MEMO# 31135

March 16, 2018

SEC Proposes Transaction Fee Pilot Program for NMS Stocks; Member Call on March 29 at 11:00 a.m. Eastern Time

[31135]

March 16, 2018 TO: Closed-End Investment Company Committee
Equity Markets Advisory Committee
ETF (Exchange-Traded Funds) Committee
ETF Advisory Committee RE: SEC Proposes Transaction Fee Pilot Program for NMS Stocks; Member Call on March 29 at 11:00 a.m. Eastern Time

The Securities and Exchange Commission (SEC or Commission) recently proposed a pilot program to study the effects that transaction-based fees and rebates in national market system (NMS) stocks may have on order routing behavior, execution quality, and market quality generally.[1] The data generated by the proposed pilot program would facilitate an evaluation of the need for regulatory action in this area. Comments on the Proposal are due 60 days after its publication in the Federal Register, which is expected soon.

We will hold a member call to discuss the Proposal on **Thursday, March 29 at 11:00 a.m. Eastern Time.** If you would like to participate in that call, please contact Ashley Scarboro at ashley.scarboro@ici.org to receive dial-in information.

Background on Exchange Transaction Fee Models

National securities exchanges historically have charged execution fees to their members. The predominant fee model employed by equities exchanges is known as "maker-taker" pricing, in which an exchange pays its members a per share rebate for providing (making) liquidity and charges a per share fee to members for removing (taking) liquidity. The exchange's revenue on a particular transaction is the difference between the fee paid by the liquidity remover and the rebate paid to the liquidity provider.[2] Rule 610(c) of Regulation NMS prohibits an exchange from charging a liquidity remover more than $0.0030 per share. Although the rule does not limit rebates, exchanges typically do not pay rebates exceeding their transaction fees to maintain net positive transaction revenues.

Transaction fees and rebates are controversial aspects of market structure. ICI has argued that maker-taker pricing harms regulated funds and other investors in three primary ways. First, it reduces market transparency and impairs the ability of regulated funds to evaluate the quality of executions they receive because quoted prices—and prices included on trade reports—do not account for access fees or liquidity rebates and therefore do not fully reflect net trading prices. Second, maker-taker pricing incents brokers to route customer orders to maximize rebates and minimize fees for themselves, and these incentives may conflict with brokers' legal duty to seek best execution for customer orders. Third, maker-taker pricing increases fragmentation by encouraging the proliferation of new trading venues and order types designed expressly to avoid fees or harvest rebates.

We submitted a letter in 2016 advocating for an SEC pilot program to study how transaction fees and rebates affect market quality.[3] The SEC's Equity Market Structure Advisory Committee (EMSAC) formally recommended that the Commission undertake a transaction fee pilot later that year.[4] The Commission took these recommendations into consideration when developing the Proposal.

Summary of the Proposed Pilot Program

The Proposal contemplates a broad pilot program to test the impact of transaction fees and rebates on order routing behavior, execution quality, and market quality. The proposed pilot would impose new, temporary restrictions on the fees that equities exchanges charge for matching buy and sell orders in "pilot securities," a term that would include nearly all NMS stocks, including exchange traded funds (ETFs) and closed-end funds. The Proposal would require the Commission to categorize pilot securities into four groups to enable study of how different pricing restrictions affect market quality. The proposal pilot would run for between one and two years. The Proposal also would require the equities exchanges to prepare and post on their websites new information, including specified order routing data and standardized pricing information.

The following chart summarizes the key terms of the proposal, which are explained more fully below:[5]

Outline of the Proposed
Transaction Fee Pilot for NMS Stocks

Eligible Securities

NMS stocks with a share price ≥ $2 per share that do not close below $1 per share during the proposed pilot and that have an unlimited duration or a duration beyond the end of the post-pilot period

Pilot Design

Test Group 1

$0.0015 fee cap for removing & providing displayed liquidity (no cap on rebates)

Test Group 2

$0.0005 fee cap for removing & providing displayed liquidity (no cap on rebates)

Test Group 3

Rebates and Linked Pricing Prohibited for removing & providing displayed & undisplayed liquidity
(Rule 610(c)'s $0.0030 cap continues to apply to fees for removing displayed liquidity)

Control Group (Remaining Pilot Securities)

Rule 610(c)'s cap continues to apply to fees for removing displayed liquidity (no cap on rebates)

Duration

2 years with an automatic sunset at 1 year unless, no later than thirty days prior to that time, the Commission publishes a notice that the pilot shall continue for up to another year; plus a 6 month pre- and 6 month post-pilot period

Data Collections

The Commission will publish an initial list of pilot securities; primary listing exchanges will publish lists of their primary listed securities included in the pilot and changes to those lists; all equities exchanges will publish standardized summaries of their transaction fees and rebates as well as order routing datasets.

Applicable Trading Centers

Equities exchanges (including maker-taker & taker-maker) but not alternative trading systems or other non-exchange trading centers

Pilot Securities Would Include ETFs and Closed-End Funds as well as Small-Cap Stocks

The Commission proposes to include in the pilot program all NMS stocks[6] that meet the following three criteria: (1) have a share price of at least $2; (2) do not close below $1 per share during the proposed pilot;[7] and (3) have an unlimited duration or a duration that would continue for at least six months after the end of the pilot period.[8] More than 90 percent of all NMS stocks—including ETFs, closed-end funds, and small capitalization stocks—could satisfy these criteria and be included in the pilot.[9]

ICI recommended a narrower pilot program, one focused on a group of highly liquid common stocks (*i.e.*, a pilot that would exclude ETFs and closed-end funds). The Commission preliminarily believes, however, that a "more comprehensive pilot covering all NMS stocks…would produce a more meaningful dataset to facilitate a broader analysis of the impact of transaction fees and rebates across the full spectrum of NMS stocks."[10] The Commission further notes that a more comprehensive dataset would permit "more in-depth analyses among different segments of the securities market, which may be more informative than a narrower pilot."[11] The Commission acknowledges that including less liquid issuers in the transaction fee pilot "may result in the reduction or elimination of transaction-based rebate incentives" that could otherwise be used to attract liquidity in those stocks, but the Commission notes that other aspects of the pilot—such as reducing fees for removing liquidity—might attract liquidity providers.[12]

Proposed Pilot Calls for Three Test Groups and One Control Group

The Commission proposes to place each NMS stock that meets the initial criteria for inclusion in the pilot into one of three test groups or a control group:[13]

- Test group 1 would cap the fee an exchange can charge for removing or providing liquidity at $0.0015 per share.

- Test group 2 would cap the fee an exchange can charge for removing or providing liquidity at $0.0005 per share.
- Test group 3 would retain the $0.0030 per share cap for removing liquidity, but would prohibit equities exchanges from paying rebates—either for removing or providing liquidity—and from offering a discount or incentive on transaction fee pricing applicable to removing (providing) liquidity that is linked to providing (removing) liquidity (the Proposal refers to this practice as "linked pricing").[14] The prohibition on rebates and linked pricing would apply not only to displayed top-of-book liquidity, but also to depth-of-book and undisplayed liquidity. By contrast, the fee caps in test groups 1 and 2 would apply only to top-of-book quotes.
- The control group would remain subject to the $0.0030 per share access fee cap in rule 610(c) of Regulation NMS. Consistent with this rule, exchanges would face no limitation on charging fees for posting liquidity or paying rebates to members for NMS stocks in this group.

Each test group would contain 1,000 NMS stocks, and the remaining eligible NMS stocks would be included in the control group.[15] This proposed selection methodology is intended to help ensure that each of the proposed test groups and the control group would have a similar composition.[16] The Commission believes this pilot design would promote the representativeness of results and would provide useful data to study the impact of transaction fees and rebates on order routing, execution quality, and market quality.

Duration of One to Two Years

To gather sufficient data to analyze reliably the pilot program's impact on order routing behavior, execution quality, and market quality, the Commission proposes a two-year term for the pilot program, with an automatic sunset at the end of the first year unless, prior to that time, the Commission publishes a notice extending the pilot for up to another year.[17] The Commission believes that a two-year pilot period would provide market participants adequate time to gain experience with the different test groups and would make it worthwhile for market participants to adapt their behavior.[18]

In addition, the Commission proposes a six-month pre-pilot period and a six-month post-pilot period. The pre-pilot period would enable the collection of data to establish a baseline against which to assess the effects of the proposed pilot. The post-pilot period would help assess any post-pilot effects following the conclusion of the proposed pilot.[19]

Pilot Data Would Be Available Publicly

The Proposal would require the Commission and the equities exchanges to collect and make publicly available several reports to facilitate an evaluation of the impact of the pilot, promote transparency about the pilot, and provide basic information about exchange fees and rebates. The Proposal would require the reports prepared by exchanges to be freely available and easily accessible by the public on the exchange's website for at least five years from the conclusion of the post-pilot period. The proposed reports include:

- **Initial list of pilot securities.** The Proposal would require the Commission to publish on its website a notice with the initial list of pilot securities, which would identify the securities that would be included in the proposed pilot and assign each security to a designated test group or the control group. The Commission proposes to publish this notice at least one month prior to the start of the pilot period.[20]
- **Pilot securities exchange lists and pilot securities change lists.** The Proposal would require each primary listing exchange to publicly post on its website a downloadable file with a list of its primary listed securities included in the proposed

pilot as well as an updated cumulative list of all changes to any pilot security for which it serves as the primary listing market.[21] Exchanges would be required to update these reports prior to the beginning of trading on each day that US equities markets are open throughout the duration of the pilot, including the post-pilot period.
- **Summary of transaction fees and rebates.** The Proposal would require equities exchanges to post summaries of transaction fees and rebates (and changes to this information) monthly, within 10 business days of the first day of each month.[22] These monthly reports also would include data on average and median realized fees. These reports would be required throughout the duration of the pilot, including the pre- and post-pilot periods.
- **Order routing datasets.** The Proposal would require equities exchanges to prepare and make available two sets of order routing data containing aggregated and anonymized broker-dealer routing information for all pilot securities.[23] One dataset would provide information on liquidity-providing orders, while the other would include data for liquidity-removing orders. The information would be aggregated by day, by security, by exchange, and by broker-dealer.[24] The Proposal would require exchanges to post order routing data for a particular month by no later than the last day of the following month (*e.g.*, each exchange would be required to post data for March by April 30). These reports would be required throughout the duration of the pilot, including the pre- and post-pilot periods.[25]

All Equities Exchanges Would Participate in the Pilot

All equities exchanges—including exchanges that do not employ maker-taker pricing—would be required to participate in the pilot program, *e.g.*, conform their fee schedules for each of the test groups and gather and report information as described above. The proposed pilot program would not apply to other types of trading venues, such as alternative trading systems.

George M. Gilbert
Assistant General Counsel

endnotes

[1] Transaction Fee Pilot for NMS Stocks, Securities Exchange Act Release No. 82873 (March 14, 2018), *available at* https://www.sec.gov/rules/proposed/2018/34-82873.pdf (Proposal).

[2] Not all exchanges employ maker-taker pricing. Certain exchanges have adopted “taker-maker” pricing models, in which they charge the provider of liquidity and pay a rebate to the remover of liquidity. Other exchanges charge a fee to both sides of a trade.

[3] *See e.g.,* Letter from David W. Blass, General Counsel, ICI, to SEC Equity Market Structure Advisory Committee, dated January 20, 2016, *available at* http://www.ici.org/pdf/29652.pdf (ICI Comment Letter).

[4] *See* Recommendation for an Access Fee Pilot (July 8, 2016), *available at* https://www.sec.gov/spotlight/emsac/recommendation-access-fee-pilot.pdf (EMSAC Recommendation).

[5] The SEC includes a similar chart at p. 28 of the Proposal.

[6] The term “NMS stock” includes any security or class of securities (other than an option) for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan. *See* rules 600(b)(46) and (47) of Regulation NMS.

[7] A security that closes below $1 at the end of a trading day would be removed from the pilot. *See* Proposal, *supra* note 1, at 37.

[8] *Se eid.* at 36.

[9] *See id.* at 38, n. 102.

[10] *Id.* at 39.

[11] *Id.* at 40.

[12] *See id.* at 42-43.

[13] *See id.* at 50-61.

[14] *See id.* at 53.

[15] The Commission notes that if the proposed transaction fee pilot commences before the end of the tick size pilot, the selection of the common stocks for the transaction fee pilot test groups would take into consideration the common stocks in the tick size pilot. Specifically, the Commission would divide each test group into two subgroups—one that overlaps with the tick size pilot and one that does not overlap. *Seeid.* at 46-47. This would allow researchers to control for the effects of the tick size pilot.

[16] *See id.* at 165.

[17] *See id.* at 65.

[18] The EMSAC also recommended a two-year duration for a pilot. *See* EMSAC Recommendation, *supra* note 4. ICI suggested that a year-long pilot could provide adequate information, but expressed support for a longer pilot if the Commission included a prohibition on rebates. *See* ICI Comment Letter, *supra* note 3.

[19] *See* Proposal, *supra* note 1, at 67.

[20] *See id.* at 70.

[21] *See id.* at 72-77.

[22] *See id.* at 79.

[23] *See id.* at 88-94. The specific fields for each dataset would be: code identifying the equities exchange; trading day; ticker symbol; unique, anonymized broker-dealer identification code; order type code; order size code; number of orders received; cumulative number of shares of orders received; cumulative number of shares of orders cancelled prior to execution; cumulative number of shares of orders executed at receiving market center; and cumulative number of shares of orders routed to another execution venue. Datasets of liquidity-providing orders also would require a field specifying the cumulative number of shares executed within certain specified time periods after receipt by the exchange.

[24] To track and aggregate the activity of particular broker-dealers across multiple exchanges, the Commission proposes to provide the exchanges with a broker-dealer anonymization key containing a code for every broker-dealer whose order routing data would be included in the order routing datasets. *See id.* at 91-93.

[25] During the pre-pilot period, exchanges would be required to provide order routing data for all NMS stocks because the scope of pilot securities will not be known until the Commission publishes the initial list.
