Securities Regulation Daily Wrap Up, TOP STORY—SEC proposes Transaction Fee Pilot, changes to fund liquidity risk disclosure, (Mar. 14, 2018)

Securities Regulation Daily Wrap Up

Click to open document in a browser

By Amy Leisinger, J.D.

A unanimous SEC approved a proposal to conduct a Transaction Fee Pilot under proposed new Rule 610T of Regulation NMS to study NMS stocks and the effects that transaction-based fees and rebates may have on order routing behavior and execution and market quality. The proposed pilot is designed to help inform the Commission and its staff, market participants, and investors about the impact of fees and rebates and to provide information for data-driven consideration of the need for regulatory changes (*Transaction Fee Pilot for NMS Stocks*, Release No. 34-82873, March 14, 2018).

By a 3-2 vote, the SEC also approved proposed amendments to public liquidity-related disclosure requirements for certain open-end funds adopted in October 2016 to revise the manner in which information about liquidity risk management practices is provided to investors. Under the proposal, each fund would discuss in its annual report the operation and effectiveness of its liquidity risk management program, instead of providing an aggregate liquidity classification profile of its portfolio on Form N-PORT on a quarterly basis (*Investment Company Liquidity Disclosure*, Release No. IC-33046, March 14, 2018).

Transaction Fee Pilot. The adoption of Regulation NMS put order protection requirements in place to govern intermarket trading in electronic, dispersed markets and provided rules addressing fair and efficient access to quotations and limitations on fees charged. In connection with recommendations by the SEC's Equity Market Structure Advisory Committee, Commission staff decided to develop a Transaction Fee Pilot to produce data on the effect of, and changes to, transaction fees and rebates, as well as order routing behavior, execution quality, and market quality.

Designed to facilitate an informed discussion about possible alternative approaches to prevailing fee structures, the proposed pilot would subject exchange transaction fee pricing, including "maker-taker" fee-and-rebate pricing models, to new temporary pricing restrictions across 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.

In support of the proposed pilot, SEC Chairman Jay Clayton noted that the Commission and its staff do not currently have data that enables meaningful analysis of the effects of exchange fees and rebates; Commissioner Michael Piwowar suggested that there is no need to take the current pricing structures as "immutable characteristics" of modern markets. According to Commissioner Kara Stein, for years, market participants have been debating rebates and potentially improper incentives that may be harming the quality and efficiency of trading, and the data from this study should inform approaches to improving market quality and investor experiences.

In addition to offering support for the proposed Transaction Fee Pilot, Commissioner Hester Peirce urged commenters not only to address the design of the proposed pilot but also to consider possible alternative approaches that could help identify other circumstances in which SEC regulations rules may distort market incentives.

"[T]argeted pilot programs—particularly in complex areas like this one, where intuitions are strong but evidence is scant—are and should continue to be a critical part of our rulemaking effort," Commissioner Robert Jackson asserted.

The comment period will remain open for 60 days following publication of the proposal in the Federal Register.

Liquidity disclosure changes. In October 2016, the Commission approved Rule 22e-4 to require open-end management investment companies to adopt liquidity risk management programs that include classifications of the liquidity of portfolio assets and to conduct periodic evaluations of liquidity risk. The final rule provided four liquidity time-frame categories and required reporting of the percentage of each classification on a quarterly basis. In February 2018, the SEC added six months to the deadline by which open-end funds must comply with classification-related elements of the liquidity risk management program rule and issued additional FAQs to address questions that arose with respect to liquidity classification.

The proposal would replace the "bucket" liquidity profiles to be publicly disclosed with a new requirement that each fund discuss the operation and effectiveness of its liquidity risk management program in its annual shareholder report. Further, the proposed amendments would allow funds to provide liquidity classification as required by Rule 22e-4 in multiple categories for a single position. The proposal also seeks to add a new requirement to Form N-PORT that funds and other registrants report holdings of cash and cash equivalents.

In support of the proposal, Chairman Clayton noted that there is no change in the data that will be collected. The Commission will review the nonpublic data, but the proposed changes will curb potential investor confusion and predatory trading behaviors that could arise from public disclosure. While the Commission is "well-situated to understand fund-to-fund variabilities," classification differences may not be apparent to retail investors or the markets. Together with the chairman, Commissioner Piwowar stated that disclosure should not only be accurate but should also be placed in a proper context so as to be of value to investors.

Commissioner Peirce agreed that funds' aggregate liquidity classification information should not be disclosed to the public but suggested that the proposal does not go far enough. By not also proposing to rescind Rule 22e-4, or at least seeking comment on rescission, the Commission is not taking the opportunity to fully review the overall costs and usefulness of the classification requirement prior to full implementation.

In opposition, commissioners Stein and Jackson noted their objections to the proposal. According to Stein, the proposal constitutes "a roll-back of transparency" and endeavors to "take useful disclosure away from investors." Likening the LRM disclosures to ingredient lists on food labels, she noted that they provide investors with clearer indications of what is actually in a fund, which enables better decision-making with regard to appropriateness of particular fund investments. Similarly, Jackson objected to the proposal's move to give fund investors less, not more, information about risks and its replacement of the clear, quantitative data disclosures for qualitative "discussions." Further, he said, institutional investors have resources to detect liquidity issues long before retail investors, and this informational advantage could lead institutional investors to exit "before retail investors know what has hit them."

Comments on the liquidity disclosure proposal are due within 60 days of Federal Register publication.

The releases are No. 34-82873 and No. IC-33046.

MainStory: TopStory ExchangesMarketRegulation FormsFilings InvestmentCompanies RiskManagement SECNewsSpeeches