U.S. Securities and Exchange Commission
Equity Market Structure Advisory Committee Meeting
Regulatory Structure of Trading Venues Panel

Andrew Silverman, Managing Director, Morgan Stanley

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Good afternoon – I am Andrew Silverman, the global co-head of Morgan Stanley's Electronic Trading business. I would like to thank the Chair, the Commissioners, the Trading and Markets staff and the Committee members for giving me this opportunity. I look forward to our discussion and to presenting Morgan Stanley's views on the important topic of the regulatory structure of equity trading venues in the U.S.

Exchanges and ATSs provide market functionality that have some similarities but also have key differences. These similarities and differences should be weighed carefully when considering any regulatory changes.

Given that Morgan Stanley has been an ATS operator since 1999, I will begin my remarks in this area. Regulation ATS, adopted in 1998, served an important purpose in facilitating much-needed competition in the trading of securities and automating the broker crossing function. Due to rapid advancements in technology not anticipated at that time, some brokers have taken differing interpretations around what is permissible under Regulation ATS, often couched in low level technical details of the implementation of their trading infrastructure. It could be said that some brokers lost sight of their role as a broker in the marketplace in their eagerness to grow their "dark pools".

Morgan Stanley's philosophy around its dark pools has been to leverage technology to enhance our role as a broker in seeking best execution for our clients. Morgan Stanley has never sought to compete directly with exchanges with regard to overall volume traded in any of its dark pools. This approach contrasts with the approach taken by some other dark pool operators under Regulation ATS.

Among the critical issues left to the interpretation of brokers was whether their dark pools would accept or pursue "liquidity providers" or "market makers" in order to provide their dark pools with additional liquidity. If dark pools were to accept liquidity providers, what were the permissible rules of engagement around these participants? These questions were left to the operators of broker dark pools to decide for themselves. In some cases, aggressive order handling practices that involved the use of indications of interest - or IOIs - to solicit liquidity were employed without transparency to the end client. This practice was key in allowing some brokers to establish "critical mass" in their dark pools.

At Morgan Stanley, we did not use IOIs to solicit liquidity in our dark pool. In fact, we established rules of engagement that were transparent to our clients and created obligations for our liquidity providers.

The second issue I am raising is the role of the liquidity provider in modern markets, which is an issue that is critical to both ATSs and exchanges, enabling the smooth functioning of our markets. Yet, we still do not have any meaningful regulation that clearly defines the benefits and obligations that apply to the liquidity provider whether on-exchange or otherwise. The lack of significant obligations manifests itself in times of market volatility when liquidity providers are needed the most.

The current lack of clarity around the role of liquidity provider has also led to a contentious atmosphere in the market. Given little guidance, today's de facto "market makers" were left to carve out their own advantages in the form of co-location and fast market data feeds among other things, which soon became important profit centers for exchanges. From there, the race was on to entice market markers with special order types and pricing. All of this created an air of mystery around these market makers or "high frequency traders" as they have come to be known. By having meaningful regulation that clearly defines the role of the market maker whether they are participating on or off exchange, we can take the mystery out of the market maker. In the past, people may not have always liked the specialist model, but at least they knew who he or she was and the rules of engagement, which were subject to regulation. We are not endorsing a return to the specialist model. Rather, we are pointing out the benefit of knowing which market participants are obligated to provide liquidity and under what terms.

The third issue that I am raising is the status of exchanges today. The exchange and its role has changed significantly with many exchanges becoming for-profit, public companies. This development has led to fierce competition among exchanges, which has both positive and negative aspects to it. On the positive side, we now have a very resilient equity marketplace that can withstand a major outage of a primary exchange, as we saw on July 8th of this year. While there are varying opinions regarding the pros and cons of the fragmentation of venues and liquidity caused by competition, it is an undeniable benefit that fragmentation makes our market more resilient in the face of inevitable technology outages experienced by market participants.

A negative side of this fierce competition between exchanges is that the drive to increase profits conflicts with the idea of being an SRO and fulfilling the utility function that was originally envisioned by Congress. Specifically, are for-profit exchanges best positioned to drive market structure changes as if they are an unbiased participant acting solely in the public interest?

There are several recent high profile examples of exchange decisions that illustrate this conflict. One example involved an exchange that rushed the rollout of its retail liquidity program within a relatively short time period after regulatory approval. This could be viewed as a contributing factor to a well-known market event that resulted in a crisis for a major broker. A factor to some degree in this example is the competitive drive for increased exchange profits and market share. This, combined with the exchange's limitation on liability, seems like a recipe for the possibility of questionable decisions being made that may favor exchange profitability at the expense of market stability.

Now that we've addressed the roles of ATSs, liquidity providers and exchanges in today's marketplace, let's turn to whether the rules regulating exchanges and ATSs should be harmonized. As discussed, exchanges and brokers each serve vital, but different, roles in the marketplace. Any potential regulation must take into account these differences. One area where rules for both exchanges and ATSs could be harmonized is in defining the role of the liquidity provider in a way which accounts for both exchanges and ATSs. Another area that should be harmonized is requiring for-profit exchanges to accept appropriate liability. The immunity from liability granted to exchanges by Congress was during a time when the exchanges served as public utilities and not as the for-profit, commercially driven public companies that they have become.

There are areas where regulation should not be harmonized given the distinct roles played by brokers and exchanges in the marketplace. I will highlight one area which is access. A broker having discretion over who may access their dark pools is vital to creating the desired environment for investors to achieve their trading objectives. The exchanges, on the other hand, are required to provide access to their platforms to all brokers who choose to become members. It is important to note that this requirement also comes with benefits, including protected quote status requiring all brokers to send orders to them.

In closing, the US equity markets are the best functioning in the world. Both retail and institutional investors receive arguably the highest execution quality that they have ever received. But our markets are also not perfect. I believe that clearly defining each market participant's role and responsibility based on the specific function that each participant serves, will allow us to continue to improve our market going forward. Thank you again for this opportunity. I appreciate the Commission for its willingness to tackle these complex and important issues.