Consumer Federation of America

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Changes to Equity Markets Require Structural Reforms
CFA White Paper Proposes Market Reforms to Benefit All Investors

Washington, D.C. (September 9, 2014) – Regulatory policy has not kept pace with the significant changes that have occurred in our stock market within the last few decades, according to a CFA white paper on market structure. The white paper analyzes those market changes and proposes reforms that are designed to foster transparency, ensure high market quality, minimize conflicts of interest, guarantee a level playing field for all market participants, and promote stability within the marketplace.

"Our current equity market structure reflects in many ways the achievement of the Exchange Act's goal of having multiple competing venues linked through technology," said CFA Financial Services Counsel and report author Micah Hauptman. "While competition and technology have brought great progress to our equity markets, the pendulum has swung too far. Excessive competition has resulted in a market that is unnecessarily complex, fragmented, lacking basic transparency mechanisms, and ridden with conflicts of interest. The technological arms race has led to trading activities that disadvantage long-term investors, expose the financial system to excessive risks, and shake investor confidence."

In the white paper, CFA advocates for policies to be designed to promote healthy competition that serves the interests of investors and capital formation. The goal should be to ensure that market participants are using technology in productive rather than destructive ways. While the paper details significant ways in which our markets are not delivering on the objectives that Congress intended when it created the National Market System, it also reminds stakeholders to keep perspective in how our markets are actually functioning.

"Despite what some may claim, our markets aren't 'rigged,' such that they require wholesale change," said Hauptman. "Indeed, meaningful improvements to our equity market structure are required, but they're not beyond our reach."

The following are among the key policy changes needed to address market shortcomings:

1) A trade-at rule should be adopted to counter the drop in displayed liquidity that results from the rise of off-exchange trading.

Despite a 1975 congressional mandate that U.S. equity markets be transparent, the reality is that our markets are increasingly opaque. Almost 40 percent of share volume is now traded off-exchange, primarily by broker-dealer internalizers and dark pools. This trading occurs with little to no price transparency. The relative decrease of displayed prices in our equity markets indicates that our national market system has failed to deliver this critical component of a transparent, competitive, and efficient market, to the detriment of investors and market quality.

Our national market system functions best when displayed liquidity is promoted to the maximum extent possible. Publicly displayed price quotes provide investors and the market with transparent and accessible liquidity, and provide price discovery on a forward-looking basis, indicating the prices at which trades can be made immediately. These are all necessary components to form an efficient and well-functioning market, an environment in which different venues can compete to deliver to investors the best prices and executions available.

In order to encourage displayed liquidity, a trade-at rule should be adopted. A trade-at rule would encourage venues to display their prices by preferencing the routing of trades to venues that are providing displayed quotes for inclusion in the consolidated data feed. As a result, a higher percentage of trading would occur on lit venues and a lower percentage of trading would occur off-exchange. This would increase transparency of prices and re-centralize liquidity between exchanges, making that liquidity more accessible. By promoting pre-trade price transparency, a trade-at rule would also foster healthy price competition between venues, which will ultimately result in better values for investors.

2) To address unhealthy competition among trading venues, the Commission should conduct a pilot project to study the effects of eliminating maker-taker pricing and should require retail brokers to provide significant price improvement to their customers when their orders are internalized.

There are a multitude of trading venues in our national market system competing for business and offering brokers inducements for their business. In addition, brokers have a large degree of flexibility when making routing decisions on their clients' behalf. As a result of these dynamics of intense competition between venues, a willingness to provide inducements for brokers' business, and broad broker flexibility in how they execute trades it is more likely today that brokers will route their clients' orders in ways that serve the brokers' best interests, rather than the best interests of their clients. Brokers' routing decisions can also lead to market imbalances of supply and demand, in which orders have trouble interacting. This can adversely affect market quality.

One way in which trading venues compete for brokers' business is through maker-taker pricing, the practice of paying rebates to traders who make trades available to other traders and charging slightly higher fees to traders who immediately access those available trades, keeping the difference. In addition to affecting brokers' routing decisions, maker-taker pricing creates misplaced trading incentives generally, such that traders are more likely to trade based on the economics of the inducement rather than the economics of the underlying trade. This can lead to unnecessary and unproductive trading volume. Maker-taker pricing also creates unnecessary market complexity. Because of the growth in competition between trading venues, exchanges continuously seek unique and creative ways to differentiate themselves by offering different pricing models that attract different types of traders. However, no reasonable justification based on the interests of investors and capital formation has been offered for creating these new venues and pricing schemes.

If the distortions that result from maker-taker pricing cannot be cured comprehensively, maker-taker should be eliminated. As a first step, the Commission should conduct a well-designed pilot program that produces meaningful information about the consequences of eliminating maker-taker pricing.

Another way in which trading venues compete for brokers' business is through payment for order flow arrangements. Under a PFOF arrangement, a wholesale broker pays a retail broker for the retail broker's routing of orders to the wholesale broker. In most cases, the wholesale broker internalizes the orders, executing them against its own inventory. Internalization increases undisplayed liquidity. To counterbalance the harms to market quality that result from internalization and to guarantee that investors receive significant benefits from internalization, payment for order flow should be allowed, but subject to a requirement that retail brokers that receive payment for order flow must provide significant price improvement to their customers.

3) Disparities in how market data is provided to different market participants must be eliminated.

Exchanges currently are allowed to structure their data transmission systems so that certain preferred customers, by and large high frequency traders, are able to receive data, and make valuable trading decisions based on that data, faster than the general public. Data is therefore provided in a manner that is unfair and unreasonably discriminatory.

Exchanges have the financial incentive to maintain a meaningful differential between the times at which critical trading information can be accessed by different market participants. Selling access to the same market data at different speeds makes the faster data much more valuable, which in turn, generates greater profits for the exchanges. And, exchanges own and control the market data that they provide to the public and to preferred customers, which allows them to structure their data transmission systems so as to maximize their profits. The same exchanges that provide direct feeds to preferred customers also comprise the voting members of the Consolidated Tape Association (CTA), a committee that governs and operates the consolidated data feed.

The significance of certain market participants' receiving market data ahead of the public cannot be overstated. First, any perception that exchanges are operating a two-tiered market based on a market participant's ability to pay for favored access can harm investor confidence and tarnish market integrity. Beyond mere perception, however, investors are tangibly being harmed as a result of certain market participants' receiving, and trading on, advance information. (See below.)

Providing all market participants with equal access to information is the cornerstone of a fair and efficient market. Thus, the Commission should strive to ensure a level playing field for all market participants, with no favored access. Toward this end, the Commission should revise Rule 603(a) of Reg. NMS to make clear that a direct, proprietary feed cannot be received by any market participant before the consolidated feed is published. The Commission must also bring enforcement actions when it finds that exchanges' provision of market data violates its rules. Finally, given the exchanges' conflicts of interest related to owning and controlling market data, substantial revisions must be made to the CTA's governance and transparency, so as to ensure that the consolidated data feed operates for the public benefit rather than for exchanges' profit motives.

4) High frequency trading should be subject to appropriate regulations to prevent predatory and harmful practices and to promote the market making function that such firms can and should provide.

With the increase in automated trading and improvements in technological innovation, our markets have become faster, to the point that trades occur in the span of microseconds. While the technological sophistication that high-frequency trading (HFT) firms use and the dominant role that they play in the market does not by itself suggest harm to investors or the market, HFT firms can, and indeed do, deploy their technological advantages and dominant role in ways that are unproductive and harmful to investors and to the market. For example, HFT firms often pay exchanges to receive market data ahead of the public. Using that data combined with their technological prowess, they send quotes faster than, and execute profitable trades ahead of, others.

Additionally, HFT firms engage in trading activities that are in some cases intentionally predatory and manipulative. In other cases, they engage in trading activities that are not intentionally predatory and manipulative, but that nonetheless disadvantage other traders and adversely affect market quality. HFT firms also expose the market to broader systemic risks. Seemingly, any catalyst – either internal via a computer or software malfunction, or external via another market participant's activities – can set off a chain reaction that causes instability for HFT firms, and in turn, the overall market. When such events happen, market liquidity evaporates and volatility skyrockets. As a result of these activities, HFT has become perhaps the single greatest driver of the perception that there is a two-tiered market that is not serving the interests of long-term investors.

Several proposals, including requiring minimum resting times and batching of orders have been offered to reduce the specific harms that HFT can create. They deserve further attention and scrutiny. In addition, while many may be quick to vilify HFT, we should recognize the important role that HFT can play in our markets. HFT firms contribute the lion's share of trading volume to the market and are the market's de-facto liquidity providers. If the Commission accepts this premise, however, it must subject HFT firms to liquidity provision obligations. First, this would mean requiring them to register with the Commission and be much better regulated. It would also require them to continuously provide meaningful quotes to the market so as to smooth over any imbalances in supply and demand, regardless of whether the particular market conditions suit them. If these reforms are adopted, then in consideration of their liquidity provision obligations, HFT firms should be compensated. Re-establishing this critical market making role and holding HFT firms accountable for their actions will improve day-to-day market quality and promote long-term market stability.

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The Consumer Federation of America is an association of more than 250 nonprofit consumer groups that was established in 1968 to advance the consumer interest through research, advocacy, and education.