order-handling decisions. And the exchanges receive significant revenues for the data.

According to Crenshaw, this results in public (SIP) feeds that cannot compete with the “prop” data feeds and tilts the system heavily toward the exchanges, which sell the prop data feeds at high prices without any meaningful competition from the public feeds. Thus, Crenshaw argues, the investing public ultimately pays the price.

In her statement, Crenshaw described the SEC’s recent rule changes to address both the NBBO and market data feed issues. The final rule amended Regulation NMS in several respects, with the effective date commencing June 8, 2021. The changes include a new definition of “round lot” that results in the inclusion of odd-lot quotations, as well as improving the speed and content of the data in the SIP feed. Round lots are now defined under a five-tiered system based on price, so that the round lot for the most expensive stocks ($10,000 or more) is “1,” those between $1,000 and $10,000 is “10,” those between $250 and $1,000 is “40,” and those below $250 is “100.” In so doing, the NBBO will reflect, as round lots, what were previously excluded from the NBBO as odd lots. Further, the improvement in speed and addition of some depth-of-book data in the SIP feed should reduce, to some extent, the alleged gap between the public and proprietary data feeds. These changes, according to the SEC, will increase transparency in the markets and improve the NBBO as a useful metric for pricing information.

Conclusion

While the October 14 report did not fault the market participants in the GameStop event, it is likely the SEC will soon publish for comment numerous proposals for rulemaking regarding equity market structure. Gensler may propose a ban on PFOF, which would certainly prompt widespread industry opposition. But looking at Gensler’s most recent testimony, he now appears more focused on how to facilitate “greater competition and efficiency on an order-by-order basis” and not necessarily on banning PFOF or exchange rebates. Indeed, many believe the SEC will not, in the end, take any action that could increase costs for retail investors, especially when PFOF has opened up investing to millions of young people, including women and minorities. Arguably, the SEC would be blowing up a system that allows average people to trade for free.

More likely are:

- Proposals regarding best execution to attempt to ensure that broker-dealers and wholesale market makers consider, on an order-by-order basis, all potential venues when routing or internalizing orders to provide retail customers with the best prices available at any time between receipt of the order and execution, whatever data sources are used by the market maker;
- Proposals to bolster disclosures under Rules 605 and 606 of Regulation NMS to provide more granularity regarding PFOF arrangements and better mitigate potential conflicts of interest;

- Proposals regarding the “tick” size used on the exchanges to improve competitiveness with wholesale market makers; Further proposals regarding a change from a T+2 to a T+1 (or even T+0) settlement cycle;
- Separate proposals regarding digital engagement practices (“gamification”) following the recent SEC request for comment; and
- Given the recent changes to Regulation NMS that add odd-lot orders to the NBBO and improve market data available through the SIP, it is not clear that any additional proposals are likely regarding the NBBO or market data.

Stay tuned.

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