“Regulation”

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Why Ratings?

- Public signals as efficient response to scale economies in information production
  - Public signals can discourage due diligence

  --Value, capital structure, project choice & reg.
- Source of systemic risk
  - Systematic (aggregate) risks
  - Not enough heterogeneity in views, still underlying common view (potentially wrong)
  - Hardwired into regulation
  - Hence reduced regulatory reliance (LeMieux)

Regulatory Reliance

- Capital standards, suitability, regulatory eligibility of collateral
- Dodd-Frank pulled back (but not state, local and to a degree global)
- Suggests importance of uniformity in standards across spaces—corporates, munis and mortgages; rating agencies
- Regulatory reliance as anti-competitive
- Pulling back partially addresses “common view”—goal: promote diverse signals

What Did Dodd-Frank Do?

- Pull back on “regulatory reliance” to reduce systemic risk
  - Replacing with verbal descriptions
- Supervise closely CRAs/registration
- Supervision vs. reduced reliance as substitutes! (Consistency of response)
  - Regulatory design not optimal, before or after
- Attempt to create prospectus liability
- Franken Amendment study

Diverse Views on Regulating

- 99 Senators voted on both LeMieux and also Franken Amendment (push on limiting “shopping” by encouraging rating assignment board)
- Both were adopted, yet only 30 Senators supported both (64 voted for Franken and 61 then voted for LeMieux after Franken adopted); just four opposed both
- Supervision vs. LeMieux: Substitutes

Credit Rating Agencies & Proxy-Voting Advisors

- In both contexts presence of these entities and underlying scale economies has limited independent information production (e.g., by asset managers, etc.)
  - Malenko and Malenko (2016) for proxy voting
- Regulators supported these businesses
  - NRSROs necessary until Dodd-Frank
  - Proxy-voting advisors aided by required disclosure of mutual fund votes and SEC staff's favorable Egan-Jones Letter, shielding clients from conflicts of interest

The Nature of Reputation

- Asymmetric information about “type” and rating inflation decisions
- Trust and technical competence
- Fusion CMBS ex., S&P--Baghai & Becker
- Scope of reputation across product lines?
- Regulatory and market punishment
- “Controls” vs. equilibrium adjustments

Paying for Information

- How is an informational intermediary paid?
  - -Classic problem in economics
- After information provision—why pay?
  - -Information already released (Arrow (1962))
- Before information provision: hard to value! (Arrow (1962))
- Investor pays?
  - -Difficult to exclude, *public good*
  - -Manuals of ratings, but exclusion hard “after copiers”
- Issuer pays? – conflict of interest

Payment and Price Efficiency

- Investor-pay model gives the information seller the incentive to reduce the information content of prices to enhance the value of the information that can be sold – relative to what would be in prices.
- Issuer-pay model gives the informational seller the incentive to maximize the proceeds and promote price efficiency since the info is fully reflected in price
- Maximizing price efficiency is consistent with allocational efficiency

Solicited vs. Unsolicited Ratings

- Selection leads unsolicited ratings (those ratings not purchased by the issuer) to be lower than solicited (purchased) ratings.
- This could reflect selectivity underlying the purchase of credit ratings and implicit punishment from unsolicited ratings.
- Is the solicited rating relatively high or the unsolicited rating relatively low?

Solicited vs. Unsolicited Ratings

- SEC view has shifted dramatically from 15 years ago—now unsolicited ratings seen as objective (and encouraged) and a benchmark for evaluating solicited ratings
- Analogy to the “theory of the second best”-

--frictions may be encouraged to help mitigate other frictions in a “second best” setting

Subtle Issues

- How to limit systemic risk?
- Do informational intermediaries enhance overall informational production?
- Does regulatory reliance mitigate agency?
- Should the CRA view the issuer or investor as client? (Dbl reputat, asym info)
- What does reputation mean?
- How does the way we pay for ratings affect whether to promote price efficiency?
- When are unsolicited ratings desirable?

Overview of Equity Trading

- Where have we been?
  - Regulation NMS; nature of competition
  - Statistical evidence and past trading changes
  - Maker--taker pricing
- Where are we going?
  - Challenges of “maker-taker,” “taker-maker”
  - Enhanced importance of “Best Execution”
  - Speed & fast trading; high-frequency trading
  - Increased role of regulatory “pilot studies”
    - Short sales, tick size, maker-taker, bond opacity
  - Fixed-income—declines in opacity, inventory

How did NMS lead to fragmentation?

- Fills by components and execution in many pieces—”trade-through” rule
- Reward to tops of book (not full order book) promotes proliferation of platforms
  - Only tops of book protected (incongruity)
- NMS is highly prescriptive—induces fragmentation (not central market), fragility
  - Neither investor nor broker can fully manage overall execution (complaint in M. Lewis book that traders respond to initial fills)

NMS and Best Execution

- “Best Execution” is a responsibility of broker-dealer, not the platforms
  - The platform and broker as substitutes
- NMS order protection rule transfers some mechanics to platforms via NMS linkages
- Best execution is much more germane when there is a serious “routing” decision
- Best execution can be distorted by incentive payments (important issue)

“Maker-taker” vs. “Taker-maker”

- “Maker-taker”
  - Subsidize “maker” (limit order)—rebate
  - Charge fees to “taker” (market order)
  - Encourage liquidity provision
- “Taker-maker” (“inverted model”)
  - Subsidize “taker” (market order)—rebate
  - Charge fees to “maker” (limit order)
  - Enhance attractiveness for market orders
  - Similarities to “payment for order flow” model

Agency Problem

- Distortion in the routing decision due to distinct buckets for routing fees & rebates vs. execution—sets up “agency” conflicts
- Evidence in the form of routing to platforms that offer rebates, poor/slow execution (both empirically, theoretically)
- Battalio, Corwin and Jennings (*JF*, 2016) paper identifies some problematic brokers
- Disclosures on routing practices and execution costs would be very useful
  - Inadequate disclosure regime

Solving the Agency Problem

- Angel, Harris and Spatt (2011, 2015-QJF)
- Ban fees—would change effective tick size
- Direct payment to customer
  - Ban side pocket or kickbacks
- Ranking based upon net rather than gross price (E-Bay, shipping fees)—NMS prescription
- Transparency at trade level (“confirms”)
- Helpful?—Theory v. practice vs. 605/606

Policy Questions

- To what extent are current practices consistent with Best Execution standards? (Agency theoretic)
- Should NMS reflect gross or net prices?
- Should we ban rebates/fees?
- Adjust caps downward? Pilot analysis?
- Should we direct fees and rebates to the customer (banning side pockets)?
- Would “confirm” disclosure or enhanced 605/606 disclosures be helpful?

Competition Among Exchanges

- Parent companies operate 3-4 exchanges
- Academics mostly ignore data charges
- Buy market share for more data revenue
- Anti-competitive practices in the competition for orders
- MiFID II challenge to “soft dollars” for research (another conflict of interest) may not be contained in Europe & lead to new focus on “Best Execution,” even in U.S.