SEC Proposes Transaction Fee Pilot for NMS Stocks

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On March 14, 2018, the Securities and Exchange Commission (SEC) proposed Rule 610T of Regulation NMS under the Securities Exchange Act of 1934 to conduct a pilot program (Pilot) to study the effect of equity exchange transaction fees and rebates, and changes to those fees and rebates, on order routing behavior, execution quality and market quality.[1] As discussed in more detail below, the Pilot would apply to equity exchanges, but not to alternative trading systems (ATSs) or other non-exchange trading centers; would involve certain NMS stocks; and would have a duration of one year unless the SEC extended the Pilot for a second year. The Pilot would have three different test groups (Test Groups), each with a different pricing limitation, as well as a control group (Control Group). The SEC believes that the Pilot would provide a valuable source of data to facilitate an informed discussion about the need for regulatory action to address any potential negative effects of such fees on order routing behavior, execution quality or market quality. Broker-dealers may be particularly interested in the proposed reduced fee caps and limitations on rebates in the Test Groups, as well as the proposed publication of broker-dealers' anonymized order routing data. The SEC has requested comments on the proposal by May 25, 2018.

I. Background: Transaction Fees

The fee models adopted by exchanges, particularly the maker-taker and taker-maker pricing models, have attracted considerable attention over the years. With the “maker-taker” fee model, a trading center pays its broker-dealer participants a per share rebate to provide (i.e., make) liquidity in securities, and the trading center assesses them a fee to remove (i.e., take) liquidity. The trading center earns as revenue the difference between the fee paid by the “taker” of liquidity and the rebate paid to the provider or “maker” of liquidity. Other trading centers have inverted this model, adopting a “taker-maker” pricing model in which they charge the provider of liquidity and pay a rebate to the taker of liquidity.

The SEC, the SEC's Equity Market Structure Advisory Committee (EMSAC) and other industry members and commenters have explored the potential benefits and concerns of these pricing models. In its proposing release, the SEC summarized the concerns raised by various interested parties regarding maker-taker access fees, including that the maker-taker fees may (1) create a conflict of interest for broker-dealers, who must pursue the best execution of their customers' orders while facing potentially conflicting economic incentives to avoid fees or earn rebates from the trading centers to which they route those orders for execution; (2) undermine market transparency, since displayed prices do not account for exchange transaction fees or rebates and therefore do not reflect the net economic costs of a trade; (3) serve as a way to effectively quote in sub-penny increments on a net basis when the effect of a maker-taker exchange's sub-penny rebate is taken into account, even though the minimum quoting increment is expressed in full pennies; (4) introduce unnecessary market complexity through the proliferation of new exchange order types (and new exchanges) designed solely to take advantage of pricing models; and (5) affect routing choices by driving orders to trading centers with fees that are lower because they do not subsidize rebates. In contrast, others have indicated that the maker-taker model may have positive effects by enabling exchanges to compete with non-exchange trading centers and narrowing quoted spreads by subsidizing posted prices. In response to these issues, the EMSAC and others recommended the adoption of a pilot program to further study the effects of exchange trading models.

II. Current Fee Limitations: Rule 610(c) Under Regulation NMS

The SEC previously addressed issues related to exchange fees when it adopted Rule 610(c) under Regulation NMS. Rule 610(c) prohibits trading centers from imposing, or permitting to be imposed, any fees for the execution of an order against a "protected quotation"[2] that exceed or accumulate to more than $0.0030 per share. For maker-taker exchanges, the amount of the taker fee is bounded by the cap imposed by Rule 610(c) on the fees the exchange can charge to access its best bid/offer for NMS stocks. This cap applies to the fees assessed on an incoming order that executes against a resting order or quote, but does not directly limit rebates paid. The Rule 610(c) cap on fees also typically indirectly limits the amount of the rebates that an exchange offers to less than $0.0030 per share in order to maintain net positive transaction revenues. For taker-maker exchanges, the amount of the maker fee charged to the provider of liquidity is not bounded by the Rule 610(c) cap, but such fees typically are no more than $0.0030, and the taker of liquidity earns a rebate.

III. Proposed Pilot Program

To study the effects of transaction-based fees and rebates, the SEC would conduct the Pilot as follows:

A. <u>Applicable Trading Centers</u>

The Pilot would apply solely to equities exchanges, including both maker-taker and taker-maker exchanges. The Pilot would exclude both options exchanges as well as ATSs and other non-exchange trading centers, since their fees currently are not subject to Rule 610(c).

B. <u>Securities</u>

The SEC proposes to include in the Pilot all NMS stocks, including common stocks and exchange-traded products (ETPs), with an initial share price at the time the pre-Pilot period commences of at least $2, an unlimited duration or a duration beyond the end of the post-Pilot period, and no restrictions on market capitalization (the Pilot Securities).[3] Throughout the duration of the Pilot, including the pre- and post-Pilot periods, if a Pilot Security in one of the Test Groups closes below $1, the security would be removed from the Test Group and would no longer be subject to the Pilot pricing restrictions.

C. Proposed Pilot Design

Proposed Rule 610T(b)(1) would require the SEC to publish on its website a notice containing the list of securities that are subject to the Pilot, and assign each of them to a designated Test Group or to the Control Group. Each Test Group would be selected through stratified sampling by market capitalization, share price and liquidity, and the composition of each Test Group would remain constant for the duration of the Pilot, except for changes due to mergers, delistings or removal from a Test Group due to the share price of a stock closing below $1. Each Test Group would contain 1,000 NMS stocks, with the remainder of eligible NMS stocks to be included in the Control Group.[4] The Pilot Groups would be subject to the following pricing restrictions:

- **Test Group 1:** For Pilot Securities in this Test Group, equities exchanges could neither impose, nor permit to be imposed, any fee(s) for the display of, or execution against, the displayed best bid or offer of such market that exceeds or accumulates to more than $0.0015 per share. This cap would apply to transaction fees assessed on the remover (taker) of liquidity as well as those assessed on the provider (maker) of liquidity.
- **Test Group 2:** For Pilot Securities in this Test Group, equities exchanges could neither impose, nor permit to be imposed, any fee(s) for the display of, or execution against, the displayed best bid or offer of such market that exceeds or accumulates to more than $0.0005. This cap would apply to transaction fees assessed on the remover (taker) of liquidity as well as those assessed on the provider (maker) of liquidity. As compared with Test Group 1, Test Group 2 would test the impact of materially lower rebates and fees on order routing decisions, execution quality and market quality.
- **Test Group 3:** For Pilot Securities in this Test Group, equities exchanges generally would be prohibited from offering rebates, either for removing or posting liquidity, and from offering a discount or incentive on transaction fee pricing applicable to removing (providing) liquidity that is linked to providing (removing) liquidity (Linked Pricing). However, exchanges would be permitted to adopt new rules to provide non-rebate Linked Pricing to their registered market makers during the Pilot if the non-rebate discount or incentive is in consideration for meeting market quality metrics specified in the exchange rule. The prohibition on rebates would apply to displayed top of book liquidity, depth of book liquidity and undisplayed liquidity. Transaction fees for securities in Test Group 3 would remain subject to the current Rule 610(c) access fee cap for accessing a protected quotation. Test Group 3 is intended to allow the SEC to test the effects of an outright prohibition on transaction-based rebates and determine whether rebates create a conflict of interest for broker-dealers when they decide where to route an order to post or take liquidity, and if those conflicts have an effect on order routing behavior, execution quality or market quality.
- **Control Group:** NMS stocks selected as Pilot Securities that are not placed in one of the three proposed Test Groups would be placed into the Control Group. Pilot Securities in the Control Group would remain subject to the current Rule 610(c) access fee cap.

D. Duration

The SEC proposes a two-year term for the Pilot, with an automatic sunset at the end of the first year, unless prior to that time the SEC publishes a notice determining the Pilot should continue for another year. The SEC also proposes a six-month pre-Pilot period and a six-month post-Pilot period. The pre-Pilot period is intended to gather current data to help establish a baseline against which to assess the effects of the proposed Pilot. The post-Pilot period is intended to help assess any post-Pilot effects following the conclusion of the Pilot. Pursuant to Proposed Rule 610T(c), the SEC would provide public notice of the start and end dates for the pre-Pilot, Pilot and post-Pilot periods, including any suspension of the one-year sunset of the Pilot.

E. Data

As part of the Pilot, the SEC believes that the following data should be collected and made publicly available, as described below, to facilitate the SEC's ability to assess the impact of the Pilot and promote transparency about the Pilot Securities as well as basic information about equities exchange fees and changes to those fees during the Pilot.

1. Pilot Securities Exchange Lists

Proposed Rule 610T(b) requires the equities exchanges to post two lists regarding Pilot Securities. Prior to the beginning of trading on the first day of the Pilot period, Proposed Rule 610T(b)(2) would require each equities primary listing exchange to publish on its website a downloadable list of all securities in the Pilot for which the exchange serves as the primary listing exchange (Pilot Securities Exchange List). Each primary listing exchange would also be responsible for keeping current its Pilot Securities Exchange List and making any necessary updates prior to the beginning of trading on each business day that the US equities markets are open for trading.

Proposed Rule 610T(b)(3) would require each equities primary listing exchange to maintain and publicly post on its website downloadable files containing a list of each separate change applicable to any Pilot Securities for which the exchange is the primary listing exchange (Pilot Securities Change List). The list would be updated by the primary listing exchange to include all changes to a relevant security since the inception of the Pilot, and is intended to serve as a cumulative list with all changes to Pilot Securities that have occurred subsequent to the posting of the Pilot Securities Exchange List.

2. Exchange Transaction Fee Summary

Proposed Rule 610T(e) would require each national securities exchange to publish standardized select data on transaction fees and rebates to facilitate analysis of the Pilot data (Exchange Transaction Fee Summary). Such data would be required for the duration of the Pilot, and would include changes to fees and rebates for NMS stocks in each Test Group and the Control Group, as well as average and median realized fees measured monthly. The SEC believes that the Exchange Transaction Fee Summary should facilitate comparison of each exchange's basic fee structure across all equity exchanges, and help identify changes to those fees in summary fashion.

3. Order Routing Data

To provide public data to facilitate the analysis of the impact of the Pilot on order routing behavior, execution quality and market quality the SEC proposes in Proposed Rule 610T(d) to require, throughout the duration of the Pilot, as well as during the pre-Pilot period and post-Pilot period, that each exchange that trades NMS stocks publicly post on its website a downloadable file containing sets of order routing data for the prior month. The proposed rule would require that the order routing data contain aggregated and anonymized broker-dealer order routing information, as well as order routing data for liquidity-providing orders and liquidity-taking orders that is aggregated by day, by security, by exchange and by broker-dealer on an anonymous basis.

In preparing the data sets, the equities exchanges would be required to anonymize information relating to the identity of individual broker-dealers before making the order routing data available to the public. To facilitate review across multiple exchanges, the SEC proposes to provide a unique code for each broker-dealer. The SEC would provide equities exchanges, on a confidential basis, a Broker-Dealer Anonymization Key that would provide the anonymization code for every broker-dealer whose order routing data would be included in the order routing data set. To protect the identities of broker-dealers, this key would be provided only to representatives of the SEC and the equities exchanges. In addition, proposed Rule 610T would state that the identities of broker-dealers contained in the order routing data sets and Broker-Dealer Anonymization Key are regulatory information and that exchanges would not be permitted to access or use the information for any commercial or non-regulatory purpose.

The SEC is proposing that each equities exchange be required to publicly post two data sets on its websites. One data set would include daily volume statistics of liquidity-providing orders by security and by anonymized broker-dealer, separating held and not-held orders. The second data set would include daily volume statistics of liquidity-taking orders by security and by anonymized broker-dealer, separating held and not-held orders.

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[1] Securities Exchange Act Release No. 82,873 (March 14, 2018), 83 Fed. Reg. 13,008 (March 26, 2018).

[2] Rule 600(b)(58) of Regulation NMS defines a “protected quotation” as a “protected bid or a protected offer.” Rule 600(b)(57) of Regulation NMS, in turn, defines a “protected bid or protected offer” as a quotation in an NMS stock that is (i) displayed by an “automated trading center,” (ii) disseminated pursuant to an effective national market system plan, and (iii) an “automated quotation” that is the best bid or best offer of a national securities exchange or national securities association.

[3] The SEC explains that ETPs include exchange-traded funds, trust or partnership vehicles that are not registered under the Investment Company Act of 1940 because they do not invest primarily in securities, and exchange-traded notes.

[4] If the Pilot overlaps with the Tick Size Pilot, then the Pilot's three Test Groups would each be divided into two subgroups–one that overlaps with the Tick Size Pilot and one that does not–to protect the integrity of data in both pilots.

Authors

Andre E. Owens

PARTNER

Chair, Broker-Dealer Compliance and Regulation Practice

Co-Chair, Securities and Financial Regulation Practice

andre.owens@wilmerhale.com

+1 202 663 6350

Tiffany J. Smith

PARTNER

Co-Chair, Blockchain & Cryptocurrency Working Group

tiffany.smith@wilmerhale.com

+1 212 295 6360

Cherie Weldon

SPECIAL COUNSEL

cherie.weldon@wilmerhale.com

+1 212 230 8806