MEMO# 31547

January 4, 2019

SEC Adopts Transaction Fee Pilot Program for NMS Stocks

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TO: ICI Members
ICI Global Members
Closed-End Investment Company Committee
Equity Markets Advisory Committee
ETF (Exchange-Traded Funds) Committee
ETF Advisory Committee
RE: SEC Adopts Transaction Fee Pilot Program for NMS Stocks

The Securities and Exchange Commission (SEC or Commission) recently adopted rule 610T of Regulation NMS which establishes 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] ICI strongly supported this rulemaking.[2] The data generated by the pilot program will facilitate the SEC's evaluation of the need for regulatory action in this area and will enable the Commission to make more informed and effective policy decisions. The Commission will designate by notice the commencement of the transaction fee pilot program.

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.[3] Rule 610(c) of Regulation NMS prohibits an exchange from charging a liquidity taker 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, the avoidance of fees or the harvesting of rebates increases fragmentation by encouraging the proliferation of new trading venues and order types designed to exploit exchange transaction pricing structures.

Summary of the Pilot Program

The transaction fee pilot program will impose new, temporary restrictions on the fees that equities exchanges charge for matching buy and sell orders in "pilot securities," a term that includes all NMS stocks—including exchange traded products (ETPs)—with average daily trading volume of at least 30,000 shares, with a price of at least $2 per share that do not close below $1 per share during the pilot, and that have an unlimited duration or a duration that extends at least six months after the end of the pilot. The pilot will require the Commission to divide pilot securities into three groups to enable study of how different transaction pricing restrictions affect market quality. The pilot will run for one year, unless the Commission issues a notice extending the pilot for up to another year. As part of the pilot, the equities exchanges will be required to prepare and post on their websites standardized summaries of their transaction fees and rebates. The exchanges also will be required to transmit to the Commission specified order routing data on a monthly basis.

The following chart summarizes the key terms of the transaction fee pilot, which are explained more fully below:[4]

Transaction Fee Pilot for NMS Stocks (Rule 610T of Regulation NMS)

Duration

2 years with an automatic sunset at 1 year unless, no later than 30 days prior to that time, the Commission publishes a notice that the pilot shall continue for up to 1 additional year; plus a 6-month pre-pilot period and 6-month post-pilot period

Applicable
Trading Centers

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

Pilot Securities

NMS stocks with average daily trading volumes ≥ 30,000 shares with a share price ≥ $2 per share that do not close below $1 per share during the pilot and that have an unlimited duration or a duration beyond the end of the post-pilot period

Group

# of NMS Stocks

Fee Cap

Rebates Permitted?

Pilot
Design

Test Group 1

730

$0.0010 fee cap for removing and providing displayed liquidity (no cap on rebates)

Yes

Test Group 2

730
(plus appended Canadian interlisted stocks)[5]

Rule 610(c)$0.0030 cap continues to apply to fees for removing displayed liquidity

No

Rebates and Linked Pricing Prohibited for removing and providing displayed and undisplayed liquidity (except for specified market maker activity)

Control Group

Pilot Securities not in Test Groups 1 or 2

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

Yes

Pilot
Data

1. Pilot Securities Exchange Lists and Pilot Securities Change Lists (primary listing exchanges must post these lists on their website)
2. Exchange Transaction Fee Summary (each equities exchange must post this report on its website)
3. Order Routing Datasets (supplied to the Commission by the equities exchanges)

Pilot Securities Include A Broad Range of NMS Stocks, Including ETPs

The “pilot securities” included in the transaction fee pilot program will consist of NMS stocks[6] that meet the following four criteria: (1) have an average daily trading volume of at least 30,000 shares; (2) have a share price of at least $2; (3) do not close below $1 per share during the pilot;[7] and (4) have an unlimited duration or that will continue for at least six months after the end of the pilot period.[8] The Commission adopted the last three criteria largely as proposed, but the 30,000 share average daily trading volume requirement is a new criterion that the Commission introduced to reduce the size of the pilot. In the Adopting Release the Commission explains that the amount of fees/rebates on thinly-traded securities are "economically insignificant" and therefore would be "unlikely to impact order routing behaviors of broker dealers."[9]

The broad definition of "pilot security" means that ETPs, including exchange-traded funds, will participate in the pilot if they satisfy the four criteria above. The Commission received a number of comments, from ICI and others, explaining that the pilot could affect competitive dynamics in the ETP marketplace. If market quality varies among the pilot program's test groups and control group, trading volume might migrate from ETPs in groups with lower market quality to similar products in groups with better quality.[10]

Commenters proposed three alternative modifications to the pilot program to address this potential competitive concern. Some commenters, including ICI, urged the Commission to rotate pilot securities through all pilot groups to mitigate potential anticompetitive effects. Other comments recommended that the Commission exclude ETPs from the pilot entirely, while a third group suggested that the Commission place ETPs with similar underlying holdings in the same pilot group.

The SEC declined to adopt any of these recommendations. In declining to adopt ICI's suggestion, the Commission stated that rotations would increase the complexity—and, potentially, cost—of the pilot and that it prefers a shorter, less complex pilot.[11] With regard to the suggestion to exclude ETPs from the pilot, the Commission explained that it might be unable "to draw meaningful conclusions about the impact of changes to transaction fees and rebates on ETPs by observing the effects of the [pilot] on other securities, in part because ETPs have a unique create-and redeem process that does not apply to other NMS stocks."[12] The Commission declined to place similar ETPs in the same pilot group because categorizing ETPs this way would involve "the exercise of subjective judgment," grouping similar ETPs together could "negatively impact the representativeness of the different treatment groups," and the Commission believes that it "may learn more from a study that compares how different pricing regimes affect similarly-situated ETPs" compared to a study that keeps similar ETPs in the same pilot group.[13]

Pilot Will Contain Two Test Groups and One Control Group

The Commission will place each pilot security into one of three pilot groups (two test groups and a control group) through a stratified sampling methodology that will permit comparisons among each pilot group.[14] Each test group will contain 730 pilot securities, and the remaining pilot securities will be included in the control group. The pilot groups will be as follows:

- Test group 1 will cap the fee an exchange can charge for removing or providing liquidity at $0.0010 per share. This test group is designed to facilitate an analysis of the extent to which exchanges reduce rebates from their current levels as a result of a materially reduced cap on the fees used to subsidize those rebates, and the impact of a reduced fee and rebate level on order routing behaving, execution quality, and market quality. In addition, by materially reducing the fee cap, test group 1 might provide useful date on the extent to which current exchange fee levels serve as a disincentive to take liquidity on an exchange.[15]
- Test group 2 will retain the $0.0030 per share cap for removing liquidity but will prohibit equities exchanges from paying rebates—either for removing or posting liquidity—and from offering a discount or incentive on transaction fees applicable to

removing (providing) liquidity that is linked to providing (removing) liquidity (the Adopting Release refers to this practice as “linked pricing”). An exchange will, however, be permitted to provide non-rebate linked pricing to its registered market markers in consideration for meeting market quality metrics.[16] The Commission believes that test group 2 will provide useful information on trading in the absence of rebates that will facilitate a data-driven approach to better understand the role and effect of rebates in the current equity market structure.[17]
- The control group will remain subject to the $0.0030 per share access fee cap in rule 610(c) of Regulation NMS. Consistent with this rule, exchanges will face no limitation on charging fees for posting liquidity or paying rebates to members for transactions in NMS stocks in this group. The Commission explains that a control group is vital to test the effects of fee changes in the test groups because it provides a baseline for analyzing the effects of the pilot against the status quo.[18]

The design of the final transaction fee pilot differs in three significant ways from the Commission’s proposal. Two of these differences pertain to the size of the pilot, which will include two test groups of 730 NMS stocks each, rather than three test groups of 1,000 each as proposed. The Commission attributes its decision to adopt a smaller pilot to commenter concerns with the size of the proposed pilot.[19] The Commission notes, however, that the pilot will have adequate statistical power to analyze the impact that changes to exchange transaction pricing might have on stocks.[20] The third significant difference is the fee cap level of test group 1. The proposed pilot would have capped fees for removing or providing liquidity at $0.0015 and $0.0005 per share in test groups 1 and 2, respectively. The Adopting Release states that the Commission adopted the $0.0010 access fee cap in test group 1 in response to a recommendation from its Investor Advisory Committee.[21]

The Pilot Will Run for One to Two Years

The Commission has determined that the pilot will have a minimum duration of one year and a maximum duration of two years. Specifically, the pilot will have a two-year term, but will include an automatic sunset at the end of the first year unless, prior to that time, the Commission publishes a notice that the pilot shall continue for up to an additional year.[22] The Adopting Release notes that the pilot duration should be long enough to make it economically worthwhile for market participants to adapt their behavior and not “wait out” the pilot. The duration also should allow for the collection of a robust and representative data set over a sufficiently long period of time to permit analysis into the impact of transaction-based fees and rebates and the effects that changes to those fees and rebates have on order routing behavior and market quality.[23]

In addition, the Commission adopted a six-month pre-pilot period and a six-month post-pilot period.[24] The pre-pilot period is designed to enable the collection of data to establish a baseline against which to assess the effects of the pilot, while the post-pilot period is intended to help assess any post-pilot effects following the conclusion of the pilot.

Some Pilot Data Will Be Available Publicly

Rule 610T will require the Commission and the equities exchanges to prepare and, in some cases, publish reports on the transaction fee pilot. Public reports prepared by exchanges must 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 reports include:

- Initial list of pilot securities. The Commission will publish on its website a notice with the initial list of pilot securities. This notice will identify the securities that will be

included in the pilot and assign each security to a test group or the control group.[25] The Commission will publish this notice at least one month prior to the start of the pilot period.[26]
- Pilot securities exchange lists and pilot securities change lists. Each primary listing exchange will be required to publicly post on its website a downloadable file with a list of its primary listed securities included in the pilot as well as an updated cumulative list of all changes to any pilot security for which it serves as the primary listing market.[27] Exchanges will 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. Each equities exchange will be required to post summaries of its transaction fees and rebates (and changes to this information) monthly, within 10 business days of the first day of each month.[28] These monthly reports also will include data on average and median realized fees. These reports will be required throughout the duration of the pilot, including the pre- and post-pilot periods.
- Order routing datasets (not publicly available). Each equities exchange will be required to prepare and transmit to the SEC two sets of order routing data containing broker-dealer routing information for all pilot securities.[29] One dataset will provide information on liquidity-providing orders, while the other will include data for liquidity-removing orders. The information will be aggregated by day, by security, by exchange, and by broker-dealer. The order routing datasets for a particular month must be submitted by no later than the last day of the following month (e.g., each exchange must submit data for March by April 30). These reports will be required throughout the duration of the pilot, including the pre- and post-pilot periods.[30]

All Equities Exchanges Will Participate in the Pilot

All equities exchanges—including exchanges that do not employ maker-taker pricing—will 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. Other types of trading venues, such as alternative trading systems (ATSs), will not participate.

SEC Encourages Public Analysis of Pilot Data

The Commission states that it will consider—and encourages others to consider—how the transaction fee pilot affects market quality. Market participants may submit their analysis of pilot data to tradingandmarkets@sec.gov with the words “Transaction Fee Pilot Analysis” in the subject line, and the Commission will post those reports on its public website.

The Commission is particularly interested in analyses that consider the following questions in contemplating the impact of the transaction fee pilot:

- To what extent do access fees and rebates impact routing decisions for liquidity-taking orders? Are orders to take liquidity more likely to be routed to an exchange (compared to an off-exchange venue or ATS) in a lower access fee environment than they are currently? To what extent are impacts or changes in routing decisions driven by potential conflicts of interest created by transaction fees and rebates rather than other factors such as fill rates and execution quality?
- To what extent do access fees and rebates impact routing decisions for liquidity-supplying orders? Are orders to provide liquidity less likely to be routed to an exchange (compared to an off-exchange venue or ATS) in a lower rebate environment than they are currently? To what extent do impacts or changes in order routing

appear to be driven by potential conflicts of interest caused by rebates rather than other factors such as execution quality (e.g., fill-rates, time to fill, capturing the quoted spread, adverse selection, or reversion)?
- What impact does a reduction or elimination in rebates have on the national best bid or offer (NBBO), including spread width and the depth of interest displayed at the NBBO? To what extent does a potential decrease in depth of interest at the NBBO result in lower fill rates or smaller fill sizes for investor orders? Are natural investors better able to obtain queue priority in exchange order books, and are they more frequently able to capture the quoted spread when posting passively (e.g., buy on the bid and sell on the offer)?
- Are there common characteristics for securities (e.g., average daily trading volume, price, or market capitalization) where a reduction or elimination of rebates begins to impact quoted spread? If so, what are those common characteristics and at what level do reduced rebates begin to have an impact on quoted spread? To what extent does a change in quoted spread affect transaction costs for investor orders? If quoted spread widens in a security, to what extent is the potential spread cost offset by the reduction in the transaction fees paid, or a change in the ability to capture the quoted spread?
- Are there common characteristics for securities where a reduction or elimination of rebates does not impact quoted spread? If so, what are those common characteristics (e.g., average daily trading volume, price, or market capitalization)?
- Are there common characteristics for securities (e.g., average daily trading volume, price, or market capitalization) where a reduction or elimination of rebates begins to impact effective spread?
- How can we best understand the effects of rebates provided on inverted venues (where rebates are paid to takers of liquidity)?
- What impact do lower access fees and rebates have on the amount of displayed and non-displayed liquidity on exchanges?
- In the absence of rebates, do competition and market forces operate to produce a market equilibrium (within the current regulatory structure) that constrains transaction fees to levels at or below today’s current access fee cap? What do such market forces, and any resultant equilibrium pricing, tell us about the need to impose a cap on access fees? Does the pilot provide any data that suggests, in the absence of rebates, an access fee cap would still be necessary as long as Rule 611 of Regulation NMS continues to impose order protection requirements on exchanges with protected quotes?
- What is the impact of a lower fee cap on trading volumes on each exchange? What is the impact of a lower fee cap on other measures of liquidity on each exchange? How should we understand the difference between volume and liquidity?
- What is the impact of lower rebates on the ability of smaller exchanges to attract liquidity-supplying orders?

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endnotes

[1] Transaction Fee Pilot for NMS Stocks, Securities Exchange Act Release No. 84875

(December 19, 2018), *available at* https://www.sec.gov/rules/final/2018/34-84875.pdf (Adopting Release).

[2] ICI submitted two letters in support of the Commission's proposal to conduct a transaction fee pilot program. *See* Letter from Susan Olson, General Counsel, ICI, to Brent J. Fields, Secretary, SEC, dated October 1, 2018, *available at* https://www.ici.org/pdf/31417a.pdf; Letter from Susan Olson, General Counsel, ICI to Brent J. Fields, Secretary, SEC, dated May 23, 2018, *available at* https://www.ici.org/pdf/31218a.pdf.

[3] 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.

[4] The SEC includes a similar chart at p. 7 of the Adopting Release.

[5] *See* Adopting Release at 38-40 for the SEC's discussion of how Rule 610T addresses Canadian interlisted stocks.

[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 will be removed from the pilot. *See* Adopting Release at 370 (Rule 610T(b)(1)(ii) of Regulation NMS).

[8] *See id.*

[9] *See id.* at 59. The Commission also states that the level of trade volume in such securities might not produce sufficient statistical power to analyze the securities in isolation, given the limited number of observations for each security.

[10] *See, e.g.,* Letter from Susan Olson, General Counsel, ICI to Brent J. Fields, Secretary, SEC, dated May 23, 2018 at 4-5, *available at* https://www.ici.org/pdf/31218a.pdf.

[11] *See* Adopting Release at 36-37.

[12] *See id.* at 33.

[13] *See id.* at 37.

[14] *Seeid.* at 52.

[15] *See id.* at 63.

[16] *Seeid.* at 370 (Rule 610T(a)(2) of Regulation NMS).

[17] *See id.* at 71.

[18] *See id.* at 83.

[19] *Seeid.* at 59.

[20] *See id.* at 57.

[21] *See id.* at 62.

[22] *See id.* at 374-375 (SEC Rule 610T(c) of Regulation NMS).

[23] *See id.* at 106-107.

[24] *See id.* at 374.

[25] *See id.* at 370-371 (Rule 610T(b)(1)(i) of Regulation NMS).

[26] *See id.* at 135-137.

[27] *See id.* at 371-374 (Rules 610T(b)(2) and (3) of Regulation NMS).

[28] *See id.* at 378-381 (Rule 610T(e) of Regulation NMS).

[29] The Commission proposed that the order routing datasets would be available publicly but, after reviewing comments, determined that the public release of these datasets could create confidentiality concerns. Accordingly, the Commission decided to require the exchanges to send these datasets to the SEC. *See id.* at 131.

[30] During the pre-pilot period, exchanges must 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 of pilot securities.