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NMS Plans Require Good Governance to Strengthen Market Structure

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An important, but little understood feature of US market structure is the operation of National Market System (NMS) Plans. NMS Plans came about through the 1975 Amendments to the Securities and Exchange Act, and essentially provide a mechanism for Self Regulatory Organizations (SROs) to analyze, discuss and make decisions regarding important market structure initiatives intended to enhance the operation of the National Market System. Amongst other plans, there currently exists 1) an NMS Plan to implement a Tick Size Pilot Program, 2)an NMS Plan to Address Extraordinary Market Volatility and 3) the Consolidated Tape Association Plan / Consolidated Quotation Plan (CTA/CQ Plans).

What's the plan?

NMS Plans are likely to be getting some more scrutiny in the future, because of a bill currently being worked on in the House of Representatives that seeks to change how the NMS Plans are managed and how decisions are made. Currently this privilege rests solely with the SROs (i.e. Exchanges) involved in that area of market structure, but this draft bill would require that NMS Plans also have representation from the broker dealer community. As reported by Bloomberg recently, a number of exchange operators recently wrote a letter to members of the House Financial Services Committee objecting to any changes in the governance of NMS Plans.

Profound Effects on Market Structure Rule Making

Changing the governance of an arcane construct of US financial markets regulation may not seem important, but it strikes a blow at the anachronistic way for-profit exchanges get to set the rules by which they play and could have a profound effect on how our markets work.

In 1975 when NMS Plans came into law, all exchanges were member owned organizations – meaning they existed to serve the benefits of their broker dealer owners and the market overall. When they demutualized at the turn of this century they became public companies responsible to deliver profits to their shareholders, but got to keep their SRO status and other benefits. Many in the industry, including SIFMA (which represents broker-dealers, banks, and asset managers) have been critical of NMS Plan governance and believe that better outcomes could be achieved with wider industry participation.

Take for example the CTA/CQ Plan – this encompasses the Security Information Processor (SIP) which is one of the most controversial pieces of market infrastructure. The SIP was involved in a Nasdaq outage in August 2013, and one related to the NYSE in October 2014. It is also now renowned for being slower than direct feeds (sold by exchanges) often disadvantaging investors who depend on the SIP. This leaves many wondering what incentive do exchanges have to fix and reform the SIP when they are selling a competing product - a product that makes up a significant part of their revenue (approx. 20%).

Or consider the NMS Plan to Address Extraordinary Market Volatility (a.k.a. LULD Plan for Limit Up/Limit Down). This was initiated following the May 2010 Flash Crash and was implemented in phases during 2013. However, as we learned in August last year these new LULD rules did little to address extraordinary market volatility. As selling pressure and volatility built up overnight, structural flaws in market structure were exposed that led to repeated halting in hundreds of securities. Many stocks opened down 20% or more and there was a severe dislocation in the pricing of exchange traded products. Of course, it is impossible to say whether a different governance structure for the NMS Plan would have resulted in better outcomes on August 24th 2015, but broader participation from the trading community would undoubtedly add fresh perspective and resources to the problem.

A Good Plan

The draft bill currently being drawn up in the House is just a couple of pages long, and calls for a simple change to rule making governance. However the benefits it could bring about are significant – not just for the Plans currently being worked on, but ultimately by redefining the role of SROs in a demutualized world.

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