Opening Statement of Frank Hatheway

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Equity Market Structure Advisory Committee

Customer Issues Subcommittee Panel

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Good afternoon Chair White, Commissioners, Staff, Committee Members and my fellow panelists. My name is Frank Hatheway. I am the Senior Vice President and Chief Economist of Nasdaq. I thank the Commission and the Committee for inviting me here today to discuss the assigned topic of "Customer Issues" with a particular emphasis on enhancing the execution quality and order routing disclosures required pursuant to Rules 605 and 606. Nasdaq appreciates the Commission's and the Committee's thoughtful consideration of the subcommittee's insightful work on these issues, and looks forward to actively participating in the dialogue regarding specific proposals that emanate from this process.

Nasdaq has always viewed our top priority to be operating well-regulated markets that serve the needs of investors, market participants, and our 3,700 listed companies around the globe that contribute so much to the growth of the world economy. We have been a staunch advocate for transparency and make information widely available to investors through our innovative data products. As head of the team that both produces data on our U.S. and European markets and also analyzes data from many other markets, I join you today to discuss the recommendations of the Customer Issues Subcommittee.

Investors must have confidence that our markets operate in a manner that serves and protects their interests. This confidence enables our listed companies to raise capital to finance economic growth. Since its earliest days, the Commission has rightly concluded that earning investors' confidence requires a level of transparency beyond that which is required in other industries. Nasdaq supports this transparency in respect to our many operations whether it takes the form of producing reliable market data, describing our operations in our rulebook, regulating the disclosure obligations of our listed companies, or producing detailed reports to be consumed by the investing public.

The subcommittee's recommendations include some needed enhancements in the disclosure requirements of Rules 605 and 606 of Regulation NMS. Investors need modernized execution and routing performance metrics to account for changed market conditions. Changes we have previously supported for updating Rule 605 include finer speed measurements, consistent definitions of market centers and covered orders, and coverage of the life of each order. Rule 606 also needs to better reflect today's markets and we welcome the subcommittee's efforts to modernize the Rule 606 disclosures. Nasdaq will also digest and respond to the Commission's recent proposing release on the disclosure of order handling information. Finally, Nasdaq takes a more cautionary note toward the recommendation that the SEC benchmark and monitor investor confidence in market structure.

We share the subcommittee's view that payment for order flow is an important customer issue in today's markets. Like the subcommittee, we note that the order handling disclosure proposing release addresses payment for order flow and includes a number of questions about potential disclosure obligations. We will reserve comment on this issue until we have reviewed the Commissions' release.

In Nasdaq's view, Rules 605 and 606 have had a positive impact on execution and routing practices since their implementation. The rules have provided valuable, comparative tools for brokers that handle orders on behalf of retail investors. While individual retail investors generally do not review the 605 statistics themselves, the existence of the reports appears to provide precisely the form of discipline that the Commission envisioned when it adopted Rules 605 and 606.

Based on our review of Rule 605 and Rule 606 reports, however, it is not clear that Rules 605 and 606 continue to provide the level of transparency necessary to exert meaningful pressure on market centers to provide superior execution quality and routing practices. Rules 605 and 606 have lagged behind technological advances that enhance market quality and consequently render the metrics utilized in the rules less useful to investors. Developments in market structure have created ambiguity and potential inconsistency regarding the scope of operations and orders reflected in Rule 605 and 606 reports. In certain respects, this ambiguity may ultimately harm transparency by masking relevant differences, providing a false sense of execution and routing quality, and justifying sub-optimal execution and routing practices.

Nasdaq, as co-chair of the Tick Size Pilot Data Subcommittee, has been deeply involved in the current effort to produce execution quality statistics on the stocks covered by the Tick Size Pilot Program. The Pilot will result in the most detailed execution quality statistics ever to be made public by the SROs and their members. While the requirements of the Pilot should not be taken as a template for updating Rule 605, the creation of the execution quality statistics for the Pilot has been very instructive with respect to obtaining and processing order and execution data from a wide range of trading centers.

The subcommittee makes two specific recommendations with respect to the Rule 605 data (Recommendation #2).

The first recommendation is that the scope of Rule 605 be aligned with Rule 606 by requiring every broker-dealer, except for those with de minimis order flow, to report Rule 605 statistics. We support this recommendation. Rule 605 reports miss important information about the overall execution quality of a covered order because they only cover routing handled by market centers. Orders are now commonly handled by smart order routers that may or may not sit within a market center. With a smart order router, an order may be routed to many market centers before achieving an execution. Any price slippage or delays that may occur as the order was received by multiple non-executing market centers is not captured in the data.

The second recommendation is to expand the statistics required under Rule 605 and increase the granularity of Rule 605 reports by segregation of Immediate or Cancel (IOC) orders from other covered orders. At a very high level, I question whether continuing to mandate disclosure of aggregate statistics is a worthwhile endeavor. The goal in evaluating a market center is to evaluate their execution quality performance for orders that are *like mine*. That evaluation is very difficult with aggregate data which only offers statistics for the average order. The Pilot will produce detailed disaggregate information on every individual market or marketable limit order received by a trading center. The Pilot will also produce aggregated statistics with a much greater level of detail and granularity than Rule 605 data or the subcommittee's recommendations. The marketplace of ideas will show which type of data is more informative. I encourage the Commission to consider the relative usefulness of data produced under the Pilot as they decide whether to add more detail and granularity to Rule 605 aggregate data or pursue an alternative based on disaggregated data.

If the Commission decides to increase the level of detail and granularity of aggregated data, rather than require the disclosure of disaggregated data, then we support the subcommittee's recommendations.

The subcommittee makes three recommendations applicable to both Rule 605 and Rule 606 data.

The first recommendation is to improve the accessibility for Rule 605 and 606 reports. Obtaining Rule 605 and 606 reports requires visiting multiple websites and potentially paying user fees to access the data. Processing of Rule 605 or 606 data into a visually accessible format is also not a trivial undertaking. The SEC's Data Visualization Tool addressed a market failure where exchanges' order book data required a substantial infrastructure investment to process, but that is not the case for Rule 605 and 606 data where a number of vendors offer visualization tools. Before replacing existing vendors' offerings, the Commission may want to consider other alternatives for making the data widely available and accessible.

The second recommendation is to improve standardization and consistency of Rule 605 and 606 data by considering centralized report creation by an unbiased and trusted source. Nasdaq has previously stated that to make informed trading decisions, investors need consistent information on similarly situated orders being handled by competing venues. Based upon Nasdaq's review of Rule 605 reports, it appears that market centers do not define covered orders consistently. Improved consistency would help investors and firms better understand the overall statistics reported regarding covered orders. Experience with the Pilot, however, shows that consistency will not be 100% achievable even when report production is highly coordinated or even centralized. Consistency may be a goal that the Commission determines can be better met in the context of the Consolidated Audit Trail initiative.

The third recommendation is for Rule 605 and 606 calculations to depend on the feeds used for routing and execution. Like the previous recommendation on consistency, my work on the Pilot reveals that this recommendation has a strong intuitive appeal that is at odds with the incumbent IT infrastructure of many trading centers. Furthermore, a recent academic study has shown that the differences between using SIP and proprietary data feeds to measure execution quality are exceedingly small.[1] The Commission should carefully evaluate whether the benefits of mandating the use of routing and execution data feeds for execution quality measurement outweigh the costs.

The subcommittee makes two recommendations specific to Rule 606. To an extent, this commendable effort has been superseded by the proposing release on disclosure of order handling information. We will review and respond to the proposing release in due course, and my responses today may be further refined as we consider the release. As a general matter, Nasdaq supports consistency between reporting obligations pursuant to Rules 605 and 606, and so we support the first recommendation that the scope of Rule 606 disclosures be expanded to include exchanges and ATSs. The second recommendation calls for removing the listing market classification, increasing granularity with respect to OTC equities and various order types, improving consistency of destination identification, plain English documentation, and linking information in Rule 606 reports with information in Rule 605 reports. We are broadly supportive off all these recommendations.

Finally, Nasdaq shares the subcommittee's belief that the Commission would benefit by knowing whether investors believe that the markets are operating in their interest (Recommendation #1). We also have an understanding of the strengths and weaknesses of surveys through the many surveys we commission, participate in, and review. In my view, surveys of individual investors, even sophisticated individual investors, are strongly influenced by recent investment performance, market volatility, news headlines, macroeconomic conditions, and other factors which are at best only loosely related to market structure, business models, or corporate disclosure. Furthermore, a great deal of information on investor sentiment can be gleaned from existing public sources and surveys. I encourage the SEC to fully explore these alternatives as a cost effective means to achieve the ends of the subcommittee's first recommendation before sponsoring or conducting its own survey.

I thank the Chair, the Commissioners and the Committee for their time and attention. We appreciate the Committee's thoughtful consideration of these issues and welcome the opportunity to work with the Commission and the Committee to consider important changes in market structure for the benefit of investors and listed companies. I look forward to your questions.

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[1] Bartlett, Robert P. and McCrary, Justin, How Rigged Are Stock Markets? Evidence from Microsecond Timestamps (July 20, 2016). UC Berkeley Public Law Research Paper No. 2812123. Available at SSRN: http://ssrn.com/abstract=2812123.