John Ramsay tackles exchange fees in part 2 of his breakdown of the SEC's recent market structure proposals

Introduction

In our [recent post](), we began our review of the SEC's proposed changes to Regulation NMS,1

the comprehensive set of rules adopted for U.S. equities in 2005.2

That post looked at changes to the one cent minimum "tick size" that affects how markets can rank and display orders, in light of the dramatic market changes that have occurred since 2005.

In this post, we look at the proposal to change the cap on fees that exchanges can charge participants to access their displayed quotes. On this topic, too, it is helpful to look at market realities and changes since 2005. Consider these points:

-As we noted in the last post, U.S. equities market volume has tripled in the interim.

-There have been enormous advances in technology efficiencies. One interesting factoid: the average price for a laptop computer in October 2005 was $1,081.3

Today, laptops with more functions are available at a fraction of that price, notwithstanding general price inflation.

-Another consideration is the nature of the exchange business. IEX has previously detailed how exchanges can reap huge scaling benefits in offering their products and services.4

Taken together, these factors reasonably call into question whether the fee limit set 18 years ago makes sense today.

Another big trend is the proliferation of highly complicated fees and rebate "tiers" tied to trading volume of individual firms. The SEC is also seeking to rationalize the way that those fees are set, and we provide the details and context for that proposal as well.

What Rules Apply Today

Rule 610 sets a cap on the amount that exchanges can charge participants to access their displayed quotes at $0.003 per share (or $0.30 for a standard 100-share "round lot"), sometimes referred to as "30 mils" (throughout this post, one mil equals one-hundredth of a cent per share). This cap was set in connection with the adoption at the same time of a "protected quote" status for electronic quotations displayed by exchanges. The protected quote rule bars market centers, including exchanges, alternative trading systems ("ATSs"), and market makers, from trading a stock at a price worse than that of a protected quote, unless the market center first executes against that quote. The rule against "trading through" protected quotes was meant to incentivize the use of electronic quotations on exchanges and ensure that investors could get access to the best displayed prices anywhere in the market.

The SEC explained that it wanted to prevent an exchange from taking advantage of this new trade-through requirement by charging excessive access fees as a kind of "toll" to access protected quotes. The Commission said it meant to bar an exchange from using its regulatory status to charge excessive access fees and then rebate most of those fees to liquidity providers who post displayed quotes. As discussed below, this outcome arguably has come about despite (or perhaps because of) the 30-mil standard, which was selected because it was in the range of the highest access fees that were being charged when the rule was adopted.5

There are no other specific limits on transaction fees exchanges can charge, or rebates that they can pay to those who supply quotes. Exchanges must make filings describing their fee schedules, although a legislative carve-out allows fee filings to be made "immediately effective," without prior SEC approval. The Commission has a window of time to disapprove fees that have been put into effect if it determines they have not been well-justified, but this after-the-fact process can be difficult and time-consuming.

What Has Changed?

Two main trends are worth noting. First, as noted above, since 2005, there have been enormous advances in technology and efficiencies that have reduced the cost of processing data and transactions. In contrast, the 30 mils allowed by the rule has become less of a cap than the standard rate charged by all of the highest volume exchanges. By comparison, ATSs typically charge access fees around or less than 10 mils, one-third as much. As a result, orders posted on exchanges are relatively expensive for investors and others to access compared to alternatives. This discordance between the price to access liquidity on exchanges compared to other platforms has led many in the industry to call for a change in the cap, and even an executive for one of the large exchange companies proposed in 2018 to test reducing the cap by two-thirds.6

Second, exchange fees have become progressively more complicated and abstruse, with a multitude of fee and rebate "tiers." A widely cited study in 2018 by RBC Capital Markets identified over 1,000 possible pricing "paths" across all the exchanges that then existed (there are more today), driven by over 3,700 pricing variables. The number of variations also speaks to how targeted exchange pricing can be, with the best pricing tiers being sometimes offered on a bespoke basis.7

Although there is no transparency on how many firms may qualify for a given tier, as one indication of the skew, one exchange executive suggested at a public meeting in 2018 that credits to five of its top trading firms exceeded all the fees of any type they paid, resulting in a net payout each month to those firms.8

The fee and rebate tiers are often set based on volume thresholds – typically measured as the total volume of trading by a firm on a particular exchange during a month as a portion of the total consolidated volume by all firms on all markets in the same month. One result of this structure is that the top rebate tiers require a level of trading that may only be achievable by a small number of firms. Another is that the amount of the rebate benefit that accrues to a particular trade cannot be determined at the time the trade occurs because the tier level is not determined until month-end.9

Access fees and rebates are closely connected because exchanges use access fee revenue to fund the rebate payouts. They set their fee schedule to achieve a "net capture" (access fees minus rebates), which amounts to a small portion of the fees they take in. The SEC estimated that the average net capture of revenue related to non-auction trading is about 2 mils per share and concluded that the main reason access fees are pegged at 30 mils on most exchanges is to fund rebates.10

Exchanges using this "maker-taker" model rely more heavily on revenue from the sale of technology and data products than from net transaction revenue. IEX is distinct from other exchanges in adopting an "agency" model that seeks to provide superior execution, does not use rebates, and generally charges fees to both parties to a trade, but at rates lower than the access fees charged by the large maker-taker exchanges.

What Did the SEC Propose and Why?

Access Fee Cap

As detailed in our last post, the Commission proposed to create four new tick sizes, ranging from one-tenth of a cent up to a full cent, specifically, at $0.001, $0.002, $0.005, and $0.01. The tick size in each tier would be tied to a stock's average bid-offer spread, with the tier allocations reset each quarter. The SEC proposed to reduce the access fee limit from 30 to 10 mils for all stocks other than those assigned the narrowest, one-tenth of a cent, tick. For those symbols, the access fee cap would be reduced to 5 mils, $0.0005 per share.11

The SEC explained that the lower cap for stocks with the narrowest increment was meant to avoid having an access fee that would represent more than half of the minimum tick size, which could result in "unintended distortions."12

Tick size and access fees are related to some extent, since the same access fee applied to a narrower tick increment represents a larger share of the spread and stock price. But the SEC made clear that it believed picking the right access fee cap involves factors other than tick size, including:

-The need to align pricing with current transaction costs, reflecting the changes noted above.

-Keeping the rate consistent to avoid creating too much complexity.

-Helping to address concerns about the rebate system. In other words, because high access fees are used to fund rebate payments, reducing the size of the first element necessarily reduces reliance on the other.

-Maintaining the ability of an exchange, like IEX, to use an agency exchange model. In this regard, reducing access fees below 10 mils could preserve an exchange's ability to use the maker-taker business model but severely undercut the ability to depart from it.

Making Fees and Rebates Transparent

Separate from the fee cap, the Commission also proposed a new mandate for fee transparency. Specifically, it proposed to prevent exchanges from setting fee schedules such that the fee or rebate applied to a given trade cannot be determined at the time of the trade. This approach would essentially require an exchange to use a prior month's volume in setting volume-based tier levels. One purpose is to create more transparency around fees and rebates in general. A related purpose is to facilitate the ability of investors to recover rebate benefits related to their individual trades, should they wish to do so.

Issues and Alternatives

Based on our own discussions with industry participants, we believe there is substantial support for a reduction in the access fee cap. As noted, one exchange executive previously has proposed to test a reduction in the access fee cap for all stocks to 10 mils. With this context, we think the question is likely not whether the fee cap will be cut, but by how much and how broadly the lower limit will be applied. The SEC outlined various possible alternatives in its proposal. The following are two that seem likely to draw significant interest.

Single Cap Alternative

The access fee cap could be set at a lower, single cap of $0.001 per share (10 mils) for all equities priced over $1.00 per share. This is very close to the SEC proposal, except for the exclusion of the lower, 5-mil access fee cap it added to accommodate its lowest proposed tick increment. Recall that the Commission determined that the size of the maximum access fee should not exceed half of the tick increment. For that reason, the SEC acknowledged that a single 10-mil fee cap would not work in tandem with a 10-mil tick but could work with others. For example, when applied to a $0.005 tick, the $0.001 access fee would represent only one-fifth the tick size (in comparison, the existing 30 mil standard represents almost one-third of the one cent tick size).

The potential benefits of this alternative include relative simplicity and allowing exchanges to keep the basic structure of their existing fee model, while reducing the distorting effects of rebates. It would also substantially reduce costs for investors to access exchange quotes without eliminating the ability of an exchange to adopt an agency business model.

Multiple Caps Proportional to Tick Size

The current access fee cap of 0.3 cents per share is 30% of the one cent tick size. This alternative would maintain this same proportion for any new tick size. Under the SEC's four-tier tick proposal, this would translate to four different access fee caps, ranging from 30 to 3 mils. If the SEC chose to adopt a two-tick regime, at a half-cent and one cent, applying this alternative would result in a cap of 15 mils for the half-cent cohort and no change to the existing cap for the one cent stocks.

This alternative would align access fees and tick size in a more nuanced way, but it would be more complicated than the single cap alternative and could seem to deviate from the SEC's original basis for adopting a cap – placing an upper limit on what "outlier" exchanges can be allowed to charge for access to their quotes. It also would provide more room for rebates than a single 10-mil cap. For that reason, those who want to see the influence of rebates reduced may find it less appealing.

Conclusion

In the case of tick and trade increment proposals covered last week, the SEC said it was seeking to level the playing field among trading venues and increase the level of displayed liquidity in the markets. The proposals to reduce access fees and change the way that fee tiers are calculated are in some ways complementary, if not quite a quid pro quo. The SEC seems to be saying: exchanges need to be able to better compete, but the cap should be updated, and fee structures need to be rationalized to recognize the unique role they play as public markets that are accessible to all.

The third part of the story is about the prices that exchanges send out. The question posed is, when an exchange displays its "best prices," do they truly represent the best prices available? That is the question we will tackle in the final installment. Stay tuned!

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[1] See Securities Exchange Act Release No. 96494, 87 FR 80266 (December 29, 2022) ("Proposing Release").

[2] See Securities Exchange Act Release No. 51808, 70 FR 37496 (June 29, 2005) ("Reg NMS Release").

[3] ZDNET (November 5, 2005), quoting NPD Group.

[4] IEX, "The Cost of Exchange Services" (January 2019), avail. at https://iextrading.com/docs/The%20Cost%20of%20Exchange%20Services.pdf.

[5] Reg NMS Release, 70 FR at 37545.

[6] Letter from Stacy Cunningham, President, NYSE, to Brent J. Fields, Secretary, SEC, dated October 2, 2018, avail. at https://www.sec.gov/comments/s7-05-18/s70518-4470779-175854.pdf.

[7] RBC Capital Markets, "Complexity of Exchange Pricing and Corresponding Challenges to Transparency and Routing" (October 2018), avail. at https://www.sec.gov/comments/s7-05-18/s70518-4527261-176048.pdf.

[8] SEC Roundtable on Market Data Products, Market Access Services, and Their Associated Fees (October 25, 2018), Transcript at 74-75, avail. at https://www.sec.gov/spotlight/equity-market-structure-roundtables/roundtable-market-data-market-access-102518-transcript.pdf.

[9] Proposing Release, 87 FR at 80269.

[10] Id. at 80312.

[11] This is the proposed regime for all stocks with a price at least at $1.00 per share. For protected quotes in stocks with lower prices, the fee cap would be adjusted to 0.05% of the quotation price per share from the current level of 0.3% of the quotation price.

[12] Proposing Release, 87 FR at 80290.