The SEC to (Sort of) Speak on the Market Structure Overhaul

Plus, spotty convictions around events and notably low correlations

The SEC on Market Structure

With time running out (potentially) on the current SEC administration, we've finally heard something on the Market Structure Overhaul proposals…somebody ring the bell! Really, it's the linchpin of what has been an extremely active SEC. **While the administration has been historically busy in sheer size of proposals and rules, the commission has remained remarkably quiet as it pertains to the Market Structure Overhaul**: a wide ranging set of proposals addressing everything from forced retail orders to exchange; reduction in minimum price increments/exchange access fees; best execution definitions as well as enhanced transparency.

Each component of the proposal offers a different level of controversy—with probably 80% in the very high category—and as we get closer to final rule implementation, significantly higher levels of complexity and regulation are going to prove to be a battle. The crazy thing is, time is running out quickly, so it is extremely odd that it has taken this long to get to this point (the truncated comment period ended almost one year ago!). While the presidential election at this point seems like a distant event…it really isn't. **Remember: the SEC is a highly politicized commission, where the complexion is dictated in a way that puts voting power in the party hands of the residing president. Which way that goes is anybody's guess (if you have the energy to talk about it) but there is a real chance that this current SEC regime is not in place come this time next year.** If that does turn out to be the case, there is a real chance that the most aggressive market structure proposal (at least since 2005's Reg NMS), for the most aggressive SEC of maybe all time, could largely be dead on arrival once litigation gets involved.

The meeting on March 7 is **being hosted by the SEC, at the SEC, and by some who have been vocal SEC proponents in the recent past (the minority has been skeptical). It is difficult to imagine a full on assault on policy/rule suggestions at an event that the commission is in control of, so this is most likely an effort to solidify their position.** Meanwhile, all walks of the industry have expressed an overabundance of negativity around not only the Market Structure Overhaul Proposals but also the general record-setting rule/proposal agenda—"regulatory overreach" being the key buzzword of any regional STA event for the past two years.

It's interesting there is not fair representation from the larger exchanges (NYSE, Nasdaq, etc.), large investment banks (Goldman Sachs, J.P. Morgan, etc.), nor market makers (Citadel, Virtu, etc.), so there is some concern the hosting and vetting by the SEC will be a bit of a singular angle, but we will see. SEC commissioner Hester Pierce has not only been vocal on the load of regulation but also about taking a non-measured approach to industry input that is lacking in policy and correctly constructed. The proven tendency of proposing the extreme and then dimming it down is a dangerous way of rule-making. **In the end, however, this does set up for the SEC to finally put their proposals to rule, at which point, expect the industry opposition to lawyer up**—and as mentioned, with time potentially running out.

Details, Concerns, and Industry Stances

1. **Enhance Order Competition (exchange auction proposal)**
This is easily the most controversial and the least likely to see adoption—at least not without an epic legal battle). **The retail wholesalers currently agree to take "held" order types from the brokers, i.e., guaranteed execution.**

Questions and Concerns:

- What happens to liquidity when the liquidity isn't there at auction, and the wholesaler is no longer in agreement to guarantee execution?
- How burdensome of an implementation process will arise, including technology/compliance costs?
- How prepared are the exchanges to take financial responsibility for errors? Can the system handle the messaging load?
- The 1% ADV Threshold actually reduces the list of eligible venues/exchanges capable of offering a market once going to auction.
- *If* an auction were to exist, wouldn't best-ex dictate which venue is better rather than forced venue participation?

Keep in mind, the retail trader currently enjoys zero commission trading, obtainable markets, unlimited size in 10,000+ listed stocks and ETFs, at prices at or better than what institutions receive.

While a few key wholesalers enjoy the bulk of this flow, the competitiveness, as cited at the conference, is ultra-fierce. If performance isn't there, the retail broker turns the spigot off for that executing broker. Execution report cards are delivered daily, and margins are extremely tight…a good quote from the wholesaler community—**"if the getting is so good, there would be a thousand market participants lining up."** The retail participant/broker wants the order eaten up, both the good with the bad, and these wholesalers consume both.

2. **Tick Size and Access Fees**
This is not an easy pass through itself but it has shown bi-partisan support. It would still constitute a dramatic change and difficult implementation. The wholesaler response here will most certainly be an extended litigation exercise upon adoption intention.

Three notable efforts on this front:

- Adopt minimum variable pricing increments (MPI's)/tick sizes for quoting and trading NMS stocks (adjusted by name quarterly based on typical/average trading metrics).
- Reduce access fee caps from 30mils to 10mils (lower in some circumstances).
- Introduce new odd-lot best bid/offer benchmark.

Again, this is largely an effort to move retail executions from an off-exchange to on. In theory, harmonization (the #1 buzzword) of tick sizes and quoting across all venues should increase competitive forces on that execution and including the odd/lot transparency can add to the liquidity picture. **There are some concerns, however:**

  - The wholesale market maker will be forced to trade at these tighter levels and will see a margin/profitability dent both in the spread opportunity and the exchange rebate to offset a take fee (typically 30mils take, 28mil rebate)—will less profitability for the wholesaler alter the PFOF structure and ultimately lead to a re-snap of retail broker commissions?
  - Will the liquidity disincentive actually work to widen spreads, and eliminate liquidity providers?
  - The current structure guarantees automatic execution—will this new structure eliminate the liquidity wholesalers provide?
  - While ultimately providing less liquidity at a price point, what relevance does the National Best Bid and Offer (NBBO) provide for institutions looking to execute sizable orders?

- Is added volatility at price levels, less size, complexity in MPI adjustments, and added messaging load going to be too disruptive to a system which already enjoys significant efficiencies?

3. **Best Execution**
While this would seem to make sense to maintain a fair market and best customer execution, FINRA has already laid out best execution policy. Therefore, this can be viewed as the SEC's first official recognition. **Does having multiple regulatory bodies addressing the same issue cause confusion or lack of cohesion as they set policy on essentially the same rule? Who enforces? Additionally—the SEC addressed this in practice with 2005's Reg NMS—is it worth $700M as estimated by the SEC to implement and run?** That's likely highly debatable and offering enough legal counter to implementation.

To understand the SEC's perspective here, it's worth looking back at Reg NMS. Where in particular, there are outdated rules as it applies to retail order flow:

> "Moreover, the Commission has not interpreted a broker's duty of best execution for retail orders as requiring that a separate best execution analysis be made on an order-by-order basis.[149] Nevertheless, retail investors generally expect that their small orders will be executed at the best displayed prices. They may have difficulty monitoring whether their individual orders miss the best displayed prices at the time they are executed and evaluating the quality of service provided by their brokers.[150] Given the large number of trades that fail to obtain the best displayed prices (e.g., approximately 1 in 40 trades for both Nasdaq and NYSE stocks), the Commission is concerned that many of the investors that ultimately received the inferior price in these trades may not be aware that their orders did not, in fact, obtain the best price. The Order Protection Rule will backstop a broker's duty of best execution on an order-by-order basis by prohibiting the practice of executing orders at inferior prices, absent an applicable exception."
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> [149] See, e.g., Securities Exchange Act Release No. 37619A (Sept. 6, 1996), 61 FR 48290, 48323 n. 362 ("Order Handling Rules Release") ("Commission has recognized that it may be impractical, both in terms of time and expense, for a broker that handles a large volume of orders to determine individually where to route each order it received."). See also infra, section II.B.4 (discussion of duty of best execution).
>
> [150] See supra, note 53 and accompanying text (discussion of difficulty for investors to monitor whether their order execution prices equal the best quoted prices at the time of order execution).
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> Source: Page 77, 2005's Reg NMS

While FINRA already officially outlines Best Execution, the SEC's standard is maintained through the trading rule itself. The Order Protection rule, specifically, seemingly satisfies concerns on a broker/dealer not executing an order at the most optimal price for a customer. While the details of Reg NMS point to a retail customer expecting the best displayed price, the reality is, in the structure of PFOF, the retail customer is typically getting better prices than an institution would…the transparency of Rules 605/606 (more on that below) raises the competitiveness for these executing broker/dealers - if your performance is not there, you will not get the flow.

4. **Execution Transparency Disclosures**
This is the SEC's proposal to refine the aforementioned rule 605. It likely offers the least controversy, and potential success for implementation, as it represents modernization of reporting with the ultimate goal of greater transparency. As alluded to above, the natural competition can get enhanced through this as broker/dealers further prove their worth. **This seems to make sense and—so far—rebuttals have been few.**

Volumes Sources and Liquidity

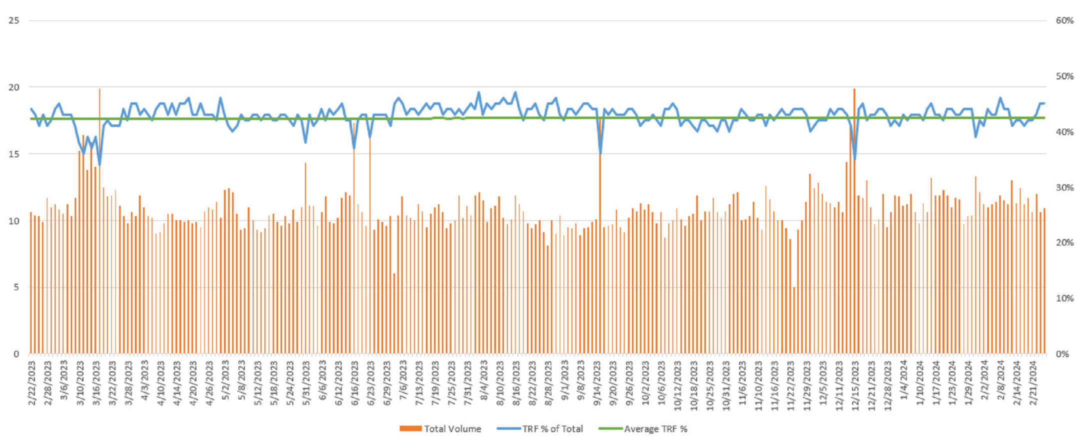
The Nvidia earnings report was quite the frenzy. It always seems like it in the moment, whether it be an important eco or earnings report (the inflation and jobs data of the past 1.5 years seemingly always having an intense focus on a market looking for a disinflation tract to support prices)—**but Thursday's NVDA quarterly release seemed to be the most intense microscope on an event most can remember**. The implied volatility going into the event suggested a +/- 10% move and it didn't disappoint. **Interestingly, however, while going into the year it seemed like this market was set to "normalize"—i.e., see historic levels of cash hoard be put to work and possibly see some more consistent volatility and price action—that hasn't really been the case.** Obviously, propelling the AI secular growth story and mega cap tech earnings to go along with the other bullish narratives—i.e. largely intact broader disinflation train, equity fund inflows, buybacks, etc. At the moment, and most importantly overwhelming some of the bearish narrative, is the Fed's hawkish fed price re-pivot. This indicates **a market ready to return to the bull market personality of "rise on fumes," and searching for the known unknowns in data points**.

With the market's '24 rate cut expectations in line with the 75 bps from the December dot plot, we will look for quick acceleration and decelerations (the norm) around data point deliveries. The week of February 26, there is a focus on the PCE inflation on Thursday and the ISM manufacturing on Friday. Keep in mind, in terms of the bullish/bearish tug of war—the recent higher blip in CPI (possibly seasonality influenced) brought some of the best conviction and volume in a while - market volumes are up 15% with a S&P 500 decline of 1.8 standard deviation (frequency = 7x/year), only to be retorted by the NVDA report with slightly less volume support (up 10%) but a standard deviation of 2.7, equating to a frequency of less than 1x/year. This indicates that **conviction will come in bursts, liquidity will build around the events, only to quickly revert, but from a conviction perspective to support momentum, the feather is still in the cap of the bulls**.

It's not shocking to see the sharp rise in FINRA TRF reported volumes over the past few days, as illustrated in *Figure 1*—the retail crew is hitching the wagon to a rising star. Retail volumes are likely in the 20% of total market volume range at the moment. Obviously, that can be impactful from an institutional participation perspective—impacting expected impact cost, along with continuous institutional volume. **Interestingly, investment bank-reported volumes (the majority of institutional execution) is sitting below the 15% threshold, as indicated in Figure 2, which helps paint the quality of the liquidity story and speaks to the market's ability to revert quickly back into a listless volume/direction personality.**

Figure 1

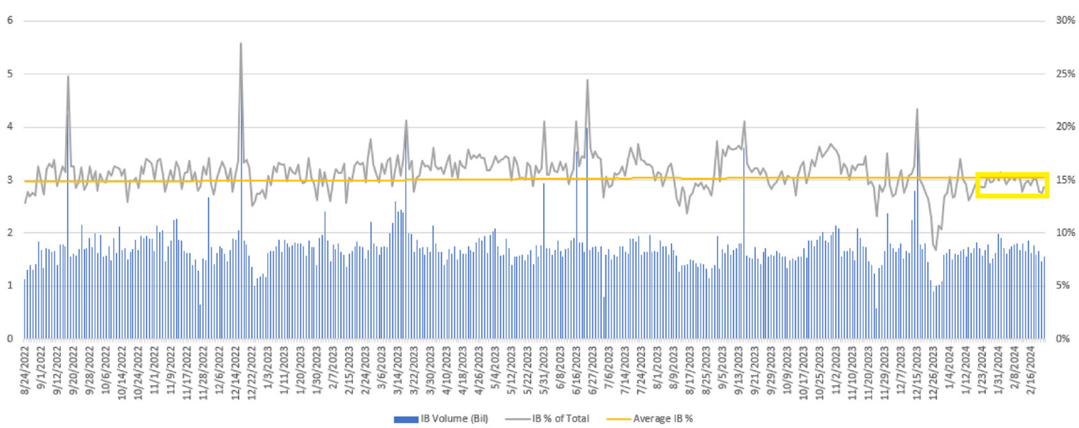
One Year TRF Volume (February 2023-2024)



Source: Liquidnet

Figure 2

18M Investment Bank Volume (August 2022 - February 2024)



Source: Liquidnet

Alarmingly Low Correlations

Lastly, it's a good time to check in on correlations, which are alarmingly low. Certainly at a point where, had the NVDA earnings report gone the other way, this market was ready to go all in on risk-off everything. Remember, while low correlations mean the traditional asset manager can enjoy better fundamental stock picking, overall risk has grown. In a market where most strategists will point to a catalyst vacuum, it is interesting to see where a valley in correlation can coincide with an ensuing market pull-back (and vice versa). Although the narrative doesn't feel like it, it's just another incremental setup to suggest the data watching will be intense, like a market walking on eggshells.

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