Clearpool Group

Viewpoints on Trading and Market Structure

January 2018

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Introduction

Launched in 2014 and based in New York, Clearpool Group is an independent agency broker-dealer and provider of tools to assist other broker-dealers in the areas of routing, execution, pre- and post-trade compliance and risk monitoring. Our clients are primarily institutional broker-dealers who, in turn, serve some of the largest asset managers. Clearpool's Algorithmic Management System (AMS) and execution services allow these broker-dealers to deliver advanced electronic trading solutions to the benefit of these asset managers, and the long-term investors who they serve.

While we are a small broker-dealer, we account for nearly 2% of the average daily volume in the U.S. markets. Clearpool therefore has a significant interest in ensuring that the regulations overseeing the markets are fair and equitable, and allow for the most orderly, efficient and competitive markets possible.

To this end, Clearpool has submitted several comment letters on various trading and market structure proposals of significance to Clearpool, its clients, and the ultimate investor.[1] We also recently co-signed a petition for rulemaking to the Securities and Exchange Commission (SEC) relating to a number of concerns surrounding market data fees.[2] In addition, we serve as a working group member with the Healthy Markets Association.

The recommendations set forth below echo many of the views expressed in those letters and the rulemaking petition, as well as address other issues we believe need to be examined to ensure that broker-dealers and other market participants can

[1] *See, e.g.*, Letter from Joe Wald, Chief Executive Officer, Clearpool, to Brent J. Fields, Secretary, SEC (File No. SR-NYSE-2016-45; File No. SR-NYSEMKT-2016-63; and File No. SR-NYSEArca-2016-89), dated December 16, 2016 (https://www.sec.gov/comments/sr-nyse-2016-45/nyse201645-1430031-10.pdf), Letter from Ray Ross, Chief Technology Officer, Clearpool, to Brent J. Fields, Secretary, SEC (File No. SR-BatsBZX-2017-34), dated June 12, 2017 (https://www.sec.gov/comments/sr-batsbzx-2017-34/batsbzx201734-1797219-153617.pdf) (Bats Market on Close Letter), and Letter from Ray Ross, Chief Technology Officer, Clearpool, to Brent J. Fields, Secretary, SEC (File No. SR-NASDAQ-2017-074), dated September 11, 2017 (https://www.sec.gov/comments/sr-nasdaq-2017-074/nasdaq2017074-2436763-161051.pdf).

[2] The rulemaking petition can be found at https://www.sec.gov/rules/petitions/2017/petn4-716.pdf.

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operate as effectively as possible under the current structure of the US equities markets.

Background

Small broker-dealers such as Clearpool play a significant role in the securities markets, particularly in serving other broker-dealers, and in facilitating the trading of small and mid-size stocks. At the same time, Clearpool and other similarly situated broker-dealers continue to be underrepresented in the debate over the reform of the structure of the markets, which can lead to a lack of understanding of the impact on these broker-dealers of market structure reform initiatives. Clearpool is therefore faced with many unintentional consequences of regulations on trading. Adding to that is the impact on Clearpool and other small broker-dealers of actions taken by other market participants that are often disproportionate to the impact of these actions on larger broker-dealers.

It is therefore imperative that Clearpool remains ever vigilant and cognizant of the many issues that are currently being examined relating to trading and market structure reform to remain competitive vis-à-vis other market participants. These include the costs surrounding trading, the transparency of market information, technological advancements in trading tools, and the oversight of broker-dealers by SROs.

We commend several recent efforts to create a meaningful dialogue on these issues, including the work of the SEC's Equity Market Structure Advisory Committee, the report issued by the Department of the Treasury on the capital markets ("Treasury Report"),[3] and the FINRA360 review,[4] to name a few.

As these and other efforts progress, we urge regulators and policymakers to take small broker-dealers such as Clearpool into account when considering reforms to the rules and regulations overseeing trading and market structure. At the end of the day, investors will be ill-served if the impact of regulation and certain market practices prevents Clearpool, and the broker-dealers which we serve, from competing in the current market environment and from continuing to provide innovative trading tools to assist investors.

[3] The Treasury Report can be found at https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.

[4] Information about the FINRA360 review can be found at https://www.finra.org/about/finra360.

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Summary of Recommendations

Controlling the Costs of Trading

- Fees Relating to Market Data and Exchange Trading: Exchanges should be required to provide transparency and reporting around the fees from proprietary data products they provide as well as the fees surrounding trading. Exchanges also should be required to disclose the amount of revenue generated by the SIP Plans. There should be a broader examination and a holistic review of the current structure for the provision of market data including the collection, distribution, and sale of market data.

- NMS Plan Governance: NMS Plan governance should be updated and modified, including adding representation from broker-dealers with voting rights. NMS Plans also should recognize exchange operators as a single entity for purposes of voting to prevent exchanges from effectively purchasing votes by opening additional exchanges or not shuttering defunct exchanges.

- Proposed Rule Changes Relating to Fees: The SEC should scrutinize rule changes relating to fees more carefully to determine whether there is a need for any action related to a filing. The SEC also should ensure that fee changes are "fair and reasonable," "not unreasonably discriminatory," and an "equitable allocation" of reasonable fees among persons who use the data and ensure that these factors are considered when determining whether to approve SRO rule changes that set data fees.

Increasing Transparency of Order Routing Protocols and Disclosures

- Reform of Rules 605 and 606: The SEC should finalize rules relating to the reform of Rules 605 and 606 and examine other ways to improve the content and accessibility of the Rule 605 and 606 reports. The SEC's Division of Economic Research and Analysis (DERA) also should examine the role of SIP and proprietary feeds in Rule 605 and 606 reporting.

Creating Sensible Rules for Automated Trading and New Trading Technology

- Oversight of New Technology: Regulators must make better efforts to understand the impact of technology on the markets, and the details of the operation of new products that are being introduced into the markets, to

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assist in ensuring that regulation makes sense and does not inhibit advancements in technology. Regulators also must remain vigilant in overseeing new trading tools and technology and, as such, trading tools and other products provided by unregulated entities should be held to similar scrutiny and oversight as those tools provided by broker-dealers.

- Balancing Regulation: Regulators must balance regulation for firms that provide technology that impact trading to not impede the continued technological innovation provided to investors and other market participants.

Improving Oversight of Broker-Dealers

- Guidance on Regulation: FINRA should provide broker-dealers with increased guidance on its rules and regulations. When FINRA does provide guidance, it should be in writing, publicly available, and readily accessible.

- Better Coordination within FINRA: FINRA should ensure that there is better coordination among different departments within FINRA to avoid duplication on examinations.

- Remedying Violations: Firms should be provided sufficient time to remedy any FINRA violations that may be found, particularly if those violations were minor or administrative in nature and were not done with any wrongful intent, and firms should be able to work more collaboratively with FINRA staff to remediate these violations.

- Familiarity with Subjects of Examinations: FINRA should ensure that examiners are better familiar with the specific business model of the firm they are examining prior to conducting an examination.

- Transparency Regarding FINRA Funding: FINRA should make public its funding mechanisms, and how it spends its revenues, to ensure that fees charged to members represent an equitable allocation of costs associated with its regulatory functions, and to provide transparency over the use of fines that are collected from members.

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Discussion

I. Controlling the Costs of Trading

It has become increasingly difficult for many smaller broker-dealers to compete with the so-called "bulge bracket" firms in the current market environment due, in part, to issues related to the costs associated with trading. For smaller broker-dealers, trading as efficiently as some larger broker-dealers can prove difficult as the cumulative fees related to, for example, the costs of paying for market data charged by exchanges, puts these broker-dealers at an unfair advantage vis-à-vis their larger competitors, especially as investors seek to limit the number of counterparties with which they interact due to pressures to reduce costs. Similarly, fees charged by exchanges relating to trading can disproportionately impact smaller broker-dealers.

Our current market structure also has created an environment where smaller broker-dealers end up subsidizing larger-sized firms when it comes to the costs surrounding trading. For example, for larger sized broker-dealers, the high fixed costs associated with exchange membership, market data, and connectivity are more than offset by the favorable tiered pricing structure for execution and related volume discounts provided by the exchanges to these brokers. At the same time, smaller broker-dealers, in order to remain competitive, increasingly must utilize larger firms for access to the markets to take advantage of their pricing structures.

At the end of the day, while on paper larger sized broker-dealers are paying the same fixed costs associated with exchange trading as Clearpool, those fees are offset both by the favorable pricing provided by the exchanges, and the order flow they receive from offering market access to smaller firms. We do not see any slowing to this trend – fixed costs continue to rise and discounts provided by exchanges to larger broker-dealers continue to improve as these firms aggregate increased flow from smaller brokers. This results in a concentration of more flow into fewer entities, thereby increasing the overall risk for the markets, and presents a potential barrier to entry into the markets for many smaller firms.

The time is ripe for exchanges to price their offerings more competitively and equitably for all market participants, and become more transparent regarding the revenue generated by such offerings. Smaller broker-dealers cannot wait for market driven solutions to address concerns raised by the costs of trading and to create a more competitive or equitable environment for market participants, as it is clear that exchanges have little interest in changing the status quo.

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Market Data Fees

Of all the issues relating to the costs of trading, the trend toward higher market data fees has had the most negative impact on the securities markets. As has been discussed recently in a number of different forums, there are currently no viable alternatives for broker-dealers to paying exchanges for their market data, particularly as it relates to the choice of obtaining market data information via the Securities Information Processor ("SIP") or exchanges' proprietary data feeds. Clearpool and other broker-dealers are compelled to purchase the exchanges' proprietary data feeds both to provide competitive execution services to our clients and to meet our best execution obligations. In turn, exchanges have become increasingly reliant on the revenues generated by market data vis-à-vis other revenues such as those generated from trading and listings that the incentives for exchanges to place their interests ahead of the users of market data has increased, as have the disincentives to reign in market data fees.

The Treasury Report addressed the issues surrounding the reliance of broker-dealers on exchanges' market data. Specifically, the Report recommended that the SEC and FINRA issue guidance or rules clarifying that broker-dealers may satisfy their best execution obligations by relying on SIP data rather than proprietary data feeds if the broker-dealer does not otherwise subscribe to or use those proprietary data feeds.[5] We do not believe, however, that such guidance or rules would eliminate the need for broker-dealers to subscribe to proprietary data feeds. While such guidance or rules may clarify a broker-dealer's regulatory obligations as they relate to best execution, it would not obviate our business obligations to purchase the exchanges' proprietary data feeds to continue to provide competitive execution services to, and to fulfill the needs of, our clients.

Compounding the difficulties for market participants, the current level of transparency around market data offerings also is lacking. As discussed in the rulemaking petition on market data discussed above, exchanges are not required to itemize by product or service their revenues from the sale of market data, or to indicate whether their market data revenues derived from the sale of proprietary data or SIP data. In addition, there is a lack of transparency concerning the allocation of the revenue collected by exchanges for the dissemination of data through SIPs, and exchanges are not required to disclose any information about their costs related to the collection and dissemination of market data. It is therefore very difficult for consumers of market data disseminated by exchanges to understand the reasonableness of pricing without additional information about these offerings. Increased transparency also would facilitate the SEC and others to

[5] *See* Treasury Report, *supra* note 3, at p. 64.

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better determine whether exchanges are meeting their obligations under the Exchange Act when it comes to the provision of market data.

Finally, to genuinely address issues surrounding the SIP, we believe the governance around SIP Plans must be changed. Currently, SIP Plans are governed by SROs that have conflicts of interest in the provision of market data (*i.e.*, the exchanges, excluding FINRA) as they are selling market data products that directly compete with the SIPs. These SROs therefore have a disincentive to either invest in the SIPs or to make SIPs competitive products to their proprietary data products, and it is unlikely that they would vote to make needed changes to the SIP Plans.

Exchange Trading Fees

The fees charged by exchanges for trading is another area that is ripe for improvement. While the industry has seen the benefits of competition when exchanges are forced to compete regarding certain types of fees, these benefits have not yet translated to a significant number of the fees associated with trading. The lack of competitive price pressures has contributed to an environment where the revenues collected by exchanges have eclipsed the need to keep fees in check.

For example, as we discussed in a previous comment letter,[6] the current closing auction process is operated as a monopoly by, and is a significant source of revenue for, the exchanges. The exchanges have taken advantage of the increased volume around the close, at the expense of market participants, by charging higher fees for participation in their closing auctions than for trading conducted intraday. Given that exchanges have been able to operate with minimal competition in the close, as exchange revenues become more dependent on such fees, protecting these revenues could come at the expense of what is best for the overall market. We commend the SEC on its recent approval of the Cboe Market Close, a significant step towards increasing competition around the closing auction.

The tiered pricing structures of exchanges around trading fees also have provided questionable benefits for market participants, particularly smaller broker-dealers such as Clearpool. Significantly, the current tiered pricing models, which include hundreds of different pricing tiers, raise issues around conflicts of interest. This occurs as exchanges chase order flow and provide rebates and other pricing incentives to the largest trading firms at the expense of smaller market participants, who cannot take advantage of such rebates and, in effect, end up subsidizing the trading of the larger firms. Tiered pricing structures also challenge the concept of

[6] *See* Bats Market on Close Letter, *supra* note 1.

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"fair access" and, with hundreds of different pricing tiers and related order types, contribute to the opacity around pricing and the complexity of the markets. Even the most sophisticated of market participants are challenged under these structures to comprehend what they are paying for the purchase or sale of a stock.

Proposed Rule Changes Relating to Fees

Given the significance of issues surrounding the costs of trading, Clearpool believes market participants should have a greater ability to provide input when an exchange makes a change to a fee associated with market data or other trading fees. As SROs, exchanges are required to file rule changes, including those relating to fee changes, to the SEC. These changes, however, are typically made on an "immediate effectiveness" basis.[7] This often does not provide sufficient opportunity for market participants impacted by such rule changes to review the fee change or to provide any comments prior to those changes becoming effective. We believe allowing these rule filings to become immediately effective also does not provide time for the SEC to conduct more than a minimal review to ensure that a filing is consistent with the requirements of the Exchange Act. While we appreciate the desire to balance the needs of exchanges to be able to make changes to and implement changes to fees quickly in a competitive environment, we believe market participants impacted by these changes need the ability for a more meaningful comment process.

Recommendations

- Exchanges should be required to provide transparency and reporting around the fees from proprietary data products they provide as well as the fees surrounding trading including, at a minimum, the revenue itemized by each product and the associated number of clients that use each product.

- Exchanges should be required to disclose the amount of revenue generated by the SIP Plans, as well as, among other things, the sources of that revenue and the allocation of revenues resulting from data distributed through SIPs.

- There should be a broader examination and a holistic review of the current structure for the provision of market data including the collection, distribution, and sale of market data. Such review should include an

[7] Section 19(b)(3)(A) of the Exchange Act provides that, notwithstanding the provisions of Section 19(b)(2), a proposed rule change shall take effect upon filing with the SEC if designated by the SRO as, among other things, "establishing or changing a due, fee, or other charge imposed by the self-regulatory organization."

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examination whether there should be one source of market data, *i.e.*, wrapping proprietary market data into the SIP, and treating such as a utility, particularly if other actions discussed above to remedy concerns regarding the costs of trading are not taken. At the same time, the SIP should be "upgraded" to support the speed necessary for the dissemination of data in a timely manner.

- NMS Plan governance should be updated and modified, including adding representation from broker-dealers with voting rights. NMS Plans also should recognize exchange operators as a single entity for purposes of voting (*i.e.*, eliminate current "one vote per exchange registration" model) to prevent exchanges from effectively purchasing votes by opening additional exchanges or not shuttering defunct exchanges.

- The SEC should scrutinize rule changes relating to fees more carefully to determine whether there is a need for any action related to a filing.[8] As the Treasury Report recommended, the SEC should ensure that fee changes are "fair and reasonable," "not unreasonably discriminatory," and an "equitable allocation" of reasonable fees among persons who use the data and ensure that these factors are considered when determining whether to approve SRO rule changes that set data fees.

II. Increasing Transparency of Order Routing Protocols and Disclosures

The need for increased transparency of order routing protocols and related disclosures (in addition to transparency around trading fees discussed above) has become critical to an efficient market structure. In order to make important decisions about the best venues to which to send orders, market participants need to have the right information available.

Clearpool strongly supports the meaningful initiatives undertaken by the SEC to increase transparency around market information, including the reform of Rules 605 and 606, and associated reports required by those rules. Increased information about broker-dealers' order routing practices and execution quality will be important to market participants for purposes of further analysis and comparison of

[8] For example, the SEC may, at any time within 60 days of the filing of a proposed rule change made on an immediate effectiveness basis, temporarily suspend the rule change if it appears to the SEC that such action is: "(i) necessary or appropriate in the public interest; (ii) for the protection of investors; or (iii) otherwise in furtherance of the purposes of the [Exchange] Act."

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trading venues and will help investors talk to their broker-dealers about order routing practices and the management of conflicts of interest.

Increasing transparency also will play a role in addressing issues surrounding Regulation NMS. The post-Regulation NMS market structure has now matured, and what we are left with is a complex ecosystem that has bred conflicts of interests, bias and information leakage in ways that did not previously exist. Clearpool believes an important way to address these issues is by providing market participants with the tools to transparently display routing protocols, the control to make changes to their routing protocols, and the analytics to support and validate routing protocols.

As regulators continue to examine how to increase transparency of market information, it will be important to examine any new burdens to market participants, specifically, as discussed above, those that may perpetuate a reliance on the data provided by exchanges on the orders routed to, and executed on, their venues. It will therefore be imperative to ensure that the burdens associated with market data do not jeopardize the advancements made relating to the transparency of market information.

Recommendations

- The SEC should finalize rules relating to the reform of Rules 605 and 606 and examine other ways to improve the content and accessibility of the Rule 605 and 606 reports.

- We agree with recommendations made by the SEC EMSAC's Customer Issues Subcommittee that the SEC's Division of Economic Research and Analysis (DERA) should examine the role of SIP and proprietary feeds in Rule 605 and 606 reporting.

III. Creating Sensible Rules for Automated Trading and New Trading Technology

Automated trading has become an integral part of the trading process. When determining the most efficient approach to executing a trade, brokers must now take into account, among other things, the impact of the increase in volume of trading attributed to certain market participants and the significant amount of automated trading in general, as well as the new technology and tools available when trading.

Investors also have become more diligent in choosing their counterparties and the venues to which they route their orders due to the technology available, particularly

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the use of algorithms. In our discussions with investors, they have told us that when selecting a broker, ease of system use, reliability and quality of technical support, followed by proven execution quality of algorithms were key factors.

Clearpool believes that navigating today's complex market structure would effectively be impossible without the technology and related tools that have been introduced into the markets by firms such as Clearpool to bring more transparency and control to automated trading and, in particular, algorithmic trading. Regulators and other policymakers must therefore examine the regulatory burdens that are placed on firms such as Clearpool that may impede the continued technological innovation that is provided to investors and other market participants.

As an agency only broker-dealer providing technology and execution services to other broker-dealers, Clearpool is held to higher level of scrutiny and compliance by regulators than, for example, certain vendors and other technology firms that provide tools such as order management systems (OMS) and execution management systems (EMS), tools that also play a significant role in automated trading.

As new firms, and new technologies, are introduced into the markets (*e.g.* artificial intelligence, data management systems), it will be important for regulators to ensure that they understand how these new technologies operate, and the risks they inject into the markets, particularly for tools provided by firms that remain unregulated, or are not regulated at the same level as Clearpool and similarly situated broker-dealers. This is especially true given that many of these unregulated firms may also not have the same level of expertise as their regulated counterparts. At the same time, overregulation of firms such as Clearpool may stifle innovation in technology by those firms who best know the operation of the trading business.

Recommendations

- Regulators must make better efforts to understand the impact of technology on the markets, and the details of the operation of new products that are being introduced into the markets, to assist in ensuring that regulation makes sense and does not inhibit advancements in technology.

- Regulators must remain vigilant in overseeing the new trading tools and technology being introduced into the markets and, as such, trading tools and other products provided by unregulated entities should be held to similar regulatory scrutiny and oversight as those tools provided by broker-dealers.

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- Regulators must balance regulation for firms that provide technology that impact trading to not impede the continued technological innovation provided to investors and other market participants.

IV. Improving Oversight of Broker-Dealers

As a smaller broker-dealer, there are a number of issues that Clearpool believes needs to be addressed regarding the structure and operation of SROs vis-à-vis their oversight relationship of broker-dealers. These include issues relating to SRO examinations and enforcement, the need for improvements to the guidance provided to broker-dealers, and potential SRO conflicts of interest.

Significantly, based on our experience with FINRA examinations, we believe that creating an environment focusing on compliance, rather than enforcement and the imposition of fines, would result in a more collaborative relationship between FINRA and the broker-dealers it oversees. Occasionally, there appears to be a blurring of the lines between efforts by FINRA to ensure that there is compliance by broker-dealers with rules and the rush to enforcement to address potential violations. This, combined with situations where broker-dealers are subjected to enforcement actions or examination findings based on "unofficial" legal positions taken by FINRA staff (*i.e.*, "regulation by enforcement") can make it difficult for broker-dealers to understand the standards that they will be held to.

To address these issues, and as the rules governing broker-dealers become more complex, Clearpool believes increased guidance by FINRA would significantly improve the ability of broker-dealers to comply with the requirements of rules and regulations. We commend many of the recent efforts by FINRA to address this issue, as part of the FINRA360 organizational review[9] and encourage further initiatives to assist smaller firms in their compliance efforts.

Duplication of examinations among different departments within FINRA, and between FINRA and the SEC, also can prove costly and time consuming to a broker-dealer, particularly smaller broker-dealers such as Clearpool. This is especially true when asked to respond to duplicative requests for documentation from staff from different departments within FINRA.

[9] For example, FINRA recently issued a report containing a summary of its examination findings that firms could use in tailoring their compliance and supervisory programs to their businesses. *See* Report on FINRA Examination Findings, December 6, 2017, at https://www.finra.org/sites/default/files/2017-Report-FINRA-Examination-Findings.pdf. FINRA also recently launched a Small Firm Helpline and implemented other initiatives to assist small firms.

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Given the complexity of rules, it also is important for firms, particularly smaller firms, to be able to work with FINRA staff to remediate violations, especially if those violations were minor or administrative in nature and were not done with any wrongful intent.

Given the diversity of the business models that exist today among broker-dealers, even among the universe of small broker-dealers, we also have found that some examiners are unfamiliar with the specific business model of the firm they are examining prior to conducting an examination. This lack of familiarity may result in an inefficient use of time and resources by firms, resulting in ambiguity during the examination process.

Finally, Clearpool believes there is a need for FINRA to address potential conflicts of interest vis-à-vis the broker dealers they regulate. Specifically, we believe FINRA should avoid situations where there is a conflict between its regulatory responsibilities, on the one hand, and their commercial and economic interests, on the other hand.

Recommendations

- FINRA should provide broker-dealers with increased guidance on its rules and regulations. When FINRA does provide guidance, it should be in writing, publicly available, and readily accessible.

- FINRA should ensure that there is better coordination among different departments within FINRA to avoid duplication on examinations.

- Firms should be provided sufficient time to remedy any FINRA violations that may be found, particularly if those violations were minor or administrative in nature and were not done with any wrongful intent, and firms should be able to work more collaboratively with FINRA staff to remediate these violations.

- FINRA should ensure that examiners are better familiar with the specific business model of the firm they are examining prior to conducting an examination.

- To help address potential conflicts of interest, FINRA should continue to increase transparency around its funding mechanisms, and how it spends its revenues, to ensure that fees charged to members represent an equitable allocation of costs associated with its regulatory functions.

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