INVESTMENT COMPANY INSTITUTE

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May 23, 2018

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: *Transaction Fee Pilot for NMS Stocks (File Number S7-05-18)*

Dear Mr. Fields:

The Investment Company Institute (ICI)[1] strongly supports the Securities and Exchange Commission's ("SEC" or "Commission") proposal to conduct a pilot program to assess how exchange transaction fees and rebates affect market quality for national market system (NMS) stocks.[2] We appreciate that the Commission has undertaken this effort to study and improve market quality for investors. We urge the Commission to adopt the Proposal, with minor changes, and commence the pilot as soon as possible. We explain below why the Commission should study how exchange transaction pricing affects market quality and why the pilot will facilitate such a study. We also offer suggestions to streamline the implementation of the pilot program and improve the analysis of data gathered by the pilot.

I. Importance of Studying How Exchange Transaction Pricing Affects Market Quality

Rule 610(c) under Regulation NMS caps the fee that exchanges can charge to access a protected quotation (an "access fee") at $0.0030 per share.[3] The predominant transaction pricing model that has emerged under this rule is the "maker-taker" fee model, in which an exchange pays its broker-dealer

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[1] ICI is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US$21.7 trillion in the United States, serving more than 100 million US shareholders, and US$7.5 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

[2] *Transaction Fee Pilot for NMS Stocks,* Securities Exchange Act Release No. 82873 (March 14, 2018), 83 FR 13008 (March 26, 2018) (Proposal).

[3] The $0.0030 per share cap on access fees applies to NMS stocks quoted at $1.00 or more. Rule 610(c) under Regulation NMS also limits fees to 0.3% or less of the price per share for NMS stocks quoted at less than $1.00.

participants a per-share rebate to provide liquidity and charges a per-share access fee to participants that remove liquidity. The transaction revenue earned by a maker-taker exchange is the difference between the fee charged to the liquidity remover and the rebate paid to the liquidity provider. Maker-taker exchanges generally charge liquidity takers approximately $0.0030 per share while paying rebates of roughly $0.0020 per share.[4]

Transaction fees and rebates have wide-ranging effects on equity markets, including—potentially—the way brokers handle customer orders, market transparency, and complexity. Maker-taker pricing structures may, at times, conflict with a broker's obligation to deliver best execution to a client by providing an incentive to route customer orders in a way that maximizes rebates earned and minimizes fees paid. Transaction fees and rebates also undermine market transparency because the prices displayed by exchanges—and provided on trade reports—do not include fee or rebate information and therefore do not fully reflect net trade prices. In addition, transaction fees and rebates contribute to market complexity through the proliferation of new order types and trading venues designed to exploit different transaction pricing models. We believe the conflicts of interest, decreased transparency, and unnecessary complexity associated with transaction fees and rebates may reduce market quality to the detriment of investors. We applaud the Commission's proposal to study how changes to Rule 610(c) under Regulation NMS affect equity markets.[5]

II. The Proposal Outlines a Well-Considered Pilot to Enable the Commission and Others to Assess How Exchange Transaction Fees and Rebates Affect Market Quality

The proposed transaction fee pilot is well-designed and should provide the Commission and other interested parties with data on how market quality varies as a result of changes to Rule 610(c). The Proposal describes the creation of three test groups and a control group to facilitate an analysis of how transaction pricing affects market quality during the test period. Each of the three test groups would examine a different aspect of transaction pricing and produce data to make an assessment of whether rule 610(c) should be recalibrated.[6] Test Groups 1 and 2 would reduce the $0.0030 per share cap on exchange access fees to $0.0015 and $0.0005 per share, respectively, while Test Group 3 generally would prohibit equity exchanges from offering rebates or establishing linked pricing arrangements that would effectively compensate a market participant for transacting on the exchange. The structure of all three test groups may encourage exchanges to compete on the basis of innovation, differentiation of services, and ultimately on the value their trading model presents to investors, not on the amount of money rebated to their participants.

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[4] *See* Proposal at n.126.

[5] *See* Letter from David Blass, General Counsel, ICI, to SEC Equity Market Advisory Committee, dated January 20, 2016, *available at* https://www.ici.org/pdf/29652.pdf (describing how transaction fees and rebates harm investors and urging the Committee to recommend a transaction fee pilot).

[6] The pilot also could facilitate an assessment of whether market quality varies within each pilot treatment depending on liquidity or other factors, which could suggest potential actions to improve liquidity for thinly-traded securities.

Test Group 3 is critically important, because it permits a direct assessment of the extent to which rebates contribute to conflicts of interest and other shortcomings of US equity market structure. This assessment would not be possible if the Proposal applied only to access fees (*i.e.*, fees for removing liquidity) because exchanges could design pricing structures that compensate participants for providing liquidity, even in a low access fee environment. By prohibiting rebates in Test Group 3, the Proposal should generate data about how market quality changes in the absence of rebate-driven pricing and routing strategies. This will allow an objective assessment of the broadly-held view that rebates contribute to undesirable market behaviors, and the data gathered by this comprehensive pilot program could suggest an appropriate direction for SEC rulemaking to correct these behaviors.

We also appreciate that the Proposal focuses exclusively on Rule 610(c) under Regulation NMS and does not endeavor to test changes to other aspects of equity market structure. We disagree with market participants that advocate for studying exchange transaction pricing models only in conjunction with a holistic review of Regulation NMS.[7] There is no reason to delay this discrete pilot program—potentially for years—while regulators and market participants debate the feasibility of test driving changes to other aspects of equity market structure. We believe, moreover, that it would be infeasible—or at the very least unduly complicated—to test changes to more than one aspect of Regulation NMS. In this regard, it would be difficult or impossible to discern which aspect of such a pilot produced a change in market quality while ensuring that each test group and the control group contains a representative sample of NMS stocks. For a similar reason, the Commission should not incorporate a trade-at provision in this pilot program, as some have suggested. Adding trade-at to the proposed transaction fee pilot could obscure the results and undermine the principal purpose of studying how exchange transaction fees and rebates affect current market structure.

III. Recommendations to Streamline Implementation of the Pilot Program and Improve the Analysis of Pilot Data

We recommend that the Commission initiate a transaction fee pilot program for NMS stocks without delay. As the Commission finalizes and implements the pilot, we suggest that it take steps to: (1) mitigate the potential for the pilot to distort competitive dynamics in the market for exchange-traded products (ETPs) and enhance identification of treatment effects; (2) disclose the criteria that the Commission plans to use to assess market quality; and (3) enhance the scope of order handling data available to institutional investors to improve the analysis of pilot data.

[7] *See* Letter from Chris Concannon, President and Chief Operating Officer, CBOE, Thomas Wittman, CEO, The Nasdaq Stock Market LLC, and Thomas W. Farley, President, NYSE, to Jay Clayton, Chairman, SEC, dated October 13, 2017, *available at* https://www.sec.gov/comments/265-29/26529-2641078-161300.pdf.

A. Mitigate potential competitive distortions in the ETP market and enhance identification of treatment effects

We urge the Commission to ensure that the process of assigning NMS stocks to a test group or the control group through stratified sampling by market capitalization, share price, and liquidity does not distort competition between ETPs, such as ETFs and closed-end funds. ETP issuers compete vigorously across market segments. According to ICI's computation of Morningstar data, an investor seeking to purchase an ETF focused on the US technology sector, for example, could choose from 53 products. As another example, an investor seeking exposure to long-term California municipal debt could choose from 18 closed-end funds. The investor's decision will depend on various factors, including metrics that could be affected by the proposed transaction fee pilot, such as spread size, average daily volume, and intraday volatility. If competing ETPs are in different test groups—and market quality varies among the test groups—investors might migrate toward products in the test groups with better market quality.[8] This arbitrary result would tilt the playing field in favor of ETPs that happen to be assigned—at random—to test groups that perform better at the expense of other products.

The Commission should implement the pilot in a way that avoids this potentially detrimental and adverse result. One way to mitigate the potential for the pilot to distort competition among ETPs would be to rotate each stratified sample of pilot securities through each of the three test groups and the control group during the pilot period. Rotating the stratified samples through the entire range of rule 610T(a) treatments would ensure that all pilot securities experience the market conditions particular to each pilot treatment. Rotating the stratified samples through each test group and the control group should not adversely affect the validity of pilot data and, in fact, may provide further insights into the effect of transaction fees on market quality, by allowing an assessment of trading activity around rotation dates. Moreover, rotations through each pilot group allow for potential differences in market quality to be assessed at the individual security level. Importantly, rotating the stratified samples through each pilot group should not delay the Commission's adoption of a final transaction fee pilot and is unlikely to impose more than a *de minimis* implementation burden or other costs on market participants.

If the Commission adopts this approach, we recommend that it specify the timing and manner of each rotation at the outset of the pilot to allow market participants to program their systems and take other necessary steps to prepare. To facilitate preparation by market participants, the Commission could announce the rotation schedule in the initial list of pilot securities described in proposed rule

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[8] We believe the pilot is less likely to cause anticompetitive effects with respect to the stocks of operating companies because company fundamentals—which can differ significantly among competing firms—drive a substantial portion of the trading in these securities. Because ETPs with similar investment strategies are more substitutable than stocks of operating companies, market quality metrics likely play a greater role in driving flows to ETPs.

610T(b)(1).[9] Assuming a two-year pilot period, rotations could occur every six months to ensure that each stratified sample experiences each pilot bucket.[10]

B. Disclose criteria to assess market quality

We urge the Commission to provide additional detail about the metrics it intends to use to assess market quality before, during, and after the transaction fee pilot. The most important metrics that buy-side traders use to assess market quality include trading costs—*e.g.*, spreads, slippage, and implementation shortfall—displayed liquidity, depth of book, fill rates for passive orders, the percentage of buy orders executed at near, far, and mid-market prices on a market-wide and venue-by-venue basis, adverse selection of passive orders, volume, choice of trading venue, intraday volatility, and (for ETPs) intraday premium or discount to fair value. We also encourage the Commission to look for evidence that alternative trading systems (ATSs) or other trading centers are modifying their fee structures to offer rebates or other incentives to attract order flow, as this could suggest that brokers alter routing decisions in response to trading center pricing at investors' expense.

C. Enhance the scope of order handling data available to institutional investors to improve analysis of pilot data

We appreciate that the Proposal will require exchanges to provide access to extensive order handling data on their websites for free. Pilot data should be available to the public at no cost so that academics and other interested constituencies can analyze the effects of lower transaction fees and rebates on trading in NMS stocks.

Market participants—especially institutional investors, such as regulated funds—will have a keen interest in analyzing changes in the execution quality of their orders during the pilot period. Regulated funds routinely analyze order handling data—to the extent broker-dealers make this information available—to reduce trading costs and improve long-term returns for their shareholders. Although SEC rules do not compel broker-dealers to provide institutional investors with granular order handling information, a pending Commission rulemaking would address this disclosure gap and improve vastly the resource-intensive, ad hoc process that institutional investors undergo today to evaluate broker-dealer order routing decisions and compare execution quality across broker-dealers.[11] If

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[9] The rotations also could be noted on the pilot securities exchange lists and the pilot securities change lists in proposed rules 610(T)(b)(2) and (3).

[10] If the Commission believes it would be helpful to gather data around more transition points, it could consider rotating pilot securities more frequently (*e.g.*, every three months). A three-month rotation schedule could help mitigate potential distortions that arise toward the beginning of the pilot period while market participants adjust their trading behavior in response to pilot treatments. If the Commission uses a three-month rotation schedule, it should consider reordering the rotation sequence after the first year to reduce any seasonality impacts from treatment effects.

[11] *Disclosure of Order Handling Information,* Securities Exchange Act Release No. 78309 (July 13, 2016), 81 FR 49432 (July 27, 2016) (Proposed Order Handling Disclosures). ICI strongly supports the Proposed Order Handling Disclosures and urges the Commission to adopt this proposal, enhanced by the modifications described in our comment letter. *See* Letter

the Commission adopts this proposed rule in the near-term, institutional investors could utilize the new disclosure information to assess changes to market quality during the pilot. The disclosures could be especially helpful to smaller asset managers that may have difficulty obtaining order handling information from brokers today.[12]

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ICI strongly supports the Commission's Proposal to conduct a pilot program to evaluate how changes to the cap on exchange access fees in rule 610(c) under Regulation NMS affect market quality. The exchange pricing models that currently predominate under this rule may pose conflicts of interest for broker-dealers, decrease market transparency, and increase complexity and fragmentation of the equity market to the detriment of investors. Consequently, the Commission should finalize the Proposal and initiate the pilot as quickly as possible to determine the magnitude of these harms and gather data about the regulatory action that would mitigate or address them. If you have any questions on our comment letter, please feel free to contact me at (202) 326-5813, or George Gilbert, Assistant General Counsel, at (202) 326-5810.

Sincerely,

/s/ Susan M. Olson

Susan M. Olson
General Counsel

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

Brett Redfearn, Director, Division of Trading and Markets
David Shillman, Associate Director, Division of Trading and Markets
John Roeser, Associate Director, Division of Trading and Markets

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from David W. Blass, General Counsel, ICI, to Brent J. Fields, Secretary, Commission, dated September 26, 2016, *available at* https://www.ici.org/pdf/16_ici_sec_order_routing_ltr.pdf.

[12] Commission action on another transparency initiative—enhanced disclosure requirements for NMS stock ATSs—also could improve understanding of pilot data, especially if the enhanced disclosures increase transparency into ATS pricing structures.