ModernIR

Market Structure Analytics™

5/9/2018

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090
VIA EMAIL

RE: Transaction Fee Pilot for NMS Stocks, File No. S7-05-l 8

Dear Mr. Fields,

We're offering comments **supportive of** the proposed Fee Pilot program because incentives distort markets.

ModernIR is a financial technology firm and the largest provider of next-generation market intelligence to publicly traded companies. For more than thirteen years we've used proprietary software, algorithms and mathematical models to translate trade-execution data in context of market rules into discrete price-setting market behaviors. Our objective is to help clients understand and measure the modern U.S. equity market.

If one is trying to understand supply and demand for stocks, there's perversity in fee structures today. Fees are supposed to be earned by providers of services for delivering value. Go back to the Buttonwood Agreement in May 1792, and you find two sentences confederating brokers around that idea. They would give each other preference – thereby aggregating order flow. They would charge a minimum commission so as not to undercut each other on price. If a broker wanted to charge MORE for added value, it was an individual prerogative.

Today the blunt truth about fees is that they're designed to facilitate setting the bid and the offer. Since the market is an interconnected web with competing "nodes" that by law share prices and customers around a single best price for every traded issue, how do exchanges set prices? They pay somebody to do it.

The term is a "trading rebate" or credit. Then the exchange has the best price, and trades under Reg NMS must move to the best price. All three big exchange groups operate multiple platforms so they can pay traders to both buy and sell, thus setting the bid and the offer.

This is what's commonly called the "maker-taker" market to describe differing fees for what used to be considered equal action: Buying and selling. Maker markets incentivize traders to set the offer. Taker, or inverted, markets pay traders to buy, which sets the bid.

Price-setting information then becomes valuable data that's sold back to traders and brokers – the latter required to buy it in order to establish that they're giving customers best prices. A study of financial results in public documents for the two largest U.S. stock-listing venues shows that a majority of net revenues are generated from data and services rather than stock-trading.

Whose interest is served by a focus on setting prices rather than matching buyers and sellers? The interests of those selling data.

Not only that, but incentivized trading at different platforms can be aggregated into issue market-share that permits exchanges to capture a higher portion of revenue from the Consolidated Tape Association. It's all about quote-share and trade-share, and the only way to manipulate those two items is via incentives to quote and trade.

Far too few issuers understand the paucity of "real" prices now, because nobody else explains structure to them – and the SEC should be doing so. Today, nearly 45% of all market trading volume comes from borrowed shares, data we have collected and measured since 2010 and which has steadily risen. In effect, traders use credit-extension to set prices while owning nothing at the close. The average trade size in the Russell 1000 by our measures is now 165 shares.

Yet any trade of any size can price the market. It's not uncommon to see a trade for a single share price the entire market for a given stock, especially at the open following earnings. It's a remarkable feat of what we conclude are immediate-or-cancel orders hitting every venue and canceling all but a minute quantity.

It's hard to imagine a market more different from the original intent than the one we've got today. Now tack on Exchanged Traded Funds comprising 50% of market volume, according to data from the NYSE's Arca platform. ETF shares are created via collateral provided by IN-KIND EXCHANGE from brokers (the IRS regards it as a tax-free event), which receive rights to create ETF shares of value equal to the collateral.

Blackrock then can do what it wishes with the collateral, including selling it to pocket gains, though it must be ready to supply collateral back if a broker redeems ETF shares. So say it holds FB as investment itself through selling other collateral and investing the proceeds in FB. It could then farm out FB to brokers in a creation basket, thus avoiding all the capital gains everybody else has to pay.

How to trade that as a market-maker (read: arbitrager)? Buy IVV shares (at an inverted market) and short FB (for a rebate to boot). Return 50,000 shares of IVV to Blackrock and receive equal-value FB shares in return (which the broker promptly sells). This way, Blackrock moves out a low-tax basis stock, FB, that today or tomorrow brokers will return to Blackrock in exchange for the right to create IVV shares all over – but the tax basis will reset to Blackrock, which records no tax consequence and no transaction costs, and no fund turnover. And the trader profits on the spreads.

If you're on the investor-relations team at FB, you're trying to assign rational context to stock performance when motive is instead how to profit on the fluctuating value of collateral traded for in-kind ETFs shares. *And it's exacerbated by fee structures that make arbitrage schemes profitable and central to market form*.

Neither ETF arbitrage, nor regulatory data feed revenues, nor CTA data revenues have anything to do with matching risk-taking capital with enterprising issuers using capital markets to raise money and gauge fair value. In fact, they obfuscate both pursuits. No wonder capital-formation has shifted to private equity where 100% of the volume, so to speak, is rational, and free from distorting incentives.

I blame not the exchanges for exploiting rules but the Securities and Exchange Commission for failing to uphold the Securities Act. It expressly forbids discrimination against any exchange constituency, including, by name, issuers. Has the SEC ever convened a series of meetings bringing together issuers and the long-term investors they court to explain in layman's terms how exchange fees affect trading in their shares?

Every part of fee schedules crafted by exchanges must pass muster with the SEC. The Commission has permitted the market to skew sharply toward benefiting intermediaries at the expense of the core constituents, issuers and investors. It's your duty, regulators, to ensure that all constituents are served well and fairly, and informed properly.

The problem now is we have market so dependent on incentives that in their absence we may be shocked at the paucity of real orders. Nevertheless, the market should be transparent and simple. Paraphrasing Benjamin Graham, famous value investor, the more complicated a financial instrument, the less it should be trusted. Most issuers would be staggered by the complexity of the rule structure, the fee schedules, the order types, the smart order routers and algorithms forming the infrastructure for price-setting in stocks. They think fundamentals price stocks. Ah, the folly.

Against that backdrop, we have four recommendations for this study, which, again, we support because the current fee structure, as we've illustrated here, promotes arbitrage, and price-setting as its own end:

1. *Explain it to issuers*. Partner with **NIRI**, the professional association for public companies with some 1,600 corporate members, to communicate nationally and by chapter, and form an Issuer Advisory Committee with success measures that matter to issuers rather than intermediaries.

2. *Put the 50 most active ETFs in the incentive-free Group*. A fair read on the impact of creation and redemption in ETF shares by the hundreds of billions of dollars monthly cannot be achieved without removing trading incentives.

3. *Give issuers a chance to select a Group* (with perhaps choice A and choice B).

4. *Consider uncapping fees in one Group*. Capped fees to me are a lousy idea, a price control, though I know traders will demur. By capping fees, but not incentives, the SEC is encouraging exchanges to make money in other ways – such as gouging brokers on data-feed costs and selling technology services. The Buttonwood Agreement did the opposite, setting a floor on fees.

In sum, make issuers an active participant in this study and in improving the market for their shares, which requires outreach from the Commission. It's a vibrant and interested constituency to boot and our whole market system would benefit from greater participation in rulemaking from its foundational sector.

Yours Sincerely,

Tim Quast
President and founder