1401 H Street, NW, Washington, DC 20005-2148, USA
202/326-5800 www.ici.org

January 20, 2016

SEC Equity Market Structure Advisory Committee
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Re: *Pilot Program on Maker-Taker Fee Model (File No. 265-29)*

Dear Committee Members:

The Investment Company Institute ("ICI")[1] appreciates the opportunity to provide its views to the Equity Market Structure Advisory Committee ("Committee") of the Securities and Exchange Commission ("SEC" or "Commission") on the "maker-taker" fee model commonly used in the U.S. equity markets. ICI members engage in the markets on behalf of scores of millions of retail investors. To provide long-term benefits to their investors, our members have a compelling interest in ensuring that regulations governing the operation of U.S. equity markets promote fairness, efficiency and competition. ICI believes that the maker-taker fee model that exists in today's markets reduces price transparency, impairs the quality of execution of fund orders and needlessly increases market complexity.

We urge the Committee to recommend to the Commission that it promptly implement a tailored pilot program to determine whether investors would benefit, as we believe they will, from a market structure that removes the incentives of brokers to route orders based on the levels of fees charged and rebates offered by trading venues. Section I of this letter describes the evolution of the maker-taker fee model and explains why access fees and liquidity rebates have become controversial aspects of equity market structure. Section II explains the potential harms that access fees and liquidity rebates pose to funds and their investors, and Section III sets out the details of a pilot program that would assess how the maker-taker fee model affects trading in the most highly liquid stocks.

---

[1] ICI is a leading, global association of regulated funds, including mutual funds, exchange-traded funds, closed-end funds, and unit investment trusts in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's U.S. fund members manage total assets of $17.9 trillion and serve more than 90 million U.S. shareholders.

I. History of Access Fees and Liquidity Rebates

The maker-taker fee model refers to the practice, employed by exchanges and other equity trading venues, of charging fees to participants that remove liquidity (*i.e.*, "takers") from the market while paying rebates to those participants that add liquidity (*i.e.*, "makers"). Fees to take liquidity, "access fees," and liquidity rebates became a prominent feature of the equity markets as a result of the business practices of electronic communications networks ("ECNs") and Nasdaq. At the time the Commission incorporated ECN orders into the public quotation system, ECNs and Nasdaq competed vigorously with each other for order flow. To attract liquidity onto their limit order books, ECNs and Nasdaq began offering liquidity rebates to reward market participants for submitting "resting" limit orders that gave depth to the trading book. These venues also imposed a per-share access fee on incoming marketable orders that removed liquidity from the order book by executing against the resting limit orders. These access fees acted as a subsidy to subscribers that placed standing limit orders on an ECN's book because non-subscribers could remove liquidity, and pay the associated fee, but could not place orders on an ECN's book and therefore could not receive rebates. The use of liquidity rebates moved quickly to marketplaces other than Nasdaq and ECNs, as exchanges and other execution venues began using variations of this pricing methodology in an attempt either to gain order flow through attractive pricing arrangements or to incent the routing of certain types of orders.

When the Commission proposed Regulation NMS, it considered a variety of mechanisms to address the impact of access fees and liquidity rebates on order routing practices. Ultimately, the Commission capped access fees at what it believed was a *de minimis* amount – $0.003 per share for securities quoted at $1.00 or more.[2] The SEC believed the $0.003 per share cap on access fees would, among other things, enhance the integrity of Regulation NMS by ensuring that trading venues could not charge substantial fees for accessing protected quotations. Regulation NMS did not expressly eliminate or limit liquidity rebates but, in practice, the access fee cap has limited the size of liquidity rebates because execution venues typically use the fees collected on one side of a transaction to fund the rebates paid on the other side. The difference between the fee collected and the rebate paid equals the revenue earned by a venue on a transaction – typically not more than $0.001 per share.[3] If a trading venue offered a rebate that exceeded the fee, its trading operations would generate losses, rather than gains, on nearly every transaction.

The maker-taker fee model and $0.003 per share cap on access fees have become controversial features of equity market structure for a variety of reasons. First, access fees and liquidity rebates

---

[2] 17 C.F.R. § 242.610(c). This rule also limits fees to 0.3% or less of the price per share for securities quoted at less than $1.00.

[3] *See* Memorandum to SEC Market Structure Advisory Committee, from SEC Division of Trading and Markets, dated October 20, 2015 at 21, *available at* http://www.sec.gov/spotlight/emsac/memo-maker-taker-fees-on-equities-exchanges.pdf.

diminish price transparency because quoted prices – and prices included on trade reports – do not include fee or rebate information and therefore do not fully reflect net trading prices. Second, trading commissions have decreased dramatically since the SEC adopted Regulation NMS in 2005, making the $0.003 per share cap on fees more than a *de minimis* component of trading costs today. Third, the maker-taker fee model may create a conflict of interest for brokers that have a legal duty to seek best execution of their customers' orders because the practice of charging fees only on orders that remove liquidity and paying rebates for orders that provide liquidity creates incentives for brokers to route orders in a way that maximizes rebates earned and minimizes fees paid. Finally, exchange fees and liquidity rebates have contributed to increased market complexity and fragmentation. Each of the consequences of access fees and liquidity rebates negatively affects funds and their millions of investors as discussed in more detail below.

II. Access Fees and Liquidity Rebates Have Great Potential to Harm Funds and Retail Investors

ICI believes that access fees and liquidity rebates may harm registered funds and their investors primarily in three ways. First, these fees and rebates reduce market transparency and impair the ability of funds to evaluate the quality of the executions they receive. Second, access fees and liquidity rebates may reduce the likelihood of a fund's orders receiving best execution, taking into account price and other factors, including timeliness of execution. Third, access fees and liquidity rebates increase market complexity to the detriment of funds and their investors. We discuss each of these concerns in turn below.

A. Access Fees and Liquidity Rebates Reduce Price Transparency

Access fees and liquidity rebates undermine price transparency by masking the true economic price of quotes and executed transactions. SEC rules generally require markets to display, rank, and accept bids and offers in whole penny increments, but factoring access fees and liquidity rebates into quoted prices causes the true economic costs of trading to be measured in subpennies. These invisible subpenny spreads complicate funds' ability to evaluate execution quality because brokers are not required to report the size of any fee charged or rebate provided by a trading venue for a particular order. This lack of transparency and added complexity in determining the true cost of execution make it difficult for funds, and particularly smaller funds, to evaluate the quality of the executions they receive.[4] Access fees and liquidity rebates obfuscate prices to the point where only significant effort,

[4] Funds receive a range of information from their brokers regarding the routing of their equity market orders, the potential conflicts of interest brokers face, and the execution quality provided by different brokers and trading venues. These reports, however, are not presented in a uniform manner that allows for easy comparison across different brokers. ICI, together with other trade associations for the securities industry, has recommended that the Commission adopt a rule that would require broker-dealers to provide to institutional investors at regular intervals certain standardized disclosure regarding order routing and execution quality information. *See* Letter from Dorothy M. Donhue, Deputy General Counsel, ICI, Stuart J. Kaswell, Executive Vice President & Managing Director, General Counsel, Managed Funds Association, and Randy Snook, Executive Vice President, Securities Industry and Financial Markets Association, to Mary Jo White, Chair, SEC, dated

time and investment in sophisticated and expensive technologies can decipher the quality of executions. We do not believe such a system is beneficial for funds as investors, much less for their millions of underlying retail shareholders.

Market structure should facilitate investors' ability to evaluate the quality of executions they receive from their brokers. Rules governing equity markets should enable investors to engage more effectively with brokers about the reasons for routing decisions, request that their orders not be routed to a particular venue, and assess the performance of their brokers. Reducing access fees and liquidity rebates could promote the development of this type of market structure by causing quotes and reported prices to more closely reflect actual net trading costs.

The benefits that would accrue to fund investors in a more transparent market far outweigh the costs that some believe might result from eliminating the maker-taker fee model. A number of commenters have noted that access fees and liquidity rebates have narrowed spreads in the equity markets by providing incentives for posting liquidity.[5] We believe other changes to market structure, including decimalization, also have contributed to narrower spreads.[6] Moreover, the pilot program that we outline below would provide data that would allow the Commission and others to assess the effect of access fees and liquidity rebates. The Commission could use this data to great effect in considering the benefits and costs of increased equity market transparency.

B. Access Fees and Liquidity Rebates May Interfere with Funds' Execution Quality and Compromise Broker-Dealers' Best Execution Obligation

Funds rely on brokers to execute orders on their behalf, but access fees and liquidity rebates present potential conflicts of interest that could influence the order routing practices of these intermediaries. We are concerned, for example, that brokers may prefer to post a fund's limit orders on the market or markets that offer the highest rebates for providing liquidity – or, for market orders, route to the market(s) that charge the lowest fee to take liquidity – even though a different market might offer the best possibility of an execution for those orders. Such practices could harm funds and their investors by increasing the likelihood that a fund's limit orders will be executed only when prices are moving against the fund and by creating unfavorable signaling that would make fund market orders vulnerable to latency arbitrage trading strategies.

October 23, 2014, *available at* https://www.ici.org/pdf/28480.pdf. We continue to believe that such a rule would improve funds' ability to assess execution quality and urge the Commission to propose the rule as quickly as possible.

[5] *See e.g.*, Larry Harris, "Maker-Taker Pricing Effects on Market Quotations," at 1 (Nov. 14, 2013), *available at* http://bschool.huji.ac.il/.upload/hujibusiness/Maker-taker.pdf.

[6] *See* Remarks of Matt Lyons, Senior Vice President & Global Trading Manager, the Capital Group, at the October 27, 2015 Meeting of the Equity Market Structure Advisory Committee, *available at* http://www.sec.gov/news/otherwebcasts/2015/equity-market-structure-advisory-committee-102715.shtml.

The Commission could promote a more fair equity market structure for investors by eliminating brokers' incentives to route orders in a manner designed to avoid fees or capture rebates. As discussed in Section III below, the Commission should evaluate for highly liquid stocks whether significantly reducing access fees and eliminating rebates would mitigate this potential conflict of interest. Under such a market structure, brokers would have greater incentives to route fund orders to the markets that could offer the best execution, which certainly would benefit funds and their shareholders.

C. Access Fees and Liquidity Rebates Increase Market Complexity

The maker-taker fee model has contributed to the development of a market structure that is needlessly complex. We believe that trading venues should compete on the basis of innovation, differentiation of services, and ultimately on the value their model of trading presents to investors, not on the amount of money rebated to market participants. Unfortunately, the maker-taker fee model drives access fees toward the maximum allowed, incents the development of complex order types designed to exploit current fee schedules, and spurs the proliferation of new venues designed to enable certain market participants to avoid fees and maximize rebates at the expense of funds and their investors.

Equity market venues use fees and rebates to compete with one another for order flow. The competition for order flow encourages trading venues to offer the largest liquidity rebates possible, which drives fees toward the $0.003 per share maximum. Although execution venues retain only a small portion of the fees that they collect, they modify pricing frequently to attempt to gain more order flow and optimize trading revenue. The frequent changes to fee schedules add complexity to the marketplace as market participants must adjust their order routing methodology with each fee change.

Execution venues also compete for order flow by developing new order types designed specifically to allow certain classes of market participants to avoid fees or harvest rebates. These varied order types often interact with other order types in nuanced ways that can make it difficult for market participants to understand fully the operation of a particular market. The competition for order flow also encourages the creation of new venues that are developed primarily to offer pricing structures to attract orders from specific types of market participants or trading strategies. These new venues further increase market complexity and fragmentation without providing real/intrinsic value or innovative services.

Reducing access fees and liquidity rebates may lower costs to funds and their investors by encouraging markets to adopt more stable pricing regimes and slow or halt the proliferation of new order types and venues created only to take advantage of this unnecessarily complex and convoluted market structure. Moreover, a market structure that provides a lower-cost access fee also would reduce current incentives to route orders to "dark" venues that charge lower fees than exchanges. In turn, order flow to "lit" markets should increase.

III. The SEC Should Study the Impact of Access Fees and Liquidity Rebates through a Pilot Program

Consistent with Chair White's remarks at the October 27, 2015 meeting of the Equity Market Structure Advisory Committee, the Committee should urge the Commission to conduct a carefully tailored pilot program to study how modifications to the maker-taker fee model would affect equity market structure.[7] An SEC-mandated pilot program would provide market-wide data regarding the effects of access fees on order routing behavior, price transparency, and market fragmentation. In the absence of a pilot program, trading venues that voluntarily (or unilaterally) reduce access fees or rebates risk losing market share to those that offer generous rebates financed by high fees.[8]

ICI believes that a general consensus exists among market participants that the current form of the maker-taker fee model negatively impacts equity market structure. Accordingly, we urge the Committee to recommend that the Commission move forward quickly with a two-step pilot program designed to evaluate how access fees and liquidity rebates affect investors, including funds and fund shareholders. The pilot program should aim to evaluate whether funds and other investors would benefit from a market structure that significantly reduces the incentives of brokers to route orders based on the levels of fees and rebates. Although we recognize there are various interrelated market structure issues that should be considered carefully to avoid unintended consequences, these matters should not derail or unduly delay the Commission's efforts in this area. A discrete, well-designed pilot program would provide valuable data that would allow the Commission to advance its market structure priorities and bring real benefits to investors. After analyzing the data gathered during the pilot period, the Commission could determine whether additional refinements to the maker-taker fee model would enhance market structure.

We submit that an effective pilot program should include the following attributes:

- **Pilot securities should be highly liquid.** The pilot should consist of one control group and a test group of 50-60 randomly selected highly liquid stocks, as measured by

---

[7] *See* Opening Remarks of Chair Mary Jo White, SEC, at the October 27, 2015 Meeting of the Equity Market Structure Advisory Committee, *available at* http://www.sec.gov/news/statement/chair-white-emsac-10-2015.html ("A pilot to study [the maker-taker fee model and the conflicts presented by this model] has been suggested and should be seriously considered.").

[8] On February 2, 2015, Nasdaq implemented an "access fee experiment" that reduced access fees to $0.0005 per share and liquidity rebates to $0.0004 per share for 14 pilot stocks. Nasdaq found that its market share declined in most of the stocks included in the experiment. Nasdaq's displayed liquidity also declined in most, but not all of the experiment stocks. *See* Frank Hatheway, "Nasdaq Access Fee Experiment," at 1 (March 2015), *available at* http://www.nasdaqomx.com/digitalAssets/97/97754_nasdaq-access-fee-experiment---first-report.pdf.

average daily trading volume, during the 52-week period prior to the start of the pilot.[9] The pilot should include only NMS securities that are common stocks of operating companies – not exchange-traded funds, closed-end funds or other types of securities – and issuers should not be given the option of opting out of the pilot.

- **Reduce access fees and then eliminate liquidity rebates for highly liquid stocks.** The first phase of the pilot would involve reducing the cap on access fees. When the SEC adopted the access fee cap 10 years ago, it determined that a $0.003 per share cap on access fees was *de minimis*. There is a broad consensus among market participants that this decade-old cap is too high for today's market structure and we believe, at a minimum, the Commission needs to reevaluate this amount. We recommend that the Commission limit access fees for pilot securities to no more than $0.0005 per share on liquidity providing and liquidity removing trades. Fees at this level would be *de minimis* in today's market structure as the Commission intended in adopting Regulation NMS in 2005. The second phase of the pilot, which would begin six months after the first phase, should eliminate the payment of liquidity rebates for pilot securities to provide data to determine whether these payments influence order flow for such highly liquid securities. We believe rebates are not necessary to incentivize liquidity providers for these types of stocks.[10]

- **Adequate duration.** The Commission should ensure that the pilot program runs long enough to generate sufficient data to analyze reliably the effects and impact of access fees and liquidity rebates on the market and investors. We believe a one-year pilot period would be long enough for the Commission to gather this data but would support a longer period if the second phase of the pilot on rebates starts six months after the first phase.[11] We recommend that the Commission engage in a proactive, ongoing review of the data gathered during the pilot period to evaluate whether any modifications to the pilot are necessary.

[9] An examination of the most-actively traded stocks over the 52 week period ending November 20, 2015, showed nearly 100 stocks that each traded in excess of 9 million shares per day on average and more than 250 stocks that each traded in excess of 4 million shares per day on average.

[10] If the SEC decides to restrict the payment of liquidity rebates on a permanent basis as a result of the pilot, the restriction should be limited to the most highly liquid stocks. The results of the pilot program should not be applied to other, untested, less liquid groups of securities.

[11] We note that the Commission has determined that a one-year pilot period would afford the Commission adequate opportunity to monitor the impact of a tick-size pilot on investors and the market. Securities Exchange Act Release No. 72460 (June 24, 2014) (directing stock exchanges and the Financial Industry Regulatory Authority to submit a tick size pilot plan).

- **Criteria to evaluate the pilot.** We strongly recommend that the Commission propose the criteria that it will use to evaluate the pilot's impacts on investors and the market and solicit comment on these criteria before commencing the fee pilot. We suggest that, at a minimum, the Commission assess the pilot's impact on trading costs – including spreads – displayed liquidity, depth of book, fill rates for passive orders, the percentage of buy orders executed at near, far, and mid-market prices on a market-wide and venue-by-venue basis, adverse selection of passive orders, volume, choice of trading venue, and intraday volatility of pilot securities.

- **Buy-side participation.** The Commission should provide a meaningful opportunity for buy-side involvement in the design, operation, and evaluation of the pilot. For example, if the Commission uses an NMS plan to implement the pilot, a broad range of market participants, including funds and their managers, should participate in the administration of the plan.

* * *

ICI appreciates the opportunity to provide our views on how access fees and liquidity rebates can harm funds and their investors. We strongly urge the Committee to recommend that the Commission implement a pilot program to study how reducing access fees and eliminating rebates for highly liquid stocks affects market structure. If you have any questions on our comment letter, please feel free to contact the undersigned at (202) 326-5815 or david.blass@ici.org or Jennifer Choi, Associate General Counsel, at (202) 326-5876 or jennifer.choi@ici.org.

Sincerely,

/s/ David W. Blass

David W. Blass
General Counsel

cc: The Honorable Mary Jo White
The Honorable Kara M. Stein
The Honorable Michael S. Piwowar

Stephen Luparello, Director, Division of Trading and Markets
Gary Goldsholle, Deputy Director, Division of Trading and Markets
David Shillman, Associate Director, Division of Trading and Markets

Mark Flannery, Director and Chief Economist, Division of Economic and Risk Analysis