

United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

March 25, 2022

Memorandum

To: Members, Committee on Financial Services
From: FSC Majority Staff
Subject: March 30, 2022, Investor Protection, Entrepreneurship, and Capital Markets Subcommittee Hearing entitled, “Oversight of America’s Stock Exchanges: Examining Their Role in Our Economy”

The Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets Subcommittee will hold a hearing entitled, “Oversight of America’s Stock Exchanges: Examining Their Role in Our Economy” on Wednesday, March 30 at 2:00 pm in room 2128 of the Rayburn House Office Building and on Cisco WebEx. There will be one panel with the following witnesses:

- **Robert J. Jackson Jr.**, Professor of Law, New York University School of Law; former Commissioner, SEC;
- **Michael S. Piwowar**, Executive Director, Milken Institute Center for Financial Markets; former Commissioner and Acting Chairman, SEC;
- **Ellen Greene**, Managing Director, SIFMA
- **Nandini Sukumar**, CEO, The World Federation of Exchanges
- **Manisha Kimmel**, Chief Policy Officer, MayStreet

Overview

In the United States, there are 4,147 domestic companies and 2,404 exchange traded funds (ETFs) listed for trading on U.S. stock exchanges, representing approximately \$47 trillion in total market capitalization.¹ Trades in these securities are carried out across a variety of different trading venues including broker-dealers that internalize orders and alternative trading systems (ATS) and National Stock Exchanges (NSE). There are a total of 24 stock exchanges in the U.S. registered with the Securities and Exchange Commission (SEC) as NSEs under section 6(a) of the Securities Exchange Act of 1933.² Among these 24 exchanges, 17 are owned by three companies: the Intercontinental Exchange (ICE), Nasdaq, Inc.; and Cboe Global Markets, Inc. On average, more than 52 percent of daily equity trading activity takes place on these 17 exchanges.³ Nasdaq and New York Stock Exchange (NYSE, owned by ICE) are the two primary “listings exchanges” in the U.S. through which companies conduct new public stock offerings.⁴

Prior to 2010, NYSE, Nasdaq, and Cboe were each member-owned and not-for-profit entities.^{5,6} Between 2000 and 2010 all three exchanges carried out the process of “demutualization” to become for-profit, publicly traded companies.⁷ In a 2005 concept release issued by the SEC soliciting public comment on

¹ SIFMA, [US Equity Market Structure Analysis Why Market Structure and Liquidity Matter](#), (Sept. 2021).

² SEC, [National Securities Exchanges](#), (Accessed Mar. 2022).

³Cboe, [U.S. Equities Market Volume Summary](#) (Accessed Mar. 2022).

⁴ SIFMA, [US Equity Capital Formation Primer An exploration of the IPO process and listings exchanges](#), (Nov. 2018).

⁵ http://www.jthl.org/content/articles/V12I1/JTHLv12i1_Freeman.PDF.

⁶ Securities and Exchange Commission Historical Society, [The Institution of Experience: Self-Regulatory Organizations in the Securities Industry, 1792-2010](#) (Accessed Mar. 2022).

⁷ *Id.*

the potential demutualization of Nasdaq and the NYSE, the SEC noted that “SRO demutualization raises the concern that the profit motive of a shareholder-owned SRO could detract from proper self-regulation.”⁸

Exchanges as Self-Regulatory Organizations

Under Section 3(a)(26) of the Exchange Act, each NSE registered with the SEC is granted self-regulatory organization (SRO) status. As an SRO, exchanges have the responsibility of enforcing federal securities laws and putting in place standards to promote “just and equitable principles of trade,”⁹ and the exchanges also are required to have listing standards that would apply to any issuer that decides to list or maintain the listing of their securities on a particular exchange. Enforcement activities carried out by exchanges include trading halts and suspensions, and the delisting of a company’s stock if that company fails to follow listing (or other regulatory) requirements. Over the past several decades, a series of court rulings have established that exchanges, premised on their status as SROs, are shielded “from liability for any action that is ‘incident to’ or ‘consistent with’ an exchange’s quasi-governmental power.”¹⁰ In 2012, while carrying out the initial public offering (IPO) for Facebook, technological problems in Nasdaq systems led to delays in the initial opening of the stock. As a result of this disruption in trading, Facebook investors reportedly experienced an estimated \$200 - \$350 million in losses. Following these disruptions, a group of Facebook investors brought a class action lawsuit against Nasdaq.¹¹ In response to the suit, Nasdaq argued that it was immune from liability on the basis that it is an SRO.¹² The exchange later agreed to a \$26.5 million settlement with the plaintiffs.¹³

Exchange Liability Limits

Section 19(b)(1) of the Securities Exchange Act of 1934 grants NSEs, the authority to set their own rules as SROs. These rules are required to be filed with the SEC for public consideration and pertain to a wide variety of issues related to an exchange’s operations.¹⁴ This includes the fees that are charged by the exchanges for market data that they provide.¹⁵ Section 916 of the Dodd-Frank Act established new requirements that the SEC must follow in its consideration of new rules filed by each exchange. Among the provisions of section 916 is a requirement that each new rule filed by an exchange becomes effective upon filing unless the SEC objects.¹⁶ The SEC receives hundreds of new rule filings each year from the 24 NSEs.¹⁷ Concerns have been raised as to whether the SEC has the requisite resources to effectively consider all of these filings in a timely manner.¹⁸

Although Section 6(b) of the Securities Exchange Act sets out a number of limitations and requirements that exchange rules must meet in order to be registered as an NSE, Section 6(b) does not prevent exchanges from setting rules that limit their legal liability. As such, it is routine practice for

⁸ SEC, [Concept Release Concerning Self-Regulation](#) (Mar. 8, 2005).

⁹ Cornell Law School Legal Information Institute, [Self Regulatory Organization](#), (Accessed Mar. 2022).

¹⁰ Jacklyn Freeman, [Limiting SRO Immunity to Mitigate Risky Behavior](#), Journal on Telecommunications & High Technology Law (May 2, 2014).

¹¹ Nina Mehta, [Nasdaq Exchange Immunity May Limit Losses from Facebook Claim](#), Bloomberg (June 12, 2012).

¹² U.S. District Court for the Southern District of New York, [Opinion & Order: In re Facebook, Inc., IPO Securities and Derivative Litigation](#) (Dec. 12, 2013).

¹³ John McCrank, [Nasdaq to settle Facebook IPO lawsuit for \\$26.5 million](#), Reuters (Apr. 23, 2015).

¹⁴ SEC, [Self-Regulatory Organization Rulemaking](#) (Accessed Mar. 2022).

¹⁵ *Id.*

¹⁶ Dodd-Frank Act of 2010, [Public Law 111-203](#).

¹⁷ SEC, [Self-Regulatory Organization Rulemaking](#) (Accessed Mar. 2022).

¹⁸ See SEC Final Rule, “Rescission of Effective-Upon-Filing Procedure for NMS Plan Fee Amendments and Modified Procedures for Proposed NMS Plans and Plan Amendments,” available at <https://www.federalregister.gov/documents/2020/10/15/2020-18572/rescission-of-effective-upon-filing-procedure-for-nms-plan-fee-amendments-and-modified-procedures> (October 15, 2020).

exchanges to adopt rules that place monetary caps on their legal liability. For example, the rules for one exchange owned by Nasdaq state:

The Exchange's payments for any and all system failures on a single trading day are capped at \$250,000 under subsection (d)(1). The rule text states that for the aggregate of all claims made by all market participants related to the use of the Exchange on a single trading day, the Exchange's payments shall not exceed \$250,000. Subsection (d)(2) further provides that if the cumulative claims exceed the \$250,000 cap, this amount would be proportionally allocated among all such claims.¹⁹

National Market System Plan Governance, Market Data, and SRO Rule Filings, Exchange Rebates

NMS Plans: Much of the structure and organization of U.S. equity markets is shaped by SEC Regulation National Market System (Reg NMS), which was adopted in 2005. Reg NMS defines how equity market trading data is collected, aggregated, and disseminated to the public, among other purposes. Since 2005, the work of gathering and distributing this data has been the responsibility of several entities known as securities information processors (SIPs). The operation of each SIP is governed by an NMS plan that in turn is controlled by the exchanges in conjunction with the Financial Industry Regulatory Authority (FINRA), which is the SRO with oversight of broker-dealers.

Earlier in 2020, the SEC also sought to address the conflicts of interest by expanding the representation of non-exchange voices in the management of NMS plans.²⁰ In May of 2020, the SEC issued an order directing the exchanges and FINRA to formulate and submit a new consolidated NMS plan to govern the collection and dissemination of SIP data.²¹ The Commission cited concerns that “developments in technology and changes in the equities markets have heightened an inherent conflict of interest between the Participants’ collective responsibilities in overseeing the Equity Data Plans and their individual interests in maximizing the viability of proprietary data products that they sell to market participants.”²² Among the requirements of this order, the SEC specifically required that the newly proposed NMS plans include designated seats on the plan’s Operating Committee for an institutional investors, institutional and retail broker-dealers, a market data vendor, a stock issuer, and a retail investor representative.²³ In response to the order, Nasdaq sued the SEC to block the new consolidated NMS plan from taking effect.²⁴

Market Data: While the exchanges are responsible for administering this SIP system, which provides the primary source of public data for U.S. stock markets, all three major stock exchanges also derive a significant amount of revenue from proprietary stock market trading data that they sell to private market participants, separate and apart from the data provided by the SIPs. In December of 2020, the SEC approved a final rule to improve the quality and usefulness of the SIP market data as well as to reorganize the system by which it is delivered.²⁵ In the final rule the Commission stated that it was established, in

¹⁹ SEC, *Release No. 34-80209: Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Harmonize Liability Caps and Related Reimbursement Requirements* (Mar. 10, 2017).

²⁰ SEC, [SEC Directs Equity Exchanges and Financial Industry Regulatory Authority to Improve Governance of Market Data Plans](#), (May 6, 2020).

²¹ SEC, [Order Directing the Exchanges and the Financial Industry Regulatory Authority To Submit a New National Market System Plan Regarding Consolidated Equity Market Data](#) (May 6, 2020).

²² *Id.*

²³ *Id.*

²⁴ Investment Company Institute, [Amicus Curiae Brief in Support of Respondent: Nasdaq Stock Market LLC, et al., v. Securities and Exchange Commission](#) (Jan. 3, 2022).

²⁵ SEC, [SEC Adopts Rules to Modernize Key Market Infrastructure Responsible for Collecting, Consolidating, and Disseminating Equity Market Data](#) (Dec. 9, 2020).

part, to respond to concerns raised regarding “conflicts of interest stemming from the sale of competing proprietary data products by the exchanges that currently have majority voting power on the Operating Committee(s) of the Equity Data Plans.”²⁶ In issuing the rule, then SEC Division of Trading and Markets highlighted that “the content of national market system data for equities and the consolidation and dissemination of that data have lagged meaningfully behind the technologies and data content widely used for proprietary data products offered by exchanges.”²⁷

SRO Rule filings: The existing process used by the SEC to review and approve certain exchange filings, and fee filings in particular, has been called into question.²⁸ Exchanges are currently permitted to make certain rule changes, including fee-related changes, by making a filing with the SEC that is “effective upon filing.”²⁹ For “effective upon filing” rules changes, the public is typically not provided a formal notice or the opportunity to review and potentially challenge a rule or fee in advance of implementation. In recent years, according to experts the Committee spoke with, these filings have grown exponentially: in 2021, there were over 1300 SRO filings – more than half of which were effective upon filing, by contrast, in 2003, there were under 70 filings, total. Additionally, exchanges have been increasing fees. A 2018 analysis by SIFMA found that fees to receive market data from certain exchanges have increased by 1100% in recent years.³⁰ Similarly, transaction fee and rebate levels are also effective upon filing. Finally, exchanges offer hundreds of customized trade pricing tiers.³¹

Rebate Tiers: Stock exchanges impose what is known as an “access fee” onto their members to transact on the exchange. However, most exchanges return these fees back to the member through rebates. These rebates schemes are often complicated, opaque, and “bespoke.” A 2018 study by RBC Capital Markets determined there were over 1,000 “pricing paths,” which are fee and rebate combinations across all the exchanges, which were driven by over 3,700 different pricing variables.³² Under this system, per-share rebates are typically based on consolidated market-wide volume of transactions by an individual firm over a defined period of time. This means that rebate tiers are not like typical “volume-based” discounts, since on high volume days, the volume needed to qualify is proportionately increased. As a result, the requirements are set at levels such that the most advantageous rates are accessible to only a few of the most active trading firms, which can each receive payments totaling hundreds of millions of dollars annually, leaving many small and mid-sized firms at a disadvantage. Further, exchanges are able to create customized pricing tiers that are, at times, designed to be available only to a single firm. The net impact may create a risk of market concentration and burdens on competition, as the majority of brokers face high or prohibitive costs of entry.

Non-Exchange Trading Venues

²⁶ SEC, [SEC Adopts Rules to Modernize Key Market Infrastructure Responsible for Collecting, Consolidating, and Disseminating Equity Market Data](#) (Dec. 9, 2020).

²⁷ *Id.*

²⁸ See, generally, comment letters filed in response to and in support of SEC Final Rule, “Rescission of Effective-Upon-Filing Procedure for NMS Plan Fee Amendments and Modified Procedures for Proposed NMS Plans and Plan Amendments,” available at <https://www.federalregister.gov/documents/2020/10/15/2020-18572/rescission-of-effective-upon-filing-procedure-for-nms-plan-fee-amendments-and-modified-procedures> (Oct. 15, 2020).

²⁹ See Exchange Act Section 19(b)(3)(A).

³⁰ See [Letter from Melissa MacGregor and Theodore R. Lazo, SIFMA](#) to Brent J. Fields, SEC, (Oct. 24, 2018), (providing “An Analysis of Market Data Fees”).

³¹ See [Letter from Joe Wald, Clearpool](#), to Brent J. Fields, SEC, at 2-3, (Oct. 23, 2018).

³² See RBC study, “Complexity of Exchange Pricing and Corresponding Challenges to Transparency and Routing,” available at <https://www.sec.gov/comments/s7-05-18/s70518-4527261-176048.pdf>. (October 2018).

While majority of stock trading volume takes place on registered stock exchanges, over 40% of securities are traded through two major categories of non-exchange trading and execution venues:³³ Alternative Trading Systems (sometimes referred to as “dark pools”) and “internalizers.” ATSs usually cater to large, institutional investors who do not want to signal to the markets in advance of their large orders, whereas “internalizers” execute orders internally, without going through an exchange.

Neither of these non-exchange trading venues are under the same regulatory and member supervision obligations that exchanges must follow. There are roughly 30 SEC registered ATSs which execute stock trades.³⁴ The market dominance of some capital market participants raises concerns about systemic risk and, in particular, correlated risks arising from the relationship between financial institutions. For example, Citadel LLC is a multi-service hedge fund and financial services company, and its subsidiary, Citadel Securities LLC, which is a broker-dealer, is one of the largest market makers and, according to its website, executes “approximately 47% of all U.S.-listed retail volume.”³⁵ Citadel Securities also, reportedly, handles almost as much trading volume as Nasdaq.³⁶ Further, Citadel Securities along with market maker Virtu Financial, “account for more of the overall equity market than the New York Stock Exchange.”³⁷ With respect to Citadel, some have raised concerns about a single market maker managing such a large volume of retail order flow, and what that means in terms of pricing.³⁸ Others have questioned whether Citadel has such dominance in our financial markets that it poses a systemic risk to the entire U.S. financial system.³⁹

³³ Off-exchange trading has grown over the past decade. During the last two years, it hovers between 40-45% of all trades. See, <https://www.nasdaq.com/articles/a-deep-dive-into-dark-trades-2021-04-29>.

³⁴ SEC, [Alternative Trading System \(“ATS”\) List](#) (Feb. 28, 2022).

³⁵ Citadel Securities, [Equities & Options](#) (Accessed Mar. 2022).

³⁶ Quartz, [Citadel Gets Almost As Much Trading Volume as Nasdaq](#) (Feb. 5, 2021).

³⁷ *Id.*

³⁸ Yahoo Finance, [Biden’s SEC pick: Some crypto markets ‘rise with fraud and scams’](#) (Mar. 2, 2021).

³⁹ The Wall Street Journal, [Citadel ‘May Pose a Systemic Threat,’ Waters Says](#) (Feb. 18, 2021).

Appendix: Legislation

- **H.R. 4865, Registration for Index-Linked Annuities Act (Adams).** This bill requires the Securities and Exchange Commission (SEC) to create a new form for the registration of index-linked annuities to ensure that a purchaser can make a knowledgeable decision.
- **H.R.5795, Main Street Growth Act (Emmer).** This bill allows for the registration of national venture securities exchanges for the purpose of trading the securities of certain small companies, such as startups and emerging growth companies. Individuals and existing national securities exchanges may apply to the Securities and Exchange Commission for approval to register such an exchange, or to register a listing tier within an existing exchange.
- **H.R. ___, Securities Exchange Reform Act of 2022 (Sherman).** This bill would clarify existing law to establish that a National Securities Exchange liable when acting in a commercial capacity. It would also restrict the ability of a National Securities Exchange to use its rule setting authority as a self-regulatory organization (SRO) to put in place monetary caps on its liability. Finally, the bill would also require that a broker-dealer, SEC registered investment advisor, and investor protection organization are granted status as voting members of each national market system (NMS) plan governing body.
- **H.R. ___, To amend the Securities Exchange Act of 1934 to add certain requirements for the filing and approval of proposed rule changes by self-regulatory organizations. (Approach 1)** This discussion draft would require exchange SRO filings related to fees to go through the regular approval process, and only be effective upon an SEC order approving them.
- **H.R. ___, To amend the Securities Exchange Act of 1934 to add certain requirements for the filing and approval of proposed rule changes by self-regulatory organizations. (Approach 2).** This discussion draft would require exchanges to provide advance notice to the Commission and the public of any proposed rule so that participants may both raise concerns with the filings and adequately prepare for changes. In addition, exchanges would be limited in the frequency with which they make filings that are immediately effective, and the exchanges would not be permitted to implement a fee retroactively. Lastly, the SEC would be required to publish its review and determinations regarding all exchange filings.
- **H.R. ___, To amend the Securities Exchange Act of 1934 to improve the governance of multi-class stock companies.** This discussion draft would establish minimum listing standards for the stock exchanges that list new companies that have multiple classes of stock with unequal voting rights. The discussion draft would not apply to any existing public companies. The discussion draft would also require newly listed companies that choose to have multi-class stock structures to also include a seven-year sunset provision for that multi-class stock structure, eventually leading to “one share, one vote.”
- **H.R. ___, “Free-market Accountability through Investor Rights Act of 2022” (FAIR Act).** The discussion draft would prohibit multi-class share structures at certain large issuers (with annual revenues above \$75 billion) that are subject to bad actor disqualifications under the securities laws or have been fined in the preceding five years more than \$5 billion in aggregate amount.
- **H.R. ___. To amend the Securities Exchange Act of 1934 to require the Securities and Exchange Commission to promulgate a rule prohibiting or limiting the use of tiered rebate payments by national securities exchanges.** The discussion draft would require the SEC to engage in rulemaking to prohibit or limit the use of rebate payments by exchanges that are tiered based on the aggregate volume of transactions effected by such members.