

## MEMORANDUM

**TO:** Equity Market Structure Advisory Committee (EMSAC)

**FROM:** EMSAC Trading Venues Regulation Subcommittee

**DATE:** April 19, 2016

**SUBJECT:** Recommendations Relating to Trading Venues Regulation

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The Trading Venues Regulation Subcommittee (Subcommittee) of the EMSAC was formed to review and analyze whether the current regulatory model for trading venues is optimally serving the market as a whole and providing a level and fair playing field for all market participants. Topics considered by the Subcommittee include the appropriate regulatory structure for today's trading venues, the impact of exchanges' limitation of liability, governance of NMS plans and consolidated market data feeds.

The Subcommittee has held several meetings to discuss the range of issues under its purview and also held a meeting with industry representatives to gather further information and insights. Based on these discussions and analysis, the Subcommittee believes that overall, the current regulatory structure for trading venues works well and generally is operating fairly and effectively. As such, the Subcommittee does not believe a significant overhaul of the current structure is needed.

However, the Subcommittee recognizes that potential conflicts and tensions do exist within and among the current trading venue models and is recommending a number of changes and enhancements as described below. The Subcommittee believes that these recommendations will formalize and make more transparent the appropriate interactions between trading venues and other market participants and will further address potential conflicts and tensions. Finally, the Subcommittee believes that, in addition to these recommendations, the different roles of trading venues will likely evolve and the SEC should continue to monitor the effectiveness of the current regulatory framework to identify where potential weaknesses or abuses may occur.

***Recommendation #1 – Evaluate and clarify exchange functions subject to SRO immunity and increase rule-based exchange liability levels.***

- SRO rule-based liability levels should be increased and be applied clearly and consistently across SROs. Such rules should identify what types of activities are covered under these rules and the process by which aggrieved parties can pursue claims.
- While the Subcommittee believes liability levels should be consistent across exchanges, it recommends consideration of whether those exchanges that engage in activities that have an increased risk of negative financial exposure on participants if mismanaged, such as IPOs or opening and closing auctions, should be required to provide for higher levels of liability for these functions.

- The Subcommittee also recommends that the SEC evaluate whether there should be specific requirements on exchanges to set aside funds to be made available in the event of future exchange liability.
- The Subcommittee also discussed the scope and breadth of SRO immunity, including as it may apply to specific exchange functions, but has not reached consensus on any formal recommendations.

***Recommendation #2 – Changes should be implemented to the NMS Plan governance structure and the role of NMS Plan Advisory Committees (AC) should be expanded, formalized and made uniform.***

- Clarify the Process for Selecting AC Representatives:
  - Participants should publish on their websites solicitation of AC members in advance of selection and Participants may also recommend candidates.
  - Once the AC has been established and is operational, the AC can nominate its own replacement candidates.
  - Selections should be approved by simple majority of Operating Committee (OC).
- Expand and Formalize the Role of AC:
  - The AC should have the right to a formal vote before any matter on which the OC votes. If the OC subsequently approves any action that was opposed by a majority of the AC, the OC should explain and document its reasons for proceeding contrary to AC input. In the event that the matter is the subject of a rule filing, the OC also should summarize and explain the results of the OC and AC votes in the filing submitted to the SEC.
  - The AC should be permitted to initiate its own recommendations to the OC and the OC should respond formally to the AC's recommendations.
- Significantly Narrow the Use of Executive Sessions by NMS Plans:
  - AC members generally should have right to attend all meetings and receive all information concerning Plan matters distributed to Participants (except executive sessions and other specific related materials as noted below).
  - The Plans should limit the acceptable use of executive sessions to only matters that present a clear conflict for AC members, such as matters relating to members' regulatory compliance, or matters subject to potential or ongoing litigation between AC members and Plan Participants. To determine that AC members are conflicted for this purpose, the OC should specifically articulate the conflict and agree by a 2/3 supermajority vote to authorize the executive session.
  - The OC may also by majority vote authorize ongoing working groups, made up of a subcommittee of the OC, to resolve a particular issue or finalize a recommendation. These working groups would not require AC participation provided, however, that the working group must submit regular updates and its ultimate work product to the full OC and AC, and the OC must allow for an AC

vote (as described above) prior to taking any action on a working group recommendation.

- Limit NMS Plan Provisions Requiring Unanimous Vote:
  - OC Voting Requirements should be 2/3 supermajority vote for substantive changes, plan amendments and fees.
  - Should be simple majority vote for administrative or technical matters like requesting system changes and interpretive matters.
- Revisit Allocation of Voting Rights Among SROs:
  - Current “one vote per exchange registration” model should be replaced with allocation of voting rights at the exchange group level, i.e., one for each “exchange family.”
  - However, if an exchange family also has consolidated market share of 10% or more in the particular market relevant to the NMS Plan, it would have two votes.

***Recommendation #3 – If a rule change will require technology changes by the industry that will be prescribed through the publication of Technical Specification, the SEC and the SROs should link the implementation date of those rule changes to the publication of Technical Specifications or FAQs where appropriate.***

- Draft technical specifications should be published prior to SEC approval of any related rule change. Where possible, industry/affected parties should be provided an opportunity to review and provide comment on draft technical specifications.
- Except in limited circumstances that necessitate expedited implementation, the implementation date of technology-driven rules/systems changes should be linked to the issuance of final technical specifications (or, where there are interpretive issues that drive system changes, the issuance of FAQs and similar interpretive guidance as appropriate), that provide firms sufficient detail to implement the changes. The SRO rule filing should explicitly note the proposed implementation time period (e.g., 6 months from the issuance of final technical specifications/FAQs).
- Where possible, the duration of the implementation period should be determined after the draft specifications/FAQs are issued to allow the industry to better evaluate and determine the necessary timeframe.

***Recommendation #4 -- SEC should work to formalize by Rule the centralization of common regulatory functions across SROs into a single regulator.<sup>1</sup>***

- The Subcommittee discussed the general question of SRO obligations for exchanges, and in particular what regulatory functions, if any should, remain at the exchange level and what should be transferred to a single regulator. The Subcommittee discussed how the transition of exchanges to profit-seeking firms could raise concerns that some SRO activities might be perceived as favoring exchanges over competing venues.

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<sup>1</sup> Subcommittee Chair Ketchum recused himself on discussion of this recommendation - Subcommittee member Maureen O’Hara lead the drafting and consideration of this recommendation.

- The general view of the Subcommittee is that removing all SRO functions from exchanges is not warranted. For example, exchanges have a legitimate interest and arguably greater expertise in real-time surveillance activities that preserve and maintain a fair and orderly market. This is particularly the case for functions that are unique to a particular market, such as floor based activities or monitoring the compliance with listing standards. Other regulatory activities, however, are better done at a centralized level. Such centralized activities include, for example, the surveillance of cross-market activities.
- The Subcommittee recommends more centralization of common regulatory functions across SROs when such centralization can avoid duplication of effort or when it can result in more effective handling of regulatory activity. Examples of such rules-based centralization could be order marking, account type indicators, and the like which are currently set by each SRO but could more effectively be done on a centralized basis. With the eventual rollout of CAT, the risk of duplicative regulatory oversight increases, underscoring the need for active monitoring to ensure against such duplication.

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The Subcommittee also has been discussing issues related to SIP effectiveness and the operation of the Consolidated Data Plans (CTA/CQ/UTP NMS Plans). The Subcommittee has not reached consensus on a recommendation in this area. The Subcommittee intends to continue its discussions and is working toward having a recommendation in this area for the full committee at its next meeting.