

COMMENT LETTER

October 1, 2018

ICI Submits Second Comment Letter in Response to SEC's Proposed Transaction Fee Pilot (pdf)

October 1, 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 writes to reiterate its strong support for the Securities and Exchange Commission's ("SEC" or "Commission") proposal to conduct a pilot program to evaluate how exchange transaction fees and rebates affect market quality for national market system (NMS) stocks.² Certain commenters have urged the Commission to abandon the Proposal because they believe it: (1) is unnecessary or redundant with other rulemaking efforts; (2) will harm investors; or (3) could disadvantage listed companies by making shares of companies that are included in one of the pilot's test groups less attractive investments than the shares of companies in the control group.³ We respectfully disagree with these commenters. US regulated funds are some of the largest investors in the US equity markets. At the end of 2017, these funds held approximately 31 percent of the shares of US-issued equities outstanding⁴ on behalf of nearly 50 million US households.⁵ As the 1 ICI is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts 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\$22.7 trillion in the United States, serving more than 100 million US shareholders, and US\$7.3 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 See, e.g., Letter from Elizabeth K. King, General Counsel and Corporate Secretary, NYSE Group, Inc., to Brent J. Fields, Secretary, Commission, dated May 31, 2018, available at <https://www.sec.gov/comments/s7-05-18/s70518-3755194-162578.pdf>; Letter from Isabel Janci, Vice President, Investor Relations, Home Depot, to Brent J. Fields, Secretary, Commission, dated June 29, 2018, available at <https://www.sec.gov/comments/s7-05-18/s70518-3974750-167145.pdf>. 4 2018 Investment Company Factbook at 39, available at https://www.ici.org/pdf/2018_factbook.pdf. 5 See id. at 143, available at https://www.ici.org/pdf/2018_factbook.pdf. Mr. Brent J. Fields October 1, 2018 Page 2 of 6 representative of these important market participants, we emphatically believe the proposed transaction fee pilot will benefit—not harm—investors by generating data that the Commission can use to evaluate whether permanent changes to rule 610(c)

under Regulation NMS would improve equity market quality. No other SEC rulemaking will provide this information, so the fee pilot is an essential component of the SEC's mission to maintain fair, orderly, and efficient markets and to protect investors. We further believe that the common stocks of listed operating companies will not become less attractive investments if they are included in one of the pilot's test groups because market structure is not a primary consideration guiding the investment decisions of long-term investors, such as regulated funds. Nevertheless, we recommend an adjustment to the design of the pilot that would substantially ameliorate the potential for the pilot to harm issuers. We urge the Commission to adopt the Proposal, with the modifications that we recommended below and further described in our letter of May 23.⁶

I. The Proposed Transaction Fee Pilot Will Provide Data that the Commission Can Use to Evaluate Equity Market Quality

The Proposal outlines a thoughtfully-designed transaction fee pilot that can facilitate a data-driven approach to potential market structure reforms. As explained in our letter of May 23, the exchange transaction-pricing models that proliferate under the \$0.0030 per share access fee cap in rule 610(c) of Regulation NMS have wide-ranging, negative effects on equity markets and investors.⁷ Exchange transaction fees and rebates may, at times, create conflicts of interest with a broker's obligation to obtain best execution for a customer. 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 by encouraging trading venues, particularly national securities exchanges, to compete on the basis of the amount of money rebated to market participants, rather than other factors, such as innovation, differentiation of services, or the value their model of trading presents to investors. This complexity manifests in various ways, including through the proliferation of new order types and trading venues designed to exploit different transaction pricing models. The Proposal would help the Commission gather data to assess whether changes to rule 610(c) under Regulation NMS could reduce conflicts of interest, increase transparency, and eliminate unnecessary complexity from equity markets. We disagree with comments suggesting these objectives could be met through Commission rulemakings to enhance disclosure requirements for alternative 6

See Letter from Susan M. Olson, General Counsel, ICI, to Brent J. Fields, Secretary, Commission, dated May 23, 2018, available at <https://www.ici.org/pdf/31218a.pdf>. ⁷ See *id.* at 2. 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. Mr. Brent J. Fields October 1, 2018 Page 3 of 6

trading systems (ATSs) or for broker-dealers that handle orders for institutional customers.⁸ We endorse both of these disclosure rulemakings and believe they will complement the transaction fee pilot. But, they are not a substitute for it. The disclosure rulemakings could help institutional investors identify whether the conflicts of interest created by exchange transaction fees and rebates influence broker order-handling decisions. They they will not directly reduce the potential for exchange transaction pricing models to create conflicts of interest for broker dealers, nor will they provide data that would allow an institutional investor to measure the impact of fee avoidance on routing decisions. A transaction fee pilot would do both, and we urge the Commission to initiate one as soon as possible.

II. Investors Will Benefit from the Proposal

Commenters asserting that the proposed pilot would harm investors miss the mark by focusing on the potential for the pilot program to increase transaction costs (primarily through modestly wider spreads) for some NMS stocks⁹ while overlooking the potential for the pilot program to improve other market quality metrics. As a threshold matter, it is not clear that the Proposal would cause spreads to widen. Importantly, however, the proposed transaction fee pilot would provide data on spreads as well as a wide range of other market quality metrics that will facilitate the

Commission's consideration of whether modifying the access fee cap in rule 610(c) of Regulation NMS would improve equity market quality for investors. We believe that long-term investors stand to benefit substantially from this holistic evaluation of market quality. Transaction costs, including spreads, are a subset of the criteria that buy-side traders use to evaluate market quality. Other important metrics include: 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 exchange-traded products (ETPs)) intraday premium or discount to fair value. When assessing market quality, buy-side traders generally emphasize the overall performance of parent orders, rather than child orders. Wider spreads for child orders would not necessarily indicate worsening market quality if they are associated with benefits at the parent-order level, such as a reduction in implementation shortfall due to less conflicted order routing or decreased adverse selection. We also would not consider wider spreads to be a negative outcome if they result from increased price transparency in the equity markets. Rule 612 of Regulation NMS prohibits specified 8 See, e.g., Letter from Jeffrey S. Davis, Deputy General Counsel, Nasdaq, Inc., to Brent J. Fields, Secretary, Commission, dated August 31, available at <https://www.sec.gov/comments/s7-05-18/s70518-4291709-173191.pdf> (citing the Commission's recent adoption of enhanced ATS disclosure requirements and its ongoing consideration of amendments to rules 600 and 606 under Regulation NMS as a reason to delay action on the Proposal). 9 See e.g., Letter from Elizabeth K. King, General Counsel and Corporate Secretary, NYSE Group, Inc., to Brent J. Fields, Secretary, Commission, dated July 10, 2018, available at <https://www.sec.gov/comments/s7-05-18/s70518-4022871-167340.pdf>. Mr. Brent J. Fields October 1, 2018 Page 4 of 6 market participants from displaying, ranking, or accepting quotations, orders, or indications of interest in any NMS stock priced in an increment smaller than \$0.01.¹⁰ Accordingly, the quotes displayed at a trading venue (and reported on public data feeds) do not reflect the actual net price of trading at that venue, i.e., the price in subpenny increments, after applicable transaction fees and rebates are taken into account.¹¹ Nevertheless, these subpenny net prices can factor into order routing decisions and, potentially, create incentives for brokers to route orders to venues that charge lower fees or pay higher rebates. If spreads increase because the pilot program reduces or eliminates the incentive for broker-dealers to route orders on the basis of fee avoidance or rebate capture, we would view this as a positive development. In this case, the wider spreads would reflect more accurately different views about the value of a stock, unobscured by transaction fees and rebates.¹² The Commission should not abandon the Proposal due to concerns about potentially wider spreads or higher transaction costs. Instead, the Commission should commit to conducting a comprehensive evaluation of equity market quality, one that uses metrics in addition to spreads—as ICI urged in its comment letter of May 23. The Proposal would provide the Commission with the data necessary to conduct the holistic evaluation that we recommend and to assess whether a permanent change to rule 610(c) of Regulation NMS would improve market quality for investors.

III. The Proposed Pilot Should Not Cause Common Stocks of Operating Companies in Test Groups to Become Less Attractive Investments than Control Group Issuers Certain listed companies have expressed concern that common stocks in one of the Proposal's test groups would be less attractive investments because they might have wider bid-ask spreads and less liquid markets than securities in the control group.¹³ We believe this result is unlikely. Market structure simply is not a significant factor driving the investment decisions of long-term investors, such as regulated funds, and the advisers that act on their behalf. A regulated fund relies on the portfolio manager(s) of its investment adviser to pursue the investment strategy described in the fund's 10 This "subpenny rule" applies to bids, offers, and indications of interest of at least \$1.00 per share. 11 See

Memorandum to SEC Market Structure Advisory Committee, from SEC Division of Trading and Markets, dated October 20, 2015 at 27, available at <http://www.sec.gov/spotlight/emsac/memo-maker-taker-fees-on-equities-exchanges.pdf>.¹² We also would not view wider spreads as a negative outcome if they are accompanied by convergent liquidity, e.g., appreciably larger size at the national best bid or offer on a single trading venue. Convergent liquidity likely would suggest a reduction in fragmentation and complexity that would benefit investors.¹³ See, e.g., Letter from Michael Sherman, Senior Vice President & General Counsel, Genesis Healthcare, Inc., to Brent J. Fields, Secretary, Commission, dated June 26, 2018, available at <https://www.sec.gov/comments/s7-05-18/s70518-4016861-167309.pdf>. One listed company (in its capacity as an issuer) supports the Proposal, and its letter explains why the proposed pilot should not harm issuers. See Letter from Mehmet Kinak, Vice President – Global Head of Systemic Trading & Market Structure, and Jonathan Seigel, Vice President – Senior Legal Counsel, Legislative & Regulatory Affairs, to Brent J. Fields, Secretary, Commission, dated June 12, 2018, available at <https://www.sec.gov/comments/s7-05-18/s70518-3832746-162769.pdf>. Mr. Brent J. Fields October 1, 2018 Page 5 of 6 prospectus. For example, the portfolio manager for an index equity fund generally makes purchase and sale decisions to minimize the tracking error of the fund from its benchmark. Conversely, portfolio managers for funds that employ “active” investment strategies (e.g., capital appreciation or growth) often make investment decisions based on the “fundamentals” of a company, such as the quality of its management team, earnings, earnings growth, or valuation relative to peer companies. Market structure factors, such as bid-ask spread or participation in an SEC pilot program, generally do not factor into these investment decisions. Rather, portfolio managers rely on buy-side traders to navigate the market structure and execute investment decisions in the manner most beneficial to the fund. Although we believe it is unlikely that the pilot will generate the harms asserted by issuers, a small modification to the design of the proposed pilot would largely address issuer concerns. The Proposal calls for the Commission to distribute pilot securities among three test groups and one control group using a stratified sampling technique that “would result in each [t]est [g]roup and the [c]ontrol [g]roup containing a group of stocks that, as a group, reflect a similar distribution of market capitalization, share price, and liquidity.”¹⁴ The composition of these groups would remain constant during the pilot period, unless an NMS stock is removed from the pilot. The SEC could mitigate the potential for the pilot to create competitive distortions among pilot securities by rotating each stratified sample through each of the three test groups and the control group during the pilot period. Rotating the stratified samples through the entire range of pilot treatments would ensure that all pilot securities experience the market conditions particular to each pilot treatment. As we explained in our letter of May 23, 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.¹⁵ Moreover, rotations through each pilot group would allow for potential differences in market quality to be assessed at the individual security level.¹⁶ In addition, rotating pilot securities through each pilot group would mitigate the potential for the pilot to distort competition in the ETP market, which we believe is a more likely outcome of the Proposal.¹⁷ ¹⁴ See Proposal at n. 116. ¹⁵ See Letter from Susan M. Olson, General Counsel, ICI, to Brent J. Fields, Secretary, Commission, dated May 23, 2018, available at <https://www.ici.org/pdf/31218a.pdf>. ¹⁶ Rotations also could address other concerns raised by issuers. Some issuers, for example, believe that the potential for bid-ask spreads to widen could increase costs for issuers conducting a share repurchase program. See Letter from James D. Rollins III, Chairman and Chief Executive Officer,

BancorpSouth Bank, to Brent J. Fields, Secretary, Commission, dated June 11, 2018, available at <https://www.sec.gov/comments/s7-05-18/s70518-4055526-169041.pdf>. Rotating all pilot securities through each of the pilot groups would ensure that all issuers conducting share repurchase programs experience the market conditions particular to each pilot group over the duration of the pilot, which should reduce the potential for issuers in one or more of the groups to incur disproportionately higher costs compared to issuers in other pilot groups. 17 As explained in our letter of May 23, if ETPs that track the same index or pursue similar strategies are placed in different pilot groups—and market quality varies among the pilot groups—investors might migrate toward products in the pilot Mr. Brent J. Fields October 1, 2018 Page 6 of 6 * * * We appreciate the opportunity to comment on the proposed transaction fee pilot program. We urge the Commission to finalize the Proposal, with the changes suggested above and in our letter of May 23, and commence the pilot as quickly as possible to begin gathering data about how rule 610(c) under Regulation NMS affects market quality. 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 Robert J. Jackson Jr. The Honorable Hester M. Peirce The Honorable Elad L. Roisman 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 groups with better market quality. This arbitrary result would tilt the playing field in favor of ETPs that happen to be assigned—at random—to pilot groups that perform better at the expense of other products. We believe that pilot has a greater potential to cause competitive distortions among ETPs than among 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.