Recap: STA National 2023

This month's Securities Traders Association (STA) annual conference in Washington, D.C. is one of the more anticipated industry events of the year, with strong representation from all angles of financial services participants. This time last year, the SEC had yet to officially introduce the Market Structure Overhaul proposals, but it didn't take much clairvoyance to sense the shape and areas looming for address. With those proposals released officially in December 2022, followed by a condensed—and robust—comment period, there remains very much a "wait-and-see" conundrum as the SEC has not given guidance or sense of thought about industry analysis or suggestions.

In terms of room "temperature" there was certainly an overabundance of negativity around the proposals, from all walks of the industry. Not just the higher profile Market Structure overhaul, but also what has been a very aggressive SEC agenda. "Regulatory overreach" was one of the many notable soundbites, along with some other predictable ones like: "promote a healthy and competitive market," "encourage innovation," "depth of analytics around cost impact," "empirical evidence," "added drama to capital markets," and always the crowd pleasing "harmonization."

Along with the buzzwords, there were palpable themes running through the speaker panels. **The aforementioned overreach being front and center, but also the potential impacts of the four pillars of the Market Structure Overhaul, the quickly evolving/growing ETF market, predictive analytics through AI, and separation of retail from institution as a definition. Below is a summarization of some these key themes.**

Regulatory Overreach

It seemed appropriate that on the Friday of the STA conference closure, the Wall Street Journal runs an A1 story titled "Hedge Funds Must Disclose Short Selling"…to go along with the notion of over-reach. The crux of the article is further disclosure and putting a 2010 Congressional law to practice. Passed along party lines among the SEC commissioners at 3-2, with the naysayers alluding to discouragement of short selling along with further burdensome reporting requirements—on top of redundancy of already mandated short sale statistics. **Importantly, another rule/proposal to add to the list: Names Rule, ESG Disclosure, Liquidity Rule, Money Market Funds Reform, Custody Rule, T+1, Predictive Analytics, Liquidity Risk Management, etc.**

In the time of Gary Gensler's role as Chairman of the SEC, there have been 47 proposals vs. 19 during Mary Jo White's tenure (April 2013 - Jan. 2017) and 22 during Jay Clayton's run (May 2017 - Jan. 2021)—a double from the prior two administrations. The buy side, sell side, and issuer industry representatives are all citing the "unprecedented onslaught" during the conference. The closest comparable is Mary Schapiro's agency, handling the initial response to the financial crises, putting forward 59 proposals and 18 final rules. Importantly, Gary Gensler's agenda stands out significantly in the sense that the vast majority of proposals historically are mandated by congressional legislation—hence Schapiro's aggressive agenda. **The current aggressiveness is leaving most market participants perplexed, citing lack of purpose or justification.**

SEC Commissioner Hester Pierce cited the load of regulation as problematic. To do things right, need to be measured to go along with industry input. Roundtables with industry participants along with concept releases can be the more efficient vessel rather than a rushed and misunderstood full market proposal. **To go from a very extreme proposal to a more moderate proposal can have severe unintended consequences, which seems to be a bit of Chair Gensler's strategy. To propose the extreme and then dim it down, is a dangerous way of rule-making. Or to put another way, to throw as much as possible on a board and see what sticks, or partial sticks, doesn't solve for cost benefits and efficient markets.** The administration seems capable of handling the proposal approval process, but not practicality or realism of market impact.

Market Structure Overhaul Proposals

Well documented, as the most far-reaching and impactful proposal since 2005's Reg NMS. It is complex and really falls into four categories, with some support, total support, and no support being the profile across the spectrum of industry reaction. These have all been well reported on, and as mentioned earlier, **the street waits with bated breath**. Generally accepted as Chairman Gensler's attempt to dismantle the PFOF structure as we know it, and move volumes back to on-exchange from off—ironically, the major exchanges see this proposal as too extreme, and that is the general consensus. **Much of the STA conference and industry commentary can be related back to this proposal—whether it be retail orders to auction, tick size, access fees, odd lots included in National Best Bid and Offer (NBBO), best execution, etc. Below is a summary and industry concerns of the proposals (quick as can be) and to the earlier point, as controversial as it was this time last year.**

1. **Enhance Order Competition (exchange auction proposal)**
    a. Easily the most controversial, and the least likely to see adoption (or at least not with an epic legal battle)
        i. **The retail wholesalers currently agree to take "held" order types from the brokers—i.e. guaranteed execution. What happens to liquidity when the liquidity isn't there at auction, and the wholesaler no longer is in agreement to guarantee execution?**
        ii. **How burdensome of an implementation process will arise (technology/compliance costs)?**
        iii. **How prepared are the exchanges to take financial responsibility for errors? Can the system handle the messaging load?**
        iv. **The 1% ADV Threshold actually reduces the list of eligible venues/exchanges capable of offering a market once going to auction.**
        v. ***If* an auction were to exist, wouldn't best-ex dictate which venue is better rather than forced venue participation?**
    b. Keep in mind, the retail trader currently enjoys zero commission trading, obtainable markets, unlimited size in 10,000+ listed stocks and ETF's, at prices at or better than what institutions receive.
    c. 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 conference referring to the notion of the small number of participants with overwhelming share—**"if the getting is so good, there would be a thousand market participants lining up."** 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**
    a. Not an easy pass through itself, but has shown early bi-partisan support but would still constitute a very dramatic change and difficult implementation. The wholesaler response here will most certainly be an extended litigation exercise upon adoption intention). **Three notable efforts here:**
        i. **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).**
        ii. **Reduce access fee caps from 30mils to 10mils (lower in some circumstances).**
        iii. **Introduce new odd-lot best bid/offer benchmark.**

b. Again, largely an effort to move retail executions to on-exchange from off. In theory, harmonization (buzzword #1), 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. **However:**

   i. **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?**

   ii. **Will the liquidity disincentive actually work to widen spreads, and eliminate liquidity providers?**

   iii. **Again, current structure guarantees automatic execution—will new structure eliminate the liquidity wholesalers provide?**

   iv. **Ultimately providing less liquidity at a price point, what relevance does the NBBO provide for institutions looking to execute sizeable orders?**

   v. **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

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

b. 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."

   (Page 72 of 2005's Reg NMS)

c. **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.** And 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

a. The SEC's proposal to refine the aforementioned rule 605. Likely offering the least controversy, and potential success for implementation, as it offers modernization of reporting and ultimate goal of even better transparency. As alluded to above, the natural competition can get enhanced through this as broker/dealers further prove their worth. **This would seem to make sense and so far rebuttals have been few.**

ETFs

ETFs are having enormous impact on structure. In the US alone, the segment represents $7 trillion under management with year-to-date inflows of $330 billion (down from $600 billion record in 2022). There is 60% in equity ETFs and 40% in fixed income. Of the 2023 inflows, 20% are in actively managed funds, and of the 350 or so new listings, roughly 74% are in the active category. **How do the regulatory changes impact the ETF space? In many ways, ETFs were not taken into consideration at all in the proposals and of the $7T in the US. There are potential extreme detrimental effects to the retail investor as 60 - 70% are held by retail.** The panel moderated by Adam Gould (Tradeweb) in conversation with Eric Pollackov (Invesco), Giang Bui (Nasdaq), and Reggie Browne (GTS) is worth a listen.

There appears to be a lack of sophistication in the ETF industry, particularly at the SEC, especially when a third of volumes are going through this medium. The Market Structure overhaul will have significant impact here, and even actions like T+1 can have real consequences on spreads (how do international funds settle in new rule?). ETFs directly touch retail households and allows direct inclusion into markets, particularly around retirement funds. When you look at the different styles: FI, listed derivatives, options, small caps, etc.—all different complexions and we're talking mostly here about mom + pop main street. **There is a marketplace solution that will effectively higher costs and wider spreads and can impact capital requirements and sustained settlement failures to clients can lose investor confidence.**

Why was T+1 even proposed—and it revolves around the GameStop situation—while ETFs get wrapped up in that solution. Just the ability to create products so you don't have a restriction on how many shares are outstanding—nuances like this call for unique ETF structure, rather than throwing in with single stock equities.

And as one of the pillars' impacts on ETFs, tick size to a tenth of a penny is totally irrelevant to an institutional investor. How can someone trust what they see on a screen at a tenth wide, along with competition from HFT and best bid/offer—it makes the quote irrelevant. **Fractionalized tick sizes equal fractionalized liquidity, not just for traditional asset managers, but also ETFs. The industry would call for separation of treatment as it pertains to ETFs.**

Predictive Analytics through AI

Along the lines of the Short Selling proposal mentioned above, there are many examples that don't have the juice of the Market Structure Proposal, however, they are drawing attention within the industry. At the end of July, the SEC proposed a rule to address the use of AI by broker/dealers and investment advisors. **While a different topic than the SEC's goal of addressing gamification in apps, the predictive analytics proposal falls in the category of technology regulation overkill. And the overarching theme of targeting technology decreases improvement/evolution and takes away from investment opportunities.**

Both the SEC representation at the conference and the industry participants believe this proposal to take too broad of an approach to the "covered technology." In the proposal, a means in which firms may "evaluate and determine whether its use of certain technologies in investor interactions involves a conflict of interest that results in the firm's interests being placed ahead of investor's interests—should a conflict exist, firms would be required to eliminate, or neutralize the effect of, any such results." The term "predictive data analytics" in the SEC proposal is intended to include AI solutions as well as technology solution that may include AI, and all such technologies. **The vagueness of the definition of "covered technology" lends it to being applied to commonly used spreadsheets, software, and math formulas.**

The SEC, of course, is suspicious that investment advisors are using AI to monitor their clients trading habits and using that information to encourage them to trade more. On the flip side—and the consensus from the conference is that the proposal is deficient—could have used roundtable processes to better form, and will require significant advisor investment to meet requirements.

Separation of Retail and Institutional

The SEC has split what they view as "investor" definition between self-directed individuals and institutions. Previous administrations looked at investors wholistically, and not a separate perspective for the mom + pop trader versus the institutions. The panel hosted by Kimberly Russel (State Street) in conversation with Dalia Blass (Sullivan & Cromwell) and Mehmet Kinak (T. Rowe Price) is worth a listen. Pointing to the overarching theme that why would these two factions be split? Particularly, if the goal of this current SEC is to help and protect the retail investor, **isn't it the institutions that are carrying the vast majority of the retail investors assets (retirement funds far outstripping value of personal accounts)? This change in concept is key, and not looking at this investor definition collectively can have a devastating impact.**

Chairman Gensler has explicitly stated that his end client is not the sell side or buy side end client. Hence, the rules have been detrimental to the institutions and their general ability to operate. Largely these rules have left the industry scratching its head and trying to figure what are we trying to solve for? **The 1940 Investment Company Act is a good example of how the relationship between regulator and industry can be achieved. Congress, regulator, and industry all working cohesively to target the problem and solve for it. Even then, the regulator is going to ask for more onerous burdens on the industry, which have time to be deliberated and agreed upon. Capital formation is important for the same end client, and that is the INVESTOR as a whole, not a split between self-directed and institutions.**

A good example is the Liquidity Risk Management Rule, largely in response to the market events surrounding the absolute throes of the Covid-19 pandemic and market impact. While the potential for breaks and redemption satisfaction was stressed, **didn't the government mandate an economy shutdown?** And what happens when you shut down the economy? The whole ecosystem starts to crack, much like it did for example in the short-term lending markets and overall market dislocations. But was this an industry problem or more an impact of complete and total government assertion of power?

Capital formation is the key to all investors, and all investors should be classified the same.

In general, there is real concern surrounding the current SEC regimes' approach to rulemaking and the manner in which it is implemented. No punches were pulled. And while the conversations weren't all that different in topic than they were this time last year, the year's long digestion of proposals and rules, at record setting levels, has opened up to more deep thought. The Washington STA conference is always a strong gathering, with all manner of industry participants, and hopefully the above summarizations on themes can give some sense of "finger-on-the-pulse" as the industry attempts to lobby—most importantly in Washington D.C.—on a rulemaking regime that will impact all.

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