James J. Angel, Ph.D., CFA
Associate Professor of Finance
Georgetown University[1]
McDonough School of Business
Washington DC 20057

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Securities and Exchange Commission
100 F St. NW
Washington, DC 20549-9303
Rule-comments@sec.gov

Re: Transaction Fee Pilot

File S7-05-18

Dear SEC:

Here are my additional comments on the proposed transaction fee pilot program. It appears that the various commenters have wildly differing perspectives on what will happen under the pilot. This is strong evidence as to why the pilot is necessary. Whenever possible, we should base rulemaking on solid empirical evidence and not just on a gut feel about what is right. As mentioned in my first comment letter, I support the pilot program. Here are a few suggested improvements:

Is $.30/100 shares the optimal level of the fee cap?

As I discussed in my previous letter, the cap on maker-taker access fees of $.30/ 100 shares is a price control made necessary because of the side effects of other regulations, most notably the Order Protection

[1] All opinions are strictly my own and do not necessarily represent those of Georgetown University or anyone else.

Rule.[2] Price controls are evidence that some problem in the market is leading to unacceptable outcomes. However, there has been no serious economic analysis, let alone a cost-benefit analysis, of what the optimal fee cap (if any) should be. This pilot will provide solid evidence that can be used to determine the optimal fee cap.

Some commenters allege that the proposed reductions in the fee cap will result in higher bid-ask spreads. Whether a higher bid-ask spread for a particular stock is good or bad is up to debate. The bid-ask spread is the price of immediacy, and it is a mistake to think that a smaller spread is always better. The spread is a cost to those who demand immediacy, but it is a reward to those who supply it (including retail customer customers placing limit orders as well as professional market makers). The notion that the price of immediacy should be zero is as flawed as the notion that the price of bread should be zero. Consumers might like the idea of free bread, but no one will produce any at a zero price. If the current structure has resulted in an artificially narrowed spread, then perhaps the spread should widen to the economically optimal amount. Indeed, this was the thinking that led to the tick size pilot.

Include a $.40/100 shares treatment group to examine the impact of a higher fee cap.

If reducing the fee cap will increase bid-ask spreads, it would stand to reason that raising the fee cap should reduce bid-ask spreads. I thus recommend the inclusion of an additional $0.40 /100 shares treatment group in the pilot. This will help provide solid evidence as to the optimal level of the price cap on transaction fees.

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Include off-exchange trading platforms in the pilot.

There is a concern that allowing off-exchange venues to pay higher rebates puts national securities exchanges at a competitive disadvantage. This is a valid concern. One of the stated reasons for the pilot is to reduce conflicts of interest in order routing purportedly caused by the rebates. Basic fairness and common sense dictate that the same rules on transaction fees should apply to off-exchange venues as well. Allowing off-exchange venues to pay higher rebates than exchanges will push more activity to the less regulated and sometimes less-transparent off-exchange markets.

Design a kill switch if something goes wrong.

Some commentators allege that some very very bad things will happen if the pilot takes place. In particular, some issuers fear that their stock may be placed in a treatment group that puts them at a disadvantage to a competitor. For example, they may not be assigned to a quality-improving pilot group

[2] See https://www.sec.gov/comments/s7-05-18/s70518-3718525-162501.pdf

because they are stuck in a control group stuck with the existing fee cap. Fortunately, even though those firms may compete vigorously in the product markets, they do not compete in the same way in the stock market.

My own intuition is that the impacts of the pilot on bid-ask spreads will be quite modest. I suspect it will take a powerful microscope to measure those impacts. Thus, I do not agree with the argument that there will be serious investor harm from the pilot. Even if one group would be disadvantaged by being in the wrong treatment group, it would only be for a temporary length of time.

The same arguments apply to ETFs. In my previous comment letter, I stated that I thought that similar ETFs should be in the same treatment group to avoid unfairness. Upon further reflection, I now believe that similar ETFs are probably the best natural controls for each other, as their underlying portfolios are virtually identical. Thus, similar ETFs should definitely be in different treatment groups to increase the power of the pilot.

But I could be wrong. Just in case, the Commission should monitor various measures of market quality and have plans in place to suspend the pilot on short notice if such very very bad things actually occur. While I do not believe such plans will be necessary, the Commission should be prudent and have contingency plans in place. Medical researchers will terminate a clinical trial early if there is abundant evidence one way or the other about the results. If the pilot produces immediate results, such as showing a dramatic increase in market quality for one particular treatment group, then it could be suspended quickly and that particular group's treatment could become the new rule. Likewise, if the pilot produces fast and unequivocal results showing harm to one particular treatment group, that treatment should be halted.

Rotate the treatment groups to balance fairness issues and increase power of the pilot.

It is common in experimental design to switch treatment groups. In this pilot, each group of stocks could be switched from one treatment or control group to another each quarter. The additional operational overheard would be minimal. The exchanges seem to have little trouble adjusting their fee schedules and tier sizes on a monthly basis, so adjusting the security master of which stocks are in which treatment groups on a quarterly basis should not be difficult, either.

The switches would allow for more "differences in differences" analysis of the impact of the different treatment groups. This will increase the quality and power of the pilot without requiring a longer run time. Switching stocks from one treatment group to another would also balance out any relative advantage or disadvantage to being in a particular group over time, especially if all stocks would expect *ex-ante* to spend the same amount of time in each treatment group.

Respectfully submitted,

James J. Angel, Ph.D., CFA
Georgetown University