NIRI LA – Equities Markets and IEX Update

The NIRI Los Angeles Chapter hosted a luncheon on March 8, 2017, to discuss the equities market structure and its impact on Investor Relations, the rise of high frequency trading and how this relates to the new IEX exchange. Our speaker, John Longobardi, IEX, Listings, has spent his 30-year career in the trading and the exchange industry. John provided meaningful insights into the complexity of the markets and discussed how the exchanges operate and where they are – and are not – providers of efficient markets.

Stock Markets and Regulation

Today, the stock market is driven by technology and is defined by its regulatory context. The complexity of the market structure is fueled by Exchange groups operating numerous exchanges. For example, NYSE has four exchanges and Nasdaq has three exchanges. Additionally, securities are traded on exchanges and other venues, such as dark pools, and there is high frequency trading, which can provide liquidity, but may also create malicious behavior.

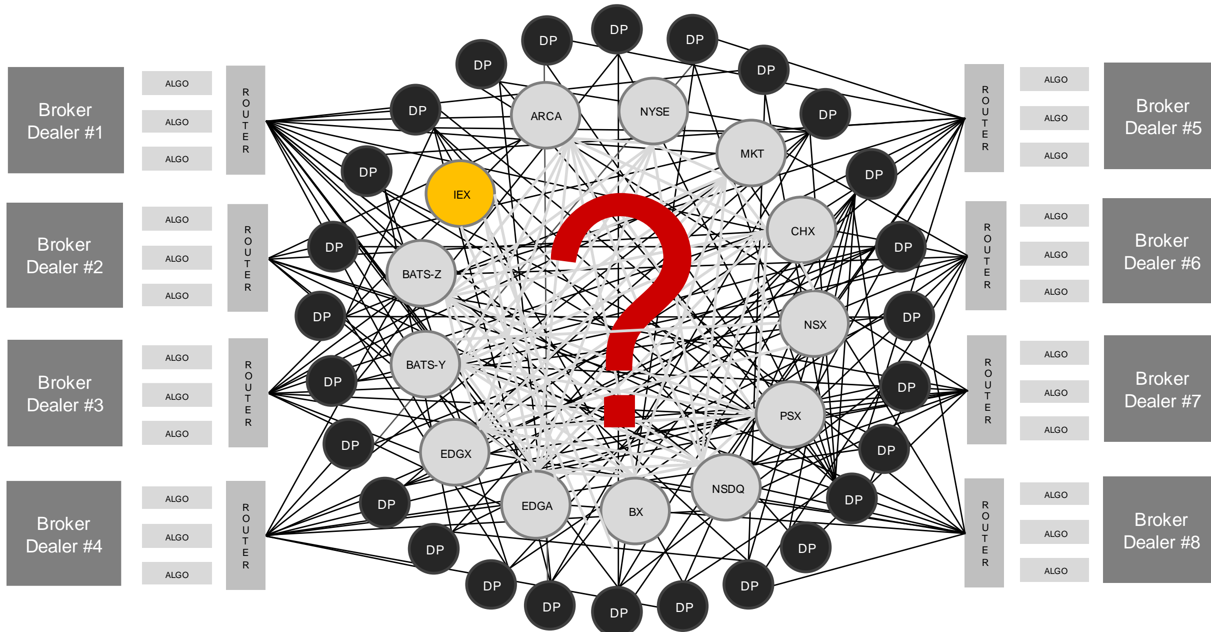
While the purpose of a stock market is to provide public companies access to capital and an exchange for investors to buy and sell shares – exchanges do not always serve the best interests of issuers and the investors. Increasing regulations (to ensure a free and open market and protect investors and the public interest) have resulted in a pattern of unintended consequences.

Unintended Consequences of Regulation

One example of unintended consequences resulted from the 2007 implementation of Regulation NMS – which was intended to create a fairer market. Regulation NMS was established with four key tenets:

1. **Order Protection Rule** – a single best price
2. **Access Rule** – capped exchange fees for trades; ensured all could see market quotes
3. **Sub-penny Rule** – prohibits increments under one cent
4. **Market Data Rules** – combine and distribute data from many places into a single feed

With the rise of electronic trading, it became more difficult for issuers to obtain market intelligence from a live person on the exchange floor. This fueled dramatic fragmentation, leading to immediate and automatic execution of orders. This activity created an increasing inability to manage volatility, and led to a fragmented market.



©IEX Group, Inc. (used with permission)

The United States now has 13 public exchanges and approximately 50 dark pools, which raises the probability of parties taking advantage of information in the market. According to former SEC Chair Mary Jo White, “Too much fragmentation may in turn detract from efficient execution and an opportunity for investor orders to meet directly by creating opportunities for excessive intermediation.”

In addition, exchange fees and listing options vary. It is estimated that NYSE, BATS and Nasdaq use, in aggregate, more than 300 order types. NYSE, which offers about 100 different order types, is moving its NYSE MKT exchange to NYSE American to operate in a similar manner to IEX. NYSE also will change its NSX Platform to an “inverted” exchange, offering rebates for liquidity takers and charging those providing liquidity. Nasdaq has filed for a new order type called Extended Life Order. This order type would apply only to orders identified as “retail” and would sit exposed for at least one second and then jump ahead of other investors to get filled.

Conversely, IEX offers five different order types and expects to begin listing companies in the third quarter of 2017. IEX will be the only listing exchange without rebates and high-speed trading priorities, thus removing the intermediary, allowing real buyers and sellers to meet so they share in the spread of the bid/offer. Additionally, IEX makes its data available on its website for free in a digestible format, thus challenging conventional practices.

High Frequency Trading (HFT)
The markets now average 1,000 trades per second. Is HFT passive or predatory? It can provide value in terms of liquidity – but at times exhibit destructive behavior. The SEC frowns on malicious HFT behavior, and we are seeing a rise in scrutiny and the consideration of additional regulation. Characteristics of HFT generally include:

- Extraordinarily **high-speed order submission/cancellation/modification systems** (in excess of five milliseconds or very close to minimal latency of a trade);
- Use of programs or algorithms for **automated decision making** without human direction for each individual trade or order;
- **Use of co-location services, direct market access or individual data feeds** to minimize latencies;
- **Very short time-frames** for establishing and liquidating positions;
- **High daily portfolio turnover** and/or high order-to-trade ratio intraday;
- Submission of **orders that are cancelled immediately** or within milliseconds;
- Ending the trading day in as close to a **flat position** as possible.

The Rise of Asset Allocation and What It Means for IR
Peer performance, indexes and ETFs increase stock volumes but provide no meaningful intelligence. Traditionally, IR is tasked with courting active stock-pickers and sell-side coverage. Active stock-picking is now in a steep decline and the Blackrocks and Vanguards of the investment world don't use sell-side research.

Key Takeaways
➢ Adapt!
➢ The complexity of the stock market is driven by technology and will continue to be defined by its regulatory context.
➢ The equities markets will continue to evolve.

Further Reading
"SEC urged to review rules for equity market trading" – *Financial Times*, March 30, 2017
"Complicate, then prevaricate" – *The Economist*; Feb. 27, 2016

NIRI LA Sponsors: