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"Solutions in Search of a Problem: Chair Gensler's Equity Market Structure Reforms"

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Introduction

Chairwoman Wagner, Ranking Member Sherman, and esteemed members of the subcommittee, thank you for the opportunity to appear before you today to discuss proposed changes by the Securities and Exchange Commission (SEC or Commission) to the rules governing U.S. equity market structure. My name is John Ramsay, and I am testifying on behalf Investors Exchange, also known as IEX. IEX is a national securities exchange that facilitates the trading of U.S. equities, combining a transparent business model with innovative design and technology to drive performance for investors.

My testimony today is focused on the changes the SEC proposed to the set of rules known as Regulation NMS, which were adopted in 2005, nearly 20 years ago.[i] Regulation NMS sets the basic "rules of the road" for how equities trade, including the minimum "tick size" for displayed quotations, defining how participants must account for those quotations, the prices exchanges may charge to access them, and similar matters.

As described below, the equity markets have changed in profound ways since Regulation NMS was adopted, but the rules remain largely unchanged. There is a demonstrated need, and an abundance of empirical support, as well as support by investors and industry commenters, to make targeted changes to these rules, to ensure they match the needs of the stock markets that exist in 2024, not those of an earlier generation. The proposals the SEC put forth in this regard (NMS Proposals) appropriately identify aspects of the rules that need to be updated.[ii]

Background

Regulation NMS is a comprehensive set of rules that covers all aspects of trading in equity markets, most importantly in "NMS stocks," meaning those that are listed for trading on a national stock exchange. The core elements of that rule set include:

A standard "tick size," which sets the minimum price increments that markets can use to rank and display orders. The SEC initially set a single standard of a one cent minimum tick for all stocks that are priced at one dollar or more. The Commission explained that it wanted to discourage gaming by participants who display prices at an economically insignificant amount in order to gain priority of execution, and it viewed the one cent minimum as meeting that purpose at that point in time.

The Order Protection Rule, which gave preference to exchange electronic quotations by giving them "protected quote" status, meaning participants may not trade at a worse price that is displayed on an exchange without first attempting to access that price.

A cap on the access fees that exchanges can charge to access these protected quotations. The cap was meant to prevent exchanges from exploiting their new status as protected quote venues by charging a high "toll fee" that was out of step with market pricing. The access fee cap was set at 30 cents per hundred shares, often referred to as "30 mils," based on comparing the fees that were typically charged by other venues at the time.

New standards for the publication of consolidated market data, which provides a combined view of the best prices across all exchanges. These requirements left in place conventions which required that the displayed best prices show, in almost all cases, only quotes to trade at least 100 shares.

As we all know, the equity markets have been completely transformed in the intervening 19 years since Regulation NMS was adopted. At that time, New York Stock Exchange was still largely a floor-based market and controlled the lion's share of trading in its listed stocks, and Nasdaq was not even operating as an exchange. Today, there are 16 different exchanges, and most of these are managed by three large conglomerates that control the lion's share of trading. There are many more alternative trading systems that function like exchanges in many ways. Whereas the time to match trades was often measured in seconds or minutes in 2005, trading times today are typically measured in millionths of a second. Advances in technology have been no less profound. In 2005, the iPhone was still two years away from its debut. Personal computers were bulky, inefficient, and extremely expensive by today's standards.[iii]

In light of these changes in technology and market dynamics, the SEC has been reviewing the need to modify these rules and has been collecting relevant data for many years, spanning multiple SEC administrations. This includes the issuance of "concept releases" and the public roundtables and pilot programs, all resulting in thousands of public comments. Against this backdrop, the NMS Proposals represent the first congruent set of measures to adapt the rules to modern circumstances.

The Commission has very clear statutory authority to update these rules that have been in place for the last two decades. Congress granted to the SEC very broad authority in Section 11A of the Securities Exchange Act of 1934 to write comprehensive rules to help develop a "national market system" for equities. This authority obviously carries with it the authority to revise the rules as circumstances change.[iv]

Further, the NMS proposals are targeted at those aspects of the rules where the need for change is clearest. In making these proposals, the SEC included both primary proposals and also laid out various alternative approaches for each of these aspects. For each alternative approach, the SEC summarized its analysis of the potential costs and benefits of each, allowing public comment and other feedback to be provided. Many public commenters addressed both the primary and alternative approaches. The comment period, which has remained open for nearly 18 months, has ensured that interested parties have had ample opportunity to provide input, and the Commission has had ample time to evaluate these views, review the evidence, and conduct a thorough and comprehensive analysis.

The Basis and Substantial Support for Changes to Regulation NMS

Tick Size

The one cent tick size standard is seriously outdated. This is true for multiple reasons.

First, the proportion of quoting in high volume stocks that occurs at prices that consistently run up against this minimum increment has grown enormously. Trading in such "tick-constrained" stocks now accounts for a clear majority of all share volume.

That means exchanges can't display prices in the increments where people want to trade. This undermines the ability of exchanges to compete against venues that are not subject to this restriction, and it also means the displayed quotes that all participants rely on are less accurate gauges of true market prices. As a result, the spreads between bid and offer prices are arbitrarily wider, costing investors money.

The one cent constraint also drives complexity in exchange pricing – exchanges offer a huge variety of different fee and rebates schedules that help to compensate for the fact that participants can't quote more accurately.

The SEC proposed to replace the current one cent standard with four new tick sizes, keyed to how narrowly different stocks are quoted, with the narrowest increment proposed at one tenth of a cent. Most commenters, IEX included, expressed the view that tick sizes that are this narrowly drawn would create too much complexity. The SEC separately proposed an alternative of a half-cent tick for more actively traded stocks that trade with a narrow

“spread” in bid-offer prices, while retaining the one cent standard for all others. The SEC’s proposal discussed this alternative in detail, including an economic analysis.

A broad cross-section of market participants, including IEX, overwhelmingly commented in favor of this alternative. The clear benefit of this approach is that participants would be able to see quoted prices that are much closer to the prices at which they want to trade. Another benefit to adding a half-cent tick size for some stocks is that the SEC and industry can learn from experience whether the market would benefit from further narrowing later. Without this change, investors will continue to pay more than necessary, and the markets will continue to suffer a decline in the use and usefulness of displayed quotes, which support the price discovery function that all participants, whether they trade on exchanges or not, rely on.

Because of the clear benefits of this alternative, it was overwhelmingly endorsed by a wide range of commenters, including institutional investors representing around 25 *trillion* in assets under management.

Access Fees

As noted above, the access fee cap was meant to serve as a check against exchanges’ charging rent-seeking toll prices to access their protected quotations. But the level of the cap was tied to the perceived market conditions in 2005. And because the fee cap was set at 30 mils, this rate has become pegged as the standard rate to access protected quotes.

For reasons similar to those affecting other aspects of the rules, U.S. markets have evolved in ways that demand a change in the cap. The SEC’s proposal would effectively reset the fee cap from 30 mils to 10 mils, for all stocks other than those that would be subject to the smallest tick size. The Commission clarified that if the smaller tick sizes were not adopted, the reduction to 10 mils would apply to all stocks priced at one dollar and above.

There are many reasons why a substantial and uniform reduction in the access fee cap of this magnitude is warranted.

First, alternative trading systems that offer the ability to trade with bids and offers on a continuous basis, like exchanges, but that do not benefit from having protected quotes, typically charge no more than 10 mils to access liquidity on their markets.

Second, high access fees distort the usefulness of displayed quotations. For stocks trading at the minimum one cent increment, 30 mils equates to a full 30% of the spread. Like other changes we discuss, this change will allow the prices investors see to better match the actual economics of their transactions.

Third, institutional investors disproportionately bear the impact of high access fees because they often have to absorb those costs when they need access to liquidity on exchanges to meet their trading needs. That amounts to billions of dollars of added costs to the many millions of individual Americans whose savings are held by these fiduciaries. The added cost to access displayed quotes is also a factor driving institutional investors away from exchanges and towards other, less transparent venues which, again, harms price discovery.

Fourth, extraordinary advances in technology mean that exchanges are able to match transactions much more efficiently than was the case in 2005.

Finally, even those commenters who have objected to this specific change have generally acknowledged the fee cap could be reduced by half for those stocks that are given a narrower tick size – or a reduction of 50% for those stocks assigned a half-cent tick size. But it is not clear why participants should be required to pay double – a penalty rate in effect – to access quotes in the great majority of stocks that would still be trading at the one cent increment. And there is a significant benefit to the relative simplicity of a single fee cap, apart from the question of where the limit is set.

Because of these clear benefits, virtually all institutional investors, who disproportionately bear the burden of high access fees, that have weighed in, along with many other participants, have supported a substantial, across-the-board reduction in the access fee cap.

Increasing Transparency of Exchange Fees

Today, most exchanges set transaction prices based complicated sets of rules governing fees and rebates charged or paid to individual brokers, such that it is difficult or impossible to determine what was paid or rebated on account of each individual trade. A main reason for the lack of transparency is the practice of determining prices for each broker and transaction based on the volume of trading the broker conducts during the month the trade occurs. That means determining the fees for each trade is necessarily a backward-looking process – it is impossible to know what net fees or rebates a broker was charged or was paid until well after the time the trade is completed.

In the NMS Proposals, the SEC proposed to require that volume tests or other factors must be applied so the economics for each trade are known at the time the trade happens. In effect, if an exchange were to base its pricing on how much volume the broker conducts on the exchange during a certain period, it would need to apply the test to trading volume in a preceding period.

This change would provide two big benefits. It would give more transparency so that market participants, including investors, can better evaluate the net prices charged for each trade. Also, where brokers sending client orders receive rebate benefits, this greater transparency means that institutional investors would have an increased ability to negotiate with their brokers for a return of those payments for their own accounts. Because of those benefits, this aspect of the proposals also received overwhelming support.

Implementing New Lot Sizes and Odd Lot Data

One way that markets have changed since Regulation NMS was adopted involves a large increase in the proportion of trading that occurs in "odd lot" amounts, those that are for less than 100 shares. This trend corresponds to the proportion of trading that is now conducted in high priced stocks, for which 100 shares can amount to a very large dollar investment. In fact, the average price of stocks in the Dow Jones Index nearly quadrupled between 2004 and 2019, and it increased another 18% from 2020 to 2022. Not coincidentally, odd lot trades account for more than half of all trades in the market today. Still, it remains the case that the consolidated data feeds that average investors use to see the best prices available only show quotes for at least 100 shares, even though odd lot quotes are often available at better prices.

In 2018, the SEC adopted changes to address this problem by setting new round lot levels affecting the prices that are shown that are adjusted for stock price, and it also required the consolidated data feeds to show odd lot quotes, not only round lots, at the best available prices. But implementing these changes has been indefinitely delayed for various reasons.

As part of its Regulation NMS proposals, the SEC proposed to speed up the implementation of these changes. This is another common-sense measure to make sure the prices that investors can see match the prices at which they want to trade. And because of the clear benefits from these changes, commenters broadly supported implementing them sooner, concluding there was no reason to delay.

There is No Reason to Delay

In fact, there is no reason to delay adoption of any of the specific changes described above. The SEC recently adopted changes to Rule 605, which requires brokers to provide certain execution statistics that can help investors to make comparisons among different brokers on various measures. The changes to Rule 605 were also long overdue and broadly supported. Some firms are now arguing that the SEC should do *nothing* more to change equity market rules until Rule 605 changes have been implemented – another 18 months – and after some further delay to see what those reports may reveal. But the idea that no other changes can go forward until new broker reports can be issued seems to

misunderstand the point of the changes to Regulation NMS, or the point of Rule 605, or both.[v]

First, the data contained in broker reports is not needed to determine whether the changes to tick size, access fees, and other changes described above should go forward. Consistent with their purpose, the improved broker metrics will allow better broker comparisons based on how brokers perform under the rules of the road in place at the time. But there is no reason that the prior issuance of the new broker reports should drive decisions about how to update rules on exchange tick increments, access fees, and price transparency.

Further, there is an abundance of existing data that is relevant to and supports these rule updates. This includes, among other things, extremely detailed trade by trade and order by order data from market vendors, daily data produced by exchanges that is broadly available, data produced daily by the securities information processors, data on off-exchange trading that is produced by FINRA, and other sources.

For these reasons, the idea that new 605 reports must be fully in place and analyzed before moving ahead with other changes seems less like a reasoned argument than a calculated effort to stall any other updates.

Conclusion

It is often said the U.S. equity markets are the strongest in the world, and that is undeniably true, but it has not occurred by happenstance. A big part of the reason for their success is that regulators have been vigilant over many years in updating the rules of the road to match the new vehicles, methods, and pathways that form our complicated markets. Changes in the character of investing and trading since 2005 have been enormous – there can be no dispute about that. There is no point in relying on antiquated rules to govern the vastly changed landscape that has grown up around them.

The Commission has all the data, input, and rationale for moving forward with these changes to Regulation NMS, without delay.

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[i] See Securities Exchange Act Release No. 51808, 70 FR 37496 (June 29, 2005) ("Reg NMS Adopting Release").
[ii] *See* Securities Exchange Act Release No. 96494 (December 14, 2022), 87 FR 80266 (December 29, 2022).
[iii] *See* IEX, "The Clock is Ticking on Equity Market Reform" (February 2023), avail. at https://www.iexexchange.io/blog/the-clock-is-ticking-on-equity-market-reform.
[iv] *See* IEX comment letter of October 19, 2023, at 1-5, avail. at https://www.sec.gov/comments/s7-30-22/s73022-434239-1076742.pdf.
[v] *See* IEX, "Repaving Highway 605: Better Investor Disclosure Does Not Mean Stalling Further Reform", October 12, 2023, https://www.iex.io/article/rule-605-better-investor-disclosure-does-not-mean-stalling-further-maket-structure-reform.