Securities Regulation Daily Wrap Up, EXCHANGES AND MARKET REGULATION—Trade and public interest groups clash with exchanges over proposed NMS fee pilot, (May 30, 2018)

Securities Regulation Daily Wrap Up

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Industry trade and watchdog groups and exchanges are divided in their reactions to the SEC's proposed pilot program to assess how exchange transaction fees and rebates affect market quality for national market system (NMS) stocks. As the comment period ended, the Investment Company Institute (ICI) urged the SEC to go forward with the proposal, writing that current exchange pricing models may create conflicts of interest for broker-dealers, decrease market transparency, and increase market complexity and fragmentation. Industry watchdog Better Markets agreed, saying that payments by the exchanges that incentivize and induce routing decisions at the expense of best execution and market quality represent an "entrenched and insidious" market practice that requires forceful intervention by the Commission. Nasdaq and Cboe Global Markets sharply disagreed, however, with Nasdaq even writing that the current proposal will likely harm investors and issuers.

Designed to facilitate an informed discussion about possible alternative approaches to prevailing fee structures, the SEC's proposed pilot would subject exchange transaction fee pricing, including "maker-taker" fee-and-rebate pricing models, to new temporary pricing restrictions across three test groups and require exchanges to prepare and publicly post data. The pilot would last for up to two years and apply to all NMS stocks and include all equities exchanges, including "taker-maker" exchanges.

ICI. In the view of the ICI, the proposed pilot is well-designed and should provide the Commission and others with data on how changes to Rule 610(c) under Regulation NMS affect equity market quality. The ICI believes that the structure of the test groups may encourage exchanges to compete on the basis of innovation, differentiation of services, and ultimately on the value their trading model presents to investors, not on the amount of money rebated to their participants. In particular, the ICI noted the importance of Test Group 3, which prohibits the use of rebates. This test group will allow an objective assessment of the broadly-held view that rebates contribute to undesirable market behaviors, and the data gathered could suggest an appropriate direction for future SEC rulemaking to correct these behaviors, the ICI wrote.

Better Markets. The SEC should approve the pilot as quickly as possible, Better Markets wrote, stating that the Commission has heretofore lacked sufficient data to outlaw rebates and other practices such as front-running and information leakage that harm investors. As did the ICI, Better Markets noted the importance of the "no-rebate" test group, observing that the SEC's proposal itself shows that all of the exchanges that engage in rebates have done so even when the access fee is very low. Given the history of the exchanges in subsidizing rebates, a very low access fee cap (as was proposed by the Equity Market Structure Advisory Committee) is not an effective way to simulate a "no-rebate" environment, Better Markets wrote.

Better Markets also stressed that the pilot must include all NMS stocks above $2 per share without regard to capitalization levels. In Better Markets' view, leaving out small or mid-cap issuers will handicap efforts to settle debates regarding market liquidity issues and harm efforts at future reforms. Better Markets believes that the pilot should also prohibit issuers from exempting themselves out of the pilot, given that no issuer currently has any say over the exchanges' decisions to set access fee or rebate levels on its stock, or over exchanges' decisions to sell special access and premium exchange data to certain market participants.

Nasdaq. Nasdaq blasted the proposal, however, writing that the SEC's record lacks even the most basic evidence to justify a pilot. Before the Commission can even consider studying how transaction fees impact order

routing behavior, Nasdaq wrote, it must first gather and analyze existing data and improve existing transparency tools, such as enhancing the Duty of Best Execution and modifying SEC Rule 606 to enhance disclosure of order routing behavior, as recommended by the Treasury Department. Moreover, the proposal as designed will not achieve its stated goal because it excludes Alternative Trading Systems and broker-dealer matching venues that account for 39 percent of U.S. trading volume. In Nasdaq's view, the proposal erroneously assumes a static environment, when it is changing a major variable (access fees) in one segment of the market without properly anticipating or accounting for the dynamic impact on the remaining 39 percent.

Nasdaq also regards the proposal as a "risky market experiment" with public companies and public investors. Nasdaq observed that the proposal would affect 3,000 issuers and their shareholders, with potential unintended consequences that may reverberate throughout the U.S. economy. Accordingly, the proposal cannot be considered a mere pilot, and the SEC cannot avoid its burden of conducting accurate cost-benefit analysis by categorizing a risky experiment as a "pilot," Nasdaq wrote. The proposal's enormous scope will also make it intrusive and costly, imposing far greater costs through "government rate-making" than the potential benefits sought. In addition, the SEC's failure to apprise itself of the economic consequences the proposal makes its promulgation arbitrary and capricious and not in accordance with the Exchange Act and the Administrative Procedure Act.

Cboe Global Markets. Cboe Global Markets also questioned the proposal's logic and the SEC's legal authority to impose federal price controls. In Cboe's view, the Commission has proposed to perform a large-scale experiment on the deepest and most liquid equities market in the world, despite demonstrable evidence that investor execution quality is higher than ever before.

Cboe believes that the pilot will likely impact investors by disrupting the pricing structures for 3,000 equity securities, thus increasing spreads and lowering liquidity. Cboe estimates that if the pilot causes effective spreads to widen by as little as 10 percent for only the top 100 securities, the pilot would cost investors over $400,000,000 more in annual execution costs. Cboe asserted that the SEC's price control pilot is unnecessary, that data resulting from the pilot will not yield useful information, and that potential conflicts of interest can be examined and addressed in much less intrusive ways and without subjecting the equities market and investors to potentially significant harm.

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