To: Professor Howell E. Jackson
From: Christian Fernandez-Andes
Re: Transaction Fee Pilot Program Litigation – *New York Stock Exchange LLC v. SEC*, No. 19-1042 (D.C. Cir.)
Date: February 11, 2020

FACTUAL BACKGROUND

There are several ways that stock exchanges structure their transaction fees. The most predominant is the "maker-taker" model whereby the exchanges pay traders a rebate to post bids to buy securities or offers to sell, and subsequently charge them when said bids or offers are accepted.[1] This model helps attract order flow towards exchanges and away from "off-exchange" trading venues, which have increasingly diverted substantial order flow away from stock exchanges.[2] "Since 2005, the [SEC] has prohibited exchanges from imposing transaction fees in excess of $0.0030 per share for the execution of an order against a 'protected quotation.'"[3] "As a practical matter, however, exchanges [believe that they] are constrained from offering rebates in excess of $0.0030 per share in order to maintain net positive transaction revenues."[4] And, while some question the utility of the maker-taker model, "[the] debate over maker-taker pricing has been largely theoretical, with only a few empirical studies on the topic."[5]

On March 26, 2018 "the Commission published . . . a proposed rule to change the permissible fees and rebates applicable to exchange transactions in a subset of publicly traded securities in order to study the effects that transaction-based fees and rebates may have on, and the effects that changes on those fees and rebates may have on order routing behavior, execution

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[1] Opening Brief for Petitioners, at 7.
[2] *Id.*
[3] *Id.* at 9.
[4] *Id.*
[5] Opening Brief for Respondent Securities and Exchange Commission, at 10.

quality, and market quality more generally."[6] In said proposed rule,[7] "the Commission pointed to concerns raised by some . . . that the maker-taker model has the potential to create a conflict of interest for broker-dealers," since they are bound by the "best-execution" requirement.[8] The SEC speculated that "some broker-dealers may disregard that duty by making order-routing decisions based on which exchange will charge the lowest fee or pay the highest rebate."[9] However, "the Commission [also] acknowledged evidence showing that maker-taker models have [some] positive effect[s]," since they allow exchanges—which are highly regulated and required to have a certain level of transparency—to have a competitive advantage over non-exchange trading venues.[10] In order to deal with the potential effects of the maker-taker model, "the Commission proposed a 'pilot' program to facilitate analysis of the impact of fees and rebates on the equities exchanges broadly."[11]

After going through the notice-and-comment rulemaking procedures, the SEC adopted the transaction fee pilot program on December 19, 2018.[12] The rule attempts to provide data to this dilemma by having two randomly selected "test groups" of 730 stocks each be subject to different regulations regarding rebates and transaction fees.[13] Test Group 1 will have the transaction fee capped at only $0.0010,[14] while Test Group 2 will have rebates and transaction discounts disallowed totally.[15] "Only stocks with an average daily trading volume of 30,000 or more shares and with a share price of $2 or more that do not close below $1 per share during the Rule's pilot

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[6] Opening Brief for Petitioners, at 10.
[7] 83 Fed. Reg. at 13,008.
[8] Opening Brief for Petitioners, at 10.
[9] *Id.*
[10] *Id.* at 11.
[11] *Id.*
[12] *Id.*
[13] *Id.*
[14] *Id.*
[15] *Id.* at 12.

period are eligible for inclusion in the Test Groups."[16] The pilot period will last one year unless the Commission publishes notice that it will be extended for a subsequent year at the end of the first; it cannot last more than two years.[17] The rule also prescribes six-month pre- and post-pilot periods during which exchanges must publish "a monthly downloadable file containing sets of anonymized order routing data[,]"[18] including routing information for "liquidity-providing orders [as well as] liquidity-taking orders, both aggregated by day, security, and broker-dealer."[19] "The Commission determined that the Pilot was necessary because (i) competitive dynamics were insufficient to remedy any potential market distortions caused by maker-taker fee models . . . and (ii) existing and anticipated data sources were inadequate to meaningfully analyze the impact that exchange transaction fee-and-rebate pricing models have on order routing behavior, market and execution quality, and our market structure generally—issues about which academics and industry participants fundamentally disagree and that could have profound effects on the [National Market System]."[20] The New York Stock Exchange, Nasdaq, and Cboe brought this challenge in the D.C. Circuit seeking that the SEC's rule be set aside.

ARGUMENTS

I. WHETHER THE SEC EXCEEDED ITS AUTHORITY UNDER THE EXCHANGE ACT

The Exchanges first argue that the Commission exceeded its authority under the Securities Exchange Act of 1934 (the "Exchange Act") when "it promulgated the Rule[,] because the Commission did not find that the Rule's experimental fee cap and rebate prohibition will further

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[16] *Id.*
[17] *Id.*
[18] *Id.*
[19] *Id.*
[20] Opening Brief for Respondent Securities and Exchange Commission, at 10.

the objectives of the Exchange Act."[21] Specifically, the exchanges claim that this action exceeded statutory authority because "Congress has not authorized the Commission to promulgate regulatory requirements on an experimental basis for the purpose of gathering information about whether those new requirements are appropriate."[22] The Exchanges note that "[w]hen exercising [its general] rulemaking authority, the Commission is required to find that the rule is 'necessary or appropriate in the public interest,' that it will 'protect investors,' and that it will promote 'fair and orderly markets.'"[23] The Exchanges thus argue that "the Commission did not even purport to find that reducing exchange transaction fees to a maximum of $0.0010 and prohibiting rebates for a subset of stocks will further the public interest, the protection of investors, and fair and orderly markets."[24] Petitioners go on to assert that "the Commission repeatedly conceded that the standards imposed by the Rule could *harm* the securities market and investors, and that it is[, in part,] promulgating the Rule to determine whether those harms will in fact materialize."[25] Nonetheless, even though the Commission conceded that the fee pilot program could potentially have adverse consequences, the SEC justified its decision based on its desire to obtain useful information that could shed light on the extent to which fees and rebates affect the market.[26] The Exchanges sum up their first point by noting that "[n]owhere in the Exchange Act or in any other statute did Congress grant the Commission authority to conduct harmful experiments on only a subset of the securities market just to gather data."[27] Further, the Exchanges contrast the SEC with other agencies—such as the FCC—noting that "Congress has expressly granted several other agencies

[21] Opening Brief for Petitioners, at 24.
[22] *Id.* at 24–25.
[23] *Id.* at 25 (quoting 15 U.S.C. § 78c(f); *id.* § 78k-1(a)(2)).
[24] Opening Brief for Petitioners, at 26.
[25] *Id.* at 28.
[26] *Id.*
[27] *Id.* at 29.

the power to undertake experimental action in limited, defined areas[, unlike the SEC]."[28] Additionally, the Exchanges contend that "[the Commission's course of action] is also inconsistent with the APA because it is arbitrary and capricious for an agency to take regulatory action that it concedes could do more harm than good."[29]

The SEC, on the other hand, argues that it is acting properly in this rulemaking endeavor as it is seeking to accomplish its statutory mandate "to facilitate the establishment of a national market system[,]"[30] which includes ensuring "(i) the economically efficient execution of securities transactions; (ii) fair competition among markets; (iii) price transparency; (iv) the practicability of best execution of investors' orders; and (v) an opportunity for investors' orders to be executed without the participation of a dealer[.]"[31] It adds that the D.C. Circuit "has long recognized agencies' ability to develop needed data through experimentation[,]"[32] which legitimizes their claim that the experimentation is sought in pursuit of satisfying a statutory mandate.

The Commission further argues that the Exchanges' statement that the SEC failed to make an adequate showing as to whether the rule is necessary or appropriate "misunderstands the Commission's obligations under the Exchange Act."[33] Specifically, the SEC contends that "Congress [already] found that 'assuring' its objectives for the NMS 'is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets.'"[34] The Commission, however, concedes that it "must explain its conclusion that a rule furthers Congress's

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[28] *Id.*
[29] *Id.* at 31.
[30] Opening Brief for Respondent Securities and Exchange Commission, at 5. *See* 15 U.S.C. 78k-1(a)(2); Regulation NMS, 69 Fed. Reg. 11,126, 11,130 (proposed Mar. 9, 2004).
[31] Opening Brief for Respondent Securities and Exchange Commission, at 5.
[32] *Id.* at 21.
[33] *Id.* at 28.
[34] *Id.* (quoting 15 U.S.C. 78k-1(a)(1)(C)).

objectives and its 'reasons for believing that more good than harm will come of its action[.]'"[35] The SEC also asserts, however, that "[t]he Commission reasonably concluded that [the] regulatory benefit justifies the Pilot's potential burdens."[36] Specifically, the Commission contends that it "determined that the Pilot is the best means of gathering otherwise unavailable empirical data to answer" important unresolved questions about the maker-taker system in place.[37] "The Commission did acknowledge that it cannot predict the outcome of the Pilot with certainty[,]"[38] however, "that is because the Pilot's effects on the market are precisely what it is testing."[39] And, the Commission contends, it "candidly and exhaustively considered these potential effects and the likelihood that they would occur."[40] Thus, the SEC argues that it "capped transaction fees for securities in Test Group 1 at $0.0010/share in part because commenters . . . suggested it as a means of reducing the Pilot's complexity without interfering with exchanges' ability to compete or the Commission's ability to measure the effect of a significantly reduced fee cap on order routing behavior, execution quality, and market quality."[41] The SEC also noted that it had "explained that it was important to have a no-rebate test group because one purpose of the Pilot was to gather data on the extent to which rebates create market distortions and introduce conflicts of interest in order routing."[42]

Most of the Amicus Briefs focused on the validity of the rule on policy grounds as opposed to whether the SEC's actions violated the APA—which is the heart of the appellate dispute. Royal Bank of Canada, as amicus for Respondent, argued that there was significant evidence showing

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[35] *Id.* at 29 (quoting *Maryland People's Counsel v. FERC*, 761 F.2d 768, 779 (D.C. Cir. 1985)).
[36] *Id.* at 30.
[37] *Id.*
[38] *Id.* at 31.
[39] *Id.*
[40] *Id.*
[41] *Id.*
[42] *Id.* at 31–32.

the maker-taker model was harmful, pointing to the potential conflicts of interest as well as market complexity and price opacity.[43] Likewise, Investor's Exchange argued that the pilot program will provide data which is essential in dealing with this new maker-taker issue in the securities market.[44] Citadel Securities, GTS Securities, LLC, and IMC, however, argue that the proposed rule will cause bid/offer spreads to widen while also causing liquidity to decrease and transaction costs to increase.[45]

At oral argument—in a panel consisting of Judge Sentelle, Judge Edwards, and Judge Pillard—Judge Edwards attempted to frame the Petitioners' argument as forbidding pilot exploratory programs flat-out where the agency's enabling statute is silent, because the APA does not expressly provide for them.[46] Judge Sentelle, audibly more sympathetic to the Exchanges' argument, instead framed the Petitioners' argument as whether to proceed with this type of activity where the APA and the Securities Acts are silent on the issue.[47] Additionally, Judge Pillard remarked that in a way, the Exchanges were faulting the SEC for their neutrality and good faith in not claiming to know the exact outcome of the pilot program, apart from attaining valuable data.[48] Judge Sentelle, on the other hand, remarked that the APA does not expect neutrality at the rulemaking stage, since the agency should have made up its mind on whether to a rule would be useful and whether to proceed with it long before then.[49]

II. WHETHER THE COMMISSION ADEQUATELY CONSIDERED THE EFFECTS OF THE RULE ON EFFICIENCY, COMPETITION, AND CAPITAL FORMATION.

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[43] *See generally* Brief of Amicus Curiae RBC Capital Markets, LLC in Support of Respondent and Denial of the Petitions for Review.
[44] *See generally* Brief of Amicus Curiae Investors Exchange LLC in Support of Respondent.
[45] *See generally* Brief of Amicus Curiae GTS Securities LLC, Citadel Securities, and IMC in Support of Petitioners and Vacatur or Rule.
[46] Oral Argument.
[47] *Id.*
[48] *Id.*
[49] *Id.*

The Exchanges also assert that when the SEC engages in rulemaking it must also consider "whether the action will promote efficiency, competition, and capital formation[,]"[50] which the Petitioners claims the Commission did not do in this instance.[51] The Exchanges contend that "[d]espite acknowledging [] possible harms to market efficiency [pointed out in comment letters] . . . , the Commission declined to determine, as it is required to do under the Exchange Act, whether these harms will actually come to pass, or otherwise attempt to determine the Rule's effect on efficiency."[52] Additionally, Petitioners point out that commenters warned of damage to the Exchanges' abilities to compete with alternative trading venues, yet the Commission basically just replied it cannot know the specific effects of its rule *ex ante*.[53] The Exchanges attempt to analogize this situation to *Chamber of Commerce of the United States v. SEC*, 412 F.3d 133 (D.C. Cir. 2005), where the court found that the SEC failed to justify its rule by merely stating it was unable to determine its effects before enactment.[54]

The SEC, on the other hand, argued that it "explained in depth why there is insufficient data to make those determinations with any certainty."[55] Specifically, the Commission contends that it "discussed the Pilot's anticipated [effects] . . . provided detailed estimates of the costs of complying with the Pilot . . . and provided an in-depth discussion of additional effects—which are expected to be temporary—that the Pilot may have on issuers, investors, broker-dealers, exchanges, and other market participants . . . ."[56] The SEC claims that Petitioners misconstrue the

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[50] Opening Brief for Petitioners, at 33 (quoting 15 U.S.C. § 78c(f)).
[51] *Id.*
[52] *Id.* at 34.
[53] *Id.* at 35.
[54] *Id.* at 38.
[55] Opening Brief for Respondent Securities and Exchange Commission, at 33.
[56] *Id.*

Commission's statutory obligations, which they assert only requires that the SEC "*consider* or determine whether an action is necessary or appropriate in the public interest,"[57] as well as to consider "whether that action will promote efficiency, competition, and capital formation."[58] Thus, SEC contends that it consider the requisite factors and the Exchanges are placing unnecessary burdens on the Commission that are outside of the text of the Exchange Act and the APA.

To support its conclusion that the transaction fee pilot program would not hinder capital formation, "the Commission relied on a study conducted by its Division of Economic and Risk Analysis [('DERA')] regarding the effect on capital formation of the Commission's Tick Size Pilot,[59] which examined . . . the impact of quoting and trading securities at larger price intervals than the current $0.01 interval."[60] The Exchanges, however, assert that "an independent study show[ed] that, after the Tick Size Pilot had *actually commenced*, stocks in the test groups that experienced a decrease in liquidity also experienced a decrease in stock price relative to their peers in the control group, which would have impaired the ability of those test-group issuers to raise capital."[61]

At Oral Argument, Judge Edwards said it was a stretch of the APA to expect decisive prediction of a rule's exact effects at the rulemaking stage.[62] Judge Pillard, also apparently

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[57] 15 U.S.C. 78c(f).
[58] *Id.*
[59] Unlike the Transaction Fee Pilot Program, the Tick Size Pilot was the result of a statutory command from Congress, which directed the Commission to study the impact of the current tick size on the number of initial public offerings. *See* Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 106(b), 126 Stat. 306, 312 (2012). The Tick Size Pilot involved raising the price increments of small-cap public companies from $0.01 to $0.05. *Id.* The Tick Size Pilot ended in the fall of 2018 and was not without scrutiny. *See* Bill Alpert, *Congress' Failed Stock Market Experiment Cost Investors $900 Million*, BARRON'S (Sep. 14, 2018), https://www.barrons.com/articles/sec-tick-size-pilot-program-1536961160.
[60] Opening Brief for Petitioners, at 18.
[61] *Id.* at 46. *See also* Rui Albuquerque et al., *The Price Effects of Liquidity Shocks: A Study of SEC's Tick-Size Experiment*, Working Paper (Sept. 13, 2018).
[62] Oral Argument.

sympathetic to the Commission, suggested that perhaps merely predicting that one will derive useful data is a sufficient hypothesis for explaining how an agency action relates to the public good.[63] The Exchanges, however, claimed that it is always true that a new rule will provide data about its effects, and thus, that holding in favor of the SEC would essentially give agencies unfettered power.[64] Edwards, on the other, claimed that such an assertion is a slippery slope argument, and is not a good faith response given the true issues in this case.[65]

Furthermore, Judge Edward also pushed the Commission, asking where in the record the Commission specifically found there was an issue with the current "maker-taker" system in place.[66] Judge Pillard, however, said that uncertainty about the current *modus operandi* alone is itself a problem for the market that the Commission is seeking to cure, thus justifying agency action.[67] Judge Sentelle, however, notes the statute at hand does not provide for exploratory rules, unlike other agencies' respective enabling statutes.[68] Further, he notes that this court has never upheld an experimental rule where there was not express grant of statutory authority.[69]

III. WHETHER THE SEC'S DISPARATE TREATMENT OF DIFFERENT GROUPS WAS ARBITRARY AND CAPRICIOUS

The Exchanges contend that the transaction fee pilot rule "be vacated because it arbitrarily disadvantages two distinct groups of market participants."[70] Specifically, Petitioners assert that the SEC treats issuers in the control groups differently than those outside, and treats exchanges differently than off-exchange trading venues.[71] They argue that this disparate treatment, in which

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[63] *Id.*
[64] *Id.*
[65] *Id.*
[66] *Id.*
[67] *Id.*
[68] *Id.*
[69] *Id.*
[70] Opening Brief for Petitioners, at 39.
[71] *Id.*

the issuers in the control group as well as the exchanges are treated worse than other groups, violates the APA rule proscribing a burden on competition that is not necessary or appropriate—since again, the SEC has not provided an adequate justification in the Exchanges' opinion.[72]

The SEC first retorts that the Exchanges "lack standing to raise arguments regarding the Pilot's treatment of issuers."[73] They assert that "[e]ven if [Petitioners] were correct that an issuer whose stock is selected for the Pilot will suffer economic or competitive harm as a result, they nowhere assert that those harms will extend to them."[74] Furthermore, the SEC argues that the Petitioners are wrong in claiming that the APA proscribes the differential treatment exhibited here, as 15 U.S.C. 78w(a)(1) allows the SEC to "classify persons, securities, transactions, statements, applications, reports, and other matters" and "prescribe greater, lesser, or different requirements for different classes thereof." Instead, the SEC argues, it must balance any harm done to parties' competitive advantages with the benefits to be sought from the fee pilot program.[75] The SEC also contends that while the enabling statute bans ***unfair*** discrimination, it does not ban discrimination simpliciter.[76]

IV. WHETHER THE COMMISSION ADEQUATELY CONSIDERED ALTERNATIVES TO THE RULE

"An agency is required to consider responsible alternatives to its chosen policy and to give a reasoned explanation for its rejection of such alternatives."[77] More specifically, "where a party raises facially reasonable alternatives . . . , the agency must either consider those alternatives *or*

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[72] *Id.*
[73] Opening Brief for Respondent Securities and Exchange Commission, at 40.
[74] *Id.*
[75] *Id.* at 42.
[76] *Id.* at 42–43.
[77] *Am. Radio Relay League, Inc. v. FCC*, 524 F.3d 227, 242 (D.C. Cir. 2008).

give some reason . . . for declining to do so."[78] Petitioners allege that the Commission failed to adequately do so here.[79]

The Commission, on the other hand, argues that it "discussed in detail the limitations of existing data sources . . . including the data petitioners reference in their brief[,]"[80] and that therefore they adequately considered the proposed alternatives. They contend that using existing data is insufficient, that allowing companies to opt out could interfere with the data, and that strengthening the duty of best execution does not get at the issue at hand here.[81]

[78] *Laclede Gas Co. v. FERC*, 873 F.2d 1494, 1498 (D.C. Cir. 1989).
[79] Opening Brief for Petitioners, at 52.
[80] Opening Brief for Respondent Securities and Exchange Commission, at 51.
[81] *Id.* at 51–53.