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May 25, 2018

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

Re: File No. S7-05-18 – Transaction Fee Pilot for NMS Stocks

Dear Mr. Fields:

The Clearpool Group (“Clearpool”) is writing to provide its views on the SEC proposal to conduct a transaction fee pilot for National Market System (“NMS”) stocks.<sup>1</sup>

Launched in 2014 and based in New York, Clearpool Group is an independent agency broker-dealer and provider of tools to assist other broker-dealers in the areas of routing, execution, pre- and post-trade compliance and risk monitoring.<sup>2</sup> While we are a small broker-dealer, we account for nearly two percent (2%) of the average daily volume in the U.S. markets. Clearpool therefore has a significant interest in ensuring that the regulations overseeing the markets are fair and equitable, and allow for the most orderly, efficient and competitive markets possible.

To this end, Clearpool has submitted several comment letters to the Commission,<sup>3</sup> and prepared a “white paper,”<sup>4</sup> on various trading and market structure proposals and issues of significance to Clearpool, its clients, and the ultimate investor. Consistent with our previous comments, Clearpool believes the time is long overdue to address conflicts of interest around order routing and order

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<sup>1</sup> *Transaction Fee Pilot for NMS Stocks*, Securities Exchange Act Release No. 82873 (March 14, 2018), 83 FR 13008 (March 26, 2018) (Proposal).

<sup>2</sup> The Clearpool Group offers advanced electronic trading software and provides independent agency broker-dealer execution services. Clearpool’s algorithmic and execution management systems allow market participants to take control of better quality execution by delivering advanced electronic trading solutions for an evolving equity market microstructure and competitive landscape. For further information on the Clearpool Group, see [www.clearpoolgroup.com](http://www.clearpoolgroup.com).

<sup>3</sup> See, e.g., Letter from Joe Wald, Chief Executive Officer, Clearpool, to Brent J. Fields, Secretary, SEC (File No. SR-NYSE-2016-45; File No. SR-NYSEMKT-2016-63; and File No. SR-NYSEArca-2016-89), dated December 16, 2016 (<https://www.sec.gov/comments/sr-nyse-2016-45/nyse201645-1430031-10.pdf>); Letter from Ray Ross, Chief Technology Officer, Clearpool, to Brent J. Fields, Secretary, SEC (File No. SR-BatsBZX-2017-34), dated June 12, 2017 (<https://www.sec.gov/comments/sr-batsbzx-2017-34/batsbzx201734-1797219-153617.pdf>); and Letter from Ray Ross, Chief Technology Officer, Clearpool, to Brent J. Fields, Secretary, SEC (File No. SR-NASDAQ-2017-074), dated September 11, 2017 (<https://www.sec.gov/comments/sr-nasdaq-2017-074/nasdaq2017074-2436763-161051.pdf>).

<sup>4</sup> See <http://info.clearpoolgroup.com/blog/2018-viewpoints-on-market-microstructure-from-clearpools-founders>.

execution, including conflicts arising from access fees, liquidity rebates, and related incentives to route orders in today's markets.

While ideally, competition and market forces would produce a solution that obviates the need for the transaction fee pilot, we believe that some regulatory solution may be necessary to force market participants, particularly exchanges, to change the manner in which they conduct business. We therefore support the SEC conducting the proposed pilot, at the very least, to allow the SEC and market participants to gather data to determine the effects that transaction-based fees and rebates, and changes to those fees and rebates, may have on order routing behavior, execution quality, and market quality.

We are hopeful that the pilot will assist the SEC in making informed decisions in this area and in reevaluating the current access fee caps. As discussed in more detail below, we have several comments on the scope of the proposal and associated recommendations to lessen any adverse impact of the proposal on the markets and market participants.

## **I. Proposed Pilot Design**

The pilot is proposing three test groups, Test Groups 1 and 2 with fee caps of \$0.0015 and \$0.0005 respectively, and Test Group 3 that prohibits rebates ("no rebate" or "zero" bucket). Transaction fees for securities in Test Group 3 would remain subject to the current \$0.0030 access fee cap for accessing a protected quotation.

### Inclusion of Zero-Rebate Bucket is Critical for the Pilot

Clearpool strongly supports the inclusion of the zero bucket in the pilot, and believes the focus of the pilot should be on this test group as this is the only test group that gets to the crux of the issues surrounding conflicts of interest in order routing.

While the Proposal states that the pilot would be "substantially more informative with a no-rebate bucket than a pilot without one," we do not see how a pilot that is supposed to test conflicts of interest in order routing could be conducted in any meaningful way (or at all) without such a test group. We wholeheartedly agree with the SEC that "if rebates create a conflict of interest for broker-dealers when they decide where to route an order to post or take liquidity, and if those conflicts have an effect on order routing behavior, execution quality, or market quality, then only a complete prohibition on rebates will allow the Commission to study directly these conflicts and their effects by observing what would happen in the absence of rebates."<sup>5</sup>

The Proposal requests comment on possible alternatives to the proposed structure of the test groups. Given the importance of the elimination of rebates to addressing conflicts of interest,

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<sup>5</sup> Proposal at 13022. The Proposal states that inclusion of a zero access fee test group could force exchanges to create entirely new revenue models for securities in this test group. We do not believe that concerns expressed regarding lost revenue to exchanges for eliminating transaction-based fees entirely or costs associated with the creation of new revenue models only for the duration of the pilot, warrant not including such a test group in the pilot.

ideally we would like to see all three test groups contain a prohibition on rebates such as that in Test Group 3. To that end, we recommend that, if the SEC is open to alternatives to the composition of the proposed test groups, that Test Groups 1 and 2 also include the same constraints on rebates as in Test Group 3. Specifically, we believe that it would be beneficial to test the impact in Test Group 2 of a prohibition on rebates with no constraints on access fees. We also believe that given changes in the way securities trade in today's markets, that the SEC should consider looking at access fee caps differently. Particularly, as prices of stocks have gone up, looking at restrictions using, for example, basis points as a reference may be more reliable than using the current fee cap reference points, as the current fee caps will impact stocks differently based on their particular price. Therefore, we propose that Test Group 1 contain the same constraints as Test Group 3 but with an access fee limitation expressed in basis points.

While we understand that such changes may provide additional complexity to a pilot, and that the SEC may not desire to have Test Groups 1 and 2 include a rebate prohibition for statistical analysis purposes, we believe that the SEC should think "outside of the box" in constructing the test groups and that such changes would get to the intended purposes of the pilot better than the manner in which the test groups are currently proposed.

#### Clearpool Strongly Supports the Prohibition on "Linked Pricing"

Under the zero-rebate bucket, exchanges generally would be prohibited from offering a discount or incentive on transaction fee pricing applicable to removing (providing) liquidity that is linked to providing (removing) liquidity ("Linked Pricing").

Clearpool strongly supports the prohibition on Linked Pricing. Significantly, such a prohibition will be important to ensure that exchanges do not "work around" the prohibition on offering rebates through providing other incentives. Prohibiting Linked Pricing also will be important to ensure that the SEC obtains accurate information about what would happen in the absence of incentives created by offering rebates and the potential conflicts of interest they can present.<sup>6</sup>

Clearpool has spent a significant amount of time examining the impact of incentives that exchanges provide for order routing and related conflicts of interest. For smaller broker-dealers, much of the conflicts surround the costs of trading, where smaller broker-dealers end up subsidizing larger-sized firms when it comes to such costs. Significantly, the current tiered pricing models offered by exchanges, which include hundreds of different pricing tiers, raise issues around conflicts of interest similar to those presented by incentives provided through Linked Pricing. This occurs as exchanges chase order flow and provide rebates and other pricing incentives to the largest trading firms at the expense of smaller market participants who cannot take advantage of such rebates and, in effect, end up subsidizing the trading of the larger firms.

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<sup>6</sup> We agree that Test Group 3's prohibition on rebates and Linked Pricing should apply to depth-of-book and undisplayed liquidity. Similarly, we believe the fee caps in the other Test Groups also should apply to depth-of-book and undisplayed liquidity.

Given the ability of exchanges to potentially work around the prohibition on offering rebates through all types of incentives, including tiered-pricing models, we recommend that such tiered pricing not be permitted in any of the test groups during the pilot. Only in this manner can we assure that the SEC obtain as accurate information as possible during the pilot.

The Proposal discusses an alternative where there would be a limitation on Linked Pricing across all test groups; Clearpool would support such a change to the proposed pilot. As the Proposal notes, “given that Test Groups 1 and 2 would undergo a reduction in fees due to the lower caps in each of those groups, which likely would lead to a corresponding reduction in rebates, exchanges may choose to alter other like incentives, which would allow them to supplement the incentive they provide for activity in securities in Test Groups 1 and 2, and could distort the information obtained from the Pilot.”<sup>7</sup> We do not agree with the SEC’s conclusion, however, that it is unnecessary to prohibit like inducements for Test Groups 1 and 2 because, from the exchanges’ perspective, enhancing like inducements would further erode margins related to transaction activity. We believe exchanges will do whatever is necessary, and provide any inducements available, to secure order flow.

Finally, under the proposal, exchanges would not be prohibited from adopting new rules to provide non-rebate Linked Pricing to their registered market makers if the non-rebate discount or incentive is in consideration for meeting market quality metrics specified in an exchange rule. While we agree that there would not be conflicts of interest presented when market makers trade for their own accounts, in many cases, those same market makers may also be facilitating customer orders and, at the time of order placement, may not know if an execution will ultimately be for a customer or for themselves. Given such a scenario, we believe that the proposed exemption may be difficult to implement and monitor, and may provide market makers running client businesses with an unfair pricing advantage over non-market making firms. We therefore believe that any exemption must be narrowly tailored, apply only to a market maker’s principal trading, and be limited to exchange programs that the SEC has examined and approved after ensuring that they will not be counter to the purpose of the pilot.

## **II. Applicable Trading Centers**

The pilot would apply to all equities exchanges, including “taker-maker” exchanges but would not include non-exchange trading centers, such as ATSS. The Proposal requests comments on the scope of applicable trading centers in the pilot.

### Do Not Expand Pilot to Include ATSS

We believe that the pilot should not be expanded to include ATSS. While including ATSS in the pilot would increase availability of data for that segment of trading activity in NMS securities, expanding the pilot to non-exchange trading centers, such as ATSS, would increase the complexity and costs of the proposal and may not be practical or warranted for purposes of the pilot.

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<sup>7</sup> Proposal at 13072.

Significantly, including ATNs in the pilot could require ATNs to change their fee models and renegotiate their pricing arrangements with their customers in order to assess fees differently than they do today solely to accommodate the pilot. In addition, subjecting ATNs to the pilot would have the effect of imposing, in the terms of a pilot, a new regulatory regime on entities whose fees are not currently subject to the requirements applicable to exchanges, and that are currently not subject to access fee caps in any respect.

Finally, it is worth noting that a large portion of off-exchange liquidity comes from trading venues other than ATNs. While we believe that trading in such venues may raise potential conflicts of interest, including conflicts which are the subject of this proposal, if the pilot were to be expanded to non-exchange trading centers, it would need to eliminate rebates of any kind regardless of the form of the market center (exchange, ATN, or otherwise) to truly address conflicts of interest around order routing. We believe that such conflicts are worthy of SEC examination but are probably outside of the scope of the proposed pilot.

If the pilot were expanded to include ATNs or other non-exchange trading venues, we do not believe that all such venues should be included. For example, if a venue does not allow brokers to participate and/or there would be little or no conflicts of interest (*e.g.*, commissions are not based on whether liquidity was provided or taken), the pilot should not inhibit such venues from continuing to serve the interests of investors in the markets. As the Proposal states, “to the extent ATNs do not charge transaction-based fees, it is not practicable to include them in a pilot that is structured to test the impact of changes in transaction fees.”<sup>8</sup>

### **III. Data Associated with the Pilot**

The pilot would require that certain data be collected and made publicly available to facilitate the ability to assess the impact of the pilot, and promote transparency about the pilot securities and basic information about exchange fees and changes to those fees during the pilot.

#### Exchange Transaction Fee Summary

The pilot would require exchanges, through an Exchange Transaction Fee Summary, to post publicly standardized select data on transaction fees and rebates, including changes to fees and rebates in each test group and the control group. The Proposal states that the summary should facilitate comparison of each exchange’s basic fee structure across all equities exchanges and help identify, in summary fashion, changes to those fees.

The Proposal notes that because changes to transaction fees and rebates currently are described using Form 19b-4 in individual proposed rule change filings that can be fairly complex, compiling a dataset of fees and fee changes from Form 19b-4 fee filings alone for use in studying the pilot would be cumbersome and labor intensive for researchers and may discourage research. The Proposal

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<sup>8</sup> Proposal at 13016. We agree with the expansion of the pilot to “taker-maker” exchanges to ensure that the pilot covers all of the methods by which trades are executed on the exchanges, and therefore where there are potential conflicts of interest.

states that the SEC also recognizes that exchanges may use unique terminology to describe their fees, which could make comparison of fees across exchanges difficult for a researcher, so the proposal provides for standardized terms to ease comparison across exchanges.

Clearpool strongly supports requiring exchanges to make information around fees associated with the pilot publicly available in an easily accessible manner. Currently, market participants must go to great lengths to compile and understand the changes made by exchanges around fees. While exchanges generally send out alerts and notices about such changes, this is not always the case and, as stated above, the current filing process is cryptic and very difficult to understand.

While not the subject of the pilot, we also reiterate our comments in our recent paper that market participants should have a greater ability to provide input when an exchange makes a change to a fee associated with trading fees. While we appreciate the desire to balance the needs of exchanges to be able to make changes to and implement changes to fees quickly in a competitive environment, market participants impacted by these changes need the ability for a more meaningful comment process. We are hopeful that the Exchange Transaction Fee Summary will facilitate more meaningful comments on exchange filings in addition to addressing some of the complexity and confusion surrounding the method by which exchanges currently make changes to transaction fees and rebates using the 19b-4 rulemaking process.

#### Order Routing Data

The proposal would require exchanges to prepare and disclose order routing data containing broker-dealer order routing information that would be publicly posted on each exchange's website. In preparing the datasets, exchanges would be required to anonymize information relating to the identity of individual broker-dealers before making the order routing datasets publicly available. The Proposal states that exchanges would not be permitted to access or use that information for any commercial or non-regulatory purpose including, but not limited to, setting transaction fees, marketing, business development, and customer outreach.

Clearpool supports increased transparency around order routing data by the exchanges. We cannot say enough about the importance of gathering such data, and making the data accessible to the public; this is something that has long been needed by the industry to shed light on potentially harmful practices related to payment for order flow and associated conflicts of interest. Significantly, disclosure should facilitate analysis into routing behavior in response to varying levels of fees and rebates and allow for a closer examination of how broker-dealers may change their order routing behavior in response to changes in fees and rebates at each exchange.

While we applaud the proposed dataset that would be required to be disclosed by exchanges, we would recommend the consideration of other data points that we believe would further facilitate the analysis of order flow and a better understanding of the efficacy of the pilot such as whether a trade is agency or principal, and whether order flow is directed or non-directed.

While transparency can be beneficial, it will be critical to ensure the confidentiality of certain aspects of the order routing information. We are pleased to see that the SEC has recognized this in

proposing anonymizing certain of the proposed data to protect confidential information. We need to ensure that increased transparency around order routing data does not facilitate the reverse engineering of proprietary order routing strategies or the use by exchanges of such information.

#### **IV. Duration and Timing of the Pilot**

The SEC is proposing a two-year term for the pilot, with an automatic sunset at the end of the first year unless, prior to that time, the SEC publishes a notice determining that the pilot will continue for up to another year. The Proposal requests comment on whether the SEC should, before taking action on the pilot, first take final action on some of the other SEC trading and market structure initiatives such as the SEC's proposed rulemakings concerning disclosure of order handling information, Regulation ATS, and/or issue new guidance on broker-dealers' duty of best execution.

We believe the time is right to move forward with the pilot, without delay, and we are hopeful that the pilot will complement the SEC's other market structure initiatives. We cannot wait for market driven solutions to address concerns raised by the conflicts of interest as it is clear that exchanges have little interest in changing the status quo.

As proposed, it also is possible that the pilot could overlap with the tick size pilot for some amount of time. While we believe it is unlikely that the pilot will overlap with the tick size pilot given the length of time necessary to get the proposal approved and operational, we do not believe that the pilot should run simultaneously with the tick size pilot, even if any overlap was minimal.

Clearpool believes that it is critical to take measured steps in changing our market structure. The tick size pilot is complex enough as it is, and preliminary results have been questionable as far as any benefits to the markets. Adding the transaction fee pilot to the mix can not only add to the complexity but also muddle the results of the pilot. We therefore recommend delaying the implementation of the pilot, if necessary, until the tick size pilot is concluded and implementing each pilot sequentially. We do not believe that concerns surrounding any possible delay in the benefits of the information the SEC anticipates realizing from the transaction fee pilot are warranted given the minimal delay, if any, from implementing sequential pilots.

#### **V. Securities to be Included in Pilot**

Each of the three test groups would be selected through stratified sampling by market capitalization, share price, and liquidity. Each test group would contain 1,000 NMS stocks, with the remainder of eligible NMS stocks to be included in the control group.

We believe that 1,000 securities in each bucket may be too large for a pilot as this, in effect, makes the pilot a market wide test. The number of securities in each bucket therefore may need to be narrowed, and we believe that fewer stocks and Exchange Traded Products ("ETPs") in each test group would be capable of providing statistically significant data.

The pilot would include all NMS stocks, which includes common stocks and ETPs. We believe that ETPs should be excluded from the pilot, as the unique characteristics of ETPs would make

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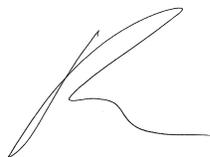
inclusion for such products difficult, at best, and create competitive disadvantages for certain ETPs, depending on the particular test group that an ETP is assigned to. If the SEC determines that ETPs should be included in the pilot, we believe that it must construct the pilot in a manner that does not disadvantage similar and competing ETP products.

Finally, we do not support allowing issuers to “opt-out” of the pilot as we believe the results of the pilot would be negatively impacted if, for example, issuers were permitted, for whatever reason, to not participate in the pilot.

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We offer our assistance to the Commission as it examines the issues raised by the proposal. If you have any questions on our comment letter, please feel free to contact me directly at [REDACTED] or at [REDACTED].

Sincerely,



Ray Ross  
Chief Technology Officer

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

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