

**Written Testimony of Joseph Saluzzi, Partner and Co-Founder, Themis Trading LLC**

**Before the U. S. House of Representatives Committee on Financial Services**

**Subcommittee on Capital Markets**

**Hearing entitled “From Order to Execution: Ensuring Efficient and Transparent Equity Markets”**

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Thank you, Chairman Hill, Ranking Member Waters, Subcommittee Chairman Wagner, and Subcommittee Ranking Member Sherman for giving me the opportunity to testify on this important topic. I would like to thank the Subcommittee on Capital Markets for taking the time to examine and question the transparency and efficiency of our equity markets.

My name is Joseph Saluzzi and I am a partner and co-founder of Themis Trading, a no-conflict institutional agency broker which we founded in 2002. We do not make markets, and we do not trade proprietarily. We do not own a dark pool. Our only business is providing best execution for our institutional clients; we are agents for long-term investors. Our clients are comprised of pension funds, mutual funds, money managers, and hedge funds, and together they represent well over a trillion dollars of long-term investor funds.

Over the past decade, the SEC has tackled some important market structure issues including the addition of a large trader id, the formation and implementation of the Consolidated Audit Trail (CAT) and the adoption of the Market Data Infrastructure Rules. While these have been constructive, other market structure issues continue to be overlooked. These issues include:

- the fragmentation of execution venues (exchanges, alternative trading systems and single dealer platforms)
- the increasing percentage of trades executed off-exchange
- segmentation of liquidity within ATS's
- stock exchange rebates
- information leakage from exchange proprietary data feeds

## **Reg NMS - Rule 611**

Today's stock market is comprised of 17 stock exchanges, dozens of alternative trading systems also known as dark pools and numerous off-exchange "liquidity providers" who are not regulated with the same disclosure and practices yardstick. This fragmentation particularly escalated after the SEC implemented Regulation NMS in 2007. While the SEC believed Reg NMS would create competition among stock exchanges to provide the best prices for investors, we are certain that they did not anticipate that their regulations would also pervasively result in a high-speed competition to trade against long-term investors. And we hope that the SEC did not think that fragmentation among 17 stock exchanges, dozens of ATSS, and numerous off-exchange liquidity platforms would be a desired result.

Most of the larger market structure issues that we listed above began after the SEC implemented Reg NMS in 2007. In [testimony](#) before the SEC's Investor Advisory Committee in 2021, current SEC Chairman Paul Atkins blamed Reg NMS for many of these issues:

"Reg NMS is unnecessarily complex, invites gamesmanship, induces widespread market fragmentation, disperses liquidity, and diminishes transparency. Indeed, we have seen Reg NMS drive order flow away from exchanges, fuel unhealthy trading volatility, and expose the markets to flash crashes because its rules have led to atomization of orders and liquidity among a dizzying array of trading venues. None of these outcomes is a hallmark of the worthy goals of a fair, orderly and efficient market."

At the first Rule 611 Roundtable on September 18<sup>th</sup>, Chairman Atkins further [critiqued](#) Reg NMS:

"Ironically, a rule intended to strengthen liquidity has instead splintered it among an unprecedented number of venues. The result is a marketplace with more trading platforms than ever, but fewer broker-dealers and traditional market makers to knit it together. Those intermediaries have succumbed to a combination of increasing technology costs, exploding regulatory costs, more competition for a shrinking active trading clientele as passive investment vehicles have become more popular and flexible, among others. Much of this is great for investors, at least in the short term, but what does it mean for marketplace health in the long term? We are 20 years out from the troubled promulgation and implementation of Reg NMS; what will things look like in another 20 years if the status quo remains?"

At the second Rule 611 Roundtable on December 16<sup>th</sup>, Chairman Atkins again [criticized](#) Reg NMS and Rule 611:

“Two decades have given us the benefit of perspective, and the verdict is clear: **Reg NMS, built on flawed foundations, has invited gamesmanship and contributed to the fragmentation of our markets, the dispersal of liquidity, and diminished transparency.** The very outcomes that we feared have come to pass. Our warnings are now lessons. And Reg NMS—Rule 611’s trade-through prohibitions in particular—command a fresh look so that we can continue to strengthen our securities markets. Indeed, we must summon the courage to acknowledge when well-intended policies have produced unintended consequences.”

We agree with Chairman Atkins and applaud the Commission for seeking ways to improve equity market structure. Reg NMS contains many flaws including the fact that Rule 611 only protects top of book visible quotes at each exchange. This leaves all other quotes at exchanges, including visible non-top of book quotes and hidden quotes, unprotected. All orders on non-exchange venues are also unprotected and can be traded through.

However, **simply eliminating Rule 611 will not fix any of the issues that Chairman Atkins has identified** or the issues that we listed above. Fragmentation of execution venues will continue. Off-exchange volume will not decrease. Segmentation of liquidity within ATSs will not change. Stock exchanges will continue to pay rebates which distort the order routing process. And exchange proprietary data feeds will continue to leak valuable order information.

We hope the SEC is not considering the elimination of Rule 611 because it potentially stands to in the way of their “innovation exemption” and tokenization plans. Allowing the trading of tokens that do not have the consent of the public companies that they track and do not confer voting rights or dividends would be akin to permitting trading in a shady, unregulated bucket shop. This would be a grave mistake which would distort the price discovery process and undermine investor confidence in the market.

### **Reg NMS - Rule 610**

The stock exchange, MEMX, has requested temporary exemptive relief from compliance with certain provisions of Rule 610(c) of Regulation NMS for all trading centers. The main reason MEMX cites for requesting [exemptive relief](#) is the **possibility** that the SEC may soon propose changes to Rule 611:

“MEMX wants to give the Commission time to consider and discuss with market participants whether and how access fees should be regulated in light of anticipated changes to Rule 611 (the “Order Protection Rule”).”

**We see no reason for the SEC to grant this temporary exemptive relief request.** The industry spent months debating the SEC’s Market Structure Rule Proposals with numerous

comment letters being filed with the SEC. The debate was healthy and concluded with the SEC approving a subset of the Market Structure Rule Proposals, one of which was the reduction in the access fee cap from \$0.003/share to \$0.0010/share. Apparently, the major stock exchanges weren't happy about this reduction and sued the SEC to get the rule reversed. The D.C. Circuit Court of Appeals then denied their petition and upheld the access fee reduction amendment. After this court ruling, the SEC accommodated the industry and issued temporary exemptive relief for one year. The access fee cap amendment has been approved by the SEC and survived a legal challenge and therefore no further delay should be granted.

Access fees and rebates are at the heart of almost every decision that an order routing algorithm makes. Below are three reasons we believe the access fee cap needs to be lowered with comments from the SEC's [Reg NMS Amendments](#) that support our claims:

**1) Lower access fees will cause exchange rebates to be lowered and potentially lessen order routing conflicts.**

According to the SEC, "the Commission estimates that the reduction in the access fee cap would lead to a decrease in the total access fees collected and rebates distributed of approximately \$3.8 billion per year, amounting to a 73% reduction in access fees paid or an 80% reduction in rebates distributed."

**2) Rebates distort supply and demand and harm the price discovery process.**

The SEC agreed that rebates are responsible for subsidizing liquidity and damaging the price discovery process:

According to the SEC, "High access fees and rebates can distort liquidity supply and demand by artificially increasing the cost of taking liquidity and the revenue to providing liquidity. This dynamic creates an environment with too much liquidity supply relative to liquidity demand."

**3) Lowering rebates and reducing liquidity subsidization could help increase the fill rates of institutional investors.**

According to the SEC, "Less competition to provide liquidity means that queue lengths could decrease and fill rates increase because it would be easier to get to the front of the order book. This effect could allow non- high frequency traders more opportunities to fill orders using liquidity-providing instead of liquidity-demanding transactions."

The MEMX proposal is clearly just another attempt by the exchanges to protect their own franchises. They are requesting a delay based on the possibility of changes to Rule 611. We acknowledge that the SEC will likely be proposing changes to Rule 611 but we don't believe

that there is industry consensus on this issue. Therefore, no assumption should be made that Rule 611 will be changed. If Rule 611 is ultimately changed, then MEMX and the proponents of higher access fees will have the chance to lobby the SEC for a new proposal to raise fees. But until then, the Court approved amendments should face no further delays and be implemented in November of this year.

### **Consolidated Audit Trail**

Born after the 2010 Flash Crash, the Consolidated Audit Trail (CAT) continues to be under attack by many industry participants.

#### **CAT History:**

- When the Commission approved the 2015 Plan, it estimated that it would cost between \$37.5 million and \$65 million to build the CAT, and between \$36.5 and \$55 million per year to operate it.
- The costs of building and funding the CAT have far exceeded the Commission's expectations. By the end of 2022, \$518 million had been spent to build the (incomplete) CAT—nearly eight times more than the top Commission estimate. And by 2023, operating costs had climbed to nearly \$200 million per year—nearly four times greater than the high-end Commission estimate.
- The CAT became operational in 2020, and the legacy audit trails were decommissioned in 2022.
- In 2023, the Commission formally approved the 2023 Funding Order which replaced the original funding model “with the Executed Share Model.”
- The Executed Share Model “divides costs evenly between the three entities who have primary roles in a transaction: (1) the buy-side executing broker, (2) the sell-side executing broker, and (3) the self-regulatory organization (SRO) involved in the transaction.....But the Commission also expressly acknowledges in the 2023 Funding Order that the self-regulatory organizations may “pass their CAT fees onto their members in full.”

The CAT is expensive and the SRO's, who developed the plan to build and maintain it, did a terrible job – from designing it to controlling costs. These cost issues started when they originally hired a subsidiary of an HFT firm to build the CAT and ended up wasting \$50 million before transferring the project to FINRA, which clearly should have had it from the start. In fact, the tool the CAT replaced, the Order Audit Trail System, was designed, managed, and paid for by FINRA. As the Court mentioned, the SROs that govern the CAT have little incentive to keep costs down since they can simply pass on the costs to the broker dealers.

After more than a decade from its conception, the CAT is finally fully operational and has already proven to be a valuable regulatory tool. However, we're concerned about the continued pressure by industry participants as well as from some members of Congress to eliminate more information from the CAT which will likely hamper and delay any future SEC investigations. Additionally, some large market participants are still not supplying all the required data. FINRA recently fined two market makers a combined \$2.2 million for failing to report tens of billions of order events. Rather than further weakening the CAT, we recommend the SEC strengthen the CAT's data and functionality and ensure that brokers are reporting the required information in a timely manner.

Maybe the CAT could use less options data. But maybe it needs more information about traders to link related accounts. After all, the point of the tool is to identify potentially concerning trading and market events.

### **SEC Enforcement**

Lastly, we've all recently seen troubling reports of trading across all types of markets, from equities, to oil futures, to prediction markets. Collectively, these reports erode confidence in the integrity and stability of our markets. Whether or not there is wrongdoing, the press reports alone make investors around the world trust our stock markets less.

As agency brokers, we trade on behalf of institutional investors who invest in US public companies. Trust and confidence in markets is an absolute necessity for investors, and we need the SEC to be effectively policing the markets. The SEC needs the right tools, like the CAT, as well as sufficient staff. It also needs the institutional will to ensure that it is investigating market abuses and bringing enforcement actions. We hope you help them with this.

### **Conclusion**

The US equity market appears to be deep and liquid but still has many underlying conflicts which compromise price/liquidity discovery and could result in a rapid deterioration of liquidity like we experienced during the Flash Crash of 2010. Rather than eliminating the trade through rule, delaying access fee reductions and continuing to weaken the CAT, the goal of market structure reform should be to encourage more displayed liquidity which would level the playing field for all participants and dampen volatility.

