SEC Transaction Fee Pilot: Our Perspective

July 2018

Overview of the SEC Transaction Fee Pilot

The Transaction Fee Pilot for National Market System ("NMS") stocks is a two-year program intending to provide greater insight into broker routing operations. The proposed SEC pilot will observe the impact that price mechanisms have on routing behavior with an emphasis on the maker-taker rebate system. Alternative trading systems will not be included. The SEC pilot design includes three test groups involving 1,000 stocks each and a control group of 5,200 stocks.

SEC Pilot Design[1]

Test Group 1	$0.0015 fee cap for removing and providing displayed liquidity (no cap on rebates)
Test Group 2	$0.0005 fee cap for removing and providing displayed liquidity (no cap on rebates)
Test Group 3	Rebates and linked pricing prohibited for removing and providing displayed and undisplayed liquidity. (Rule 610(c)'s cap continues to apply to fees for removing displayed liquidity)
Control Group	Rule 610(c)'s cap continues to apply to fees for removing displayed liquidity

SEC Pilot Timeline

Duration	The pilot is set to be two-years with a one-year sunset. The Commission must publish a notice thirty days before sunset for the continuation of the pilot. In addition, the pilot will be accompanied by a 6-month pre and 6-month post period.
July 2016	The fee pilot program was first proposed by a committee of market experts.
March 14, 2018	The SEC voted unanimously in favor of the proposal for the transaction fee pilot.
March 26, 2018	The Federal Registrar published the pilot proposal for the 60-day comment period, which closed May 25, 2018. However, comments have been submitted as recently as July 10, 2018.

Our Position on the SEC Transaction Fee Pilot

After reviewing the mechanics of the pilot, the potential ramifications of a permanent program, and the positions of critics and supporters, we believe that the pilot will disadvantage those companies included in the test groups. Additionally, we believe that a permanent policy that restricts the use of transaction fees and rebates will result in less liquidity and transparency in trading activity, both of which are important to the capital markets activities of listed companies. While additional comment letters will likely not result in the transaction fee pilot being cancelled, we do believe that listed companies should share their concerns with the SEC. We recommend companies ask that they be excluded from the pilot so that the Commission takes these concerns into account when they decide on whether or not to adopt changes to the current policies governing transaction fees and rebates.

[1] Per SEC Press Release

Overview of the Current Rebate System and Economic Spreading

Presently, the maker-taker program offers rebates to firms that provide market liquidity (such as high frequency trading firms) and charge fees to those that remove liquidity from the market (such as institutional investors). The exchanges profit from the difference between the fees and the rebates.

As described by Credit Suisse (June 4, 2018), "Stock exchanges compete for order flow through their fee models; the traditional maker-taker model pays a rebate to the liquidity supplier and charges a fee to remove liquidity. Therefore, trading centers earn the difference between the fee charged and the rebate paid. In addition, maker-taker rebates widen the economic spread potentially realized by liquidity providers. For example, the full tick and rebate capture amounts to 1.6 cents in theory for a stock trading one tick/penny wide – meaning 37.5% of the profit is from rebates."

Concerns About the Impact of the Pilot

Critics, including the major exchanges, believe that the SEC pilot will interfere with displayed liquidity and stock spreads and ultimately harm investors.

1 Impairment on market quality

- Exchanges such as the NYSE and NASDAQ have voiced concerns that the proposed pilot will impair market quality. These impairment concerns focus on widening stock spreads, which add costs to companies and investors. They assert that the pilot will cause wider spreads for those chosen as test group participants, creating stark disadvantages for test group participants that are seen as less favorable to investors due to different transaction costs.

2 Conflicts of interests for broker-dealers

- The exchanges also have stated that broker-dealers, motivated to earn rebates, will steer trade to trading exchanges that may not be in the interest of their clients. Further, they say that rebate and fee caps will also cause a loss of revenue and elevated costs to broker-dealers.

3 Exchange and investor costs

- Critics argue that exchanges and investors will both bear costs from the transaction pilot. Exchanges will lose revenue due to caps on fees, as well as having to adhere to pilot data requirements. There will be increased investor costs when moving into and out of a pilot security. The NYSE estimates that the added burden on investors could exceed $1 billion. According to the exchange, "Reducing incentives to liquidity providers is straightforward: market makers will be willing to buy at slightly lower prices and sell at slightly higher prices. As a result, investors building a position in pilot securities will pay more and receive less when they exit."

4 Disadvantaged compared to alternative trading systems

- Exchanges will not be able to compete with alternative trading systems such as dark pools because they will not be able to use fees and rebates, which attract activity to their markets.
- Concerns continue to be voiced in comment letters submitted by companies and exchanges.

NYSE *Comment Letter (May 31, 2018)* - "The Proposal fundamentally undermines competition. First, the Proposal restricts one segment of the market—national securities exchanges—from offering order flow incentives, while permitting off-exchange venues, including alternative trading systems ("ATS"), to continue to offer such incentives. This differential treatment of market competitors would materially alter the competitive dynamic among equity trading platforms and irreparably undermine the ability of national securities exchanges to compete. Relatedly, the Proposal would also harm the ability of issuers whose securities are subject to access fee caps to compete with those issuers offering unrestricted securities."

NASDAQ *Comment Letter (May 25, 2018)* – "In this case, Nasdaq believes that the current Proposal will not help but will likely harm investors and issuers, the very groups the Commission is charged with protecting. Nasdaq respectfully submits that the Proposal is flawed in several meaningful ways:

- The record contains no evidence that any Pilot is justified.
- The Proposal lacks a solid foundation.
- The Proposal as designed will not achieve its stated goal.
- The Proposal undermines the public reference price.
- The Proposal is a risky market experiment with public companies and public investors.
- The Proposal imposes impermissible government rate-making.
- The Proposal violates the Exchange Act and the Administrative Procedure Act."

Apache *Comment Letter (June 7, 2018)* – "Apache objects to the possibility that its forced participation in the Pilot could result in its stock being less attractive to investors in a market that is supposed to provide for equal treatment."

Level Brands *Comment Letter (June 21, 2018)* – "We are concerned with the design of the program and are requesting that Level Brands, Inc (NYSE American: LEVB) be excluded from the pilot test groups."

Mastercard *Comment Letter (June 21, 2018)* – "We are concerned, however, (i) that the Pilot has the potential to increase transaction costs for our shareholders, (ii) that the currently proposed scope of the Pilot may be excessive, and (iii) that the Pilot could complicate peer group metrics commonly used to evaluate Mastercard's financial performance."

Johnson Controls International *Comment Letter (June 22, 2018)* – "Inclusion in a Pilot test group could also result in an artificial disparity between a company's stock price compared to those of its peers, which would have implications for how a company's financial performance is evaluated and perceived. Due to these concerns, we respectfully request that, in the event the Pilot is implemented over the objections previously registered with the SEC through the aforementioned comment letters, the ordinary shares of Johnson Controls International pie (NYSE: JCI) be excluded from each of the three test groups and instead be included within the control group."

Market Participants in Favor of the Pilot

Many large institutional investors have been supportive of the pilot because they see benefits in understanding the market impact of transaction fees and whether they create broker conflicts of interest in order routing.

Fidelity expressed its support to the proposed pilot, stating "We support the Commission's continuing efforts to evaluate the marketplace, and we look to the Commission to help promote market integrity, which in turn can bolster investor confidence."

Similarly, Blackrock added they "welcome a pilot program which studies the impact of transaction fees and rebates on market structure" and "believe that the overall structure of the pilot will be effective at yielding relevant insights regarding the influence of transaction fees on the market."

Ontario Teachers' Pension Plan and the California Public Employees' Retirement System noted that they "applaud the Commission for acknowledging this conflict and proposing the Pilot as a necessary and appropriate step to study the effects that these incentives have on broker order routing, execution quality, and market quality overall."

For Invesco, "the data to be obtained by the Proposal will enable the Commission to identify any conflicts of interest and imbalances inherent in the current market structure and to propose new regulations to reduce or eliminate their effects."

Other institutional investors, including State Street, have recommended modifications to the proposed pilot. On May 25, 2018, State Street noted, "While we support the concept of the pilot broadly, we believe the Commission and marketplace would benefit from more clear definition of the measurement criteria for the pilot. We also believe the pilot may present certain risks, some of which could be mitigated in the design of the pilot. We recommend several modifications to the proposal in an effort to protect investors including: reducing the number of securities in the pilot; excluding exchange-traded products ("ETPs") from the pilot; and including early termination criteria for the pilot."

Bryan Armstrong, CFA
Senior Managing Director
Americas Head of Capital Markets Communications

Mateo Millett
Senior Managing Director
Americas Head of Industrials
Strategic Communications

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