March 25, 2019

Via Electronic Mail (rule-comments@sec.gov)

Vanessa Countryman
Acting Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Exchange Regulatory Structure Comments to the Investor Advisory Committee

Dear Ms. Countryman:

Healthy Markets Association appreciates the opportunity to offer our comments to the Investor Advisory Committee and Commission regarding investor protection under the modern exchange regulatory structure.

What's an exchange? It seems like a simple question, but it is getting harder and harder to answer. Exchanges used to be member-owned market centers with monopolies over the trading of companies listed on them. They held regulatory obligations over their listed companies, and oversaw the trading that occurred on them. Revenues largely came from membership, company listing fees, and to a lesser extent, transaction and market-data fees.

Fast-forward to today and exchanges are now for-profit entities often owned by third-party shareholders. Trading monopolies are generally gone. In efforts to expand their profits, exchanges have aggressively expanded and diversified their services. Seat and listing revenues have declined in relative importance, as exchanges are increasingly relying on transaction volumes and sales of access and data products. Exchanges have also largely outsourced their regulatory obligations to a single third-party service provider, FINRA. Yet they have retained sovereign immunity.

Despite these dramatic changes, the regulatory model for overseeing exchanges has remained effectively unchanged for decades. In the pages that follow, we will explore how the current regulatory regime of the for-profit exchanges is fundamentally failing investors. The phrases "for-profit" and "market regulator" are facially inconsistent. It's time for the rules to catch up with current reality.

We urge the Commission to assert its authority to ensure that all exchanges' actions are consistent with the Exchange Act and limit (to the extent possible) exchanges' regulatory responsibilities and privileges. Recent actions, such as the Commission's remand of more than 400 market data-related fees in late 2018, have suggested that the Commission is working in that direction, but much more needs to be done.

HEALTHY MARKETS
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About Healthy Markets Association

The Healthy Markets Association is an investor-focused not-for-profit coalition working to educate market participants and promote data-driven reforms to market structure challenges. Our members, who range from a few billion to hundreds of billions of dollars in assets under management, have come together behind one basic principle: Informed investors and policymakers are essential for healthy capital markets.[1]

Background on Exchange Regulatory Structure

Registered national securities exchanges are regulated directly by the Securities and Exchange Commission and are themselves self-regulatory organizations (SROs). Their operations and rules must be consistent with the Exchange Act.

In particular, an exchange's rules must:

- "provide for the equitable allocation of reasonable dues, fees, and other charges;"[2]
- not be "designed to permit unfair discrimination";[3]
- "not impose any burden on competition not necessary or appropriate in furtherance of the purposes of" the Act;[4] and
- be designed "to protect investors and the public interest.[5]

There are four main inflection points that have shaped the current regulatory regimes for exchanges: Congress's creation of the national market system in 1975; the Commission's determination to expressly allow for-profit exchanges in 1998; the Commission's implementation of Reg NMS in 2005; and Congress's direction to adopt abridged procedures for the review and approval of most exchange filings as part of the Dodd-Frank Act in 2010.

[1]To learn more about Healthy Markets or our members, please see our website at http://healthymarkets.org. For additional comment letters, Congressional testimony, and reports related to exchanges' conflicts of interest and oversight, please see https://healthymarkets.org/publications/regulatory-letters-testimony.
[2] 15 U.S.C.§ 78f(b)(4).
[3] 15 U.S.C.§ 78f(b)(5).
[4] 15 U.S.C.§ 78f(b)(8).
[5] 15 U.S.C.§ 78f(b)(5).

When Congress authorized the national market system in the 1975 Amendments,[6] it created the NMS Plan process wherein the now for-profit exchanges jointly control the costs, content, and distribution of the public market data stream.[7] At the same time, each of the exchanges separately controls access to such other connectivity and data as they see fit.

Importantly, it was not until 1998 that the Commission revised its rules to explicitly permit exchanges -- which in 1998 were all mutual organizations -- to reorganize as for-profit organizations.[8] When making the move, the Commission explained that it "does not believe that there is any overriding regulatory reason to require exchanges to be not-for-profit membership organizations."[9] In 2005, after years of contemplation, the Commission adopted Regulation NMS, which imposed a significant number of new rules and expectations on orders and trading.

Lastly, pursuant to changes enacted by the Dodd-Frank Act,[10] many of the exchanges' regulatory filings (such as to raise market data fees or change pricing tiers) are deemed immediately effective. Others must be expressly approved by the Commission before becoming effective.

Collectively, these changes have fed a deluge of exchange filings in recent years.

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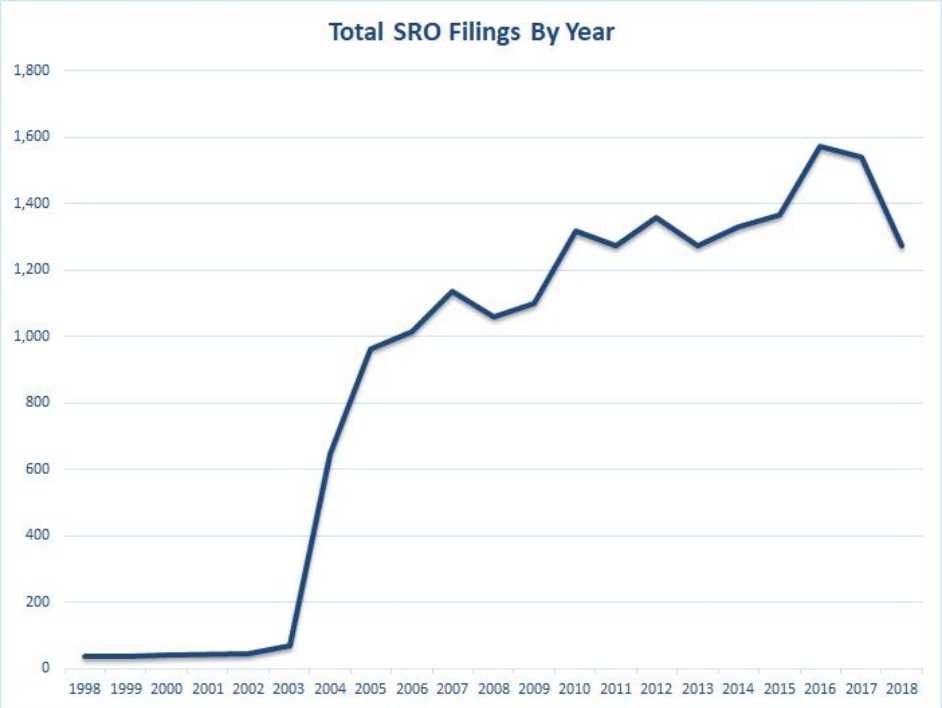
[6] *Concept Release: Regulation of Market Information Fees and Revenues*, Sec. and Exch. Comm'n, 64 Fed. Reg. 70613 (Dec. 17, 1999), *available at* https://www.gpo.gov/fdsys/pkg/FR-1999-12-17/pdf/99-32471.pdf ("1999 Concept Release"). Although the Commission had already initiated and deemed effective the CTA Plan by 1975, the Congressional action was deemed by some as necessary to remove ambiguities and clearly outline the roles and authorities of the SEC and the Plan Participants. In particular, the SEC was explicitly empowered to oversee the governance and costs associated with the provision of this governmental function. This ran directly counter to assertions made by some Plan Participants at the time that their "intellectual property" rights over the data would otherwise grant them exclusive, unfettered control (including pricing power) over the data. Not only did Congress reject that assertion, Congress further ensured that the Commission had broad authority to regulate - including overseeing the costs for - the provision of data by exchanges that is not subject to the Plans.

[7] H.R. Rep. No. 94-229, 94th Cong., 1st Sess. 93 (1975).

[8] *Regulation of Exchanges and Alternative Trading Systems*, SEC, 63 Fed. Reg. 70844 (Dec. 22, 1998), *available at* https://www.govinfo.gov/content/pkg/FR-1998-12-22/pdf/98-33299.pdf.

[9] 63 Fed. Reg. at 70880.

[10] See, Section 916, Dodd-Frank Wall Street Protection and Consumer Protection Act, Pub. L. 111-203 (2010).



By 2017, the securities exchanges and FINRA made over 1500 filings with the Commission. Of those, about 200 were directly related to listings, another 350 related to fees, and about 100 related to order types. No less than 500 were "other" filings. Many of these filings were extremely complex. The vast majority received no public comments. Many were immediately effective upon filing, and many were approved without any public findings by the Commission.

The Exchange Act grants the Commission sufficient statutory authority to oversee exchanges and protect investors, but that its regulatory apparatus has been muddied. We urge the Commission to look to the Exchange Act and simply apply those standards set forth to all aspects of exchange operations.

In particular, we wish to highlight five distinct areas where we believe the Commission should focus on asserting its authority to enhance oversight of exchanges to better protect investors:

(1) Trading incentives and disincentives;
(2) Market access and market data;
(3) Order types;
(4) Market integrity, surveillance, and immunity; and
(5) Listings.

Trading Incentives and Disincentives

The current regulatory structure has promoted stiff competition for order flow between the more than dozen equities exchanges, three-dozen alternative trading systems, and hundreds of internalizers and trading venues. At the same time, that competition has led to perverse incentives that are harming investors and other market participants.

Today most exchanges have adopted a fee and rebate system wherein they effectively tax one side of a trade, and pay some or all of that tax back to the other side of the trade. Those fees and rebates serve as powerful incentives and disincentives for order flow. Those incentives are generally paid to or by brokers using the exchange, but are not passed through to the ultimate customer. For example, a broker may be incentivized to route an order to one exchange over another, even if his customer may receive a better execution at the latter venue. Thus, the competition for order flow between exchanges may lead to inferior execution quality for the investor.

In late 2018, at the urging of the Trump Administration,[11] the Commission adopted enhanced order handling disclosure rules[12] and a transaction fee pilot.[13] These efforts should help identify and mitigate some of these risks that brokers may make routing decisions that are based on the brokers' costs, as opposed to their desires fulfill their best execution obligations to their customers. However, without significantly greater transparency and stronger rules to ensure best execution, we believe that investors will still bear significant risk related to their brokers' incentives.

Transaction pricing tiers are common across exchanges, where they serve as powerful incentives for brokers and market makers to route orders to particular venues. Pricing tiers have also become a powerful tool for exchanges to compete for order flow.[14]

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[11] Dep't of the Treasury, *A Financial System That Creates Economic Opportunities: Capital Markets*, at 62-63, Oct. 2017, *available at* https://www.treasury.gov/press-center/press-releases/documents/a-financial-system-capital-markets-final-final.pdf (Capital Markets Report).

[12] *Disclosure of Order Handling Information*, SEC, 83 Fed. Reg. 58338, (Nov. 19, 2018), *available at* https://www.govinfo.gov/content/pkg/FR-2018-11-19/pdf/2018-24423.pdf.

[13] *Transaction Fee Pilot for NMS Stocks*, SEC, 84 Fed. Reg. 5202 (Feb. 20, 2019), *available at* https://www.govinfo.gov/content/pkg/FR-2019-02-20/pdf/2018-27982.pdf.

[14] We do not believe that the Commission is generally well-equipped to act as a "price controller." However, in adopting the 30 cents per 100 shares cap on fees to access a protected quote, the Commission appropriately recognized that it would be detrimental to the markets to, on the one hand, compel market participants to interact with the protected quote, and then not restrict the fees at the venue where that quote is offered. The government mandate to access that quote necessitates the further protections to ensure the reasonability of the fee to access it. Notably, there is no cap on the rebates that venues may pay--even though those rebates facially create conflicts of interest for routing brokers. Further, we do not urge the Commission to simply mandate one pricing tier for each exchange. Rather, to the extent that the Commission permits different pricing tiers, we urge the Commission to ensure that the distinctions between customers be transparent, justified, and consistent with the exchanges' Exchange Act obligations.

But there are also important side effects of this competition for order flow: unnecessary complexity and discrimination between customers of the exchanges. To the extent that different competitors fall into different pricing tiers, it will directly impact the competitive balance between those firms.[15] As a result, pricing tiers not only impact the competition between venues for execution, but also the competition between brokers and other market participants. They help drive broker consolidation. Despite the Exchange Act's mandate that exchange fees be reasonable, equitably allocated, not unfairly discriminatory, and not an undue burden on competition, each firm is subject to whatever tiers it can convince an exchange (presumably for business reasons) to grant.

Those without market power (e.g., smaller firms or those with less order volume) are likely to obtain the worst deals. Further, over time, as order flow has consolidated to the largest firms, this has increased their ability to negotiate even better rates; further expanding the divide between large firms and smaller firms.

In practice, pricing tiers serve as a one-two punch against fair competition between firms who route orders to the exchange--and a powerful force for order flow and industry consolidation. First, pricing tiers -- by design -- offer cheaper trading for larger firms with greater order volumes. This puts smaller firms at a competitive disadvantage on order and execution prices.[16] A smaller firm's trading costs for any given trade on an exchange may be 30% or more of the costs of a larger competitor--for the exact same trade.

In fact, this disproportionate impact of pricing tiers on different market participants was expressly highlighted to the Commission by the President and COO of Cboe Global Markets, who explained that:

> This is just our top 10 firms across our four exchanges by market share. So presumably, they're making a lot of money, given the size of their market share. There are four investment banks and six HFTs. Five out of the top 10 get a check from us after the costs of their connectivity and market data. So we are cutting them a check monthly after their costs.

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[15] Remarks of Joe Wald, Clearpool Group, before the SEC Roundtable on Market Access and Market Data, Oct. 25, 2018, Transcript at 198, *available at* https://www.sec.gov/spotlight/equity-market-structure-roundtables/roundtable-market-data-market-access-102518-transcript.pdf. *Accord*, Remarks of Tyler Gellasch, Healthy Markets Association, before the SEC Roundtable and Market Access and Market Data, Oct. 26, 2018, Transcript at 280-281, *available at* https://www.sec.gov/spotlight/equity-market-structure-roundtables/roundtable-market-data-market-access-102618-transcript.pdf.

[16] Remarks of Joe Wald, Clearpool Group, before the SEC Roundtable on Market Access and Market Data, Oct. 25, 2018, Transcript at 198, *available at* https://www.sec.gov/spotlight/equity-market-structure-roundtables/roundtable-market-data-market-access-102518-transcript.pdf.

> ...
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> [At the same time, the] top 10 firms on our exchange eat up 50 percent of the capacity on our exchanges.[17]

If the top 10 firms are comprising more than half the volume, and half of them are getting checks at the end of the month, who's actually paying for the exchange operations (and the checks to the largest volume traders)?

At the same time, there are instances when exchanges do not generally face competition for trading volume, such as a listing exchange's relative monopoly on opening or closing auction trading. Interestingly, in these instances, competitive pricing has not emerged. We are aware of no defensible justification for exchanges imposing higher trading costs associated with that trading. Yet it occurs.

Put simply, the profit motive of exchanges -- left unchecked by the Commission -- has created misaligned incentives for brokers looking to route orders on behalf of their investors, discriminated against smaller trading firms stifled competition, forced consolidation, and simply imposed undue taxes on investors. Were the Commission to apply the Exchange Act requirements to pricing tiers, a lot of these issues would be resolved.

Market Access and Market Data

Market participants need market data, and the for-profit exchanges control access to it. Exchanges sell market data via a two-tiered system.[18] There is the public market data stream, which is governed by the exchanges and FINRA collectively through the NMS Plan process. And there are the faster, more informative private market data streams sold directly by the exchanges themselves.

The Commission has declared that consolidated real-time dissemination of information is "the principal tool for enhancing the transparency of the buying and selling interest in a security, for addressing the fragmentation of buying and selling interest among different market centers, and for facilitating the best execution of customers' orders by their broker-dealers."[19] Nevertheless, the public data feeds are persistently slower and offer less information than is available through the private data feeds and connectivity

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[17] Remarks of Chris Concannon, Cboe Global Markets, before the SEC Roundtable on Market Access and Market Data, Oct. 25, 2018, Transcript at 74-75, *available at* https://www.sec.gov/spotlight/equity-market-structure-roundtables/roundtable-market-data-market-access-102518-transcript.pdf.

[18] *See, e.g.*, Remarks of Hon. Jay Clayton, SEC, Equity Market Structure 2019: Looking Back & Moving Forward, Mar. 8, 2019, *available at* https://www.sec.gov/news/speech/clayton-redfearn-equity-market-structure-2019.

[19] 1999 Concept Release.

offerings sold by the exchanges.[20] While the public market data stream is facially inadequate for effective time-sensitive trading strategies and transaction cost analysis, it nevertheless provides important information for both competitive and regulatory purposes.[21] As a result, market participants rely on both the public and private market data to stay competitive and fulfill their regulatory obligations.[22]

On disappointing example of how the exchanges treat their customers is through access to historical data. Many market participants and academics believe that the public market data stream is an inadequate benchmark for measuring execution quality or for fully understanding what is going on in the markets. To better understand the markets, and benchmark performance, market participants and academics frequently use the consolidated proprietary data feeds sold directly by the exchanges. But here, the exchanges take very different views on their rights to that data.

While some exchanges may provide you with that data for free, NYSE has taken the position that it may not let you use the data at any price. Or it may charge $12,500/month for the right to use the data. Or it may give you (or its own affiliate[23]) the right to use the data for free.

Put simply, NYSE is -- in contravention of the Exchange Act -- discriminating between customers. We understand that NYSE provides this key historical data to customers of its affiliate for free, while separately charging third parties significant fees for the historical data. Even worse, NYSE requires that any third-party vendors identify their customers to NYSE--effectively using its oversight authority to obtain information that could be used by NYSE to identify the vendor's customers so that it may underbid them. These potential practices place direct burdens on competition for the distribution and use of historical market data.

While NYSE's provision of the data in real-time is plainly subject to the contours of the governing filings with the Commission, the exchange has apparently taken the controversial position that it is not bound by any of the Exchange Act requirements regarding competition, discrimination, reasonable fees, or equitable allocations of fees,

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[20] A delay is introduced by the very nature of the additional distances to travel, hardware, and formatting requirements needed for the central processor to consolidate quotations. This could be mitigated somewhat, including by distributing the collection and processing to the different data centers.

[21] Notably, in 1980, the Commission adopted the Vendor Display Rule, which requires any vendor or broker to provide the NBBO, including top of book size. 17 CFR § 242.603(c). The rule was created so that investors would not be provided misleading or narrow views of the best trading price of a security. The Vendor Display Rule effectively mandates that brokers become forced consumers of the SIP data feeds. Meanwhile, the fees for the SIP feeds--despite their relative inferiority to the private market data feeds--are significant and rising.

[22] Healthy Markets Association, *Market Data Report: How Conflicts of Interest Overwhelm an Outdated Regulatory Model and Market Participants*, Nov. 16, 2017, *available at* https://healthymarkets.org/product/market-data-report.

[23] *See, e.g.*, ICE Data Services, *available at* https://www.theice.com/market-data.

and the like for the provision of the same data one day later.[24]

Participants also need to be able to access the exchanges. What was once nominal costs to connect to exchanges and obtain essential information often now runs into the hundreds of thousands of dollars per month. For example, over just a few years, the monthly connectivity costs to one exchange rose from $2500 to $7500, for the exact same service. This is despite overall costs of transmitting data over the time has fallen.

This also has dramatic impacts on competition between brokers, as larger brokers are far-better able to pay the massive data fees than smaller firms. As Virtu Financial's Doug Cifu recently told the Commission

> So from a purely selfish point of view, right, it's a barrier to entry for competition. As we get larger, you know, we're going to be able to use our buying power, if you will, and our scale in a way that other brokers can't.[25]

One options exchange, BOX, has recently highlighted the conflicted incentives of the for-profit exchange business model, as well as the inadequate regulatory tools to police market data and market access costs.

On July 19, 2018, BOX filed to impose fees to connect to the exchange.[26] Prices went from free to $5,000 per month per connection. Pursuant to the procedures outlined in the Dodd-Frank Act,[27] the Initial Fee Filing was made immediately effective. The Commission noticed the filing for public comment. Healthy Markets Association objected. The Commission staff then suspended the Initial Fee Filing and instituted proceedings to approve or disapprove the filing. Because the suspension came after the

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[24] Notably, other exchanges do not seem to take this position. Contrast, *Historical Use of Real-Time NYSE Proprietary Data Products Policy*, NYSE, Sept. 2014, *available at* https://www.nyse.com/publicdocs/nyse/data/Policy-HistoricalUseofReal-TimeNYSEProprietary%20Data%20Products_PDP.pdf ("If a vendor of real-time proprietary NYSE Market Information would like to redistribute this data externally at a later time, the vendor must contract with NYSE directly for such use and pay the relevant fee."). The "relevant fee" is not defined in this document or elsewhere, and appears to be entirely subject to NYSE's discretion. By way of background, when Healthy Markets Association approached NYSE about obtaining historical data through a third party that already possessed it, the exchange offered very different prices for the rights to use the data over time. At the same time, we are aware of market participants receiving the rights to the data for free from another NYSE affiliate.

[25] Remarks of Doug Cifu, Virtu Financial, before the SEC Roundtable on Market Access and Market Data, Oct. 25, 2018, Transcript at 83-84, *available at* https://www.sec.gov/spotlight/equity-market-structure-roundtables/roundtable-market-data-market-access-102518-transcript.pdf.

[26] *Notice of Filing and Immediate Effectiveness of a Proposed Rule Change to Amend the Fee Schedule on the BOX Market LLC ("BOX") Options Facility to Establish BOX Connectivity Fees for Participants and NonParticipants Who Connect to the BOX Network,* SEC, Rel. No. 34-83728, July 27, 2018, *available at* https://www.sec.gov/rules/sro/box/2018/34-83728.pdf ("Initial Fee Filing").

[27] See, Section 916, Dodd-Frank Wall Street Protection and Consumer Protection Act, Pub. L. 111-203 (2010).

filing was made effective, we understand BOX billed its customers the higher charges contained in the Initial Fee Filing for the intervening period.

On September 19, 2018, BOX appealed the Commission staff's order. According to the Commission's own procedures, the staff's suspension order was then automatically stayed pending the appeal to the full Commission. On November 16, 2018, the Commission granted BOX's Petition for Review, but discontinued the automatic stay of the staff's suspension order.[28] In explicitly reinstating the suspension of the higher fees, the Commission expressed that it

> believes the continued suspension of the proposed rule change while the Commission conducts proceedings to consider the Exchange's proposal will allow the Commission to further consider the proposed fees' consistency with the Exchange Act without the risk of allowing a fee that is potentially inconsistent with the Exchange Act to remain in effect.[29]

At this point, we understood that the matter was pending before the Commission, and that the fee increases were stayed until the Commission's ultimate decision was rendered. That is not what happened.

Instead, BOX chose to abuse the Dodd-Frank Act's mechanism for review and approval of exchange fee filings to continue charging its customers the unsupported, and already twice-suspended fees. Two weeks after the Commission reinstated the suspension of the Initial Fee Filing, on November 30, 2018, BOX made a new connectivity filing that was substantively identical to the suspended Initial Fee Filing. Again, pursuant to the procedures outlined in the Dodd-Frank Act, this second filing was made immediately effective. Again, the Commission staff thereafter suspended it. Again, because the suspension came after this second filing was made effective, we understand that BOX billed its customers the higher charges for the intervening period.

Now with three suspension orders against its fee increases, BOX tried again. On February 26, 2019, BOX filed yet another substantively identical fee filing increase. Again, pursuant to the procedures outlined in the Dodd-Frank Act, this third fee filing was made immediately effective.

Again, the Commission staff thereafter suspended it.[30]

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[28] *In the Matter of the BOX Exchange LLC*, SEC, Exch. Act Rel. No. 84614, Nov. 16, 2018, *available at* https://www.sec.gov/rules/other/2018/34-84614.pdf ("November 2018 Order").

[29] November 2018 Order.

[30] *Notice of Filing of a Proposed Rule Change to Amend the Fee Schedule on the BOX Market LLC ("BOX") Options Facility to Establish BOX Connectivity Fees for Participants and Non-Participants Who Connect to the BOX Network; Suspension of and Order Instituting Proceedings to Determine Whether to*

Again, BOX petitioned for the Commission to review the staff's suspension order, which led to an automatic stay of the suspension order.[31] Again, the Commission subsequently granted the petition for review, while reinstating the suspension.[32]

All told, BOX has filed three versions of a substantively identical fee filing increase. And those fee increases have been suspended five separate times. It appears as though BOX keeps filing for the fee increases so that it may bill its customers for the higher fees--even though the Commission has directly suspended them.

Not surprisingly, we understand that at least one of BOX's customers has expressed frustration, and has challenged the imposition of the repeatedly suspended fees. BOX has responded to these complaints by changing the procedures through which customers may dispute its fees. In particular, BOX has filed to time-limit member grievances to contest billings and forced members to provide a written grievance complete with supporting documentation.[33] Again, that filing was immediately effective.

Despite the Commission's explicit determination that BOX's fee increases should not be left effective until the Commission has decided upon the final merits, BOX has effectively continued to apply the new, higher fees.

BOX's recent filings are contrary to the Commission's intent, protecting investors, the public interest, and the law. As the BOX example demonstrates, the for-profit motives of exchanges have had profound impacts on their practices surrounding market data and market access.

Complex Order Types

At root, orders to trade securities form the basis of informed "price discovery" and serve as a bedrock of our capital allocation process. While market participants often think of orders as simply offers to buy or sell securities at the market price, or at (or better than) a given limit price, in reality, the dominant market centers now have several dozen complex order types. Many of these order types are essentially compound, complex order instructions that are customized for the particular requests of specific exchange customers. While each of these order types must be filed with the Commission, they have traditionally not received significant scrutiny. Further, their sheer complexity often makes it difficult, if not impossible, for regulators and most market participants to fully

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Approve or Disapprove the Proposed Rule Change, SEC, Exch. Act Rel. No. 85201, Feb. 26, 2019, *available at* https://www.sec.gov/rules/sro/box/2019/34-85201.pdf.

[31] *In the Matter of the Petition of BOX Exchange, LLC*, SEC, Mar. 5, 2019, *available at* https://www.sec.gov/rules/sro/box/2019/box-2019-04-petition-for-review.pdf.

[32] *In the Matter of the BOX Exchange LLC*, SEC. Exch. Act Rel. No. 85399, Mar. 22, 2019, *available at* https://www.sec.gov/rules/sro/box/2019/34-85399.pdf.

[33] See *Notice of Filing and Immediate Effectiveness of a Proposed Rule Change to Amend the BOX Fee Schedule*, SEC, Exch. Act Rel. No. 88293, March 12, 2019, *available at* https://www.sec.gov/rules/sro/box/2019/34-85293.pdf.

understand how a specific order type may operate, not just on the exchange offering it, but also how it may interact with orders on other exchanges and trading venues.

In 2017, the Trump Administration highlighted concerns with the proliferation of order types.[34] This follows a 2015 settlement with the SEC by one exchange family (now part of Cboe) for failing to properly disclose how some potentially predatory order types worked.[35] An executive of another leading exchange company even declared "I am uncomfortable with having all of these order types. I don't know why we have them."[36]

The answer, of course, is competition for order flow. Even the above exchange executive, who leads the NYSE-family of exchanges, has since sidelined his efforts to dramatically cut order types. As exchanges compete for order flow and profits, they have catered to the desires of their customers who route orders. When customers request complex order types that may or may not create opportunities for information leakage or harm other investors, the exchanges are caught between their for-profit desire to please their favored customers, and maintaining integrity on their own marketplace. Of course, at a minimum, the sheer number of order types currently in the marketplace leads to unnecessary market complexity and undermines the efficacy of the price discovery process.[37]

NMS Plans, Market Integrity, Surveillance, and Immunity

The Exchange Act was adopted over eighty years ago, and its last major amendments in this area were more than forty years ago. Back then, there was much greater concentration of trading than exists today (and mutually-owned exchanges), and it arguably made sense for each exchange to be given regulatory power to police trading activities on its venue. Exchanges are also given sovereign immunity for its regulatory functions.

Trading today is fundamentally different. Market participants today seamlessly trade across different venues and different asset classes overseen by different regulators. For example, consider the options available to modern trading firms that think the US stock market looks like a good investment. They may view E-mini futures contracts or options on those contracts, which can be traded on CME. Or they may trade the SPDR S&P 500 ETF (SPY), or the Standard & Poor's 500 Index (SPX). Or they may trade options or swaps on those. Or they may trade any number of individual securities, options,

[34] Capital Markets Report, at 66.
[35] *In the Matter of EDGA Exchange, Inc., and EDGX Exchange, Inc.*, SEC, Exch. Act. Rel. No. 74032, Jan. 12, 2015, *available at* https://www.sec.gov/litigation/admin/2015/34-74032.pdf.
[36] Sarah N. Lynch, *ICE CEO calls for market-wide purge of order types*, Reuters, July 8, 2014, *available at* https://www.reuters.com/article/us-usa-senate-ice/ice-ceo-calls-for-market-wide-purge-of-order-types-idUSKBN0FD2FP20140708.
[37] Capital Markets Report, at 66.

swaps, or futures that may include one or more related or underlying instruments. Further, the financial instruments themselves may be traded on numerous venues. And the legal entities doing the trading may be regulated by several different US regulators, each with its own jurisdiction, priorities, and requirements. It would be practicably impossible for any single exchange or exchange family to perform this task well.

Not surprisingly, all of the exchanges have outsourced some part of their oversight responsibilities to FINRA. Among other regulatory services that FINRA provides exchanges, FINRA currently conducts the vast majority of cross market surveillance for the equities and options markets. Using extremely sophisticated surveillance "patterns", FINRA monitors the markets for potentially abusive trading activity that is effectuated across multiple markets and broker-dealers in an attempt to avoid detection. FINRA's cross market surveillance program currently covers 12 of the 13 active equities exchanges (meaning its cross market program covers over 99.5% of U.S. equity market activity) and is expected to cover all active equity exchanges and 100% of the U.S. equity market activity by the end of Q2 2019. FINRA also provides regulatory services for all 16 U.S.-based options exchanges (with cross-market surveillance for 8 of them).

However, despite this broad coverage, when trading activity is spread across different brokers and venues, it is nearly impossible to detect in any automated way, unless the trading activities exhibit obvious similarities (e.g., they are always with the same counterparties). Thus, despite the best efforts of FINRA and the best systems currently available, without an automated way to link trading activity to the underlying beneficial owners, there is very little chance to identify and stop sophisticated abuses without the assistance of a whistleblower.

That is why the regulators have been working to create the Consolidated Audit Trail (CAT). Proposed in 2010, the CAT has suffered years of delays and setbacks. It was originally expected to be completed years ago. Unfortunately, it is still under construction. That's largely because through the NMS Plan process, the for-profit exchanges and FINRA were collectively tasked with proposing the specifications, selecting who would build it, setting the costs to market participants, overseeing its operations, and then using its outputs.

Thankfully, Chairman Clayton has worked with his fellow Commissioners and SEC staff to pull the CAT project out of this quagmire over the past two years. The SEC has a new, highly qualified CAT Czar, and FINRA has replaced Thesys to build it. But there are still many challenges with the project. For example, once it is completed, the CAT will contain all of the trading and beneficial owner information of anyone trading in the equities and options markets. That's incredibly sensitive information.

The CAT Plan permits the exchanges to access to CAT data for regulatory purposes. We are deeply concerned with the exchanges' access to this database, which we believe poses significant risks. While the CAT Plan provides exchanges access for "regulatory" purposes, it is unclear what this access will mean, in practice. For example,

can an exchange use it to determine how market participants are taking advantage of trading on its exchange? Can an exchange use the information from the CAT to tweak its rules for trading so as to gain market share or advantage or disadvantage particular market participants, including competitors? This seems to exacerbate the exchanges' fundamental conflicts of interest as "for profit market participants" and "regulators". There is a significant risk that the exchanges may use their access to the CAT data in a manner that could disadvantage brokers' trading strategies, intellectual property, or customers. Similarly, there is risk that exchanges may misappropriate their CAT data access to disadvantage ATSs or other exchange competitors--in the name of enhanced oversight or regulation. For-profit exchanges should not be in the position of being able to utilize their enforcement authority to negatively impact their competitors.

Further, data security is a significant concern for the CAT. For any such concern, one of the primary security vulnerabilities is typically the points of access. Providing more than a dozen for-profit market participants (each with an unknown number of employees, contractors, or agents) with access to some or all of the CAT introduces significant risk for unauthorized or unintended access.

The for-profit exchanges' incentives and conflicts of interest also pose significant challenges for them to provide consistent, high-quality surveillance and enforcement over the long term. Will they enforce against their better customers? Will they invest in high-quality surveillance and enforcement? What are the incentives and disincentives for doing so? Notably, FINRA already performs the vast majority of the surveillance functions for the for-profit exchanges. FINRA has spent decades and millions of dollars developing technology and systems to process data and identify areas of concern across various venues. In general, the exchanges have not developed similar capabilities.The Commission should revise the Final Rule to extricate the CAT from the NMS Plan process entirely.[38] The Commission should take direct ownership of the CAT process and work with FINRA directly to implement it.

Lastly, there are significant concerns with exchanges' sovereign immunity.[39] While the exchanges are only performing extremely limited regulatory functions today, they may enjoy outsized protections of their for-profit activities. For example, as the exchanges have adopted all of these order types, pricing tiers, and preferential access levels, investors have brought suit against the exchanges alleging fraud. To what extent are these activities for-profit and to what extent are they "regulatory"? There have also been concerns with exchanges' liability caps, which were highlighted by high-profile exchange

[38] The NMS Plan process, which was created by Congress when exchanges were predominantly mutually-owned organizations, is fraught with conflicts of interest and should be retired in its entirety. Statement of Tyler Gellasch, Healthy Markets Association, Hearing on Implementation and Cybersecurity Protocols on the Consolidated Audit Trail Before the House Financial Services Committee, Subcommittee on Capital Markets, Securities and Investment, 115th Cong. (2017).

[39] See *City of Providence, Rhode Island v. BATS Global Markets, Inc.*, No. 15-3057-cv, Opinion (2nd Cir. Dec. 19, 2017), *available at* https://law.justia.com/cases/federal/appellate-courts/ca2/15-3057/15-3057-2017-12-19.html.

mishaps such as the failed BATS IPO and the botched Facebook IPO. In all of these cases, it is not clear what public policy purpose liability caps or bars serve. In sum, the exchanges' for-profit motives pose significant challenges to their regulatory functions.

Listings

Listing exchanges establish the expectations for their issuing companies on a broad range of issues. These listing standards have profound impacts on investors. The for-profit exchanges in the US compete for listings against each other, but also against exchanges around the globe. But the nature of listings means that the determinations are often made by executives of the listing company. Exchanges have elected to not just compete on price (e.g., listing fees), but also in other ways. For example, some listing exchanges appear to offer materially lower investor rights and protections. This has been recently exhibited in the acceptance and listing of companies with so-called "dual class" share structures. Further, some exchanges appear to provide their listed companies with other non-public information regarding trading in their securities. In both instances, the profit-motivated competition for listings may undermine investor protection and market integrity.

Recommendations

The concept of having a "for-profit" "market regulator" is simply ill-advised. We urge you and the Commission to consider what it means to be an exchange. If an exchange is to be a venue for price discovery and trading, then it should perform that function. We see no reason why such a venue cannot be "for profit." However, it should also be treated as a for-profit market participant. It should not also be imbued with the regulatory authority to set the rules of the road and essential costs for other market participants.

We urge you to consider recommendations that the Commission assert its authority under the Exchange Act to ensure compliance with the Exchange Act's requirements, and effectively eliminate reliance on the deeply conflicted NMS Plan process.

Conclusion

Thank you for your consideration. Should you have any questions or would like to discuss these matters further, please call me at [redacted].

Sincerely,

Tyler Gellasch
Executive Director