Access Fees and Regulatory Structure of Trading Venues

NOVEMBER 5, 2015

On October 27, 2015, the Equity Market Structure Advisory Committee (EMSAC or Committee) held its second meeting at the Securities and Exchange Commission (Commission or SEC) in Washington DC.[1] The Committee is considering whether various regulatory or industry initiatives would improve the function of the US equity markets. At this meeting, the Committee focused on (1) market access fees and the maker/taker fee model and (2) the regulatory structure of trading venues. The Committee also discussed issues raised by the market disruptions that occurred on August 24.[2]

As an advisory committee to the SEC, EMSAC is organized and operates pursuant to the Federal Advisory Committee Act.[3] Accordingly, the Committee's proceedings are open to the public, and the Committee, while not a formal rulemaking body, ultimately will make recommendations to the Commission for possible action. Market participants with a significant interest in any of these topics therefore should consider whether and how (e.g., a white paper or comment letter) to make their views known to the Committee in a timely manner.[4]

Opening Remarks

Each Commissioner gave opening remarks discussing his or her views on how the Committee can assist the Commission in improving the equity markets. Chair Mary Jo White opened the meeting by recognizing how "invaluable this Committee's insights are as the Commission continues its efforts to ensure that the equity markets optimally meet the needs of investors – both large and small – and issuers of all sizes."[5] Commissioner Luis Aguilar emphasized that two recent market disruptions—the market events of July 8 and August 24—highlighted the need for market structure improvements, including improved contingency plans for market openings and closings. Commissioner Kara Stein echoed the sentiment that the August 24 events underscored the need for the Committee's input on market structure issues. Commissioner Michael Piwowar noted that the SEC's website lists only three equity market structure accomplishments and indicated his hope that the Committee would add significantly to that list.

Access Fees/Maker-Taker Model

In response to comments during the EMSAC's inaugural meeting that a discussion of maker-taker fees was "essential for any thorough assessment of market structure,"[6] the Committee members and panelists discussed the advantages and disadvantages of the widely used maker-taker fee structure. Although there are multiple variations on the theme, the maker-taker pricing model generally involves the offering of rebates to market participants providing liquidity (makers) and the charging of fees to market participants obtaining access to the liquidity (takers).[7] Critics of the maker-taker model argue that it creates inherent conflicts of interest between brokers and their customers, distorts order routing decisions, and unnecessarily increases market complexity. Proponents, on the other hand, believe that the maker-taker model promotes tight spreads and enhances competition among trading venues.

In light of the differing views of maker-taker fees, Committee members varied on how they would address any concerns raised by the fees. Some Committee members called for the elimination of this fee structure entirely, arguing that it adds unnecessary complexity to the markets. Other members argued that the maximum access fees set forth in Rule 610 of Regulation NMS (e.g., $0.003 per share, if the price of a protected quotation or other quotation is $1.00 or more) is based on outdated information about the market and should be reduced to reflect current trading patterns.

Given the complexity of the issues, and concerns about unintended consequences of any changes to the regulatory requirements related to access fees, many panelists and EMSAC members supported the Commission's use of a pilot program to test any proposed changes to access fees prior to their implementation. In doing so, the Committee members, along with Chair White, emphasized that the design of any potential pilot is critical to its usefulness. For example, Committee members encouraged the application of the pilot to a broad universe of stocks, thereby facilitating an analysis of the effect of the fees on securities with different trading patterns. In addition, certain members advocated including a trade-at component in a pilot, while others argued that it introduced unnecessary complexity and could hinder the Commission's ability to attribute findings to specific factors, i.e., it would be difficult to understand whether a particular result derived from changes to the maker-taker model or the introduction of the trade-at component.

Regulatory Structures of Trading Venues

Next, the Committee discussed the regulatory structures applicable to exchanges, alternative trading systems (ATS), and the national market system plans (NMS Plans). The Committee primarily focused on three areas during the discussion: (1) the harmonization of the regulatory requirements applicable to exchanges and ATSs; (2) increased liability for exchanges; and (3) the governance and operation of the NMS Plans that provide market data via the securities information processor (SIP).

As noted by Chair White, "perceived differences between the services provided by exchanges and ATSs and their respective roles in the equity marketplace have diminished."[8] Yet, as Committee members and panelists noted, exchanges and ATSs are subject to differing levels of regulation. For example, exchanges are required to file their rules with the SEC and to regulate their members, while ATSs must comply with Regulation ATS, including filing Form ATS and Form ATS-R, and applicable broker-dealer requirements (e.g., best execution). ATSs, however, are not required to make their rules of operation public or to file changes to those rules with the SEC, nor are they required to regulate their subscribers. Given the similarity in services provided by ATSs and exchanges, the EMSAC members and panelists discussed whether there is a need to harmonize the current methods for regulating ATSs and exchanges.

In discussing the potential harmonization of regulations, Committee members and panelists emphasized the importance of considering the differences between brokers and exchanges. Panelists and EMSAC members also highlighted areas of potential and future ATS regulation, such as requirements to provide more detailed descriptions on Form ATS and to publicly disclose the more detailed Form ATS. Panelists also discussed the ATS volume reporting initiatives of FINRA.

Committee members noted that the securities industry is the only industry where for-profit public companies regulate their members and competitors, and questioned why it must be done in this manner. In response, panelists explained that exchanges are best positioned to surveil their markets—exchanges' regulatory systems are built into their matching systems—and that the existence of competition for regulation has created better results while saving Commission resources. One panelist explained that self-regulatory organizations (SROs) are the most regulated securities entities and changing this current structure would create a race to the bottom.

Panelists and EMSAC members also discussed exchange liability limitations. There was general agreement that for-profit exchanges should have appropriate liability limits, and that there should be certain areas where exchanges have immunity and other areas where liability is appropriate. One panelist suggested defining exchange functions as either core or non-core, and granting immunity from liability for core functions and permitting limited liability for non-core functions. One Committee member questioned whether exchanges should be subject to capital requirements when they are subject to higher liability thresholds and whether such a requirement would create a greater barrier to entry.

With respect to market data, panelists and EMSAC members agreed that regulatory efforts should be directed toward enhancing the governance structure of the NMS Plans overseeing market data, with a focus on the cost of market data. Committee members expressed concern with recent increases in the SIP's market data-related fees, despite decreases in technology costs and other costs related to the production of the market data as well as the decrease in the market value of the SIP market data compared to direct market data feeds. In addition, one panelist expressed concern about the conflicts of interest in the governance of the NMS Plans: (1) NMS Plan participants are exclusively SROs that are not incentivized to be competitive in the operation of the NMS Plans; and (2) NMS Plan participants generate revenue based on the sale of direct market data that conflicts with the market data provided via the NMS Plans. To resolve these conflicts, the panelist suggested changes to the governance structure of the NMS Plans, including adding representation from broker-dealers and asset managers and removing the unanimous voting requirement.

August 24, 2015 Market Volatility

The Committee discussed the volatility experienced by the markets on August 24, 2015. With the majority of the trading halts affecting exchange traded products (ETPs) and exchange traded funds (ETFs), Committee members urged the Commission to consider market structure issues specific to ETPs and ETFs. One EMSAC member urged the Committee to consider ETPs and ETFs in various classes (e.g., cash, fixed income, emerging markets) when making assessments and to harmonize the following around ETPs and ETFs: (1) the requirements of Limit Up/Limit Down; (2) the modernization of Regulation SHO; (3) the ability to adjust trades under clearly erroneous guidelines; (4) the automation of indications under NYSE Rule 123D;[9] and (5) the education around order messages. In addition to the assessment of market structure in light of ETPs and ETFs, Committee members noted two lessons learned from August 24—the need to open markets on time and the need to fine tune the re-opening process after a trading halt.

Next Steps

Going forward, the EMSAC will create subcommittees to consider particular issues and will provide the Commission with recommendations periodically. The Committee also will schedule the dates for future EMSAC meetings, with the goal of holding quarterly discussions. During these discussions, the Committee and any subcommittees are prepared to consider issues raised in public comments submitted to the EMSAC.

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[1] The EMSAC is comprised of senior executives from large institutional broker-dealers, self-regulatory organizations, an ATS, technology firms, and the AARP, along with academics with specialties in economics, finance, financial engineering, computer science and artificial intelligence, and law. Certain Committee members and Commissioners expressed concern that the composition of the Committee did not provide sufficient representation of all relevant categories of market participants. *See* EMSAC Spotlight Page, SEC, (last modified Oct. 27, 2015).

[2] The Committee focused on the Order Protection Rule of Regulation NMS in its first meeting. See Andre Owens, Bruce Newman and Mahlet Ayalew, WilmerHale, SEC Equity Market Structure Advisory Committee: Assessing Complexity in the U.S. Equity Markets (May 21, 2015), (available here).

[3] See Federal Advisory Committee Act, 5 U.S.C. app. §§ 1-16 (2015).

[4] Comments submitted to the Committee to date are available on the SEC's EMSAC Spotlight Page, as are instructions for submitting public comments.

[5] Mary Jo White, Chair, SEC, Opening Remarks at the October 2015 Meeting of the EMSAC: Optimizing our Equity Market Structure (October 28, 2015) ("Opening Remarks of Chair White"), (available here).

[6] *Id.*

[7] Inverse maker-taker pricing models in which the provider or maker of liquidity is charged a fee and the user or taker of liquidity is provided a rebate also exist.

[8] Opening Remarks of Chair White, supra note 5.

[9] NYSE Rule 123D provides requirements related to the openings and halts in the trading of a security.

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