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SEC's Equity Market Structure Advisory Committee

Reforming the U.S. Self-Regulatory Structure

April 5, 2017

Chairman Piwowar, Commissioner Stein, SEC staff and members of the Equity Market Structure Advisory Committee, thank you for the opportunity to share my thoughts with you as part of your efforts to reform the current regulatory environment for U.S. equity markets.

My name is Brett Redfearn. I am the Global Head of Equity Market Structure Strategy for J.P. Morgan Securities LLC. J.P. Morgan is a significant participant in our equities markets across cash, derivatives, portfolio trading and electronic trading. We are generally in agreement with the recommendations of the Trading Venues Regulation Subcommittee and appreciate their thoughtful work in several important areas.

After years of intensive focus on equity market structure with both policy makers and market participants of all types, some basic realities have become evident: the rules that we put in place have created some remarkable benefits, many significant challenges, and some strong entrenched interests. Arguments on all sides of these issues will be made in the name of investor confidence, price formation, and market quality. Nonetheless, it will be up to you to navigate through all of this and address outdated, inefficient and anti-competitive pricing structures and regulatory constructs in order to truly achieve these objectives.

I would like to start by making a few comments related to the recommendations of the Reg. NMS Subcommittee. As outlined in the letter that SIFMA posted last week, we agree that Reg. NMS is overdue for reform. We believe that the Order Protection Rule (OPR) should be reevaluated and possibly repealed. At a minimum, the OPR should be updated and modified to provide volume thresholds for exchanges to receive protected quotation status and to provide an exception for block transactions. We are not convinced that we need another pilot.

The Access Fee Pilot proposed by this committee would have the benefit of generating insights and data that could be used to help empirically evaluate access fee caps. However, the pilot has three important limitations: (1) it would not provide any data for over 85% of listed securities and half of the traded volume in the U.S. equity marketplace[1]; (2) It would not test the benefits that could result from an elimination of rebates, widely known to be a significant contributor to many issues in our marketplace;

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[1] The Access Fee Pilot, as proposed, would be limited to stocks that have a market capitalization of $3 BN or greater. This universe includes approximately 13% of NMS securities (excluding ETFs) and 14% of NMS securities (including ETFs). Similarly, this universe accounts for approximately 43% of average daily volume (ADV) excluding ETFs and 52% of ADV with ETFs.
Sources: BATS Global Market Volume data and JP Morgan securities reference data.

and, (3) upon completion, it would ensure that the SEC, rather than the marketplace, will again be in the undesirable position of setting fee caps and governing transaction pricing. If we proceed with this pilot as currently designed, we will miss some important opportunities such as removing regulators from the transaction pricing business.

The Pilot should contemplate the elimination of rebates. Understanding the challenges of this, there are many compelling reasons for the Commission to give serious consideration to elimination of rebates and elimination of linkages between passive posting of limit orders and transaction pricing. One of the more important reasons is that if rebates were eliminated and if transaction pricing was not linked to passive posting of orders, then market *competition* could effectively cap fees in our markets. In our view, the access fee pilot should (a) test a larger segment of securities; (b) include a segment of securities where rebates are not permitted; and (c) extend the pilot to include "inverted" venues.

Need for Revision and Modification to Self-Regulatory Model

We have a fundamental tension in our system of self-regulation. The major stock exchange groups have evolved into for-profit, publicly traded entities. This corporate structure for stock exchanges is not what was envisioned when the Exchange Act was written, nor when the Exchange Act amendments were passed in 1975. The evolution in corporate structure has not been accompanied by a similarly dramatic evolution of regulatory structure. As a result, we are overdue for revisions and modifications to our system of self-regulation.

I will comment on the following six points:

1. The old regime of **regulatory immunity** is outdated.
2. Existing **limitations on liability** are, in many cases, no longer warranted.
3. Where limits on liability might be deemed necessary, **existing levels are inappropriately low** and need to be rightsized.
4. Exchanges should be required to **maintain meaningful reserve funds** to adequately backstop their liabilities.
5. **Cross-market regulation should be centralized at one SRO** and each exchange's regulatory functions should be confined to activities that take place solely within the "walls" of that exchange, or its data center.
6. The SEC and the industry should conduct a thorough and transparent **cost accounting of the regulatory model in the U.S. across SROs** so that we can rationalize the array of regulatory fees with the various regulatory services provided.

Regulatory Immunity

On the issue or Regulatory Immunity, the SEC has an accurate and appropriate perspective on this issue. I will quote from a 2016 Amicus Brief[2]:

> "The Commission believes that absolute immunity is properly afforded to the exchanges when they are engaged in their **traditional self-regulatory functions –** in other words**,** when the exchanges are **acting as regulators of their members**. Immune activities include the core adjudicatory and prosecutorial functions that have traditionally been accorded absolute immunity, as well as other functions that materially relate to an exchange's regulation of its members. For example, an exchange should be immune when it disciplines its members for misconduct or suspends from trading by its members a security listed on its market. But the Commission believes that **immunity does not properly extend to functions performed by an exchange itself in the operation of its own market, or to the sale of products and services arising out of those functions…"**

We fully agree with this position and welcome the clarification provided by the SEC on this issue. This brief should serve as a roadmap for how regulatory immunity is treated going forward.

This issue is important because if regulatory immunity is applied properly, then brokers would no longer be in the unenviable position of having to backstop issues arising out of exchanges' operational failures, including liabilities that could arise from exchange's commercial decisions.

As the services offered by exchanges and broker-dealers have converged, exchanges' immunity and limitations on liability provide exchanges with an unfair advantage in areas where they are competing with broker dealers, alternative trading systems and vendors.

Limitations on Liability

On the issue of limitations on liability, we need to first ask: what is the basis for limiting liability for a profit-maximizing business that directly competes with its member firms and other service providers in the market? It is not obvious that any such limits continue to be warranted or necessary. We would like to see a clear justification for these limits in the current exchange landscape and, with that, clarification and delineation of when and where such limits are warranted.

Would a market failure of an exchange result in a larger systemic risk to the broader market?

One possible justification for liability limits is the concern of systemic risk to the broader market that

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[2] Brief of the SEC, Amicus Curiae, City of Providence, Rhode Island v. Bats Global Markets, Inc. et al. See link.

could accompany a market failure of an exchange. There was a time when there was a significant dependency on the primary market wherein it concentrated the trading of 70%-80% of its listed volume. That era is long gone. Our markets are highly competitive and resilient, which has been illustrated in the recent past when market-wide trading has been able to continue uninterrupted on other venues following an individual market shutting down due to a systems issue. So, any possible systemic issues would likely to be limited to the services provided by primary markets, including listing services and auctions. It would be difficult to make a case for systemic risk associated with a failure of one of the non-listing venues, notwithstanding concerns related to some reduction in competition. In sum, it seems clear that, in today's market environment, limitations on liability are less necessary than in times past, and likely unnecessary. However, were they to be retained, they should be carefully tailored to cover a discrete segment of exchange activity.

To the extent that limitations on liability are to persist, how do we draw a line between those exchange products and services that might be afforded certain limits and those that should not?
In consideration of this, we should distinguish between *essential market functions* of an exchange and *non-essential functions*.

- **Essential functions.** If there are products and services provided by the exchange that are necessary and fundamental to the trading of securities and if, as a result, every broker dealer uses those products and services out of necessity, then those products *may* be afforded some liability limit, albeit higher than exists today. An example of this would be opening and closing auctions.
- **Non-essential functions.** Other products, including premium products and services not used by or affordable to all customers, should not have the benefit of limitations on liability. This could include, for example, sophisticated routing services that compete with broker dealer smart routers and go well beyond Reg. NMS obligations.

Lastly, we think that there should be provisions that eliminate or widen limits in cases where it can be demonstrated that business decisions were made in a manner that demonstrates a disregard for the integrity of the marketplace or where economic risk was knowingly transferred onto broker dealers.

As is the case with regulatory immunity, if limitations on liability were fairly applied, then brokers would no longer be in the position of having to absorb financial risk that could result from exchange technology issues, including liabilities that could arise from exchanges' commercial decisions.

Once we have adequately delineated exchange products and services that warrant more rational limitations on liability, we need to revisit the appropriate levels for such limits.

Today's exchange liability limits are dated, inconsistent and egregiously low relative to recent

experience. At the major exchanges, they generally range from $500,000 to $3,000,000 per month. These limits could be exceeded with a single instance and a single counter-party, and even more so still, in the event of a market-wide issue. One noteworthy recent example at one exchange resulted in claims in excess of $400,000,000 dollars across multiple broker dealers.

Finding an appropriate methodology to rightsize limits will be challenging, but must be pursued. Towards this end, it would be helpful if there were greater public transparency regarding actual claims and payments made resulting from exchange issues in the past. We support the subcommittee's recommendation that "the appropriate level" could be "informed, in part, based on an exchange's level of listing activity, the costs to firms of outages or other disruptive events, and the amounts that have been paid out by the exchanges in recent years, as well as input from insurance providers on how they would model the activity to determine potential exposure and levels of insurance."

We fully appreciate that raising liability limits could increase risk and cost for new and existing exchanges. However, the current construct of immunity and limitations on liability has artificially eliminated appropriate accountability and economic resiliency. **This has been a material factor contributing to the proliferation of exchanges and market fragmentation.** This outdated construct should be addressed and rightsized.

Need for Reserve Funds

We also agree with the subcommittee's recommendation that SROs should maintain reserve funds sufficient to satisfy potential claims. This would help to ensure that new liabilities could be met when necessary, and would reduce the risk of and concern about business failure.

Regulatory Centralization

We wholeheartedly agree with the recommendation of the Subcommittee that "certain cross-market regulation should be centralized." **Individual exchanges should not be conducting duplicative and overlapping surveillance, investigations and enforcement actions beyond their own market**; **this should be done by one central regulator**. Exchanges should continue to discipline the trading activity on their own markets, under their own rules, given their "unique expertise in regulating their own markets." However, the walls of an exchange and its data center should define the scope of an exchange's self regulatory functions.

Why is this important? Broker dealers have, for some time, been subject to regulatory duplication and, at times, contradiction, where different exchanges have differing interpretations of the same or similar rules. This is inefficient for both for broker dealers and regulators. Investigation and enforcement could be more successfully performed by one regulator. As noted by the subcommittee, it would continue to make sense for an individual exchange to surveil for cross-market violations and appropriately initiate an

investigation where identified. However, "centralization should occur once surveillance progresses to the inquiry stage, or to investigations and enforcement."

We also agree that as the regulatory model evolves with the implementation of the Consolidated Audit Trail (CAT), this centralization will be even more critical. With the prospect that more exchanges could be granted access to a greater amount of cross-market trading data, the potential for duplication could increase. Our regulatory model needs to evolve with our regulatory infrastructure and centralization of cross-market trading activity is necessary.

Meaningful concerns have been raised that centralization could lead to the creation of a regulatory monopoly. To address this, a high degree of transparency, industry engagement and accountability is needed. The SEC, other SROs and the industry at large would have to be involved in governance and oversight to ensure that a single regulatory model for cross-market trading activity does not result in new inefficiencies or unintended behavioral outcomes.

Need for Regulatory Cost Accounting

Lastly, with the eventual implementation of the Consolidated Audit Trail (CAT), a new regulatory service model will be born and legacy regulatory systems and services will eventually be eliminated. In anticipation of that, it is imperative that the SEC and/or the industry conduct a thorough and transparent (public) cost accounting of the existing regulatory services and their attributable costs across U.S. self-regulatory organizations. Today, we have a broad array of regulatory fees and services. However, the information regarding which fees pay for which services is opaque. A transparent accounting of regulatory services and their costs will allow for a rational elimination of unnecessary or redundant costs which will ultimately result in further reductions in trading costs for the end investor.

Thank you for your time. I look forward to discussing further.