May 24, 2018

Via Electronic Mail (rule-comments@sec.gov)

Mr. Brent J. Fields
Secretary
U.S. Securities & Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File No. S7-05-18; Comments on Proposed Rule: Transaction Fee Pilot for NMS Stocks

Dear Mr. Fields:

The Securities Industry and Financial Markets Association (“SIFMA”) submits this letter to the Securities and Exchange Commission (“Commission”) to comment on the Commission’s proposal to conduct a Transaction Fee Pilot for NMS Stocks. SIFMA is a long-time supporter of reducing the current access fee cap, and we recognize that a pilot is one way to collect necessary empirical data to make this change. Accordingly, SIFMA broadly supports the concept of a pilot. However, we offer recommendations below to modify certain aspects of the proposal.

In addition, while SIFMA supports the Commission’s review of access fees, this pilot should not be the extent of the Commission’s review of Regulation National Market System (“NMS”). After this important first step in reviewing one aspect of equity market structure, the Commission should continue reviewing other aspects of Regulation NMS and make appropriate regulatory changes to reflect current market realities.

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1 The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA’s mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

2 Securities Exchange Act Release No. 34-82873 (March 14, 2018). The Commission’s proposed pilot will study the effects that transaction-based fees and rebates may have on order routing behavior, execution quality, and market quality more generally and will be used to facilitate a data-driven evaluation of the need for regulatory action in this area.

I. Previous SIFMA Support to Reduce Access Fee Cap

The regulatory cap on access fees was adopted in Regulation NMS under the Securities Exchange Act of 1934 ("Exchange Act") in conjunction with Rule 611 of Regulation NMS, also known as the “Order Protection Rule."\(^4\) The Order Protection Rule (“OPR”) generally requires that marketable orders be routed to the market displaying the best available automated quotation—i.e., to protected quotations. However, the OPR considers only the quotation itself, not fees charged for accessing that quotation. In adopting the OPR, the Commission recognized that, “market participants will no longer have the option of bypassing the quotations of trading centers with access fees that [market participants] view as too high.”\(^5\) Similarly, the Commission stated that some markets might take advantage of protected quotation status to charge excessive access fees, making what appeared to be the best quotation available actually inferior to another quotation—after access fees are taken into account.\(^6\) To address these issues, the Commission adopted Rule 610, capping fees to access protected quotations at 30 cents per 100 shares. The 30-cent figure was chosen because it was generally “consistent with current business practices” at the time.\(^7\)

On several occasions, SIFMA has recommended that the Commission reduce the access fee cap to no more than five cents per 100 shares because the cap has not been adjusted to reflect market developments since Regulation NMS was adopted more than a decade ago. Depending on the exchange, access fees generally equal or approach the maximum 30 cents per hundred shares, and most of that fee is used to fund a payment either to the party that posted the quotation on the exchange, as an incentive for “making” liquidity, or to the party that executed against a quotation, as an incentive for “taking” liquidity. Over time, competitive pressures, increased efficiencies from automation, and electronic trading have each operated to reduce transaction costs throughout the markets – but not access fees, which have remained at or near 30 cents per hundred shares.

II. Pilot Design

SIFMA supports the concept of the pilot, but it should be carefully structured and designed with objective metrics for evaluating the results of the pilot. The Commission should clarify whether it seeks through the pilot to determine the appropriate level of access fees or to address potential conflicts of interest arising out of rebate payments. It should further clarify the


\(^5\) Regulation NMS at 182.

\(^6\) Id. at 182 – 183.

\(^7\) Id. at 189.
goal of the pilot by defining “execution and market quality.” Execution quality and market quality are multivariate concepts, and the perception among market participants on execution and market quality can differ depending on that participant’s goals. Accordingly, the Commission should clearly specify a range of appropriate metrics that will be used comprehensively to measure execution and market quality during the pilot period. The Commission should additionally provide guidance about how the Commission staff will evaluate those metrics in determining whether or not to recommend market structure changes to the Commission following the pilot. In addition, the Commission should construct the pilot, and request appropriate data, in a manner that causes the least amount of cost and operational burdens on market participants while allowing the Commission to achieve its stated goals.

a. Goals of the Pilot

The Commission should design the pilot to test the impact that the maker-taker and taker-maker models have on broker-dealer order routing practices. In addition, the Commission should be able to test whether the pricing and rebate models lead to avoidable investor costs or create a real conflict of interest between broker-dealers and their customers. If the pilot data shows that reducing access fees generally does not harm execution and market quality, the Commission should at minimum reduce the access fee cap. However, we hope the Commission ultimately can find a more permanent solution to reduce investor costs than simply updating a static regulatory access fee cap.

b. Timing of the pilot

The transaction fee pilot should not overlap with the tick size pilot, and it should have an automatic sunset after one year. Although we appreciate the Commission’s consideration to separate the test groups, the pilots should not overlap to avoid conflating the impacts of each pilot and reduce the operational cost of only having to change dealer routing systems once. A two-year pilot, with an automatic sunset after the first year, provides sufficient time to gather statistically relevant data without an overly burdensome time-line. If the Commission observes the pilot causing a material harm to the public based on specifically defined thresholds, the Commission should consider taking a measured approach to accommodate the harmed market participants’ requests. The Commission should also provide clear deadlines for analyzing and publishing the pilot’s data, and we recommend the Commission publish its analysis no later than six months after the conclusion of the pilot.

c. Test Groups

SIFMA generally supports the proposed test groups. The Commission’s proposed test groups, including the no rebate group, would be an efficient way to test the impact of access fees. We are interested to see whether prohibiting rebates will effectively reduce the access fees through competitive forces and reduce overall trading costs. Additionally, the no rebate group will provide valuable information on what factors, other than rebates, brokers consider most
important when routing liquidity providing orders. While SIFMA supports the proposed test
groups, the Commission should consider reducing the number of securities in the pilot to include
no more than 500 securities in each test group to balance the needs of the Commission to gather
statistically significant data without over-inclusion and potentially increased costs from the pilot.
Decreasing the number of securities in the pilot will ease the operational complexity and market
impact of implementing and unwinding the pilot. As currently proposed, up to 2,000 securities
will see an immediate reduction in access fees that could revert back to current access fee levels
at the conclusion of the pilot.

The Commission should not include a “trade-at” provision\(^8\) in the pilot. A trade-at
provision is irrelevant to studying the impact of a reduction in access fees and will make the pilot
unnecessarily complicated. In particular, the question of whether broker-dealers should be
allowed to match the NBBO bears little relation to the impact of exchange rebate models.
Reducing access fees, and thus overall trading costs, will likely increase order flow to the
exchanges. As such, adding a trade-at provision to the pilot to additionally increase order flow to
exchanges would be unnecessary and possibly impose an inappropriate burden on competition.
Including the trade-at requirement also would make the pilot unnecessarily complex, time-
consuming, and expensive to implement.

We do not support including the elimination of the OPR in this pilot, and we recommend
the Commission evaluate the OPR in a broader Reg NMS review. The Commission asks whether
one or more test groups should include an elimination of protected quotation status\(^9\), and we have
previously recommended the Commission review the OPR.\(^10\) Considering access fees and
rebates are linked to the OPR, we understand the Commission’s desire to potentially evaluate the
impact of the OPR in this pilot. However, the practical implementation of suspending the OPR
in one or more test groups would materially increase the costs and complexity of the pilot.

In addition, recognizing that assigning exchange-traded products (“ETPs”) with similar
investment strategies to different market structures could have anticompetitive effects, the
Commission should ensure that ETPs tracking similar indexes or holding similar investments are
placed in the same test group. This concern is unique to ETPs. Unlike the stocks of operating
companies that differ based on company fundamentals, competing ETPs can provide investors
with exposures that are substantially similar (if not identical) to each other. When investors
evaluate these products to make an investment decision, they often compare the liquidity
characteristics of the products, such as bid-ask spread, and the expected transaction costs
associated with each product. If different fee and rebate regimes affect execution and market
quality metrics differently, placing similar ETPs into different test groups could create winners

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\(^8\) Proposal at 233-234.
\(^9\) Proposal at 63.
\(^10\) See SIFMA March 2017 Letter.
and losers among ETPs. Ensuring that ETPs tracking similar indexes are placed in the same test groups could help mitigate this concern. Alternatively, these concerns could be addressed by rotating the entire universe of ETPs together through each test group sequentially. For example, all ETPs could be placed in the first test group for months 1-3; followed by the second test group for months 4-6; third test group for months 7-9; and control group for months 10-12. The schedule and list of ETP symbols should be published in advance.

d. Trading Centers

We agree with the Commission’s reasoning to include only equities exchanges in the pilot, and to exclude Alternative Trading Systems (“ATSs”).\(^{11}\) ATSs do not display protected quotes, which were the initial basis for requiring an access fee cap in Regulation NMS. As such, creating a new regulatory restriction for ATSs is unnecessary and would distort the pilot’s results while also disrupting the existing competitive dynamics in the market with the potential to disproportionately harm one group of market participants. ATSs generally charge access fees of between 5-10 cents/100 shares and broker-dealer internalized orders do not charge access fees. Because the ATSs’ access fees are included in the total cost consideration of trading, competitive forces already push access fees to an appropriate level, and lower than the access fees charged by exchanges.

III. The Pilot Should Include a Broad Range of Appropriate Metrics

SIFMA recommends that the pilot include the measurement criteria proposed by EMSAC to measure the impact of access fees and rebates.\(^{12}\) In particular, the Commission should use a range of specific metrics to measure changes in execution and market quality including the impact on bid/ask spreads, market depth, order routing behaviors, ratio of hidden liquidity vs. displayed liquidity on the exchanges and quoting behavior. The Commission also should measure the impact of lower access fees on liquidity taking by considering the ratio of on vs. off exchange trading, order routing behaviors, price impact, slippage/realized spread, and trade volume.

The Commission should review and comment on the change in access fees’ impact on the following: quoted spreads; effective spreads; realized spreads; displayed liquidity (changes at the inside, depth at 3, 5, 10 cents beyond the NBBO); volatility (stock-level changes and number of price changes at the NBBO); hidden liquidity (off-exchange market share and mid-point exchange executions and exchange dark liquidity); changes in trading volume; behavioral routing changes as evidenced by market share shifts among trading venues, on- vs. off-exchange

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\(^{11}\) Proposal at 28-34.

trading levels, and ATS vs. internalization levels; changes in the levels of price improvement in the marketplace; percentage of time the market is locked/ crossed; slippage and price impact; retail and institutional commission pricing; shifts among Exchange order type usage; Significant behavioral changes in pricing from ATs and/or Exchange reserve quantities.

IV. The Pilot Data

a. Exchange Transaction Fee Summary

SIFMA supports requiring the exchanges to post the standardized exchange transaction fee summary to facilitate the analysis of the pilot’s data. This will help market participants see the direct effect in access fees, and the exchanges should be responsible to present this data in a uniform manner. Publishing of this data promotes transparency in the access fees and the pilot at a relatively low cost to the exchanges.

b. Confidentiality of Order Routing Data

SIFMA agrees that there is value in making certain data from the proposed pilot publicly available for academic study. However, we believe the proposed method of data publication creates too much risk of reverse engineering. More specifically, the proposal would require the exchanges publicly post order routing data and that “the order routing data must contain aggregated and anonymized broker-dealer order routing information.” The Commission acknowledges that this data is proprietary and that if it were reverse engineered, it “could have implications for the profitability of those strategies going forward.” In addition, SIFMA is concerned that this data could be used to derive commercially sensitive information regarding broker-dealers’ commercial relationships with their customers. At the same time, however, the Commission “believes the likelihood of being able to reverse engineer broker-dealers’ order-level strategies is low because the data would be aggregated by security and day and would anonymize the broker-dealers.”

In our view, the Commission is underestimating the potential for this proprietary information to be revealed. While we recognize the benefit of granular, broker-dealer specific routing information being provided to the Commission for analysis, we believe the risk to our members of this information being made public, even on an aggregated, anonymized basis, outweighs the potential academic benefit. Additionally, the intent of the pilot is not to analyze the behavior of any one broker-dealer but rather whether transaction fees between and among exchanges impact routing behavior broadly. Accordingly, if the Commission believes public

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13 Proposal at 78.
14 Proposal at 89.
15 Proposal at 191.
16 Proposal at 191.
disclosure of pilot data is necessary, then order-routing information should exclude any and all information, anonymized or not, identifying the contributing broker-dealer. Providing the public with macro trends through aggregated data on the change in access fees impact on order routing behavior provides sufficient transparency without risking revealing sensitive firm specific information.

We further recommend the publishing of broker-dealer routing data in a method like the tick-size data. The tick-size data aggregated the pilot securities within each bucket per trading day, calculated the cumulative number of orders, and published the data after 120 days.\(^{17}\) Accordingly, we recommend the order routing data publish orders aggregated by day, security and exchange and extend the publication delay from 30 days\(^{18}\) to 120 days. While we recognize the importance of the Commission to see how the access fees affect each broker-dealer’s order routing practices, the public does not need that detailed access to every broker-dealers sensitive routing practices.

c. Limit Access to the Anonymization Key

The Commission, rather than the exchanges, should be responsible for all data publication, management and anonymization to reduce risks of this sensitive order routing data being inappropriately used by the exchanges for competitive advantages. Doing so could also mitigate some of the concerns about the potential for reverse engineering. However, if the Commission grants the exchanges access to the data and anonymization key, it should address the conflict of interest and potential information leakage in a manner similar to the requirements in Regulation ATS and proposed Form ATS-N.\(^{19}\) The Proposal’s language that the exchanges are prohibited from using the pilot’s order-routing data for “non-regulatory purposes”\(^{20}\) is insufficient to address the concerns. Proposed Form ATS-N would require the ATS to identify the persons who have access to confidential trading information and describe the safeguards and procedures in place to prevent the ATSs from using the confidential trading information by the non-ATS business units operated by the broker-dealer.\(^{21}\) If provided with access to the pilot data and anonymization key, exchanges should be held to these same standards.


\(^{18}\) Proposal at 88.


\(^{20}\) Proposal at 92-94.

d. **Separate Principal Order Flow from Agency Order Flow**

The Commission should consider expanding the pilot to separate broker-dealers’ principal vs. agency order flow. To truly test the potential conflicts of interest of the maker-taker model in a broker’s order routing practice, the Commission should only consider its order routing practices when acting as an agent. The Commission may find that brokers have different routing procedures for routing principal orders than when acting as an agent. A broker may route principal orders to maximize rebates and minimize access fees which would not be considered a conflict of interest. The Commission can then focus on the data from the routing of agency flow to consider whether best execution obligations need updating.

V. **Conclusion**

SIFMA appreciates the Commission’s efforts to improve market structure by considering the impact of access fees and rebates. We believe the pilot’s general structure will provide valuable information, but the Commission should consider decreasing the scope of the pilot to no more than 500 securities in each test group. The Commission should describe its anticipated actions based on what the pilot data may show. In addition, the Commission should ensure the confidentiality of broker-dealer’s data by refraining from publicly disclosing broker-dealer identifiers, even on an aggregated and anonymized basis and limiting access to any anonymization key.

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SIFMA greatly appreciates the Commission’s consideration of the issues raised above and would be pleased to discuss these comments in greater detail with the Commission and the Staff. If you have any questions, please contact me (at 202-962-7383 or tlazo@sifma.org).

Sincerely,

Theodore R. Lazo
Managing Director and Associate General Counsel

cc: The Honorable Jay Clayton, Chairman
    The Honorable Michael S. Piwowar, Commissioner
    The Honorable Kara M. Stein, Commissioner
    The Honorable Robert J. Jackson, Jr., Commissioner
    The Honorable Hester M. Peirce, Commissioner

    Brett Redfearn, Director, Division of Trading and Markets
    David S. Shillman, Associate Director, Division of Trading and Markets