MEMORANDUM

TO: Equity Market Structure Advisory Committee (EMSAC)

FROM: EMSAC Trading Venues Regulation Subcommittee

DATE: April 3, 2017

SUBJECT: Preliminary Recommendations on SRO Liability Limits and Regulatory Centralization

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The Trading Venues Regulation Subcommittee (Subcommittee) of the EMSAC was formed to review and analyze whether the current regulatory model for trading venues is optimally serving the market as a whole and providing a level and fair playing field for all market participants. To date, the Subcommittee has considered topics including the appropriate regulatory structure for today's trading venues, the impact of exchanges' liability limits on market behavior, governance of NMS plans, and consolidated market data.

On July 8th, 2016, the EMSAC adopted two recommendations from the Subcommittee that relate to enhanced industry participation in certain SRO regulatory matters. At that time, the Subcommittee noted that it was working separately to consider recommendations in other areas, including SRO liability and regulatory centralization. Since then, the Subcommittee has held several meetings to discuss potential recommendations in these areas and also recently held a panel discussion with key regulatory personnel from CBOE, IEX, and FINRA to discuss regulatory centralization in more detail.[1] Based on these efforts, the Subcommittee developed the preliminary recommendations outlined in this memorandum, which it presents to the EMSAC for further deliberation.

<u>Preliminary Recommendation 1: SRO Liability Limits</u>

- As noted in its April 19, 2016 submission to the EMSAC, the Subcommittee has been discussing recommendations related to SRO immunity and rule-based exchange liability levels. While the Subcommittee has not reached consensus on a recommendation regarding SRO immunity, it does believe that there are improvements to be made around the structure for SROs to compensate the industry as it pertains to technology and other errors.
- The Subcommittee, with the assistance of SEC staff, compiled and reviewed a survey of the exchanges' liability rules. The Subcommittee generally agreed that exchange rules should apply consistent limits and that exchanges should create and support a reserve fund that allows for unpaid amounts to build up to a set limit.

[1] The New York Stock Exchange and Nasdaq were invited to the panel discussion but they declined to participate.

- On consistent limits, the Subcommittee noted that many exchanges already have similar limits in place. Most exchanges currently allow payment up to $100,000 per member per day, with a $250,000 aggregate limit for all members per day and a $500,000 aggregate for all claims per month. The Subcommittee recommends that all exchanges adopt the same framework, to the extent they do not already have it in place.
    - The Subcommittee additionally recommends that all exchanges adopt uniform and transparent procedures for members to submit claims.
- On the creation of a reserve fund, the Subcommittee generally supported the approach taken by NYSE, which allows for unpaid funds to be added to a "supplemental allotment" that could be used to satisfy claims in excess of the liability limits. The Subcommittee believes that the reserve fund model is one approach that would help protect market participants and SROs from unforeseen, particularly disruptive events.
    - The Subcommittee recommends higher reserve fund limits for listing exchanges in light of their role concentrating volume and pricing information for initial public offerings and opening and closing markets. While the Subcommittee did not reach consensus on what higher limits are appropriate at listing exchanges, it generally believes they should be significant with the appropriate level being 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. The Subcommittee recommends that the Commission engage SROs for further review of appropriate reserve fund limits with an opportunity for public comment.[2]

<u>Preliminary Recommendation 2: Mitigating Duplication with Regulatory Centralization</u>

- The Subcommittee previously submitted a preliminary recommendation that supported greater centralization of regulatory functions across SROs into a single regulator. The Subcommittee has continued to discuss the issue since then, and, as noted above, recently held a panel discussion with key regulatory personnel from CBOE, IEX, and FINRA to discuss the concept in more detail.
- The Subcommittee generally agrees that the following principles should guide a recommendation in this area:
    - The exchanges have unique expertise in regulating their markets, including unique aspects of their markets such as the opening or closing auctions, and it is beneficial for them to support and develop their own regulatory initiatives, like

[2] The Subcommittee considered but did not reach consensus on whether exchange groups should be permitted to hold one consolidated reserve fund for all affiliated exchanges, or whether there should be a reserve fund for each registered exchange. The Subcommittee recommends that the Commission engage SROs for further review of this question as well with an opportunity for public comment.

the BATS expedited proceedings process to address specific types of disruptive trading. There is also benefit to exchanges leveraging their regulatory and market expertise to support innovation in developing cross-market surveillance patterns.

- However, with the implementation of CAT, there is risk of significant regulatory duplication, which should be minimized, consistent with SEC policy. This risk is greatest for common SRO functions or obligations, including regulation of cross-market activity. Specifically, with the implementation of CAT, for the first time, all SROs will have access to cross-market surveillance data. As a result, there could be a natural evolution for multiple SROs to expand their surveillances to be cross-market. The Subcommittee is concerned that without intentional coordination, this could result in less efficient and effective regulatory oversight for the industry
- To promote market integrity, the SEC should articulate and support minimum standards for cross-market regulation. Such standards would be of particular use because the SROs' overlapping responsibility for cross-market conduct creates the potential for regulatory gaps, a race to the bottom, or undesirable competition for regulatory fines.

- Based on these principles, the Subcommittee discussed a potential approach that could mitigate duplicative regulation and still promote competition, innovation, and the exchanges' ability to regulate their markets.
  - Certain cross-market regulation should be centralized, with particular focus on the types of cross-market fraud or manipulation that the SEC identified throughout the CAT initiative. This approach should build on the coordination currently in place for insider trading and account for the regulation of other conduct identified by the SEC, including front running, trading ahead, quote rule violations, layering and spoofing, portfolio pumping, and marking the close.
    - The cross-market regulatory functions to be centralized would include surveillance-based inquiries, investigations, enforcement, and examinations.
    - The Subcommittee also believes that all functions concerning the specific regulation of compliance with the CAT NMS Plan should be centralized in a single SRO.
  - Under this approach, to continue to support and advance innovation in this area, the development and deployment of cross-market surveillance patterns would not necessarily be centralized. Exchanges could define and perform their own cross-market surveillance, consistent with the standards the Subcommittee recommends the SEC develop, or they could use a centralized cross-market regulator through agreements that call for collaboration in development of the cross-market surveillance program (or a combination of both exchange-only and centralized cross-market surveillance).
  - The Subcommittee believes that centralization should occur once surveillance pattern results progress to the inquiry stage and potentially lead to investigations and enforcement. Beginning at this stage of the regulatory process, the risk and

    negative impact of duplication is significant while any offsetting benefits that may be realized by having each exchange perform these functions is minimal and can be achieved through continued collaboration between the centralized regulator and the exchanges.

        - As a necessary component of this approach, the Subcommittee recommends that SROs develop and adopt a transparent formula for the allocation of fines paid as a result of centralized cross-market regulation.

    - Also under this approach, exchanges would not be prevented from regulating manipulative or fraudulent conduct that occurs on their markets or enforcing prohibitions against disruptive trading practices.

- Finally, the Subcommittee notes its belief that futures data is important to consider as the industry moves forward with enhanced cross-market surveillance with CAT data. The Subcommittee recognizes the challenges in this area but intends to engage the futures markets for a panel discussion to further explore the issue.