MEMX X Sessions
2023 Market Structure Retail Panel
TRANSCRIPT

00:00 Rule Overview

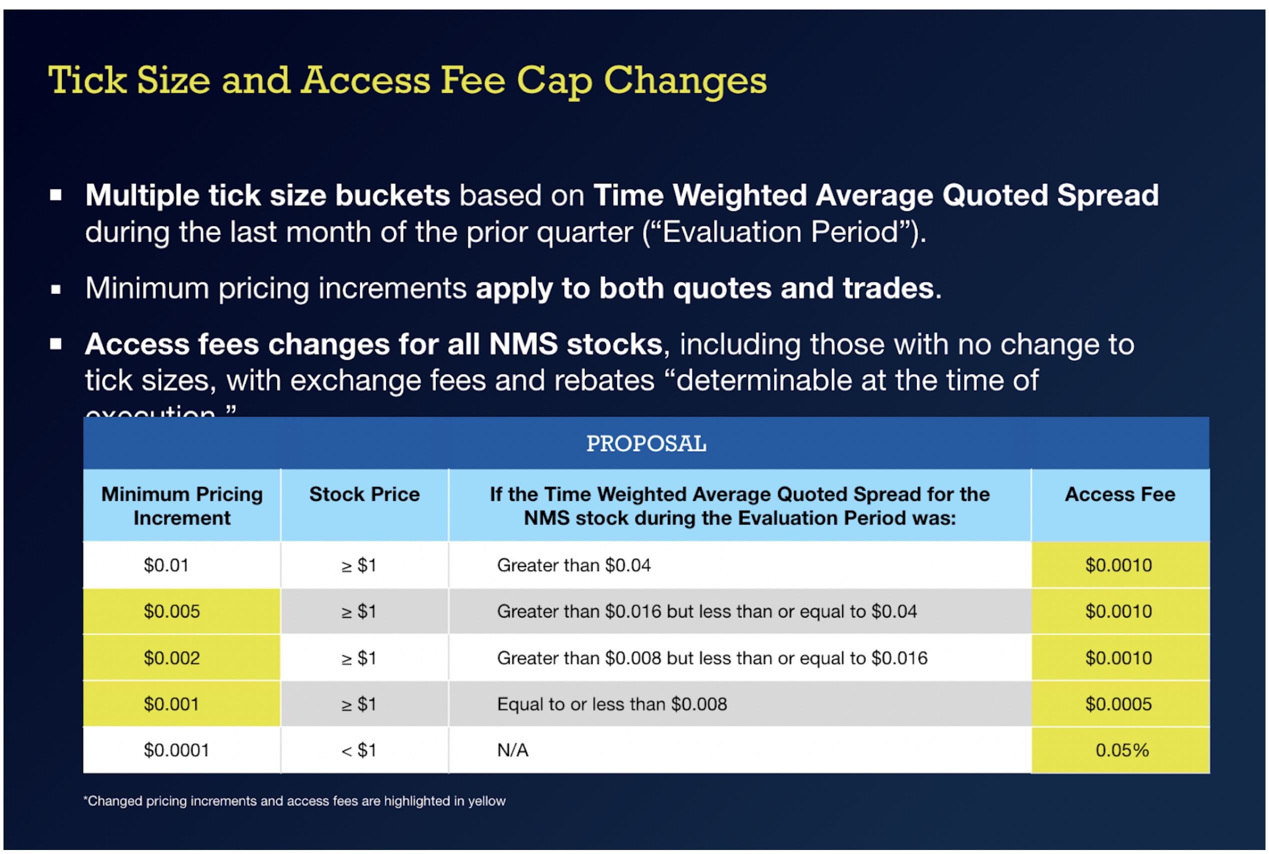
Adrian Griffiths:

Hello, I'm Adrian Griffiths, Head of Market Structure at MEMX. In this edition of X Sessions, we are talking to some of the market's leading market participants about the SEC's recent market structure rule proposals. I'm joined today by:

- Jeff Starr, Managing Director Operational Services at Schwab
- Andrew Upward, ETF Strategist at Jane Street, and
- Mike Masone, Director and Head of Market Structure at Citi

While the SEC has proposed reforms in a wide array of areas, we're going to focus today on three interrelated issues that I think we've all been spending quite a lot of time thinking about over the last several months: tick sizes, round lots, and access fees.

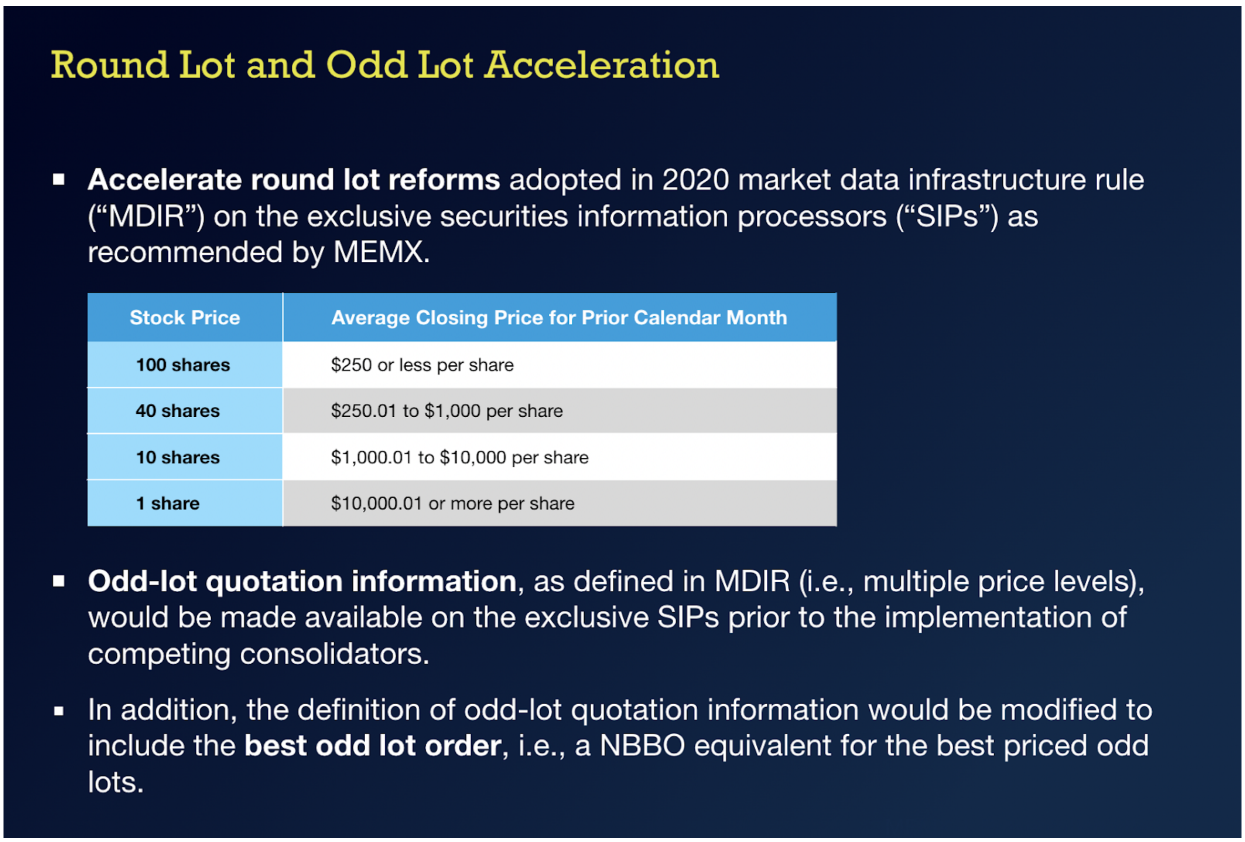
Before we get into the Q&A with our panelists, here's a very quick reminder about what the SEC has proposed.



Minimum Pricing Increment	Stock Price	If the Time Weighted Average Quoted Spread for the NMS stock during the Evaluation Period was:	Access Fee
$0.01	≥ $1	Greater than $0.04	$0.0010
$0.005	≥ $1	Greater than $0.016 but less than or equal to $0.04	$0.0010
$0.002	≥ $1	Greater than $0.008 but less than or equal to $0.016	$0.0010
$0.001	≥ $1	Equal to or less than $0.008	$0.0005
$0.0001	< $1	N/A	0.05%

As it relates to tick sizes, the SEC has proposed multiple tick size buckets based on time weighted average quoted spread during the last month of the prior quarter. These range from one cent for stocks with spreads greater than four cents all the way down to 1/10 of a penny for stocks with spreads equal to or less than 8/10 of a penny. The increment would also be harmonized for both quoting and trading.

With respect to access fees, the SEC has proposed a very significant reduction, down to 10 mils from the current 30, with a five mil access fee for stocks in the most granular tick size bucket. Any fees would have to be "determinable at the time of execution," which really just pushes back the volume-based tiering that we do to the prior month instead of the current month.



Finally, the SEC has proposed to accelerate both round lot and odd lot reforms, with odd lot reform now including the concept of the best odd lot order, which is an NBBO equivalent for odd lots.

02:08 Will the proposed SEC changes do more harm than good to retail market participants?

Now, Jeff, I want to kick things off with you since you're a representative of retail on this panel. There are obviously broader implications for the entire industry from these sets of changes, including institutions. But I think it's clear to all of us that the SEC is really focused on reforming the market for retail order handling. The purpose of the panel that we've got today is to talk about the implications of these rules on that market. The SEC thinks that there is a need for an overhaul here. I think you might have a different perspective on this, so I want to ask you two questions to kick us off. First, how have Schwab's customers been doing over the last couple years? And what do you think of the case the SEC has made for changes in this market?

Jeff Starr:

Thanks, Adrian. Our view has been quite simple. Retail investors have never had it better than they've had it over the last couple of years. Retail participation has obviously been at all time highs. We've seen new clients engage in all parts of the market, which has been great. I think the outcomes that the clients have seen is also fantastic. The current market structure really benefits the retail client. I think there's a lot of institutional clients out there that would tell you they would kill to have the execution quality that retail enjoys today.

When you look at that as the backdrop against these SEC proposals, we think you're really putting a lot of those benefits at risk by trying to change so much at once. Maybe just to quantify that a little bit, last year on our platform, clients enjoyed over $2 billion of price improvement under the current market structure. When you factor in the benefits they got from size improvement, which was executing at that same price in excess of the lit quote size, that's another $4 billion. So you're looking at $6 billion of benefits directly in our clients' pockets. I don't think that if you look at the SEC's numbers, we should put that at risk to go out and chase an additional mythical $1.5 billion, which obviously, I think everyone here will tell you there's a lot of problems with the way that that's been calculated.

Adrian Griffiths:

Thank you for that. Obviously, a lot more retail participation over the last couple years. I think from all of us in the industry, that's obviously a very important thing and something the SEC needs to spend more time thinking about, frankly.

04:57 How would tick size reforms impact retail vs. institutional businesses and alternative trading venues?

Let's move on to the specific topics. I want to start with tick sizes. There's been a lot of talk about tick size reform in the industry, I think particularly around reforming the tick size in tick constrained securities. We've put out a couple white papers on this topic. We've seen some of the participants that have put comments in the comment file also suggesting similar reforms to the ones that we had presented a couple years ago. The SEC's proposals, though, are much, much broader than this. In terms of the symbol universe, we're talking about almost 4,000 names instead of maybe less than 1,000 that are tick constrained. Those represent 70% of volume, 60% of notional traded on a daily basis. Really, that's a much broader set of reforms than I think the ones that we in the industry have been talking about.

Mike, I want to kick this off with you. Citi obviously has many different business lines that are going to be impacted by these changes, including your role as an institutional broker, ATS operator, or wealth management firm. With all those different hats in mind, what's your perspective on the tick size changes?

Mike Masone:

Well, thanks, AJ. Appreciate it. Yes, you're absolutely right. If you take a walk around this trading floor that I'm sitting on now, you will definitely get the full 360 views on any one of these topics depending on where you sit in our business. Whether you're predominantly part of our main business, which is our institutional focus, or you're operating our ATS or you're part of our wealth management business with more of a retail focus, you'll get the full panoply of views. That's been the case for the duration of my 18 years here at Citi. What we've tried to do when faced with any of these market structure changes is try to take a look at what's best for the markets overall, regardless of impacts to our business.

If there's one thing I know about our business, it's a dynamic business. This is not a business that is just static one moment in time. Rules change and we morph as an industry, and we do so quite well. I think that's to the betterment of investors. The stats that Jeff quoted should not be overlooked. That really is to the benefit of investors. So what we try to do at any given time is take a look at what's best for the markets.

Clearly, the SEC has in mind a shift in some amount of flow from off exchange venues back onto exchange. You'd be naive in thinking otherwise. Remember, the context in which most of these proposals came about was post the meme stock frenzy, really, two years ago. With the explosion of retail trading in the marketplace, even pre-pandemic with the move to zero commission trading, but certainly exacerbated by the pandemic, you saw a corresponding increase in off exchange flow and tier volumes really spiking. I think that that is clearly one of the goals, if not explicitly stated then certainly implicitly stated. We don't have a view, and I don't think the SEC should be involved in prescriptively deciding where flow should be executed. But if more flow ends up migrating towards exchanges because of these proposals, I think the SEC would consider that a win.

The institutional part of our business, to your question, Adrian, really doesn't like the idea of 1/10 of a penny or even 2/10 of a penny tick sizes. There's a whole host of problems that flow from that, penny jumping being the primary example. The ability to step in front of orders for economically insignificant amounts leads to a lot of excessive noise in the marketplace, makes it much harder for institutions to trade in size, and leaves a lot more footprint in the marketplace. The information leak problem becomes much more exacerbated in a tick regime that includes 1/10 of a penny or 2/10 of a penny. Not to mention the impact that, then, has on market data. The more granular your tick size increments are, the more market data there is in the marketplace, the more quote traffic. It seems to me that that just places an increased premium on proprietary data feeds from the exchanges and increases costs. It seems to me that we're moving in the exact opposite direction that the SEC was trying to move in with the adoption of its market data infrastructure rule just three years ago in 2020.

From an institutional perspective, I think the 1/10 of a penny, 2/10 of a penny, is really not at all ideal. From an ATS perspective, look, we operate in ATS. Certainly this is probably net negative for most ATSs in the sense that simplistically, why do you go to an ATS? It's for two primary reasons, cost and confidentiality. The cost side of that equation becomes less attractive in an environment where before, broker ATSs were significantly cheaper, and now they may not be. You will see some liquidity inevitably migrate away from ATSs, especially smaller size orders, and whenever inverted venues are quoting, I think you're going to see that trend. I believe you may end up seeing some consolidation in the ATS space, which may be a good thing for markets. Again, if you're of the view that there's too much excessive fragmentation in the marketplace, then maybe you see some smaller ATSs merge with larger ones.

From a retail perspective, it's hard to argue that this wouldn't be at least somewhat of a positive outcome. Jeff, all of your comments, very well taken. But I think generally speaking, it's probably a better outcome for retail in the sense that there'll be tighter pricing and more competition for those orders. There's already an excessive level of competition. I'm not going to get into that debate, but just broadly speaking, our wealth management business might see this differently than does our ATS business.

So again, coming back to center, we try to see what is best for markets. It's not clear to me that any of this is really required, but if it does lead to some more competition and the ability exchanges to at least quote and perhaps trade in greater competition with the market makers, then let's have at it and let the free market decide who gets that flow.

Adrian Griffiths:

11:24 How would the proposed tick reform affect market makers?

All right. Andrew, maybe let's move to you. I think Mike gave a pretty good segue there in terms of the SEC, thinking about the impact of these changes on exchange versus off exchange markets. Jane Street, obviously very active on exchange market maker, but you also have a wholesaling business. What I want to ask you is, are you concerned at all about how these changes might impact your ability to provide liquidity in either of those markets?

Andrew Upward:

Thanks, Adrian. Thank you, by the way. Thank you to MEMX for the invitation to join the panel. We're not as concerned about the current proposals for tick sizes. We do provide a great amount of liquidity on exchange. To your point, we are a wholesaler. We provide liquidity off exchange too. We don't see the proposals as being terribly concerning. Again, I think some great points have been raised earlier in the panel. Mike made some great points about the institutional perspective. From our perspective as a market maker, whether it's on exchange or off exchange, having more price points to express our liquidity provision and to fine tune our liquidity provision is good for us. I don't see it being problematic from a liquidity provider's perspective that we have a more granular tick regime.

12:50 Would quote harmonization benefit retail investors? Are there better ways to achieve the outcome the SEC is looking for?

Adrian Griffiths:

Jeff, maybe to bring you into this one. Schwab actually signed a letter with two other market participants recently. One of the things that I think have been particularly controversial as far as tick size reform goes is this idea of harmonizing the quoting and trading increment. I know in that letter, you suggested a different alternative to that. I want to get your thoughts on both the idea of harmonization as well as what you think might be a better way to achieve the outcome the SEC is looking for.

Jeff Starr:

I think the idea of the letter was to say, look, we agree that there can be tick size reform. And we think that the current proposal, as Mike aligned it, is very granular and probably too granular for most clients to understand. But we do support it and it would be good for retail clients, as Andrew even pointed out, on the whole. We are fully supportive of reform there. The idea of quoting and trading increments matching up is something we also support, I think to the extent that that provides more competition between on exchange and off exchange trading. Mike hit on this point as well. I think that that is good. More competition in any scenario will always benefit the retail clients to the extent that harmonizing those two creates more competition. We're fully supportive of that.

Adrian Griffiths:

All right, great. Moving on to the access fee cap. Access fees-

Andrew Upward:

Adrian, sorry. Can I, before we pivot [inaudible 00:15:29]

Adrian Griffiths:

Please. Go ahead.

Andrew Upward:

There was one other thought in my head that I thought I should maybe share, which is that we understand some of the concerns about a tick size that is too small. On the other hand, I think maybe what's happening in the broader industry debate at the moment is I think we're losing sight of the fact that the big problem that we've all agreed, many years ago, in fact, we've been talking about this for years. The big problem that really needs to be solved are the tick constrained securities. You mentioned this earlier, Adrian. I think part of our concern about just maybe adopting the half penny tick is, are you doing half of a job or not doing the full job of deconstraining the ticks? I think we see it as, let's keep our eyes on the prize. Let's remember why we all thought tick reform was necessary in the first place. Tackle that tick constrain problem and not lose sight of that fact. I did want to just reiterate that point.

Adrian Griffiths:

Thank you for that. That's obviously something that I think all of us think about. There are different ways that you can do reform. You could say one and done and then talk to me in 20 years, or something that is a little bit more gradual. There are different approaches to that. But yes, I think that is something that obviously we all need to think about.

16:02 Would lowering the access fee cap impact liquidity provision?

On access fees, again, there's obviously a very strong link between the access fee and the tick size regime. We had proposed in our recommendations to the SEC that the SEC do a proportional change to the access fee when they change the tick increment, so going to 15 mils in tick constrained stocks that would trade in a half penny. The proposal obviously is much broader and would impact all securities traded in the equity markets today.

Andrew, going back to you. With the access fee cap potentially being lowered, one obvious result of that is that rebates will also need to be lowered on exchange. How does that impact your models for liquidity provision? And what do you think of the net impact of this change for exchange quotes if made alongside changes to the tick regime?

Andrew Upward:

I think just setting the table quickly, we need to go back to the fact that there are a handful of proposals that are out there and there's going to be a lot of devil in the details. Let's see what actually is adopted, let's see what is actually implemented, and see what the world looks like, because I think it could go in many different directions.

But having said that, if we assume that just, let's say, this tick size proposal and the access fee part of the proposal were to be adopted, how would that look and how would we think about that at Jane Street? I think as long as the reduction in the access fee cap is commensurate with the reduction in tick size, I would suspect that there isn't going to be that much to talk about in terms of how has liquidity migrated? Has there been a sharp move to the dark marketplaces? Have things gone more lit? I don't see a lot of scope for movement as long as there's a commensurate reduction.

When you start playing with the size of the access fee cap and percentage terms as a percentage of the tick size, that's when I think the debate mushrooms and people have different viewpoints about what that's going to mean. I think it's never been clear to me that lowering the access fee cap, relative to the tick size, let's just say, is going to definitively cause there to be wider lit markets and increase in dark liquidity. I think you could have both phenomena happen, potentially. I think if you have a lower access fee cap relative to any reduction in the tick size, you could see in some instances markets widen out, certainly, and I think you could see migration to dark off exchange venues.

On the same token, there's an argument to be made that if people are happier to route to the lit market because the access fee is lower, and so people are preferencing lit markets on the take side, I could see an argument to be made that actually buttresses on exchange liquidity. I think my suspicion is that you might see a little of both and there might be a tug of war between those two dynamics. I think you can probably sum it all up by saying it depends, and no matter what happens, it's going to be really complicated.

19:42 What's the right balance to strike on access fees for all sides of the markets?

Adrian Griffiths:

I like this concept of tug of war. It's a good segue for my question for Mike, which is another kind of tug of war. Mike, institutional brokers are obviously very frequently takers of liquidity, and so lowering the access fee cap would reduce your take fee costs. I think one potential trade off that Andrew mentioned is there is going to be some impact on spreads. There are obviously multiple factors that go into that because there could be, as Andrew pointed out, different sets of incentives for takers that also impact spreads. How are you thinking about that balance there?

Mike Masone:

Well, Andrew's right. There's a push and pull on all of this. But again, let's just go back to my earlier premise. What's the best thing to do for markets? On the one hand, there just seems to be such widespread agreement that the access fee cap of 30 mils set in 2005 when NMS was passed, relative to then existing commission rates and spreads, made sense. I think the term from NMS is it was consistent with commercial practice. Pretty widespread agreement that it's not any longer. If you go back to the 2018 debate around the SEC's then transaction fee pilot and all of the years leading up to that, whether it be through the SEC's EMSAC, Equity Market Structure Advisory Committee, or other forums, there seemed to be this widespread agreement that the access fee cap should come down.

On the other hand, there's also, in my view, a pretty glaring lack of data as to what the right number should be. If we all agree we want to lower that cap, I haven't seen very persuasive data that says it ought to go down to 10 or five or whatever the number may be. I think that's one of the reasons why the SEC, in their 2018 transaction fee pilot, adopted in March of that year and passed in December. They called for a pilot to test what the right level would be. They had a bucket with five mils, 15 mils, and then one that banned rebates altogether. The exchange ultimately sued over that and they sued successfully in the DC courts, and so we never saw that transaction fee pilot hit the tape, so to speak, or see the light of day. If you use that as the basis, then we don't really have the right answer as to what that number should be. I tend to agree with Andrew. A corresponding proportionate decrease in both the tick size and the access fee is simplest and probably does the least harm to markets.

Again, back to what Andrew said earlier, why not? I think there's widespread agreement around this point. Start with your tightest spread tick constrained names where you're looking at a reduction in tick size, hopefully no less than half a penny, and correspondingly reduce the access fee cap down to, say, 15 mils to just keep it proportionately cut in half from current levels, and see what happens. That, to me, would be the most metered way of doing this, the most thoughtful way of doing it, and the one that allows the market to provide us with some actual empirical data on impact to liquidity, where does liquidity migrate. But I'm not very sanguine that that's actually the stance that the SEC is going to take.

To your question around impact on spreads, that's one of the reasons why we're contemplating a view of the world where if you reduce access fees for your most liquid tick constrained names, then there may actually be a corresponding need, for the sake of symmetry, to maybe increase access fees for your least liquid names, so that you're not losing the benefit of the sweetener that that rebate is for liquidity providers. The last thing in the world we want to do is reduce explicit costs, but at the same time, raise implicit costs and the overall cost of trading, especially in the illiquid names, which already have such a hard time existing in this market.

Adrian Griffiths:

Just to emphasize the point that you made there, I think for all of these changes, frankly, gathering data is going to be an important part of the exercise. The SEC in 2018 recognized that they didn't have data on this issue. That doesn't mean that we shouldn't do something and gather data and assess whether future changes are needed. But I think to your point, this iterative approach where you make some change, you evaluate what's happened, and then you decide whether further changes are needed, is a good way to approach many of these topics.

24:33 Would the increased transparency of round lot reform be of value to retail investors?

To round things out, let's move on to round lots and odd lots. Obviously, both of these changes came initially in the SEC's 2020 market data infrastructure rule, but we've seen just a considerable delay in the implementation of those rules. MEMX has been a very outspoken supporter of moving forward with those reforms, but at this point, we're pretty much stuck at step one, which is getting the SROs to file fees that actually meet the applicable Exchange Act standards. In the meantime, the SEC is looking to push some of these reforms further earlier. We've recommended accelerating roundlot reform in particular. I think there are a lot of potential benefits there, not just on the transparency side, but also from an execution quality perspective. We have white papers on that topic.

Jeff, let's shoot this one to you. Round lot changes obviously will flow through very directly into the information that investors get on the SIPs. I want to ask you, though, on the odd lot side, do you expect that retail investors will actually want or need access to odd lot quotation information when it becomes available?

Jeff Starr:

I think you will find the actual number of investors that will access that information to be quite small, Adrian. I also think any proposal that contemplates putting odd lots into the NBBO is also another potential point of confusion for retail clients. When our clients see a quote, they expect they're going to get executed at or near that amount. What we would love to avoid is a situation where we end up with a bunch of phone calls asking, "Well, why didn't I get executed at the price that I saw?" And then we have to have a conversation about the size that was available at that quote. I think that there's going to be limited use of that odd lot data. I would also say to the extent that it's not in the NBBO, that's probably better off for retail clients.

26:49 Would round lot reform allow market makers to quote tighter spreads?

Adrian Griffiths:

Got it. Andrew, let me ask you a question on the round lot side of these changes. We've put out, like I said, various white papers on this topic. I want to get from you, though, do you think round lot changes will actually allow you to quote tighter spreads? One interesting thing that we've seen through stock splits and high price securities is there's actually a difference in terms of which venues are actually able to compete for flow, depending on the price per share. I think we might see something similar from round lot reform. Do these changes impact where you quote in addition to how tightly you might be able to quote?

Andrew Upward:

I don't think it changes a lot for us. I think it's one of these sensible proposals that, particularly with regard to the round lot reform, can probably only help. It's hard to imagine how it could be detrimental. I think each liquidity provider out there may have a different answer to this. I think from our perspective, it's unlikely to change that much how we quote. Certainly from our perspective as a wholesaler and the execution quality that we're providing to our retail broker customers, that's really not going to change. Depending on how things get implemented, you might have changes in 605 stats, you might have changes in how execution quality and price improvement and things like that are measured. I think the all-in costs to investors are unlikely to change because of these proposals.

Not withstanding some of the good points that Jeff made about the retail experience and his end customers' experience, which I think are very important to take into accountant, so I hope policy makers are doing that. Not withstanding those issues, I think from just a pure trading perspective, it probably won't change that much, and if anything it's going to help a little bit on the margin.

Adrian, on the second part of that question about competition amongst exchanges. I think that can obviously only be a good thing too. It supports your point about this, and Mike and others on the panel are all, I think, saying similar things. Accelerating these things, for the most part, makes sense and we should probably think about doing it.

29:22 What key takeaways should the SEC take from the industry comment letters?

Adrian Griffiths:

Great. Thank you. I want to end this. Obviously, the comment deadline is very quickly approaching, so we're all knee deep in this at this point. As we work through finalizing those comments, I do want to give you guys each a chance to tell me, what are the main takeaways that you would like the SEC to take out of your respective comments?

Mike Masone:

I'll give it a start. This is really hotly debated. In the time that I've been doing this, since NMS, I'm not sure we've seen as significant a change as being proposed. And they're really personal to a lot of people, people who've been in this business for a very long time. Jeff, how long have I been working with you? I think for comments to come from the SEC that either explicitly or implicitly imply that retail firms or market makers are solely myopically focused on their own business model and not trying to do what's best for retail investors, it flies in the face of truth. You look at the markets and how they've evolved. To Jeff's earlier point, retail has never had it better. Could things be better? Of course. Naturally, I think that the SEC is clothing most of these in the gowns of increased transparency, promoting competition, reducing costs. These are mom and apple pie type things. Hard for us as an industry to stand in the way of that, and I don't think that we should.

I think generally speaking, we should try as much as possible to separate process from substance as far as these are concerned. Many of us in the industry are upset, frankly, that the SEC hasn't really included the benefit of a lot of industry expertise, be it in the form of public round tables or concept releases as they did back in 2010 on equity market structure. There are a lot of ways that the SEC could have solicited feedback from the industry that would've informed these proposals in a way that maybe would've made them more balanced, and hopefully less obtrusive and objectionable to a lot of people in the marketplace. But that's not where we are.

Substantively speaking, I think it really is extremely important that those of us who care about these things get really involved, not only in objecting to what we think is wrong, but supporting what we think we can live with, and otherwise providing some alternatives to accomplish the SEC's goals. This may be our only chance to do that before a very ambitious SEC moves to finalize some of these things. I'm afraid that unless we get involved by this March 31st comment deadline, we may have missed our best opportunity to provide the SEC with some sanity checks.

Jeff Starr:

I think that's a great point, Mike. I agree with pretty much everything you said. Working for a firm like Schwab that was founded for retail clients, has championed retail clients, frankly, it's disturbing to hear that people think we're not out for our clients' best interests at the end of the day.

What I'll say is my guess is you're going to find unanimity about a couple of things no matter who you are as we go into this comment period. One, I think every single market participant thinks this is way too much change all at the same time. You're changing too many parts of the ecosystem and it's really, really hard for anyone, as Mike said, we've all been at this a long time, to predict what outcomes we're going to see. I think in terms of the proposals, you'll see everyone come out with some version of, yes, as we said today, we think there's a path to some sort of tick size reform. Yes, we can improve disclosures across the industry. And then you'll see pretty much people line up against the auction proposal and the best execution proposal. But as Mike said, everyone should engage. We should get involved. There hasn't been a lot of opportunity to do so, and we got to use this opportunity and the comment letter as one of those chances to get our point of view out there.

Andrew Upward:

I should have gone first. I have nothing to say because Mike and Jeff just covered a lot of good ground. I echo everything they said. I do think, just to put my own spin on it, it would be great if the SEC listened to the industry, because I do think the industry is going to speak with pretty similar voices, if not the same voice, in the areas that Jeff just enumerated. It seems pretty clear that two of the four proposals are pretty good and are at least addressing areas where there's consensus that, hey, we've got work to do in these areas. That'd be the tick size and the so-called NMS proposals, as well as the 605 reform.

Then there's the other two areas where it seems pretty obvious that there's a lot of concern broadly from the industry. It's not uniform, but it's amazing how much consensus, or at least a quorum, there seems to be on the Order Competition Rule and on best ex. So my plea would just be, I hope that they listen to the industry because we are the ones with the expertise and we are the practitioners. But we'll see what happens.

Jeff Starr:

Maybe just to add one last point onto that. I don't think you can underestimate the significance when you have retail firms, institutional firms, exchanges, and market makers lining up on the same side of things. As we know, that's very rare, and this is one of those rare cases, frankly.

Adrian Griffiths:

Thank you for making that point. I do think it is quite rare that you have firms with so different business models all coming together and having a really similar take on some of these things. I do hope the SEC listens to all of us as we submit our comments. Anyway, I thought it was a great discussion today. Thank you guys for joining. I really appreciate it.

Mike Masone:

Thank you.

Andrew Upward:

Thanks, Adrian.