Consumer Federation of America

May 25, 2018

Mr. Brent J. Fields, Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington D.C. 20549

Re: Proposed Transaction Fee Pilot for NMS Stocks, File No. S7-05-18

Dear Mr. Fields:

I am writing on behalf of the Consumer Federation of America (CFA)[1] to express our support for the proposed pilot program to produce data on the effects of equity exchange transaction fees and rebates, and changes to those fees and rebates, on order routing behavior, execution quality, and market quality. We have strongly supported the concept of a pilot program to study the effects of the maker-taker pricing model[2] and we applaud the Commission for taking this critical step toward making such a pilot program a reality. We believe the Commission has, by and large, proposed a thoughtful and reasonable approach that will provide meaningful data to help inform future regulatory action. In particular, we appreciate that it would:

- Apply broadly to all exchanges and include a comprehensive set of securities for each test group;
- Include a "no rebate" test group; and
- Be implemented as a Commission rule rather than a National Market System (NMS) plan.

However, we also believe that the Commission should make several important changes to the proposal for the pilot to produce the most meaningful information possible, including the following:

[1] CFA is a non-profit association of nearly 300 national, state, and local pro-consumer organizations. It was formed in 1968 to represent the consumer interest through research, advocacy and education.

[2] *See* Letter from Micah Hauptman, CFA, to the SEC, Comment on Concept Release on Equity Market Structure, at 20, September 9, 2014, https://www.sec.gov/comments/s7-02-10/s70210-418.pdf ("Recognizing that eliminating MTPM wholesale is not something the Commission is likely to embark on, the Commission should, at the very least, conduct a well-designed pilot program that produces meaningful information about the consequences of eliminating MTPM."); *See also* Letter from Micah Hauptman, CFA, to the SEC, Comment on Proposed Tick Size Pilot, at 2, December 22, 2014, https://consumerfed.org/pdfs/SEC-tick-size-pilot-program-12-22-2014.pdf (suggesting that a better alternative to the tick size pilot program would be a pilot program eliminating maker-taker pricing or reducing the $0.30 per 100 share fee cap under Rule 610(c) of Reg. NMS.)

- Test groups 1 and 2 should directly cap rebates, rather than just capping fees. Otherwise, it is possible that exchanges will pay rebates in excess of the fee cap.
- Test group 3 (the "no rebate" test group) should cap fees both for removing *and* providing displayed liquidity, rather than just capping fees for removing displayed liquidity. Otherwise, it is possible that exchanges will charge in excess of the fee cap for providing displayed liquidity.
- Test group 3 should eliminate the market maker exception. Should the Commission decide not to eliminate the market maker exception, it should, at the very least, be actively involved in prescribing rigorous market making standards, rather than deferring to the exchanges. The Commission should take this approach both to ensure that market makers fulfil their essential role and to ensure that market makers do not exploit their privileged position in ways that subordinate their customers' interests or gain an unfair competitive advantage over non-market makers in routing customer orders.

I. Background

Trading centers in our national market system currently compete on terms that can be unfavorable to investors. In an effort to attract business, trading centers typically offer broker-dealers inducements in the form of rebates and other incentives for sending order flow to them.[3] Just as in other instances where incentives drive behavior, academic research and empirical evidence have shown that, here too, the rebates that venues offer to broker-dealers distort broker-dealers' order routing practices and the resulting execution quality obtained for their customers.[4] These incentives make it more likely that broker-dealers will route their customers' orders to capture (or avoid paying) the rebate, serving their own interests, rather than routing their customers' orders in ways that serve their customers' best interest. These incentives compromise broker-dealers' bedrock obligations to seek best execution for their customers.[5] In addition to the

[3] Importantly, exchanges may also create certain tiered pricing rates for specific "customers" of the exchange. While some details regarding the tiers may be disclosed by the exchanges upon creation, the actual economic impacts of the new tiers are not disclosed. For example, neither market participants nor the Commission typically know how many firms may qualify for the tier, who may qualify for the tier, or the overall impact of the new tier on incentivizing order flows. As a result, the only parties that know the magnitude of the conflict of interest facing the broker is the broker itself.

[4] *See* Angel, Harris, and Spatt, Equity Trading in the 21st Century, Recommendations for SEC Rulemaking Attachment, 8.1, February 23, 2010; https://www.sec.gov/comments/s7-02-10/s70210-54.pdf; Stanislav Dolgopolov, "The Maker-Taker Pricing Model and its Impact on the Securities Market Structure: A Can of Worms for Securities Fraud?", 8 VA. L. & BUS. REV. 231, 270 (2014), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2399821; Robert H. Battalio, Shane A. Corwin, and Robert H. Jennings, "Can Brokers Have It All? On the Relation Between Make-Take Fees and Limit Order Execution Quality," Journal of Finance 71, 2193-2237 (2016), http://onlinelibrary.wiley.com/doi/10.1111/jofi.12422/full; Conflicts of Interest, Investor Loss of Confidence, and High Speed Trading in U.S. Stock Markets, Hearing of the Permanent Subcommittee on Investigations, Senate Committee on Homeland Security and Government Affairs, 113th Congress (2014), https://www.hsgac.senate.gov/subcommittees/investigations/hearings/conflicts-of-interest-investor-loss-of-confidence-and-high-speed-trading-in-us-stock-markets.

[5] *See, e.g.* Norman S. Poser and James A. Fanto, Broker-Dealer Law and Regulation, (4th Edition and Supp. 2013), Aspen Publishers § 1603[B]

fact that distorting brokers' routing decisions can result in harm to investors, distorting brokers' routing decisions can also increase market complexity and adversely affect market quality.[6]

Under the predominant "maker-taker" pricing model, a trading center pays firms for orders that provide liquidity, and charges firms "taker" fees for orders that remove liquidity. But in trading venues' eagerness to seek unique and creative ways to differentiate themselves, trading venues may also offer different pricing models to attract different types of traders. For example, several venues operate an inverted "taker-maker" pricing model, charging fees for providing liquidity and paying rebates for removing liquidity.

Rule 610(c) of Regulation National Market System (Reg. NMS) limits access fees on "taking" liquidity from a protected quote at not more than $0.30 per 100 shares. This fee cap "largely codified the prevailing fee level"[7] in 2005, when transaction costs were significantly higher than they are today. Yet since Reg. NMS took effect, access fees haven't decreased materially.

Access fees and rebates are, in practice, linked. Typically, the fees that a trading center collects are then used to pay rebates on the other side. Importantly, Rule 610(c)'s fee cap does not directly limit rebates paid. While, as a practical matter, it typically indirectly limits the amount of the rebates that a trading venue pays in order for a trading venue to maintain net positive transaction revenues, that is not always the case. In some instances, maximum rebates offered by various exchanges exceed the fee cap. Exchanges may cross-subsidize rebates from other aspects of their business, for example.[8] Thus, as a general matter, lowering the maximum access fee trading centers are permitted to charge is likely to result in lowering the rebates paid. Yet, because the fee cap does not directly limit rebates paid, the amount of rebates that are paid will not necessarily be bound by the access fee cap. Relatedly, while lowering the fee cap may, as a practical matter, decrease the magnitude of the rebate's incentive, lowering the fee cap would not eliminate the rebate's incentive. The only way to eliminate the incentive is to directly prohibit rebates from being paid.

In July 2016, the Commission's Equity Market Structure Advisory Committee (EMSAC) recommended that the Commission propose a pilot program to adjust the access fee cap under Rule 610.[9] Notably, while the recommendation proposed to lower the per share fee cap to varying degrees for three different test buckets, it did not propose to include a "no rebate" bucket in the pilot. It also covered a narrow set of securities for each test bucket, restricting the pilot to stocks and ETFs with a market capitalization of greater than $3 billion. There would be only 100

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[6] *See supra*, Note 4; Jeffrey C. Sprecher, Chairman & CEO, IntercontinentalExchange, Remarks at the 15th Annual Credit Suisse Financial Services Forum (Feb. 12, 2014), http://ir.theice.com/~/media/Files/I/Ice-IR/events-presentations/transcript/csfb-transcript-2-2014.pdf; Curt Bradbury, Market Structure Task Force Chair, Board of Directors, SIFMA, and Kenneth E. Bentsen Jr., President and Chief Executive Officer, SIFMA, Opinion, "How to Improve Market Structure," N.Y. TIMES (Jul. 14, 2014), http://dealbook.nytimes.com/2014/07/14/how-to-improve-market-structure/?_r=0.

[7] Proposal at 13010.

[8] Chester S. Spatt, Is Equity Market Structure Anti-Competitive?, at 4, May 24, 2018 (finding that, "Maximum rebates offered by various exchange exceed the cap on fees under Regulation NMS (30 mills per share). Hence, cross-subsidization of trading is not uncommon.")

[9] EMSAC, Recommendation for an Access Fee Pilot (July 8, 2016), https://www.sec.gov/spotlight/emsac/recommendation-access-fee-pilot.pdf

securities for each test bucket. In addition, the EMSAC recommendation proposed to exclude inverted exchanges and ATSs from the pilot program.

In our view, the EMSAC's recommendation would have produced data with limited value. We appreciate that the Commission has improved significantly on the EMSAC's suggested approach with this proposed pilot program.

II. The Commission has, by and large, proposed a thoughtful and reasonable approach to this pilot. We believe it will provide meaningful data to help inform future regulatory action.

- **We support the proposed approach to apply the pilot broadly to all equity exchanges and to include a comprehensive set of securities for each test group**.

The proposed pilot seeks to test the impact of transaction fees and rebates more comprehensively than the EMSAC's recommended proposal. It would apply to all equities exchanges, including inverted exchanges. It would also apply to nearly all NMS stocks, which includes common stocks and Exchange-Traded Products (ETPs). Rather than limiting to issuers with a market capitalization of greater than $3 billion, the proposal would include issuers with any market capitalization with a price of at least $2 at the time of the start of the pre-pilot period. Further, rather than limiting each test bucket to 100 securities, the proposed pilot would include 1,000 NMS stocks within each test bucket.

We strongly support the broad scope of the proposal. Applying the pilot broadly to all exchanges and including a comprehensive set of securities for each test group is likely to produce a more meaningful dataset, which should facilitate a deeper analysis of the impact of transaction fees and rebates across the full spectrum of NMS stocks, including securities of different sizes, with varying share prices, liquidity levels, and resulting trading characteristics.

- **We support the proposed approach to include a "no rebate" test group.**

The proposed pilot includes a "no rebate" test bucket, which would prohibit exchanges from offering rebates, either for removing or posting liquidity. The proposal reasons that, while a lower cap should reduce the likelihood that a market participant will offer a material rebate, the possibility exists that rebates would nevertheless continue to be offered and would influence routing decisions. The Commission concludes that "only a complete prohibition on rebates will allow the Commission to study directly these conflicts and their effects by observing what would happen in the absence of rebates."[10] We strongly agree with this analysis and support this approach.

- **We support the proposed approach to implement the pilot as a Commission rule rather than an NMS plan.**

The proposed pilot would be implemented as an SEC rule rather than an NMS plan. We support this approach, as the NMS plan governance structure has proven to be unworkable and rife with conflicts of interest. It has contributed to, or resulted in, unreasonable delays and

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[10] Proposal at 13022-13023.

squabbles between NMS plan participants in the implementation of the Consolidated Audit Trail (CAT) and tick-size pilot, for example. Such is the inevitable result when for-profit corporations decide regulatory issues that affect their bottom lines.[11]

- **We support the proposed approach to data collection and assessment.**

The proposal would require exchanges to publicly post on their websites, in a downloadable file, information on their fees (including rebates) and fee changes during the proposed pilot (including for the pre-pilot and post-pilot periods) using an eXtensible Markup Language (XML). In addition, exchanges would be required to provide order routing data, including daily volume statistics of liquidity-providing orders and liquidity-taking orders, both by security and anonymized broker-dealer. We support the collection of this information, as we believe it should provide researchers and the Commission with the data necessary to study the potential conflicts of interest associated with transaction based fees and rebates, and the effects that changes to those fees and rebates have on order routing behavior, execution quality, and market quality. We also agree that breaking the data out at the broker-dear level will permit a closer examination of how different broker-dealers may change their order routing behavior in response to changes in fees and rebates at each exchange.

Unfortunately, we worry that the pricing tier disclosures, while helpful, will still not provide enough transparency to permit detailed analysis. We urge you to supplement the required disclosures with, on a monthly basis, the number of pricing tiers used by the exchange, the average total transaction cost in that pricing tier, and the number of firms who were in that tier.

We are particularly pleased that the data will be made publicly available for free, in XML format. This will allow academics, third party analysts, and other capital market participants to better understand and analyze the pilot's results. In order to further facilitate analysis and comparisons between the different exchanges, however, we urge the Commission to aggregate the data that is collected and posted by each exchange into a single, centralized repository.

While we support the proposed data collection, we believe that it would be additionally helpful if brokers' customers could also judge brokers' routing decisions. The Commission's Order Handing Proposal would provide brokers' customers with critical information regarding how their orders are handled. We urge the Commission to finalize that proposal, with our suggested changes.[12] While not directly related to the issues at hand, we also urge the

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[11] Healthy Markets Association, US Equity Market Data – How Conflicts of Interest Overwhelm an outdated Regulatory Model & Market Participants, Nov. 2017, https://www.healthymarkets.org/new-products/market-data-how-conflicts-overwhelm-an-outdated-regulatory-model; Letter from Theodore R. Lazo and Ellen Greene, SIFMA, to Brent J. Fields, SEC, July 18, 2016, https://www.sifma.org/wp-content/uploads/2017/05/sifma-submits-comments-to-the-sec-on-the-nms-plan-for-a-cat-system.pdf; Letter from Tyler Gellasch, Healthy Markets Association to Jay Clayton, SEC, Jan. 17, 2018, https://www.sec.gov/rules/petitions/2018/petn4-717.pdf; Dunstan Prial, SEC Faces Calls To Push Back Harder On Audit Trail Delays, Law360, May 11, 2018, https://www.law360.com/articles/1042904/sec-faces-calls-to-push-back-harder-on-audit-trail-delays; Rick Baert, Critics strike back at tick-size pilot program, Pensions and Investments, November 10, 2014, http://www.pionline.com/article/20141110/PRINT/311109973/critics-strike-back-at-tick-size-pilot-program.

[12] *See* Letter from Micah Hauptman, CFA, to the SEC, Comment on Disclosure of Order Handling Information, September 26, 2016, https://www.sec.gov/comments/s7-14-16/s71416-11.pdf.

Commission to finalize the proposed ATS disclosure proposal, with our suggested changes.[13] Better understanding how orders are routed and how different venues operate will allow all market participants to make more informed decisions.

- **We support the proposed pilot's duration.**

The proposal would establish a two-year term for the pilot, with an automatic sunset at the end of the first year unless, prior to that time, the Commission publishes a notice determining that the pilot will continue for up to another year. We believe this is a reasonable approach. We expect that a one-year time period will generate sufficient high-quality data to allow the Commission to reliably analyze the effects and impact of transaction fees and rebates, and changes to those fees and rebates, on order routing behavior, execution quality, and market quality. Accordingly, we believe that it will be appropriate to sunset the proposal at the first year's end. However, if the Commission is unable to generate sufficient high-quality data, it should be allowed to extend the pilot for an additional year. We would expect that, should such a situation occur, the Commission would strive to understand why it was unable to generate the type of data that it sought and remedy the deficiency so as not to repeat the same mistakes.

III. The Commission should make several important changes to the proposal for the pilot to produce the most meaningful information possible.

- **Test groups 1 and 2 should directly cap rebates rather than just capping fees. Otherwise, it is possible that exchanges will pay rebates in excess of the fee cap.**

The proposed test includes three test groups and a control group. Test group 1 would lower the cap to $0.15 per 100 shares for removing and providing displayed liquidity, but it would not directly address rebates. Test group 2 would lower the cap to $0.05 per 100 shares for removing and providing displayed liquidity, but it too would not directly address rebates.

As discussed above, while lowering the maximum access fee trading centers are permitted to charge is likely to result in lowering the rebates paid, it is still possible for rebates to exceed the fee cap, for example if exchanges cross-subsidize from their other activities.[14] For example, exchanges could easily adjust market data and connectivity costs to continue funding rebates. To address this concern, test groups 1 and 2 should directly cap rebates rather than just capping fees. Without this adjustment, these two groups would be more of a test of whether the exchanges can readily find other revenue sources to fund their conflicts of interest, rather than studying the impact of those conflicts.

- **Test group 3 should cap fees both for removing *and* providing displayed liquidity, rather than just capping fees for removing displayed liquidity. Otherwise, it is possible that exchanges will charge in excess of the fee cap for providing displayed liquidity.**

Whereas the first two test groups would cap fees both for removing *and* providing displayed liquidity, test group 3 would apply a $0.30 per 100 share fee cap only for removing

[13] *See* Letter from Micah Hauptman, CFA, to the SEC, Comment on Regulation of NMS Stock Alternative Trading Systems, February 26, 2016, https://www.sec.gov/comments/s7-23-15/s72315-19.pdf.
[14] *See supra*, Note 8.

displayed liquidity.[15] As a result, a trading center could charge in excess of the fee cap for providing liquidity. We question why the Commission would create a regulatory environment where there is an incentive to charge in excess of the fee cap for providing liquidity, particularly when the Commission simultaneously has gone in the opposite direction in the same test group by allowing exchanges to provide financial incentives for market makers, whose function is to provide liquidity. We urge the Commission to reconsider this approach, as it could create unnecessary complexity for this test bucket and make it more difficult to compare its results with the other test buckets. It could also lead to a significant preference of one pricing model over another, similarly conflicted pricing model.

- **Test group 3 should eliminate the market maker exception. Should the Commission decide not to eliminate the market maker exception, it should, at the very least, be actively involved in prescribing rigorous market making standards. The Commission should take this approach both to ensure that market makers fulfil their essential role and to ensure that market makers do not exploit their privileged position in ways that subordinate their customers' interests or gain an unfair competitive advantage over non-market makers in routing customer orders.**

Test group 3 would prohibit rebates generally, but there is a market maker exception that could threaten to undermine the results of the study. Under the proposal, an exchange would be allowed to adopt new rules to provide non-rebate discounts or other incentives to their registered market-makers if the incentives are in consideration for meeting market quality metrics specified in an exchange rule. As a result, certain market participants could still trade in order to receive incentives. Moreover, there appears to be no limitation to this exception, even for market-makers who are trading in their brokerage (agency) capacity. This means that broker-dealers who are registered market makers may still be able to engage in routing conflicts of interest, for example, if they route their customers' orders to increase their volume at a certain exchange in order to qualify for discounts.

We believe that there is virtue in establishing a truly clean, no incentives test bucket, to test whether eliminating trading incentives improves routing decisions and outcomes.
To be clear, while bona fide market making is a public good and market makers should be compensated for accepting and fulfilling their market making obligations, market making standards should not be designed and judged by exchanges for the same reasons that the Commission shouldn't defer regulatory decisionmaking to the NMS plans—exchanges' profit motives will trump their regulatory objectives. The current framework that allows each exchange to set its own market making standards leaves too much flexibility for market participants to shirk their market making obligations just when they are needed most. Permitting exchanges to continue to set market making standards here, perhaps with a few tweaks, could perpetuate this problem. Moreover, it could result in certain market participants who qualify for the exception (and the discounts) to gain an unfair advantage over market participants who do not qualify. To address these concerns, any market making standards for any exception related to this pilot

[15] The proposal states that it would apply to "accessing a protected quotation." Only after reading footnote 132 in the proposal is it clear that this test bucket would apply only to removing liquidity. The footnote states, "In other words, Test Group 3 would prohibit rebates for both posting and taking liquidity, but would remain subject to Rule 610(c), which caps fees for taking liquidity. Test Group 3 would not cap fees for posting liquidity."

should be formulated by the Commission, or else the purposes for the pilot will be likely severely undermined.

We believe that such an endeavor is beyond the scope of this pilot. Accordingly, we believe the most appropriate approach for the purposes of this pilot is to eliminate the market maker exception.

Should the Commission decide not to eliminate the market maker exception, however, it should, at the very least, be much more actively involved in prescribing rigorous market making standards, first, in order to ensure that market makers are fulfilling their essential role, and second, to ensure that they are not exploiting their privileged position in ways that subordinate their customers' interests or gain an unfair competitive advantage over non-market makers in routing customer orders**.**

Conclusion

We applaud the Commission for taking this critical step toward making a maker-taker pilot program a reality. We believe the proposed approach will provide meaningful information that can help inform future regulatory action in this space.

Respectfully submitted,

Micah Hauptman

Micah Hauptman
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