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Drop The Pilot

Regarding the Equity Market Structure Advisory Committee's recommendation for an Access Fee Pilot Program

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I can't say I was ever really a fan of Joan Armatrading, but her 1983 hit "Drop the Pilot" comes to mind following the Equity Market Structure Advisory Committee's (EMSAC) recommendation for an Access Fee Pilot Program.

Maker-taker pricing refers to the practice whereby exchanges charge customers an 'access fee' for removing liquidity and pay a rebate to customers who provide liquidity. Maker taker pricing was first developed in the late 1990's and championed by ECNs (whose quotes were not protected then) as a way to attract liquidity to their order book. Exchanges followed suit and the practice became ubiquitous by 2005 when Regulation NMS set access fee caps at 30 cents per hundred shares - implicitly constraining rebates also which would necessarily be less than that for exchange trading to be profitable.

The maker-taker system has been criticized for years for distorting the market by incentivizing broker routing strategies to preference rebates over best execution, giving rise to market making strategies that focus on capturing rebates over liquidity provision, and for driving certain types of trading into dark pools. So while I am glad that the topic is being seriously debated within the SEC, the way the proposed pilot is being constructed, it is likely to be a costly experiment that will do little to drive meaningful, positive reform of equities market structure. More specifically:

- The proposed pilot does not in fact address maker-taker pricing – the system whereby makers receive a rebate and takers pay a fee. According to the memorandum released by EMSAC the proposal will instead create four buckets of pilot securities with a different access fee cap applying to each bucket. There is no restriction on the rebate side of the equation, so maker-taker will continue to exist albeit in lesser magnitude. It will provide no information on liquidity provision or market quality in the absence of a bifurcated pricing regime. To test this I would have liked to see a bucket that included pilot securities where pricing was the same whether a trade was adding or removing liquidity.
- The cost will be significant. To implement the pilot exchanges will need to reprogram all their systems as will market participants who connect to them. Market makers, brokers and systems providers will need to update their smart order routers and all back office and admin tools. The amount of work required to implement a pricing change in the pilot buckets will be the same, if not more, than the cost of implementing a market-wide change.
- It is debatable the extent to which all market participants will decide to update their systems, drawing into question the validity of the data collected. Market makers and HFT will certainly re-program their systems, but many smaller brokers may feel the cost of making the change outweighs the benefits.
- The exchanges will fight this hard, as we are already beginning to see. Firstly they were excluded from

> the sub-committee that developed the proposed pilot. Secondly there is a proposed bucket with an access fee cap of $0.0002 which will make it extremely difficult for exchanges to make money in those securities (indeed there was discussion at the meeting yesterday of lowering it to zero). And thirdly, it does not include a trade-at bucket which exchanges have previously indicated they would like to see in return for maker-taker reform.

Now I realize that the proposed pilot was constructed to focus on access fees, because that is the mechanism available under Reg NMS; and I realize that the exchanges were invited to provide feedback to the sub-committee (but not be a member); and I realize that trade-at was left out because there is a trade-at component to the tick size pilot. However, implementing a pilot that will narrowly look at just one part of our controversial market structure will not result in any meaningful improvement.

To me, meaningful market structure reform means we need to look at all the inter-connected issues that are affecting equity market structure and address them together – a holistic approach some might say. We need to recognize that US equity markets contain many diverse participants with different needs and often opposing incentives. Everything needs to be on the table: maker-taker, trade-at, co-location, SIP feeds, market data, etc. To do that will require the SEC to answer some fundamental questions around the value of displayed liquidity and price discovery, how to regulate speed and how to ensure a level playing field with respect to market data. That level of change will take bold, decisive policy unlikely to come out of cross-sectional industry committees.
