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Invested in America

December 22, 2014

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

Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Re: File No. 4–657: Joint Industry Plan; BATS Exchange, Inc., BATS Y-Exchange, Inc., Chicago Stock Exchange, Inc., EDGA Exchange, Inc., EDGX Exchange, Inc., Financial Industry Regulatory Authority, Inc., NASDAQ OMX BX, Inc., NASDAQ OMX PHLX LLC, The Nasdaq Stock Market LLC, New York Stock Exchange LLC, NYSE MKT LLC, and NYSE Arca, Inc.; Notice of Filing of Proposed National Market System Plan To Implement a Tick Size Pilot Program on a One-Year Pilot Basis

Dear Secretary:

The Securities Industry and Financial Markets Association ("SIFMA")[1] submits this letter to comment on the proposed national market system ("NMS") plan to implement a tick size pilot (the "Proposed Plan")[2] filed by the U.S. equity securities exchanges and the Financial Industry Regulatory Authority ("FINRA," and collectively with the exchanges, the "Participants" or the "SROs") with the U.S. Securities and Exchange Commission (the "Commission"). SIFMA has supported a pilot exploring how a wider tick size might benefit small cap issuers (a "Pilot").[3] At the same time, however, we have expressed concerns regarding a Pilot that would prohibit trading between the wider quoting increments. In addition, for any pilot program to be a success, it is critical to establish clearly stated metrics for use in evaluating the results of the Pilot and determining whether it is a success. It is also essential that a Pilot not cause undue negative consequences while at the same time ensuring that the costs of the experiment are justifiable. We hope our comments are helpful to the Commission in achieving these goals.

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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] *See* Release No. 34-73511, 79 Fed. Reg. 66423 (Nov. 7, 2014) (the "Proposed Plan Notice"). The Proposed Plan was filed in response to the Commission's order requiring the Participants to act jointly in developing and filing with the Commission an NMS plan that, among other things, would widen the quoting and trading increments for certain small capitalization stocks. *See* Order Directing the Exchanges and the Financial Industry Regulatory Authority To Submit a Tick Size Pilot Plan; Release No. 34-72460 (June 20, 2014) (the "Pilot Order").

[3] *See* Wunderlich, Gary K. Jr., Written Testimony of Gary K. Wunderlich, Jr., on Behalf of SIFMA, Before the House Subcomm. on Capital Markets and Gov't Sponsored Enter., 113th Cong. (Oct. 23, 2013), available at: http://www.sifma.org/issues/item.aspx?id=8589945826.

I. Introduction

SIFMA supports the concept of the Pilot as long as it is carefully structured and designed with very clear metrics to determine whether adjusting tick sizes increases liquidity in the small-cap market or creates a more fertile environment for small and emerging growth companies to raise capital through the public markets. However, the Pilot Order and Proposed Plan present a number of significant concerns, as a matter of policy, effectiveness, and operational risk.

SIFMA opposes structuring the Pilot as an NMS plan. As we describe in more detail below, such a major change in the regulations governing equity market structure should be proposed and adopted by the Commission in its role as the primary regulator of the U.S. securities markets. Instead, by using the NMS plan construct to develop and propose the Pilot, the Commission has allowed one group of market participants (*i.e.*, exchanges) to establish a regulatory scheme that will govern their competitors (*i.e.*, broker-dealers).

In addition, SIFMA opposes including a "trade at" requirement ("Trade At Requirement") in the Pilot.[4] SIFMA has expressed opposition on numerous occasions to the general idea of implementing a Trade At Requirement.[5] For the Pilot, we believe the Commission and the SROs have provided insufficient explanation as to how a Trade At Requirement would inform the Commission regarding the impact of tick sizes on smaller companies' liquidity and capital raising prospects. Even putting aside our policy objections, the proposed Trade At Requirement is so complex that it would introduce unnecessary operational risk into the market, cause market participants to incur very significant costs, and ultimately would take more time to implement than the length of the Pilot itself.

SIFMA also believes that measures should be taken to reduce the costs and complexity of the Pilot, and the burden on market participants, including the elimination of the special market data and profitability reporting requirements. The Commission should be able to gain sufficient data from the SROs without imposing additional reporting obligations on broker-dealers.

II. The Pilot Should Not Be an NMS Plan

SIFMA believes the Pilot should not be implemented through an NMS plan. The Pilot would result in a significant change to equity market structure, and it should be conducted through Commission rulemaking (*see, e.g.*, short sale price test pilot). The process undertaken

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[4] A "trade-at" requirement may generally be described as a rule prohibiting any trading center from executing a trade at the NBBO unless the trading center was displaying that price at the time it received the incoming contra-side order.

[5] *See, e.g.*, Letter from Ann L. Vlcek, Managing Director and Associate General Counsel, SIFMA, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission (March 21, 2011), available at http://www.sec.gov/comments/265-26/265-26-53.pdf; Letter from Ann Vlcek, Managing Director and Associate General Counsel, SIFMA, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission (Apr. 29, 2010), available at http://www.sec.gov/comments/s7-02-10/s70210-167.pdf.

by the Commission thus far has allowed it to issue the Pilot Order without the benefit of public notice and comment or an economic analysis. Rather, the Commission concluded that the Pilot, with parameters specified by the Commission, is necessary, and has therefore ordered the Participants to devise an NMS plan to implement the Commission's decision. The Participants, in turn, developed the Proposed Plan on their own terms with no input from the market participants that will be most affected by the Pilot's compliance and implementation obligations.

Although the concept of the Pilot has been the subject of public discussion for years and even some legislative efforts,[6] the Pilot Order and its parameters were not subjected to public notice and comment and the protections of the Administrative Procedures Act ("APA"). The fact that the Pilot Order only contemplates temporary changes should not have spared it from full notice and comment. The Pilot's impact on the markets, and its costs, will not be theoretical, and they should be measured against any benefit to be gained. Although the Proposed Plan is now being subjected to public notice and comment, that is not the same as subjecting the deliberation of the Pilot to a Commission-conducted economic analysis as well as the requirements of the APA.

SIFMA also believes conducting the Pilot though an NMS plan bestows benefits on a limited number of market participants, namely the national securities exchanges, at the expense of broker-dealers, which are members of, and regulated by, the exchanges. Historically, participation in NMS plans has been limited to SROs, thereby precluding participation by other key market participants. Structuring the Pilot as an NMS plan unfairly gives more control of the Pilot to one set of market participants (*i.e.*, exchanges) over others (such as alternative trading systems ("ATSs"), market makers, and other executing broker-dealers).

Moreover, the Exchange Participants are not neutral parties – they are in direct economic competition with the broker-dealers that operate ATSs, make markets, or provide execution services in the securities that will be subject to the Proposed Plan. This competition creates a conflict of interest on the part of the exchanges that should have precluded their special participation in the design and implementation of the Pilot. SIFMA previously raised to the Commission its concerns with the conflicts of interest associated with exchanges acting as SROs and for-profit businesses, particularly when they compete with broker-dealers.[7] In addition, we expressed our concern with the SROs ability to design, implement, and influence outcomes on market structure initiatives, despite their own competitive interests as market participants.[8] The Proposed Plan's exemption for exchanges' retail order liquidity programs is suggestive of this conflict of interest. Considering these flaws and the absence of any enunciated need to conduct the Pilot through an NMS plan, the Commission should conduct the Pilot through Commission rulemaking.

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[6] *See* Small Cap Liquidity Reform Act of 2014, H.R. 3448, 113th Cong. (2d Sess. 2014).

[7] *See* Letter from Theodore R. Lazo, Managing Director and Associate General Counsel, SIFMA to Mary Jo White, Chair, Commission dated July 31, 2013), available at http://www.sifma.org/issues/item.aspx?id=8589944673.

[8] *Id.* at 11.

III. Substantive Issues with the Pilot Order and the Proposed Plan

A. The Pilot Should Not Include a Trade At Requirement[9]

SIFMA believes the Pilot should not include a Trade At Requirement. We see no connection between the goal of the Pilot – widening tick sizes to determine the impact on small cap issuers and their securities – and the imposition of a Trade At Requirement which is simply a measure to increase market share for exchanges. The impact of adjusting tick sizes can be fully tested and evaluated without imposing a Trade At Requirement. In addition, the Trade At Requirement makes the Pilot much more complex, time-consuming, and expensive to implement. Finally, even if it were appropriate to include a Trade At Requirement in the Pilot, the Pilot Order and Proposed Plan do not provide for the adequate testing of a Trade At Requirement.

1. The Trade At Requirement Lacks Adequate Justification

The decision to include a Trade At Requirement in the Pilot has not been adequately justified. The Pilot is supposed to address a specific issue – whether increasing minimum pricing increments for secondary market transactions benefits smaller companies. The Trade At Requirement is, in its own regard, a controversial market structure issue that has been part of the market structure discussion irrespective of the tick size discussion. The question of whether dealers are allowed to match the National Best Bid or Offer ("NBBO") or even offer price improvement based on the NBBO bears little relation to the impact of the size of permissible pricing increments. A true pilot on tick size would simply change the pricing increments for quoting orders in a sample set of securities and compare outcomes to a control set of similar securities.

Nevertheless, the Commission decided to include a Trade At Requirement in its Pilot Order. This decision needs to be revisited, and SIFMA suggests it should be reversed. The parameters for Test Group One are consistent with SIFMA's views on the structure a Pilot. And even though we have previously expressed concern about imposing restrictions on trading within the quoted spread, SIFMA supports the notion of some tick size limitations on executions. However, the Pilot has become extremely controversial with the unnecessary addition of a Trade At Requirement, which SIFMA and many others have previously opposed.

[9] SIFMA has previously opposed "trade at" in several other comment letters. *See e.g.* Letter from Ann Vlcek, Managing Director and Associate General Counsel, SIFMA to Elizabeth M. Murphy, Secretary, Commission dated April 29, 2010.

Despite its controversial nature, the Commission dedicated only one paragraph in the Pilot Order to explain why it ordered the inclusion of a Trade At Requirement in the Pilot, stating:

> When quoting and trading increments are widened in the absence of a trade-at requirement, the Commission preliminarily believes there is a possibility trading volume could migrate away from "lit venues" -- trading venues that provide public pre-trade transparency by displaying the best-priced quotations – to "dark venues" that do not provide such public pre-trade price transparency. ….The Commission believes that if trading volume in Test Group Two Pilot Securities moves to undisplayed trading centers, then including the trade-at requirement in Test Group Three could test whether trading remains on lit venues and what impact, if any, the migration of trading from lit venues to dark venues would have on liquidity and market quality for the Pilot Securities.[10]

In our view, this paragraph does not provide sufficient justification for including a Trade At Requirement in a Pilot designed to test the impact on smaller companies of changing tick sizes. The Commission acknowledges that it is speculating based on a *preliminary* belief that increasing tick sizes could *possibly* drive volume away from lit venues.[11] Notwithstanding the speculative nature of its views, the Commission seeks to address the possibility by imposing a Trade At Requirement. The Commission does not explain why increasing quoting and trading increments might drive trading to off-exchange venues that, under the Pilot Order, also would not be allowed to transact in smaller increments. Indeed, exchanges have mechanisms for mid-point crosses that should mitigate or even forestall any flight of liquidity to dark pools. Further, the Commission has not explained why this possible outcome of orders moving to off-exchange venues is something that would need to be countered or how a Trade At Requirement would be the right way to do so.

As explained below, a Trade At Requirement will significantly increase the costs associated with a Pilot, so it should not be imposed simply as an experiment. For all these reasons, we do not believe the Commission has adequately justified the inclusion of a Trade At Requirement in the Pilot.

2. The Proposed Trade At Requirement is Too Complex and Costly

The Trade At Requirement should not be included in the Pilot because it unnecessarily complicates the Pilot, which in turn will multiply the costs to be borne by market participants and significantly increases the time necessary to implement the Pilot. For example, by including

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[10] *See* Pilot Order, at 23-24.

[11] We also disagree with the notion, embedded in the Commission's rationale for the Trade At Requirement, that the exchanges are "lit venues" and all other venues that do not have protected quotations are "dark venues." For example, the exchanges provide a material amount of dark liquidity through mid-point matches and reserve size.

a Trade At Requirement in the Pilot, market makers and other executing broker-dealers would have to completely change their model for handling customer orders for just 400 securities. The costs associated with adding a Trade At Requirement to the Pilot include, but are not limited to, planning costs, software programming and testing costs, increased exchange “taker” fees, costs stemming from increased number of executions, compliance and surveillance costs including the development of reviews and reports, and employee training. The Trade At Requirement can also reasonably be predicted to result in costly information leakage, either through the display of larger size orders or by necessitating more trades at lesser size.

The complexity of a Trade At Requirement also unnecessarily increases operational risk to the market. For example, each trading center would need to change multiple systems in order to operate in compliance with the Pilot, resulting in multiple trading centers making multiple systems changes at the same time. Any systems change, no matter how thoroughly prepared and tested, creates a risk of error and negative impact to the market. The Trade At Requirement would result in a significant number of systems changes by key market participants, all for the sole purpose of a temporary trading experiment in 400 securities. Any mistake resulting from all of those systems changes could cause systemic problems. There simply are not enough benefits from Test Group Three to justify the significant implementation risk that would result.

In light of the limited number of securities and limited duration of the proposed Trade At Requirement, many trading centers may simply take the minimum steps necessary to comply with the Trade At Requirement. Moreover, if the implementation costs are too high, trading centers may simply choose to stop trading the securities subject to the Trade At Requirement, or simply decide only to execute mid-point trades in those securities. Either scenario would compromise the existing liquidity in those securities and the accuracy of the data gleaned from the Pilot.

3. The Proposed Trade At Requirement is not Workable and Should be Modified

Even if it were appropriate to include a Trade At Requirement in the Pilot, the Pilot Order and Proposed Plan have not provided for adequate evaluation of the impact of the Trade At Requirement. The Pilot Order and Proposed Plan do not clearly specify the theory or theories being tested, what data is necessary to test such theory/theories, and how the Pilot Order and Proposed Plan will lead to the generation and collection of the necessary data. A proper test does not simply change multiple variables, collect as much data as possible, then try to determine what the data shows about the impact of changing the variables.

Moreover, if the Pilot Order and Proposed Plan include a Trade At Requirement, we do not believe it will lead to useful data regarding the impact of a Trade At Requirement because the data will not reflect true behavior in a permanent “trade at” environment across all NMS securities. Market participants such as market makers and ATSs will not react to a one year “trade at” pilot on a small sub-set of small-cap securities the same way they would if “trade at” were a permanent change for a larger group of securities. For example, as already noted, some trading centers might simply cease trading is securities subject to a one year Trade At Requirement.

If, despite all the drawbacks, the Commission decides to keep a Trade At Requirement in the Pilot, broker-dealers should be allowed to internalize order flow without a limitation on size if they are displaying a quote at the price of the NBB or NBO. If this exception is not included, large orders (primarily from institutions) in these lesser liquidity securities will either need to be displayed in size or displayed in pieces – both of which will harm execution quality. A likely outcome is that institutions will simply invest less in these securities.

By excluding the size limitation from the Trade At Requirement, displayed liquidity would still be incentivized while allowing broker-dealers to efficiently execute customer transactions with price improvement. In this scenario, SIFMA would support allowing the Participant Exchanges to access their undisplayed reserve size under the Pilot as long as they were displaying at the NBBO.

Also if the Pilot includes a Trade At Requirement, we believe the exemption for blocks should be replaced with an exemption for large orders that are nevertheless significantly smaller than "Block Size" as defined in Regulation NMS.[12] We believe larger orders that are much smaller than "Block Size" orders will be subjected to significant degradation in execution quality if a Trade At Requirement is applied. In addition, keeping defined terms consistent with pre-existing definitions will reduce complexity and costs.

B. Costs and Complexity of the Pilot Need to be Reduced

The complexity and costs associated with the Pilot, whether implemented through Commission rule-making or an NMS plan, need to be limited. The Pilot is a burden the Commission seeks to impose on the industry temporarily to test whether increasing tick sizes might help smaller companies raise capital. Whether or not a larger tick size might lead to those results, the Commission should not add components to the Pilot merely because it is already undertaking the study of one issue. The fact that the Pilot is not a permanent rule should also be considered when weighing the costs and benefits. Any pilot program that requires systems and order routing changes is expensive and burdensome for the industry. It is, therefore, important not to impose such burdens and costs without good reason.

In this case, Congress expressed concerns about capital formation and liquidity in small company stocks and suggested that a larger tick size might cause greater trading activity, more research, and easier capital formation for those issues. However, the Pilot Order and Proposed Plan would require broker-dealers to go through NMS-like operational risks and costs for a study that, at its core, is straight forward – to discern the impact of increasing tick sizes on trading and

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[12] Rule 600(b)(9) of Regulation NMS defines an order as "Block Size" if it is for at least 10,000 shares or has a market value of at least $200,000. *See* 17 CFR 242.600(b)(9).

capital raising of smaller companies. The more costs are reduced, the lower the likelihood that firms will choose to limit or abstain from dealing in the Pilot Securities.

The best way to reduce costs is through reduced complexity. Reducing complexity also reduces systemic risks. Eliminating the Trade At Requirement would significantly reduce complexity. If, as suggested by the Commission in the Pilot Order, the Trade At Requirement is necessary to counterbalance possible negative consequences of Test Group Two, then simply eliminate Test Group Two. Only one test group, with modifications, is truly needed to assess the impact of increased tick sizes.

Costs can also be reduced by decreasing the number of securities subject to the Pilot. The Pilot should exclude some of the larger capitalization and more liquid companies, and focus more on smaller, less liquid companies. In particular, the proposed market capitalization threshold in the Pilot is too high and should be reduced to a level that would truly capture smaller companies – for example to $1 billion.

Finally, perhaps the most important cost of the Pilot is unstated in both the Pilot Order and Pilot Plan – namely, the costs to investors. The Pilot is likely to increase the trading costs to investors while potentially harming execution quality in securities that are required to be traded at wider spreads. It is essential that the Plan require an assessment of losses, through higher trading costs or lesser execution quality, that the Plan may impose on investors. This is perhaps the most critical measurement to make in conjunction with the Pilot. The Pilot should not go forward without addressing this issue, because the Commission must tread warily before taking any action which imposes greater costs on investors.

C. The Proposed Data Collection and Production is Too Burdensome

The data collections specified in Appendices B and C of the Proposed Plan are extremely burdensome on broker-dealers and should be eliminated. Broker-dealers already face daunting order and trade reporting requirements (*e.g.*, OATS reporting, trade reporting, short interest reporting, electronic blue sheets, implementation of CAT) that create incredible costs, impose material regulatory and compliance burdens, and lead to countless enforcement actions and fines. The proposed collections of order and profitability data unnecessarily increase the burden on all trading centers, especially market makers who would be subject to both Appendix B and C. The Commission should seek to use existing data it and the SROs already receive to perform any analysis necessary to analyze the results of the Pilot.

The data proposed to be collected from non-exchange trading centers under Appendix B alone would pose a material increase in their reporting obligations. The Appendix B data is similar to, but not the same as, Rule 605 data plus OATS data. Rule 605 and OATS are themselves each burdensome (especially OATS). To layer the Appendix B requirements on top of pre-existing Rule 605 and OATS obligations is simply excessive, especially considering the temporary nature of the Pilot.

SIFMA also believes the proposed requirement that market makers calculate and report their profitability in accordance with Appendix C should be eliminated entirely. Not only is this proposal very burdensome, but the purpose of the market maker profitability information is also unclear. The Pilot Order does not explain the theory being tested that would necessitate this information, and how this information will inform that theory. Even if market makers make more money when tick sizes increase, there is no basis for assuming that funding for research or investment banking will increase. For example, we note that most of the largest market makers do not engage in investment banking or issue research. Also, the Pilot Order does not explain why it is important to gather this information from market makers but not the exchanges.

Moreover, determining the true measure of profitability is complicated, may be attempted in numerous ways, and the most appropriate calculation may vary depending on the firm. It is unclear if the approach included in the Pilot Plan is an appropriate measure of profitability for any firm, let alone all the firms that would be subject to it. If the Commission concludes that it must obtain profitability information as part of the Pilot, the Commission should ask for the raw data and perform the calculations itself. If the Commission insists on putting such a burden on market makers, much more guidance on the calculation will be necessary.

If the Commission ultimately does require broker-dealers to submit data to the Commission or SROs, the proposal should be curtailed significantly. Finally, under no circumstance should the information be made publicly available on a disaggregated basis, even if the firms are not identified by name.

D. Additional Recommended Changes to the Pilot

We believe the price improvement exception should not be limited to “Retail Investor Orders” as defined in the Pilot Order and Proposed Plan. The proposed definition is quite complicated and will be very difficult to implement effectively. In addition, the definition simply leverages a definition created by the exchanges in connection with their own commercial offerings, not with a view toward overall benefits to the market. For example, we believe it is incorrect to exclude from the definition of “retail” any order that goes through an algorithm. It is commonplace for routing decisions for retail orders to go through routing algorithms. Moreover, we see no reason to limit the price improvement exception to retail orders to the exclusion of orders, for example, from mutual funds that represent the interests of so many retail investors. Instead, to address these issues and simplify the exception, the Commission should simply permit price improvement as an exception across the board for any orders received by a trading center for execution.

Any Pilot should also have an exemption for the execution of odd lot orders. This would be consistent with the special treatment historically afforded odd lots in many other contexts. Of course, dividing larger orders into odd lots should not qualify for such an exemption

The Pilot also should not include securities (including ADRs) listed in both the U.S. and foreign markets. If such securities are included in the Pilot, we believe the Pilot will simply encourage overseas transactions in such subset of Pilot securities.

IV. Sufficient Implementation Period

If the Commission does decide to go forward with a Pilot, especially one that has the complexities of the Proposed Plan, the Commission should allow for a very lengthy implementation period, perhaps as long as a year or more. Like the order protection rule, the Commission will need to provide considerable guidance and there will need to be considerable systems and supervisory changes before implementation, so a long implementation period will be necessary. The Commission could reduce the time the industry would need to implement the Pilot by simplifying it (*e.g.*, by eliminating the Trade At Requirement), but implementation would still require a lengthy period of time.

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SIFMA appreciates the opportunity to provide comments on the Pilot Order and Proposed Plan. If you have any questions or require further information, please contact me at (202) 962-7383 (tlazo@sifma.org), or Timothy Cummings at (212) 313-1239 (tcummings@sifma.org).

Sincerely,

Theodore R. Lazo
Managing Director and
Associate General Counsel

cc: Mary Jo White, Chair
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