Nasdaq

House Financial Services Committee, Subcommittee on Capital Markets

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

June 27, 2024

Testimony of Kevin Kennedy

Executive Vice President

Nasdaq

Representing the Equity Markets Association

Thank you, Chairman Wagner and Ranking Member Sherman, for inviting me to testify as a founding member of the Equity Markets Association ("EMA") this afternoon on the Securities and Exchange Commission's (the "SEC's" or the "Commission's") four December 14, 2022 Market Structure Rule proposals:

> **Regulation Best Execution, File No. S7-32-22, Release No. 34-96496;**
> **Order Competition Rule, File No. S7-31-22, Release No. 34-96495;**
> **Regulation NMS: Minimum Pricing Increments, Access Fees, and Transparency of Better Priced Orders, File No. S7-30-22, Release No. 34-96494 ("NMS Proposal");**
> **Disclosure of Order Execution Information, File No. S7-29-22, Release No. 34-96493 (adopted March 6, 2024 via unanimous vote)**
>
> (Also intrinsically linked and discussed below is the SEC's October 18, 2023 **Rule to Address Volume-Based Exchange Transaction Pricing for NMS Stocks, File No. S7-18-23, Release No. 34-98766**)

Please see the Appendix attached to this testimony for a list (and links) of selected comment letters submitted by the Equity Markets Association and some of our members on these proposals as they contain data and detailed arguments too lengthy to include in this formal testimony:

As noted above, Nasdaq is testifying today as a founding member of the EMA, which represents the three public company equity exchanges, the NYSE, Nasdaq, and Cboe. Established in 2015, the Equity Markets Association provides federal policymakers, regulators, and investors with in-depth analysis on important issues that impact the U.S. capital markets. Its members -- Cboe Global Markets, Nasdaq, and NYSE Group -- each operate U.S. registered cash equity and options exchanges. They manage fair, orderly, and transparent markets that incentivize capital formation and ensure a robust secondary market for trading securities. The EMA members share a common vision for the U.S. equity markets that is fair, orderly, well-regulated, protective of investors, and welcoming to listed companies, as well as one that is deeply liquid, dynamic, competitive, innovative, transparent, efficient, and grounded in displayed quotes. Of course, although the EMA members share this vision, they may sometimes differ in their views on how to most effectively achieve it. The specific views expressed in Nasdaq's testimony reflect our

own experience and vision for the U.S. capital markets, and may not necessarily track the policy positions of other EMA members.

I am also very proud to serve as Executive Vice President of Nasdaq, where I am responsible for North American Market Services. Nasdaq is a leading global technology company serving corporate clients, investment managers, banks, brokers, and exchange operators as they navigate and interact with the global capital markets and the broader financial system. We deliver world-leading platforms that improve the liquidity, transparency, and integrity of the global economy. Our diverse offerings of data, analytics, software, exchange capabilities, and client-centric services enables clients to optimize and execute their business vision with confidence.

Nasdaq's unique role as a venue that lists companies for trading and initiates IPOs for the marketplace distinguishes our point of view on market structure from others in this debate. Some other venues and trading centers have business models that only seek trading volume for trading volume's sake. They have no obligation to the broader capital markets to ensure that the public company model (and in turn U.S. IPO competitiveness) are served well.

At Nasdaq, a sound and resilient trading environment is paramount to the way we think about capital formation and driving the economy forward. We care about the trading environment for companies of all sizes (including our emerging growth companies) where investors and your constituents predominantly invest their 401Ks for retirement and where that capital supports jobs and growth in every Congressional district – for the community bank, the biotech startup and the manufacturer trying to grow and thrive in today's competitive landscape. These companies rely on the capital markets to attract investors and to impute a stable value of the price of their stock, to use that valuation to grow, hire and compete.

* * *

The U.S. equities markets today work extremely well for investors, and they are the envy of the world. This is true by almost every measure of market quality – be it depth, speed, capital formation, numbers of IPOs, retail investor access, or retail investor costs. The U.S. equities markets today also are mature, intricate, complex, and interconnected ecosystems. Thus, while there is always room for improvement and a need for adaptation, especially in a rapidly changing world, it is important to note even minor changes to equity market structure can have major and often unintended implications for the markets and market participants. For this reason, any unjustified alteration of equity market structure – no matter how well-intended – must be approached with thoughtful consideration, foresight, and supporting data.

As the SEC celebrates 90 years of regulating the U.S. equities markets, it is fair to say that few, if any, concerns remain about the equity markets that warrant revolutionary reform to address them. Evolutionary reform is imperative given the complex and interconnected nature of the U.S. equity markets. Prudence is required to ensure desired outcomes for the markets and investors.

Unfortunately, this is not how the Commission has chosen to proceed. Although we share many of the Commission's concerns about market structure and support some of its reform objectives, the Commission simply proposes to do too much, too quickly to fix an already competitive

market that is not fundamentally broken. Moreover, the Commission often seeks to act without due consideration for whether evidence actually supports the existence of the problems it identifies, whether its proposed solutions would be effective at solving those problems, whether the benefits of those solutions are real, substantial, and outweigh any associated costs, and whether less costly and more effective alternative solutions would suffice.

We also find it concerning that the Commission chose to break up into pieces its market structure reform proposals even though they are clearly and inextricably intertwined. Without providing a collective analysis of each of the proposals, the Commission has denied the public its right under the Administrative Procedures Act to understand and comment on them intelligently. Said otherwise, the Commission's approach puts Nasdaq and all market participants in a precarious position where we do not have the ability to know how this new "market structure amoeba" will respond to pressure in one area while being pushed and pulled in other areas. Likewise, it is problematic that the Commission chose to split up these proposals without providing any indication of how, and in what sequence, they would be adopted and implemented.

Another one of our fundamental concerns is that the proposals would do little to support the transparent, accessible, and publicly displayed portion of the U.S. equity markets ("lit markets"), which are its bedrock. Over the past few years, lit markets have faced an increasingly challenging environment due largely to regulatory disadvantages relative to non-transparent or "dark" markets; as a result, lit markets are experiencing significant erosion in the quality and quantity of the orders they receive. This trend is concerning because quotes displayed publicly on lit markets like Nasdaq are used exclusively to calculate the National Best Bid and Offer (the "NBBO") – the best available price to buy and sell stocks across the equity markets at any point in time during the trading day. The NBBO is the price that millions of investors rely upon each day to make investing decisions impactful to their families and their futures. We have serious concerns that the net effects of the SEC's proposals will be to undermine the integrity and reliability of the NBBO as the true best available price for stocks, and render it more difficult and expensive for Americans to invest in our markets. Moreover, the proposals will harm the capital formation process by impairing the ability of companies to use the capital markets efficiently to raise funds for expansion, job creation and growth.

With these general concerns in mind, Nasdaq takes the following positions on the SEC's market structure proposals:

<u>Regulation NMS: Minimum Pricing Increments, Access Fees, and Transparency of Better Priced Orders</u>:

Among other things, the SEC's "NMS Proposal" seeks to update minimum quoting increments, harmonize minimum trading increments among trading venues, and lower the existing cap that exchanges may charge to access liquidity on their markets.

One of these proposals – which would refine the minimum increment in which stocks can be quoted – is one that Nasdaq supports in concept. Throughout the years, Nasdaq has spearheaded

efforts to reform the existing one-size-fits-all tick size regime so that it conforms better to the way that individual stocks trade, with the result being that trading those stocks will become less expensive for investors. Although Nasdaq and others agree with the SEC in principle that tick size reform is warranted, the SEC's proposed approach to tick size reform misses the mark as it is unduly complex and both under- and over-solves the problem. Nasdaq – along with the vast majority of the industry – suggests that the SEC adopt a simpler approach of adding one tick size below one penny – at $0.005 – to help tick-constrained securities trade more naturally. Beyond lower-priced tick-constrained securities, the SEC should also consider a wider tick size for higher-priced securities that currently trade with much wider spreads.

We also support harmonizing the minimum increment in which stock orders may be executed across all execution platforms, including both exchanges and non-exchanges. Today, exchanges are subject to a regulatory disadvantage relative to non-exchanges insofar as exchanges cannot price or execute orders in increments as fine as those available on non-exchanges, with the practical result being that non-exchanges are able to win order flow by executing orders in increments that exchanges cannot legally match. We agree with the Commission that its proposal to remove this artificial regulatory disparity is needed to promote the competitiveness of exchanges.

To the extent that the Commission adopts a smaller tick size, it may be worth considering a data-driven evaluation of the appropriateness of a proportionate reduction in the SEC's cap on the fees that exchanges may charge to access liquidity on their markets ("access fees"). This access fee cap (the existence of which we oppose in principle as a form of price controls) is currently $0.003 per share on stocks with a $0.01 pricing increment, or 30% of the tick. If the SEC adopts a new, lower tick size of $0.005, we would therefore support a reduction in the access fee cap to $0.0015. We believe that this reduction would be reasonable as it would maintain the 30% proportionality of cap to tick size.

However, Nasdaq strongly opposes the Commission's proposal insofar as it would lower the cap far beyond what is needed to accommodate tick size reform. Indeed, the Commission proposes to slash the access fee cap – more than 80% in some cases – as an implicit means of addressing ill-founded concerns about exchanges' payment of rebates to market participants who send orders to Nasdaq. Since access fees fund rebates, the proposal to reduce access fees would reduce exchanges' ability to pay rebates. We expect this proposal to weaken the NBBO by restricting exchanges' ability to offer meaningful incentives to encourage more liquidity and tighter spreads, which in turn supports efficient markets. The Commission's supposition that rebates present harmful conflicts-of-interest to brokers is not supported with evidence, and it ignores the countervailing benefits associated with rebates, which are essential tools for gathering the displayed quotes that form the NBBO. It would be arbitrary for the Commission to proceed with this proposal in the absence of evidence that the current fee cap is actually harmful to the market and without meaningfully weighing the costs and benefits of those reductions. As I noted earlier, Nasdaq would support the SEC adopting a fee cap that is $0.0015 for securities in the $0.005 tick size bucket while maintaining the same $0.0030 cap that exists today for securities in the $0.01 tick bucket. This alternative would cut access fees proportionately – by half for securities in the $0.05 tick bucket – while preserving effective exchange programs that are used to gather

liquidity and bolster market quality and the NBBO. The SEC should refrain from undertaking any further cap reductions without first pausing to study the impacts of this initial change on spreads, depth, institutional trading costs and ETF pricing efficiency.

Order Competition Proposal:

Nasdaq appreciates the Commissions' desire for retail investor orders to experience greater competition. However, the Commission did not provide sufficient data and research on how its proposed solution can achieve these objectives. The SEC's proposed approach to facilitating more retail order competition is too complex, too prescriptive, and too insensitive to its costs and its negative impacts on lit markets. While requiring broker-dealers to submit retail orders to "qualified auctions" on lit markets before internalizing those orders is an intellectually interesting solution, it need not be the only permissible solution, let alone the simplest, most effective, or most efficient one.

Indeed, the SEC risks too much by solely focusing on qualified auctions, which are novel and untested. At this point, their potential effectiveness is a matter of mere speculation, but their complexities and potential disruptive impacts are certain. In lieu of imposing a prescriptive solution, the SEC should instead permit participants like exchanges to innovate their own solutions (subject to the SEC approval and public comment process) which could (but need not) include some form of retail auction, as well as enhanced retail liquidity programs.

Best Execution Proposal:

The SEC has proposed its own best execution rule as a means of establishing direct federal oversight over and enforcement of the duty of best execution. The SEC should proceed carefully and listen to industry feedback. The current proposal leaves many questions unanswered. In particular, the proposal fails to indicate how, if at all, the SEC's vision for best execution differs from those of the Financial Industry Regulatory Authority ("FINRA") and the Municipal Securities Rulemaking Board ("MSRB"), which currently administer and enforce their own best execution rules. We believe that the Commission should provide broker-dealers with a reasonable timeframe to comply with the new rule before acting to enforce it. Such a rule should take into consideration differences between institutional and retail trading objectives. Lastly, it should clarify how broker-dealers may avail themselves of rebates while satisfying their best execution obligations.

Disclosure of Order Execution Information ("Rule 605 Reform"):

Nasdaq supported the Commission's proposal, which it adopted earlier this year, to modernize and improve the usability of Rule 605 reports. The new and enhanced data that this rule prescribes will provide broker-dealers and investors with more relevant, comprehensive, and understandable information by which to make best execution determinations and to assess market quality.

In adopting revisions to Rule 605, however, the Commission tacitly acknowledged the obsolescence and incompleteness of pre-existing 605 data. Such data, however, underpins the Commission's justifications for its other market structure reform proposals, and therefore calls into question the validity of those justifications. Nasdaq and others urge the SEC to wait until it collects new and enhanced 605 data before it determines whether and how to proceed with the other equity market structure reform proposals.

Volume-Based Exchange Transaction Pricing:

I realize that the Subcommittee noticed the four Market Structure proposals from December 2022 for this hearing, but Nasdaq believes that the SEC's October 2023 proposal to outlaw exchange incentives to attract deep liquidity from our customers is inextricably linked to the earlier proposals. The proposal ignores its interplay with the SEC's other pending equity market structure proposals, several of which seek to address the same problems that the SEC identifies. Uncertainty about whether or in what form the SEC will adopt these other proposals makes it impossible to evaluate this proposal properly.

The SEC proposal on volume-based pricing proposal upends practices that are woven deeply into the fabric of the markets. As a steward of the markets and all who depend upon them, we are concerned that it would place the markets and investors at needless and significant risk.

The SEC's proposal rests upon three false premises about volume-based pricing:

- First, the SEC's supposition is inaccurate that volume-based pricing inhibits small- and medium-sized brokers from competing with larger brokers for orders. In fact, volume-based pricing is not a meaningful factor in determining the competitive positions of brokers and banning it may actually harm small- and medium-sized brokers by depriving them of the benefit of the volume-based discounts they enjoy presently. Competition among brokers depends principally upon factors that are extrinsic to exchanges and their fee model. Indeed, the Commission should address these extrinsic factors directly rather than doing so indirectly by upending established exchange business models.

- Second, the SEC presents no evidence to support its premise that volume-based pricing unduly influences broker routing decisions. It also fails to account for its ability, both now and through other pending reform proposals, to effectively manage conflicts of interest by enforcing the duty of best execution.

- Third, the SEC asserts that volume-based pricing inhibits small exchanges from competing with large ones, but inter-exchange competition is fierce and has never been more so – with 16 exchanges and counting. Exchanges also compete with dark markets, single-dealer platforms, and central risk books, which together consumed over 47% of equities volume in May of this year.

Volume-based pricing is a model that is rational, pro-consumer, and pro-competition. Volume-based pricing is ubiquitous in this and countless other industries around the world. Moreover, it is a pricing model that the national securities exchanges have employed for decades, and which is reflected in hundreds of fee filings to which the SEC either expressly or tacitly assented, without controversy, until now. Exchange pricing practices are similar to how a retailer like Target leverages its scale to attract vendors willing to supply their products at a discount, which in turn allows Target to offer lower prices to consumers.

The SEC fails to demonstrate that the proposal is rational. The proposal lacks analysis and weighting of the costs and benefits it identifies – steps that are needed to establish that the proposal is reasonable. At best, the SEC projects only meager and speculative benefits from the proposal, but it acknowledges that the proposal would not be effective in solving its concerns and may leave brokers worse off than they are now. Indeed, it may force small- and medium-sized brokers that currently rely upon arrangements with larger brokers to access their better exchange pricing tiers and technology infrastructure to pay higher exchange fees and to build this technology infrastructure themselves. The proposal also identifies a litany of serious harms, including the potential for it to accelerate the erosion of lit liquidity, thereby undermining the NBBO, widening spreads, and raising investor costs. Given that the SEC itself has recognized an imperative to reverse existing trends that erode lit markets and the integrity of the NBBO, a proposal that would only exacerbate these trends is irrational.

Finally, the proposal is arbitrary and in that it fails to account for off-exchange markets, where volume-based pricing exists now and would continue unaffected. If adopted, the proposal would thus unfairly discriminate against exchanges in favor of off-exchange markets. As stated, the proposal ignores its interplay with the SEC's other pending equity market structure proposals, several of which seek to address the same problems that the SEC identifies.

* * *

To summarize, the U.S. equities markets work extraordinarily well according to almost all measures serving investors and issuers. Nasdaq is open to refinements to market structure based on data driven and incremental changes in partnership with the SEC and broader trading environment stakeholders. We stand ready to assist the SEC and Congress to ensure our markets remain robust, competitive and serve our nation's capital formation and investing needs.

Thank you again for the opportunity to testify today as a founding member of the Equity Markets Association. I look forward to answering any questions you may have regarding our capital markets.

Nasdaq

ADDENDIX

Selected EMA Comment Letters:

1. s71823-423159-1028903.pdf (sec.gov)
2. s71823-396119-950662.pdf (sec.gov)

1. John Zecca, Comment Letter on all Dec. 14, 2022 SEC Proposals, dated Mar. 30, 2023, available at https://www.sec.gov/comments/s7-30-22/s73022-20162298-331152.pdf;
2. John Zecca, Comment Letter on NMS Proposal, dated Aug. 9, 2023, available at https://www.sec.gov/comments/s7-30-22/s73022-242819-510642.pdf;
3. John Zecca, Comment Letter on Volume-Based Pricing Proposal, dated Dec. 20, 2023, at https://www.sec.gov/comments/s7-30-22/s73022-20162298-331152.pdf;
4. Brett Kitt, Comment Letter on NMS Proposal, dated Feb. 14, 2024, available at https://www.sec.gov/comments/s7-30-22/s73022-429019-1063862.pdf;
5. Brett Kitt, Comment Letter on Volume-Based Pricing Proposal, dated Feb. 14, 2024, available at https://www.sec.gov/comments/s7-18-23/s71823-428839-1063702.pdf;
6. Brett Kitt, Comment Letter on NMS Proposal, dated Mar. 25, 2024, available at https://www.sec.gov/comments/s7-30-22/s73022-450139-1152222.pdf;
7. Phil Mackintosh, Comment Letter on NMS Proposal, dated May 7, 2024, available at https://www.sec.gov/comments/s7-30-22/s73022-468071-1262516.pdf.

8. Angelo Evangelou, Comment Letter on NMS Proposal, dated Feb. 28, 2023, available at https://www.sec.gov/comments/s7-30-22/s73022-20158236-326301.pdf
9. Patrick Sexton, Comment Letter on all Dec. 14, 2022 SEC Proposals, dated Mar. 31, 2023, available at https://www.sec.gov/comments/s7-31-22/s73122-20162799-332207.pdf
10. Patrick Sexton, Comment Letter on NMS Proposal, dated Aug. 23, 2023, available at https://www.sec.gov/comments/s7-30-22/s73022-249719-570262.pdf
11. Patrick Sexton, Comment Letter on Volume-Based Pricing Proposal, dated Jan. 5, 2024, available at https://www.sec.gov/comments/s7-18-23/s71823-365659-884582.pdf
12. Patrick Sexton, Comment Letter on NMS Proposal, dated Apr. 5, 2024, available at https://www.sec.gov/comments/s7-30-22/s73022-455851-1167994.pdf