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Via Email
May 18, 2018
Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090
Re: File Number S7-05-18: Transaction Fee Pilot for NMS Stocks

Dear Mr. Fields,

Thank you for the opportunity to comment on the proposed transaction fee pilot on behalf of Magma Trading. Magma Trading operates Magma ATS through its affiliated broker-dealer Tor Brokerage.

Background Information

When the Commission passed Regulation NMS, the selection of a $0.003 cap on fees under Rule 610(c) was made based on several factors. Among the factors was that the mandate of the trade-through rule, Rule 611, required access of liquidity from every protected venue, and the development of a true national market system would require no outliers in pricing that might be seen as gouging liquidity takers. The determination also was made on the assumption that a $0.003 level of pricing was seen as a "de minimis" level of access fee.

Since the passage of Regulation NMS, several exchanges have been consolidated into what are now essentially three exchange families. In addition, the number of firms acting as market makers and virtual (proprietary, non-broker) market makers has declined precipitously. We view this consolidation as typical of a mature industry with low margins. Despite the consolidation, there are still calls by many market participants for a lower fee cap and by some for the elimination of rebates.

Implications of the Proposed Transaction Fee Pilot

We believe that the proposed pilot will have several implications. The question for the Commission is whether or not these implications will be good for the long-term health of the market and good overall for investors.

It is no surprise that agency broker-dealers, who typically pay transaction fees, generally would like to see lower fees. There are several participants who feel that the reduction in transaction fees and elimination of rebates will somehow improve markets overall. We respectfully disagree on both fronts. We believe that lower fees and the elimination of rebates could result in wider overall bid/ask spreads and lower involvement at exchanges by market makers, who we feel are extremely important to the overall health and liquidity of the market. As the Commission asked about rebates in (SEC 34-61358), "Do they generally benefit long-term investors by promoting narrower spreads and more immediately accessible liquidity?" We believe that the answer is yes.

Agency brokers are in a difficult structural position; they have a natural conflict because they typically do not pass along transaction fees to their clients. The conflict will not be alleviated unless the beneficiary of execution quality, the brokers' client, also incurs the transaction cost. Agency brokers are required to focus on best execution, but their trade profitability depends on execution cost. It is certainly understandable that they would want the lowest cost, while the Commission must be more concerned with the overall effects on investors, including the health of and liquidity in the market.

Our estimates of the institutional market are that more than 95% of all trades involve the interaction of market makers in providing liquidity. Our belief is that the larger the institutional trade size and the greater the urgency of the trade, the less likely the possibility of "natural" liquidity showing up on the opposite side. We believe that the imposition on the market of algorithms to slice up institutional trades is the result of a market structure that has spurned market makers and their ability to provide temporal liquidity to the markets.

Lowering of transaction fees would have a pronounced effect on exchanges and other venues. The effect on venues will not be uniform; restricting top-line revenues to venues tends to hurt smaller exchanges and ATSs disproportionately. Large exchanges have diversified revenues away from transaction fees, which can be more visible to regulators and exchange members.

Lowering of transaction fees and rebates will tend to make the various venues more uniform in their pricing. We believe that different models provide innovation and distinction for the flow they attract. A loss of pricing freedom restricts the ability of venues to attract flow and tends to hurt smaller venues disproportionately. Investors may be harmed if all visible trading is directed to a triopoly of exchanges. Similarly, restricting exchanges' ability to attract market makers through rebates may drive more flow to dark venues and away from exchanges in general. The Commission should consider whether price discovery would be impacted from such a move.

Restricting exchange transaction fees also has implications beyond the exchanges. Independent venues must compete with exchanges and brokers for order flow. Without the ability to charge market data fees or technology fees, these venues are more dependent on transaction fee revenue to survive. If their models are good for investors, they can survive, but statutory reduction of fees disproportionately harms these firms and thus the investors who may benefit from innovation. We believe that innovation in any industry is important; for example, new entrants to the equity markets in the late 1990s and early 2000s dramatically increased liquidity and reduced both explicit and implicit costs for all investors.

Perhaps it would be wise to consider the overall level of fees and rebates relative to transaction volume. Are rebates, for example, still at a de minimis level relative to market size? A rough estimate of rebates per year is $2.5 billion; this compares with a rough estimate of the transaction volume in the US market of $50 trillion. The ratio of 0.00005, or about 1/200th of 1 percent strikes us as extremely low. Perhaps that very low transaction cost for equities is the reason that so many market makers and exchanges have either gone out of business or been consolidated. What is the "right" size of transaction cost to benefit the overall market? That is of course a decision that the transaction fee pilot is designed to address. Everyone may want to pay lower taxes, but at some point, there can be long-term implications that are much more important.

Some have questioned whether rebates should be allowed at exchanges. We do not have a problem with exchanges offering rebates to attract liquidity. While some people have characterized rebates as payment for order flow, we believe that rebates may be viewed instead as a payment in exchange for posters of liquidity giving up several valuable options. For one, the poster exposes an intention to buy or sell, whereas a taker of liquidity only exposes intentions on execution. For another, the poster of liquidity gives up the power to decide the time of the trade, whereas the takers of liquidity can execute at their discretion. This option is particularly valuable when several trades take place at once, either a sweep of liquidity in a stock or a trade that encompasses several stocks at once. In exchange for the risk of getting run over and/or being executed on multiple names at once, a rebate may offset the risk and make it more attractive to post. This risk of adverse selection is very real, and partly as a result, we have seen average trade sizes decline to under 200 shares at many venues. Since a market requires both posters and takers of liquidity, it seems reasonable to offer some reward in exchange for the risks of posting liquidity.

Some have questioned whether the pilot is too broad in its scope. A "pilot" is sometimes defined as "an experiment or test before introducing something more widely." With most of Reg NMS trading centered around 7,000 names, is a 1-2 year pilot that changes fees on 3,000 names really a "pilot" or in fact a de facto imposition of a significant reduction of transaction fees? In general, we believe that a much smaller and shorter pilot would still yield enough information for the Commission to gauge the benefits and costs associated with lower fees.

Some people have questioned whether the Commission should be involved at all in setting transaction fees. After all, would the Commission consider setting maximum commissions for broker-dealers to charge their clients? We feel that the Commission, given its mandate to operate a national market system, is certainly within its rights to set maximum transaction fees. However, we believe that allowing some flexibility for venues to market to specific types of flow is healthy for innovation in the markets. As long as the fees are at de minimis levels, we believe that different pricing models should be allowed.

We believe that a properly structured pilot will yield valuable information about the health of the market. In addition, there is already significant information about changes in rebate models and changing fee models by various venues over the past ten years. For example, we believe that studies have already demonstrated that removing rebates hurts overall liquidity in the market. We believe that a properly structured pilot, together with information from previous studies, will help the Commission to determine the effect of transaction fee changes. Our belief is that by building a national market system that supports market making, the Commission can improve overall liquidity in a way that benefits all investors, both in the short term and the long term.

These ideas are meant to be items for future discussion. By opening discussion on various possibilities, the Commission may work with all market participants to build a vibrant market to support both retail and institutional investors. We look forward to working with others in the market to build better liquidity to serve the investor community.

Sincerely,

George Hessler
CEO
Magma Trading