



June 28, 2018

Mr. Brent J. Fields  
Secretary  
U.S. Securities Exchange Commission  
100 F Street, NE  
Washington, D.C. 20549-1090  
[Rule-comments@sec.gov](mailto:Rule-comments@sec.gov)

Subject: File Number S7-05-18

Mr. Fields:

The American Securities Association (ASA)<sup>1</sup> welcomes the opportunity to comment on the Securities Exchange Commission's (SEC or Commission) proposed Transaction Fee Pilot for NMS Securities (Pilot). The ASA's comments set forth in this letter are derived from the diversity of our membership, the different business models of our membership, and the vast experience our members have transacting in the U.S. equity markets.

The goal of the Pilot, as stated by the Commission, is to "produce data on the effects of equity exchange transaction fees and rebates, and possible effects of changes in those fees and rebates, on order routing behavior, execution quality, and market quality more generally."<sup>2</sup>

We write to you today to raise significant concerns about this Pilot, which are set forth below, and we respectfully request that the Commission refrain from adopting it as a final rule.

- **Transparency Around Execution Quality Could Mitigate the Conflicts that the Commission Seeks to Address.** We are concerned that implementing a complete ban on an agreement where a conflict exists, when additional disclosure around execution quality could mitigate the conflict, will raise costs for investors (see further Treasury Report Reference Below). What the market needs to know is what happened to an order on its way to execution. The only way that type of detailed information will be delivered is if

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<sup>1</sup> The ASA is a trade association that represents the retail and institutional equity capital markets interests of middle market financial services firms who provide Main Street businesses with access to capital and advise hardworking Americans how to create and preserve wealth. The ASA's mission is to promote trust and confidence among investors and support efficient and competitively balanced equity capital markets that advance financial independence, stimulate job creation, and increase prosperity. The ASA has a geographically diverse membership base that spans the Heartland, Southwest, Southeast, Atlantic, and Pacific Northwest regions of the United States.

<sup>2</sup> Securities Exchange Act Release No. 82873 (March 14, 2018), 83 FR 13008 (March 26, 2018) (File No. S7-05-18).

the Commission requires more transparency around routing and speed incentives for execution. Disclosure will mitigate the conflicts that the Commission seeks to address. This is also consistent with Commissioner Peirce's view.<sup>3</sup> Finally, lost in the noise of the public debate on this issue is that if a broker misleads customers about routing disclosure or actively conceals who orders were routed to, then this behavior is a violation of existing laws and regulations.<sup>4</sup>

- **The Pilot Advantages Large Broker-Dealers over All Other Broker-Dealers.** We do not believe that the proposal considers the impact that the Pilot would have on competition among broker-dealers (Brokers). We believe that the Commission's use of the Pilot to set prices in any class of security will impact the pricing in all classes of securities as payment for order flow is cross-subsidized. Today, incentives for trading large cap securities subsidize trading in small and mid-cap securities. If you remove or decrease these incentives, the Commission will be adopting a policy that has a negative impact on all market participants and picks winners and losers. Brokers have different business models (i.e. some focus on execution, and others outsource their order flow to those who focus on execution). Reducing the incentive for executing Brokers to purchase order flow from non-executing Brokers will impact the price executing brokers pay for order flow. Any reduction in the amount of payment for order flow that small and middle-market Brokers receive for their order flow, caused by the adoption of a policy that tinkers with the rebate, will increase the overall cost of execution for everyone. Small and middle-market Brokers do not possess the same economies of scale as large Brokers. As a result, large Brokers are much more able to absorb an increase in costs and reduction in trading income. This scale necessarily advantages large Brokers who specialize in low touch execution or own Alternative Trading Systems (ATSS) over those who do not by pushing customers and order flow to the largest Brokers.

The Commission will effectively be choosing one Broker business model over another by creating a regulatory incentive for customers to move their business to and concentrate more activity with the largest firms. No evidence was put forth by the Commission to justify this type of impact on competition in the Pilot. No attempt to mitigate this impact on competition has been set forth in the Pilot. No rationale has been given to justify why the Commission would seek to favor large Brokers at the expense of main street Brokers.

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<sup>3</sup> Commissioner Peirce Equity Market Structure Speech dated, April 18, 2018: "I would suggest that we should start considering whether it's worthwhile to continue focusing on regulatory tweaks to constrain market behavior that is driven primarily by the incentives created by the order protection rule. Shouldn't we instead begin exploring alternatives that provide investors with sufficient information and flexibility to determine, in light of their own trading objectives, whether their broker is capable of executing their trades in a manner consistent with best execution, again, in light of the investor's objectives?" <https://www.sec.gov/news/speech/speech-peirce-041818>.

<sup>4</sup> Merrill Lynch Admits to Misleading Customers about Trading Venues. <https://www.sec.gov/news/press-release/2018-108>.

The Commission should and is required to undertake a rigorous cost-benefit analysis to justify any policy that favors one group of Brokers over another.

- **No Rationale for Omitting Off-Exchange Execution From this Pilot.** We do not understand why transparency around the incentives for executing off exchange (i.e. “in the dark”) were not considered as part of this Pilot. Off-exchange execution makes up a substantial portion of the trades executed, and incentives to execute in dark pool ATS’, while not transparent to the public or even to their customers, do exist.<sup>5</sup> Again, the deliberate omission of off-exchange dark pool execution from the Pilot seems to be an area where the Commission’s policy seeks to favor large Brokers who operate dark pool ATS’ at the expense of other market participants. We strongly disagree with that outcome and its impact on market competition.
- **We believe the Pilot will impair market quality because spreads will widen on a large percentage of trades across ALL classes of securities, adding unnecessary costs to capital formation for companies and harming retail investors.** Our view is that ALL securities will be impacted by this Pilot. We believe this because when firms program their algos to address any portion of the market that the Pilot covers, the adjusted algos will become the de facto market-wide functionality such that all non-Pilot names will work the same as the Pilot names. Those who believe that spreads will not widen for all securities are expressing a self-interested position as many of them run or exclusively execute orders in dark pool ATS’. Importantly, no evidence has been produced by the Commission to support a policy that would widen trading spreads and harm investors. Wide spreads are also a disincentive to long-term investment and this negative impact will fall disproportionately on small and mid-cap issuers rather than the largest issuers.
- **We Believe Execution Quality Will Be Harmed by The Pilot.** The Pilot is designed to drive execution from lit markets (i.e. exchanges) into dark pools run by large broker-dealers. We are concerned that this will make it easier for stock price manipulation to occur and it will encourage these Brokers who operate ATS’s and/or internalize order flow to more easily pick off orders. We believe that making the lit reference price less relevant will result in retail investors paying more for execution. This outcome does not improve execution quality.

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<sup>5</sup> Barclays, Credit Suisse Charged with Dark Pool Violations. <https://www.sec.gov/news/pressrelease/2016-16.html>

- **The Pilot Should Not Precede Recommendations by the Treasury Department that the SEC Finalize Rules on this Issue.** The Treasury report<sup>6</sup> provided specific recommendations about how to address conflicts and enhance market structure by adopting a final rule changing Rule 600 and 606, which would improve the Broker best execution obligation and provide needed transparency around order routing decisions. In particular, the report says that the SEC should adopt final rules with changes that would “provide institutional customers with specific disclosures related to the routing and execution of their orders, and also require broker-dealers to make aggregated information about the handling of customers institutional orders publicly available.”<sup>7</sup> The report also goes on to discuss how changes in disclosure would benefit retail investors by focusing on transaction fees paid, profit sharing arrangements, the amount received as payment for order for order flow, and transaction rebates received. We strongly support the Treasury recommendations and urge the Commission to undertake a final rule in these targeted areas, rather than approve a Pilot that stifles competition and intentionally picks winners and losers.
- **The Pilot Ignores a Broker-Dealer’s Duty to Obtain Best Execution for Clients.** Registered Brokers are required by rule to comply with best execution obligations. If the reason that interested parties are supporting this Pilot is to prevent conflicts that purportedly interfere with that obligation, then we would suggest that the SEC highlight to those parties that it actively enforces violations of best execution rules.<sup>8</sup> Brokers take compliance with their best execution obligations very seriously and this Pilot seems to casually dismiss that fact in order to reach a false conclusion that needlessly impairs competition and does nothing to further the SECs mission.<sup>9</sup> Consequently, we urge the Commission to reject these red herring arguments.
- **The Pilot Includes Too Many Securities.** We are concerned about the impact this Pilot will have on capital raising activities if, as expected, spreads widen. We believe this outcome will be particularly harsh for small and mid-cap companies as it will rise their cost of equity and decrease the amount of capital they need to expand their operations and create jobs. The bottom line is that the Pilot, which would include a thousand names

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<sup>6</sup> See United States Department of the Treasury, A Financial System That Creates Economic Opportunities: Capital Markets, Report to President Donald J. Trump (October 2017) (available at: <https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf>).

<sup>7</sup> Id at 62.

<sup>8</sup> *In the Matter of Hal S. Tunick*, Adm. Proc. File No. 3-16931 (October 28, 2015); *In the Matter of Patrick R. Burke*, Adm. Proc. File No. 3-16930 (October 28, 2015); *In the Matter of KMS Financial Services, Inc.*, Adm. Proc. File No. 3-18068 (July 19, 2017). Examples of SEC actions that charge brokers and firms with failing to comply with the obligation to obtain best execution for clients in order to generate excess commissions.

<sup>9</sup> “The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.” <https://www.sec.gov/Article/whatwedo.html>

per bucket, is far too large. Publicly listed companies **MUST have the option to opt-out of this Pilot** if, for some reason, the Commission approves this Pilot as a final rule.

- **The Commission Must Assure the Public that the Pilot Will Not Impair the Orderly Functioning of the Market by Increasing Volatility.** Is it a good public policy decision to adopt a Pilot that experiments with equity micro-market structure at a time when the Federal Board of Reserve’s macroeconomic policy involves the removal of unprecedented liquidity from the financial system? Based on the views of numerous scholars and market participants who believe that there is a direct relationship between liquidity, volatility, and price movements, we suggest that the answer is NO.<sup>10</sup> The Commission has not provided any reasoned evidence or analysis to assure the public that the Pilot would not directly cause an increase in volatility and/or lead to sharper equity price movements in a normal period or additionally contribute to such an increase during a period of declining central bank liquidity. The Commission’s mission is to “protect investors, maintain fair, orderly, and efficient markets and facilitate capital formation.”<sup>11</sup> Consequently, prior to adopting a final rule, the Commission is bound by statute to demonstrate that the Pilot will serve the public interest by not contributing to: (1) a decrease in equity market liquidity, (2) sharper equity price movements, or (3) an increase in equity market volatility. This demonstration is necessary to maintain the trust and confidence of retail investors and small businesses looking to access to the U.S. equity markets.
- **The Commission Imposes Costs That Far Outweigh Its Benefits.** The Commission both understates the potential costs of the Pilot, and simultaneously overstates the benefits. On the cost side, the Commission failed to consider the cost to small and middle market Brokers of removing incentives that cross-subsidize the trading of smaller stocks. It also failed properly to weigh the costs to investors of wider spreads and reduced execution quality, as described above. Wider spreads will also increase the cost of capital formation especially for smaller issuers, another cost the Commission proposal overlooks. These costs are magnified by the excessive scope of the Pilot. On the benefits side, the Commission overstates the value of the whole Pilot because less expensive means of achieving the same result exist. For example, the increased transparency

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<sup>10</sup> <https://www.project-syndicate.org/commentary/liquidity-market-volatility-flash-crash-by-nouriel-roubini-2015-05?barrier=accesspaylog>; Mike Szabolcs et.al., 2008 “An Empirical Behavioral Model of Liquidity and Volatility.” Journal of Economic Dynamics and Control.; “Liquidity Risk and Expected Stock Returns” Luboš Pástor and Robert F. Stambaugh Journal of Political Economy 2003 111:3, 642-685; <https://www.valuewalk.com/2017/11/liquidity-volatility-direct-linkage/>; Alexander Butler et.al., 2005 “Stock Market Liquidity and the Cost of Issuing Equity” Journal of Financial and Quantitative Analysis, Volume 40 ( <https://doi.org/10.1017/S002210900002337>); “Fighting Liquidity”, Macro Intelligence 2 Partners, January 23, 2018; <http://www.alhambrapartners.com/2014/12/22/liquidity-and-bubbles-as-systems-theory-or-inevitability/>.

<sup>11</sup> 15 U.S.C. § 78a et seq.



recommended by the Treasury Department could bring substantial benefits without imposing the high costs outlined above.

We do not believe that the Commission's intent with this Pilot is to (1) outright prohibit Brokers from allocating their order flow to executing broker dealers, and (2) force all Brokers to spend millions of dollars on sophisticated low touch execution technology in order to adopt the model used by the largest firms in the industry. This can't be the outcome the Commission desires if it intends to continue to allow for competition among Brokers and permit different business models to continue to serve customers across the country.

We appreciate the Commission's willingness to issue the Pilot as a rule proposal and not as an NMS plan. Proposing such a significant endeavor, which impacts broker-dealers of different sizes, all listed securities and all types of investors, requires public input. We applaud the Commission for taking this step.

This issue is very important to the ASA and we want to be a partner with you to determine the best way to improve transparency, execution quality, and market quality in our equity capital markets. We stand ready to work with the Commission going forward, and again, given all of the concerns listed above, we request that the Commission not move forward with adopting this Pilot.

Sincerely,

Christopher A. Iacovella  
Chief Executive Officer  
American Securities Association