

MEMORANDUM

TO: Equity Market Structure Advisory Committee (EMSAC)
FROM: EMSAC Customer Issues Subcommittee
DATE: April 19, 2016
SUBJECT: Customer Issues Subcommittee Status Report

Subcommittee Description

This Subcommittee will consider initiatives to protect investor interests and promote investor confidence. The Subcommittee is charged with assessing retail investor concerns such as trading practices and potential conflicts of interests, and making recommendations to the full Committee that would support more granular information to investors and enhance transparency. Topics include issues around meaningful execution quality and review of order routing disclosures (Rules 605 and 606), payment for order flow, as well as processes to educate retail customers on order types and market volatility.

Current Status

- The primary focus of the Customer Issues Subcommittee has revolved around four topics: (1) understanding retail investor perspective on equity market structure, (2) use of stop order types by retail customers, (3) review execution quality statistics from a retail perspective, and (4) payment for order flow. Our progress to date on each of these topics is provided below.
- We have met with a group of retail broker dealers and reviewed their recommendations. We expect to meet with other market participants including the co-chairs of the Market Structure subcommittee of the SEC Investor Advisory Committee and other industry groups.
- We also expect to review institutional order routing/execution quality issues as they relate to Rule 605/606 and proposed SEC rulemaking.
- The Customer Issues Subcommittee expects to make a final recommendation to the EMSAC at the 3Q2016 full committee meeting.

Progress to Date

1. Retail Investor Perception of Equity Market Structure

- Since the February EMSAC meeting, we have had further discussions on the benefits of understanding retail investor perception of equity market structure in a standardized manner and on an ongoing basis.
- Members of the subcommittee have reached out to the SEC's Office of the Investor Advocate (OIAD) to understand their expected survey activity.
- Additionally, we are in the process of reviewing academic studies and surveys specifically focused on investor sentiment. We expect to complete our review of these

studies over the next several weeks and make a recommendation on how the Commission can assess retail investor perception of the equity markets on a regular basis.

2. Use of Stop Order Types by Retail Investors

- The subcommittee discussed the use of stop orders, particularly by retail investors, and the operation of stop orders in volatile market conditions.
- As a general matter, the subcommittee concluded that stop orders are, and continue to be, a useful tool for investors to mitigate investment risk. However, the subcommittee also recognized that these order types by their terms may execute at prices significantly inferior to the market prices that prevail when customers enter them, particularly during periods of extreme market volatility, such as the trading that occurred on August 24th.
- The subcommittee believes that firms should review their practices regarding stop orders, with an emphasis on educating investors regarding the risks and benefits of stop orders and special considerations around the use of stop orders during volatile market conditions.
 - Firms should consider providing targeted training to registered representatives regarding the risks associated with stop orders and, where appropriate, making alternative recommendations to meet customer objectives.
 - Firms that allow customers to enter stop orders directly online should ensure that clear and comprehensive disclosures are prominently provided prior to or at the time of order entry.
 - Firms also should consider implementing other systemic safeguards around the use of stop orders, such as preventing stop orders that do not include a limit price or restricting the time of day during which a stop order may be executed.
- The subcommittee recommends that the SEC and FINRA consider issuing additional guidance to further emphasize the importance of these effective practices relating to stop orders.

3. Enhancements/Expansion of Execution Quality Reports

Execution Quality Reports at the Individual Broker-Dealer Level

- Today, Rule 605 requires market centers¹ to publish reports. Broker-dealers who route order flow to other execution venues only produce Rule 606 reports. The subcommittee sees value in expanding Rule 605 to include all broker-dealers with a possible exception for small broker dealers.
- While there would be compliance and implementation costs, the use of third party vendors may mitigate some of these concerns.
- By having all broker dealers provide Rule 605 data, there would be opportunity for market participants, academics and the press to evaluate these statistics in a consistent manner.

¹ As defined by Regulation NMS, market center means any exchange market maker, OTC market maker, alternative trading system, national securities exchange, or national securities association.

Access to Execution Quality Reports

- The subcommittee believes access to Rule 605 and Rule 606 reports should be readily available in a centralized location.
- The SEC's existing Market Structure Data and Analysis [website](#) could act as the repository for this data. There may also be opportunities to allow for visualization of this data leveraging the SEC's Data Visualization Tool.

Enhancements to Rule 605/606 Reports

- The subcommittee agrees that the general principles of standardization and meaningful disclosure should guide changes to Rule 605/606.
- Based on an evaluation of Rule 605 and Rule 606 from a retail perspective including discussions with retail broker dealers and a review of issues raised in comment letters, the subcommittee believes there is opportunity for enhancements.
- Retail-focused Rule 605 enhancements could include the following:
 - Inclusion of odd-lots
 - Segregation of Immediate or Cancel (IOC) orders
 - Inclusion of "quoted spread" and "enhanced liquidity"
 - Revision of FAQs regarding methodology to assign an NBBO for orders received in the same second as a quote change
- Retail-focused Rule 606 enhancements could include the following:
 - Instead of dividing data by listing markets, consider division by S&P 500 and Other NMS equities
 - Inclusion of a new section for OTC Equity Data
 - Segregation of data currently in the "Other" category including market open/close orders, stop/stop on quote orders with odd-lots represented in their appropriate category
 - Consistent identification of routing destination across Rule 606 reporters
 - Inclusion of plain English descriptions, definitions and FAQs
 - Possible segregation of market orders, marketable limit orders, and non-marketable orders
 - Include execution quality statistics by routing destination
- Evaluating Rule 605/Rule 606 from an institutional perspective was tabled pending the release of SEC rulemaking related to institutional execution quality. Prior to the 3Q2016 EMSAC meeting, we expect to revisit this issue and seek input from market participants. The subcommittee expects to cover institutional execution quality issues in its final recommendation.

4. Payment for Order Flow

- The subcommittee has not come to a consensus on action with respect to payment for order flow. Discussions spanned several topics including prohibiting the use of payment for order flow, managing conflicts of interest and opportunities for enhancing existing or requiring new disclosures.