BLACKROCK

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

RE: National Market System Plan to Implement a Tick Size Pilot Program On a One-Year Pilot Basis, File No. 4-657

Dear Mr. Fields:

BlackRock, Inc. (together with its affiliates "BlackRock")[1] appreciates the opportunity to comment on the national market system plan filed by the Financial Industry Regulatory Authority ("FINRA") and the national security exchanges to establish a pilot program to widen the minimum quoting increment for small and mid-sized companies.

As we stated in our equity market structure *ViewPoint*, BlackRock believes that the US equity market is one of the best functioning and most efficient markets in the world.[2] Innovations in technology and thoughtful regulation have lowered transaction costs and narrowed bid-ask spreads. Overall, decimalization, Regulation Alternative Trading Systems and Regulation National Market System have had a positive effect on market structure. Yet, the benefits of these changes may not be equally distributed across the full spectrum of equity securities. Some investors remain concerned about the scarcity of liquidity and impact of trading in small capitalization stocks. In response, the Securities and Exchange Commission ("Commission" or "SEC") has directed FINRA and the exchanges to establish a pilot program to study the effect of a wider minimum pricing variation ("MPV") to determine whether it would enhance market liquidity and efficiency.[3]

Although Blackrock generally favors allowing competitive market forces to natively determine spreads, we are supportive of efforts to rigorously measure the efficacy of regulation on market quality and capital allocation.[4] A pilot is an appropriate vehicle for this purpose as it essentially limits the potential costs and consequences of enacting rule proposals. We commend regulators for pursuing a measured, data-driven methodology to evaluate changes in market structure. However, the pilot program must be focused, thorough and well-constructed in order to yield coherent and valid insights. BlackRock believes that the following modifications to the current proposal would help to achieve these goals:

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[1] BlackRock is one of the world's leading asset management firms, managing approximately $4.525 trillion (as of Sept. 30, 2014) on behalf of institutional and individual clients worldwide, across equity, fixed income, liquidity, real estate, alternatives, and multi-asset strategies. Our client base includes pension plans, endowments, foundations, charities, official institutions, insurance companies and other financial institutions, as well as individuals around the world.

[2] BlackRock, US Equity Market Structure: An Investor Perspective, ViewPoint, Apr. 2014, available at http://www.blackrock.com/corporate/en-us/literature/whitepaper/viewpoint-us-equity-market-structure-april-2014.pdf ("Market Structure ViewPoint").

[3] Order Directing the Exchanges and the Financial Industry Regulatory Authority to Submit a Tick Size Pilot Plan, 79 Fed. Reg. 36840 (June 30, 2014) ("Tick Size Order").

[4] Even though the current MPV is one cent, this does not mean that all stocks trade at the minimum possible spread. In fact, many stocks intrinsically trade at spreads wider than a penny in order to compensate for differences in volatility and liquidity.

- Eliminate or simplify the trade-at rule in Test Group Three
- Clarify the provisions for Test Group One
- Refine the metrics used to assess the cost for investors and impact on market quality
- Clearly define the criteria for success and limit the burden imposed by the pilot

Eliminate or Simplify the Trade-at Rule in Test Group Three

The intent of the pilot is to evaluate "whether wider minimum tick sizes for small capitalization stocks would enhance market quality to the benefit of market participants, issuers, and U.S. investors."[5] BlackRock believes that this objective can be accomplished independently of establishing a trade-at requirement because this rule is not intrinsic to an assessment of market quality or wider MPVs. In the context of the pilot, the central purpose of the trade-at prohibition would be to avoid negatively affecting market maker quoting practices and pre-trade transparency by stemming the migration of trading volumes to "dark" venues. However, this is an acutely narrow interpretation; market quality is not strictly confined to quoted spreads and the displayed size at the National Best Bid and Offer ("NBBO"). The Commission, instead, should focus on assessing the impact to trading volumes, realized volatility, transaction costs and aggregate liquidity which is inclusive of non-displayed orders. These measures are more closely aligned with market quality and improvements in these dimensions are achievable irrespective of the overall composition of "lit" and "dark" trading activity. A trade-at rule would only complicate and distort the pilot results by unnecessarily commingling effects which will be caused by upsetting the balance between displayed and non-displayed liquidity.

Furthermore, if policy makers are inclined to study the impact of a trade-at requirement, BlackRock believes that illiquid small capitalization stocks are highly unsuitable as pilot securities. Meaningful insights about trade-at can only be obtained if the rule is applied across a wide range of actively traded stocks. Indeed, this point was recognized by Stephen Luparello in a recent panel at the Securities Industry and Financial Markets Association's ("SIFMA") annual meeting when he acknowledged, "If you were going to do a trade-at pilot, [the smallest company segment] is not the segment of the market you do it in."[6]

BlackRock believes that a trade-at rule may potentially increase costs for retail and institutional investors, and the decision to implement it should not be made lightly. By disproportionately compelling orders onto displayed venues, this rule subjects investors to pre-trade price impact and information leakage. Trade-at is overly prescriptive and anti-competitive because it limits the ability of market participants to be selective in their choice of liquidity partners or leverage the pricing safeguards and execution mechanisms in alternative trading venues. If trade-at is implemented independently of a reduction in exchange access fees, the rule will also exacerbate the conflicts of interest inherent in broker order routing practices.[7] Recent academic studies suggest that a trade-at or price improvement rule may be harmful to market liquidity.[8] Specifically, researchers examined the impact of the minimum price improvement amendments in Canada and Australia and found that the regulations decreased the level of dark trading and had a

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[5] Tick Size Order at 14.

[6] Dave Michaels & Sam Mamudi, Brokers Attack SEC's Plan as Trojan Horse, Bloomberg (Nov. 11, 2014, 9:21 AM), http://www.bloomberg.com/news/2014-11-11/brokers-attack-sec-s-plan-as-trojan-horse-designed-to-hurt-them.html (quoting Stephen Luparello, Dir. of the Div. of Trading & Mkts., SEC, Speech at the SIFMA 2014 Annual Meeting (Nov. 10, 2014)).

[7] Exchange access fees are central to the conflict of interest between reducing costs for brokers and achieving best execution for clients. *See* Market Structure ViewPoint.

[8] *See* Sean Foley & Tālis Putniņš, Regulatory Efforts to Reduce Dark Trading in Canada and Australia: How Have They Worked? (Oct. 2, 2014) (unpublished manuscript), available at http://www.cfainstitute.org/ethics/Documents/Trade-at%20Rule%20Report.pdf.

negative effect on market quality by shifting dark trading to the midpoint of the NBBO.[9] Additionally, the analysis found no evidence of increased lit liquidity provision or larger trade sizes in the dark following the introduction of the rules.[10] The authors conclude that "the main reason why the minimum price improvement regulation resulted in wider spreads and larger price impacts is that it effectively prohibited two-sided dark limit order markets in the large number of stocks where the spread is constrained by the tick size."[11] In light of these concerns regarding significant unintended consequences, a trade-at rule should only be considered in the pilot if it is fundamentally integral to a study of wider MPVs.

Additionally, the trade-at requirement as proposed is exceedingly complex and introduces substantial systemic risk. As others have noted, the trade-at prohibition makes the third test group the most expensive and time-consuming segment to implement as it will require the greatest modification to existing trading infrastructure and processes.[12] Moreover, if the expense required to properly implement this rule materially outweighs the potential returns from trading in this group of stocks, market makers may decide to refrain from transacting in the affected securities. This will undermine the integrity of the pilot and possibly discredit the results from this group. Eliminating the trade-at requirement would dramatically reduce the overall cost and complexity associated with the pilot by removing the need for a third test group.

In the alternative, if the Commission believes that a trade-at rule is absolutely essential to the pilot, BlackRock suggests simplifying the rule substantially. Numerous variations of a trade-at rule can be created by revising the conditions for permitting trading centers to execute orders at the protected bid or offer. For instance, in the Commission's Tick Size Order, a trading center displaying the NBBO would be allowed to fully execute an incoming marketable order, even if it exceeded the full displayed size at that venue. This is a sensible concession between immediacy of execution and the promotion of displayed liquidity. Under the proposed plan, however, participants are required to first route orders to other venues displaying equivalent bids and offers before executing any non-displayed quantity. This is a perversion of the original specification which creates excessive delay in execution and sub-optimally broadcasts order flow in illiquid names to multiple venues when there might have been sufficient reserve or non-displayed interest to accommodate the order. It may also act as a crutch for inefficient trading centers and foster continued fragmentation in markets. This inordinately and counterproductively preferences exchange interests and displayed liquidity at the expense of increased market impact and signaling costs for investors.

The current proposal also provides an exemption from the trade-at rule when there is significant size improvement as defined by an execution of block size.[13] BlackRock believes that this size improvement threshold is too high and should be lowered or more appropriately calibrated to the microstructure characteristics of the stock. If the core principle underlying a pilot of wider tick sizes is that a "one size fits all" approach is not suitable for all stocks, then it should follow that the canonical definition of a block also needs to be revised for small capitalization stocks. Nearly a third of the equities which are eligible for the pilot have average daily trading volumes which are

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[9] *Id.* at 5.

[10] *Id.* at 41.

[11] *Id.* at 42.

[12] *See* Letter from John Daley, Chairman of the Board, Security Traders Association, James A. Toes, President and CEO, Security Traders Association to Elizabeth Murphy, Secretary, SEC, at 4, dated Sept. 23, 2014; John C. Nagel, Managing Director and Senior Deputy General Counsel, Citadel to Brent Fields, Secretary SEC, at 1, dated Sept. 12, 2014.

[13] Block size with respect to an order means it is (i) of at least 10,000 shares or (ii) for a quantity of stock having a market value of at least $200,000. *See* 17 CFR 242.600(b)(9); Tick Size Request for Comment at 66433.

lower than 50,000 shares.[14] A block of 10,000 shares would be incommensurate with the volume profile for these stocks as it represents a substantial percentage of the daily trading volume. The total order quantity of most institutions would be unlikely to exceed block size for such inactive small capitalization equities.[15] Given the trading patterns of these securities, 500 or 1000 shares would be more reasonable allowances for size improvement. Additionally, institutional activity is much less likely to be characterized by block executions in today's market environment. Institutional orders are algorithmically traded and broken up into smaller non-block transactions to manage market impact and risk. Consequently, a block size exemption for trade-at would severely limit the ability of institutions to leverage non-displayed venues to manage information leakage in illiquid stocks, which will lead to increased trading costs. In summary, further analysis and consideration should be given towards optimally defining the provisions of the trade-at rule in order to avoid unintentionally harming the market and increasing costs for investors.

Clarify the Provisions for Test Group One

In the SEC's Tick Size Order, Test Group One was established to "isolate the effects of an increased quoting increment"[16] while allowing trading to "continue to occur at any price increment that is permitted today."[17] However, the language used in the proposal to define Test Group One practically eliminates the flexibility to execute at any price. The plan requires that:

> Participants will adopt rules prohibiting Participants or <u>any member of a Participant</u> from displaying, ranking, or accepting from any person any displayable or non-displayable bids or offers, orders, or indications of interest in any Pilot Security in Test Group One in price increments other than \$0.05.[18]

A strict interpretation of this rule would prevent brokers as exchange members from accepting any order unless it is priced in nickels. Since the leading Alternative Trading Systems and dark pools are primarily operated by exchange members, these trading centers would also be restricted from accepting or executing orders in penny increments. This appears to contravene the Commission's intent to provide more pricing flexibility in creating this pilot group. Additionally, the distinction between Test Group One and Test Group Two is considerably diminished if trading in increments other than \$0.05 is disallowed. Under this interpretation, it may be prudent to merge these groups as there would not be sufficient differentiation to warrant the increased burden and cost associated with a separate pilot segment. BlackRock believes that the Commission should re-examine whether the current language conforms to the true intention behind establishing Test Group One and clarify any misrepresentative wording.

[14] Estimates are based on our assessment of the eligible pilot securities. The SEC's own staff research demonstrates that the trading volume of small cap stocks varies tremendously. *See* Charles Collver, A Characterization of Market Quality for Small Capitalization US Equities, 15 tbl.5 (Sept. 2014), available at http://www.sec.gov/marketstructure/research/small_cap_liquidity.pdf (demonstrating that companies with market capitalization under \$100 million have an average daily volume ranging from \$44,000 to \$128,000, while stocks with market capitalization from \$500 million to \$1 billion have an average daily volume ranging from \$3,050,000 to \$5,494,000).

[15] In 1H2014, over 80% of BlackRock orders in equities which would be eligible for the tick size pilot were smaller than 10,000 shares.

[16] Tick Size Order at 36845.

[17] *Id.* at 36844.

[18] Tick Size Request for Comment at 66424.

Refine the Metrics Used to Assess the Cost for Investors and Impact on Market Quality

Earlier this year, the Market Structure Subcommittee of the SEC Investor Advisory Committee noted that:

> In assessing the pilot, it will be particularly important to weigh the costs and benefits to investors, so it will be important to define clear and quantifiable metrics from the outset. Benefits to investors should be the first consideration, both because this is the central mission of the Commission and because the most direct way to further the goal of capital formation is by attracting investors to buy more small and micro-cap stocks.[19]

BlackRock agrees that a proper evaluation of the impact from wider MPVs must thoroughly weigh the costs and benefits to investors. However, the metrics which the current proposal seeks to collect are inadequate and do not fully quantify all aspects of cost or the impact to market quality. The current plan requires trading centers to gather and publish data on realized, effective, and quoted spreads for any orders they receive. Such analytics, however, only provide a reasonable gauge of market impact for smaller orders which are executable at or within the NBBO at a single exchange. This is not an accurate reflection of the trading costs for institutional investors who must typically break larger orders into a series of smaller transactions across multiple venues. Any evaluation of cost would be incomplete unless it also includes the transaction costs of institutions due to their extensive participation in equity markets.[20] We recognize, however, that measuring institutional trading costs is complicated since the data required is not publicly available. We recommend that the Commission work with trading analytics firms and broker dealers who publish studies of transaction costs to assess the impact on institutional investors. Although these firms only have access to a subset of institutional transaction data, they should be able to provide the Commission with an acceptable approximation of institutional costs and the associated trends.[21]

Measures should be designed to comprehensively gauge how wider MPVs will enhance or improve upon existing market quality. In particular, the metrics used to contrast results between the control and pilot groups and timeframes must be economically equivalent and comparable in order to avoid distorting the analysis. This is not currently the case as the data requested in the proposal is noticeably biased towards observations of the quoted size at the NBBO. These statistics fail to recognize the aggregate liquidity from both non-displayed orders and the bids/offers within the full depth of book. As such, these measures are incomplete and would inequitably assess the impact of wider MPVs to market quality.[22] More emphasis should be given

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[19] *See* Investor Advisory Comm., SEC, Recommendation of the Investor Advisory Committee on Decimalization and Tick Sizes (2014), available at http://www.sec.gov/spotlight/investor-advisory-committee-2012/investment-adviser-decimilization-recommendation.pdf.

[20] A 2013 TABB study estimates the institutional share of equity market volume at 28.5% and the retail share at 14.5%. Adam Sussman, US Equities Market: 2013 State of the Industry (TABB Group, Jan. 23, 2013).

[21] The Commission has previously acknowledged the value of trading analytics firms. *See* Concept Release on Equity Market Structure, 75 Fed. Reg. 3593 at note 59 (Jan. 21, 2010) (citing U.S. Gov't Accountability Office, GAO-05-535, Securities Markets: Decimal Pricing Has Contributed to Lower Trading Costs and a More Challenging Trading Environment (May 2005) ("We obtained data from three leading firms that collect and analyze information about institutional investors' trading costs. These trade analytics firms . . . obtain trade data directly from institutional investors and brokerage firms and calculate trading costs, including market impact costs (the extent to which the security changes in price after the investor begins trading), typically for the purpose of helping investors and traders limit costs of trading. These firms also aggregate client data so as to approximate total average trading costs for all institutional investors. Generally, the client base represented in aggregate cost data can be used to make generalizations about the institutional investor industry.")).

[22] For example, assume that prior to the pilot the order book for Security ABC is comprised of a 100 share bid at $20.03, a 300 share bid at $20.01, and a 200 share bid at $20.00. If Security ABC exhibits a 600 share bid at $20.00 under the tick size pilot, then this should not be considered an improvement in market quality because it is equivalent to the liquidity which would have been accessible prior to the pilot within a 5-cent window of the NBBO. Similarly, any comparable

to metrics which holistically evaluate market quality versus those that have a very narrow interpretation. Some unbiased and empirically observable indicators of market quality are, but are not limited to:

- ***Traded volumes*** – increased trading activity normalized for market-wide activity may be indicative of an improvement in overall liquidity
- ***Average trade sizes*** – increases in average trade sizes would be expected if more liquidity is available in the market
- ***Realized volatility*** – reduced volatility and stabilization of price gaps should be the result of augmented market making and deeper markets
- ***Transaction costs*** – reduced execution costs should be an outcome from more liquid and efficient markets

Clearly Define the Criteria for Success and Limit the Burden Imposed by the Pilot

Although pilots provide a good mechanism for empirically studying the effects of market structure changes, they also impose a burden on investors and the industry as a whole. Pilots create complexity by introducing different trading regimes for stocks which require market participants to update systems and infrastructure to handle the new trading rules. This is costly to manage and it increases the risk of technical errors. As a result, the Commission must strike the right balance between gathering valuable data for rulemaking and limiting the disruption caused to capital markets. This will best be accomplished by having a finite duration and clear end date for the pilot. The current proposal to operate the tick size pilot for a one year period is an appropriate format that gives due consideration to the potential negative consequences of a pilot. The Commission's own report on decimalization stated that:

> The impact of mandating an increase in the minimum tick size for small capitalization companies on the structure of our markets . . . is, at best, uncertain. Although mandating an increase in tick sizes to levels greater than those that are presently dictated by market forces may provide more incentives to market makers in certain stocks, the full impact of such a change . . . and whether there would be other significant negative or unintended consequences, is difficult to ascertain.[23]

Given the pervasive impact that a pilot will have on capital markets, investors and issuers, any justification for a duration longer than one year should have a higher standard than "at best, uncertain." It would be reckless to approve a longer pilot period without greater confidence in the benefits which will accrue from wider MPVs. Upon completion of the one year, the Commission should also avoid extending the pilot in duration or scope unless there is unequivocal evidence that wider tick sizes have improved market quality sufficiently to warrant a continuation of the ongoing costs and burden.

Due to the cost and effort involved in conducting a pilot, the criteria for success should also be unambiguous. The proposal collects a broad assortment of data and statistics but makes little attempt to clarify how precisely market quality will be measured or what degree of improvement will be considered meaningful. Industry participants are unlikely to agree on how to evaluate market quality due to their differing perspectives. Unless there is more clarity on how the results will be interpreted, the pilot is at risk of being highly subjective and contentious. BlackRock believes that the Commission should be explicit and transparent on how it will assess success and strongly suggests using the metrics outlined above.

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migration of non-displayed liquidity to lit venues would also be non-additive. Improvement in market quality should only result from enhanced liquidity that exceeds what is currently available in a 1-cent MPV regime.

[23] SEC, Report to Congress on Decimalization (July 2012), available at http://www.sec.gov/news/studies/2012/decimalization-072012.pdf.

Conclusion

We thank the Commission for this opportunity to comment on the tick size pilot proposal. BlackRock believes that the recommendations we have proposed will improve the focus of the pilot, reduce the risk of inadvertent consequences, and help regulators to extract meaningful results. We welcome further discussion on our perspectives.

Sincerely,

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