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North America Market Structure
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SEC Market Data Roundtable Summary

Last Thursday and Friday (Oct. 25 and 26), the SEC hosted roundtables to discuss and debate issues related to real-time equity market data. The roundtables followed an SEC decision, in early October, in favor of SIFMA, in a long-standing lawsuit against Nasdaq and NYSE Arca. The decision held that neither market had properly demonstrated that fees filed in 2010 were fair and reasonable under the Securities Exchange Act of 1934.[1] The theme of data prices needing to be fair and reasonable underpinned the entire two days.

In term of the themes discussed, and the key arguments laid out:

1. ARE DATA FEES TOO HIGH?

The three big exchange groups all had very similar talking points.

1. The most-stated arguments were that the top 5 bulge bracket firms make billions of dollars from equity trading, and market data fees were a tiny fraction and thus not worth discussing.

2. They all stated that retail clients have never had it better, with near zero commissions and tight spreads, and suggested that any change to the market data regime might damage that.

3. They also kept reiterating that the most expensive proprietary feeds aren't mandated by the SEC, and thus if brokers think they are too expensive, they just shouldn't buy them. The exchanges went so far as to ask the SEC to rule on whether such feeds are required for best execution.

The buy side, sell side, prop guys and IEX argued against most or all of this. Among their main arguments:

1. Market data revenues should be fair and reasonable—and not derived based on what the biggest firms can afford to pay.

2. Yes, retail clients have it great, but that has nothing to do with the conversation. One HFT firm suggested that if market data fees were more reasonable, the firm would be able to give retail clients more price improvement.

[1] In the Matter of the Application of Securities Industry and Financial Markets Association, Exchange Act Rel. No. 84432 (Oct. 16, 2018).

3. The proprietary feeds are not a luxury; they are a must-have. Two large buy-side firms clearly stated they would not trade with firms that relied on the SIP for order routing decisions. Beyond that, as long as the exchanges control the technology and geography of the SIP, they can assure that it is inferior to proprietary feeds—making such feeds more valuable.

In the end, the SEC needs to determine what “reasonable pricing” means: does it mean pricing needs to be determined relative to the cost of production, or should fees be based on some notion of value added to the process? Similarly, the SEC needs to weigh in on the need for proprietary feeds.

One interesting tidbit from the CBOE: according to its stats, top 10 trading firms account for roughly 50% of trading volumes. The CBOE argues that after access fee rebates and SIP rebates, those 10 players are net receivers of a check from the exchange. (It was not clear if this included connectivity fees.) This suggests that the remaining players in the market are subsidizing the top 10 trading accounts. We would suggest this further highlights the need for the transaction fee pilot.

2. GOVERNANCE OF THE SIPS

The SIPs are governed by the exchanges, meaning the exchanges have a say in technology (and thus latency) decisions, as well as content in the feed.
The exchanges argued that their regulatory liability related to the functioning of the feed means they should control how it operates. They further argued that SIP latency is down more than 90% over the past decade and works extremely well.

The buy and sell sides (and IEX) all argued that the exchanges are conflicted. If they make the SIP just slow enough relative to proprietary feeds, then market participants will become captive consumers of such prop feeds, and pricing power will revert to the exchanges. Likewise, excluding such items as odd lots and depth of book from the SIP made them less than optimal for many trading purposes. One large prop firm suggested it could run the SIP at 10% of the current cost, and do so in a way that was competitive with prop feeds, from both latency and content perspectives. The street also suggested the latency numbers were deceiving because the SIPs are available only in one data center, and the majority of latency is geographic latency to get the quotes back to a broker’s own servers.

We believe that allowing multiple participants to offer competitive consolidated feeds (SIPs), competing on geography (which data center it is available in), latency, content and cost, would likely result in a SIP that is truly competitive with a broker’s in-house consolidation efforts. This would eliminate the need for scores of participants to redundantly consolidate data in real time and would introduce real efficiency into the market. The biggest challenge for the SEC would be determining how the economics would work in this near regime.

3. **CONNECTIVITY FEES**

While the exchanges have been happy to highlight how small (??) their total top line revenues for real-time data are—in the ballpark of $600 million per year, for the three big exchange groups in aggregate—they are unwilling to discuss the revenues derived from connectivity fees. Since the 2010 SIFMA lawsuit was filed, some 400+ such fees have been challenged. The SEC has stayed these challenges for one year while it works on determining the fairness of existing real-time fees. In order to receive data feeds, either prop or SIP, dealers and buy side need connectivity to the exchanges. Such connectivity is not an option. These fees have risen dramatically in recent years.

One large HFT pointed out that it pays $1.88 million for cross connects each year, and that such cross connects are basically just fiber cables worth roughly $1,300. The SEC is going to have to determine what relationship the price of such cross connects has with either the cost of cable or the value created via connectivity. Putting a value number on this connectivity is the real challenge facing the regulator.

CLOSING THOUGHTS

In the end, the two days demonstrated a vast disconnect between the big 3 exchange groups and their largest clients. Sadly, most of the discussion was around fees and governance, and little to none was spent on the actual impact on market quality and trading costs. The exchanges have much to lose in terms of revenues, and are clearly playing defense.
The SEC has made it clear that it no longer believes such fees are competitive, and it is determined to address the issue. We believe it will try to address the matter via competition rather than rate setting.

We will address this issue of market quality, and the impact on long-term investors, at length in our coming quarterly market structure update.