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Nasdaq.com

August 31, 2018

Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Re: Proposed Transaction Fee Pilot (Release No. 34-82873; File No. S7-05-18)

Dear Mr. Fields:

Nasdaq, Inc. and dozens of commenters have previously explained that the above-captioned proposal to constrain exchange access fees and rebates (“Price Constraint Proposal”) lacks empirical justification; is arbitrary and capricious in scope and impact; is unlikely to produce meaningful, actionable data; and will harm public companies and their shareholders and millions of Main Street investors who invest their savings in equities. Important developments have occurred since the end of the Notice-and-Comment period that exacerbate these problems and further weaken the questionable basis for the Price Constraint Proposal. Nasdaq respectfully suggests that in light of the developments described below, the Securities and Exchange Commission (“Commission”) should delay further action on the Price Constraint Proposal until after it has fully assessed and properly responded to these developments.

First, on July 18, 2018, the Commission amended Regulation ATS under the Exchange Act (“Reg ATS Amendments”) to address potential conflicts of interest experienced by broker-dealers that operate or route orders to Alternative Trading Systems.¹ In doing so, the Commission affirmed that the preferred method for regulating potential conflicts of interest is to increase disclosure by the potential conflicted party and thereby enable consumers to make informed purchasing decisions. The Commission implicitly affirmed that it is neither effective nor prudent to address a potential conflict of interest experienced by one party (*e.g.*, a broker-dealer) by imposing price constraints on a separate party (*e.g.*, an exchange) that is not itself subject to the perceived conflict of interest. In other words, constraining exchange fees and rebates will not address the potential broker-dealer conflicts that ostensibly motivated the Price

¹ Regulation of Stock Alternative Trading Systems, Securities Exchange Act Release No. 34-83663; File No. S7-23-15 (*e.g.*, “[w]e believe that one of the most important functions the Commission can perform for investors is to ensure that they have access to the information they need to protect and further their own interests.”).

Constraint Proposal²; nor will it help customers make informed decisions when purchasing services from potentially conflicted broker-dealers.

The Reg ATS Amendments will directly impact the very potential conflicts that the Price Constraint Proposal purports to study. According to the Commission, the Price Constraint Proposal is needed because broker-dealers cannot effectively manage the potential conflicts associated with routing orders to or away from trading centers to avoid fees or earn rebates, although they have long been obligated to do so by the duty of Best Execution. The Reg ATS Amendments address that same potential conflict by forcing broker-dealers that operate ATSs to disclose important information about their fees and rebates, matching algorithms, and other practices that could lead subscribers to use or avoid those venues. This raises at least two important questions: (1) how can the Price Constraint Proposal validly proceed before the Reg ATS Amendments are implemented when those amendments impact the very potential conflicts of interest the Commission aims to study; and (2) why is the disclosure that Exchanges already make — which still exceeds what will soon be required under Reg ATS — insufficient to address the very same potential conflicts?

Second, the Commission appears poised to adopt amendments to SEC Rules 600 and 606 of Regulation NMS under the Exchange Act³ that will also address potential broker-dealer conflicts of interest and that will also undermine the rationale for the Price Constraint Proposal.⁴ This is consistent with the U.S. Department of Treasury recommendation from October 2017⁵ and with the Chairman’s decision to place the Order Handling Disclosure proposal on the combined federal regulatory agenda.⁶ The Order Handling Disclosure changes would require broker-dealers to provide institutional customers with specific disclosures related to the routing and execution of their orders, and also require broker-dealers to make aggregated information

² See Anonymous letter to Brent J. Fields, dated June 22, 2018:

BUYSIDE: We cannot trust our brokers, and we cannot be bothered to figure out how to evaluate them, or to change to brokers we can trust. Let’s regulate the exchanges.

BROKERS: We cannot trust ourselves, we don’t want to have to disclose institutional data through a revised 606 report, and if we changed our behavior it would affect our margins. Let’s regulate the exchanges.

EXCHANGES: Are we the only ones who see how ridiculous this situation is?

³ See Securities Exchange Act Release No. 78309 (July 13, 2016), 81 FR 49432 (July 27, 2016) (“Order Handling Disclosure Proposal”).

⁴ This became clearer at the Commission’s open meeting on July 18th. See, e.g., *Statement on Adoption of Rules to Increase the Operational Transparency of Alternative Trading Systems (ATS)* by Commissioner Kara M. Stein, available at <https://www.sec.gov/news/public-statement/statement-stein-071818-1>.

⁵ See *A Financial System That Creates Economic Opportunities – Capital Markets* on October 6, 2017, available at <https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf>.

⁶ See Office of Information and Regulatory Affairs, Unified Federal Regulatory Agenda, Disclosure of Order Handling Information, available at <https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201804&RIN=3235-AL67> (Final Rule stage).

about their handling of customers' institutional orders publicly available. It is indisputable that the Order Handling Disclosure Proposal will impact the very same potential conflicts that motivated the Proposal. The Treasury Department itself stated that these rules would "mitigate the potential conflicts of interest that arise due to these compensation arrangements" further reducing the justification for the Price Constraint Proposal by providing information that customers need to make informed order routing decisions.

The Order Handling Disclosure Proposal will clearly impact the Price Constraint Proposal, and especially the Commission's arbitrary decision to exclude ATSS and broker-dealers from the Price Constraint Proposal. The proposed Order Handling Disclosures will require that retail customers receive additional information about their orders, including the disclosure of the net aggregate amount of any payment for order flow received, payment from any profit-sharing relationship received, transaction fees paid and transaction rebates received by a broker-dealer from certain venues; and descriptions of any terms of payment for order flow arrangements and profit-sharing relationships. The new disclosures required by the Order Handling Disclosure Proposal, layered on top of the Reg ATS Amendments, will dramatically enhance customers' ability to understand and address broker-dealer conflicts of interest related to a wide variety of fees and rebates. How then does the Commission explain a rush to adopt price constraints on exchanges to study the very problem that the Reg ATS Amendments and Order Handling Disclosure will shortly address directly?⁷

Realistically, while the Reg ATS Amendments and Order Handling Disclosures will assist investors in understanding the potential conflicts experienced by broker-dealers, neither is a panacea. For example, the proposed Order Handling Disclosures lack the granular level of reporting required to achieve this. Although the current proposal will add details about "zero routes", where orders were sent after no fill is received, it will still not allow investors to quantify the costs of those routes. Importantly, without that level of granularity, the lack of clarity over agency costs will persist regardless of exchange fees that are charged. If that level of granularity were provided, the industry could optimize their routing to maximize their own utility with full transparency into the economics of the market.

Similarly, while Nasdaq applauds the Commission for adopting the Reg ATS Amendments, the Commission missed an important opportunity to enhance transparency for investors by abandoning the provision requiring ATSS to disclose "routing tables or numerical order flow segmentation metrics." To the extent the Commission believes that fees and rebates contribute to broker-dealer conflicts of interest, such conflicts reside in connection with broker-dealer segmentation strategies and routing tables. Nasdaq respectfully encourages the Commission to include this proposal in the anticipated Order Handling Disclosure release in order to gain deeper insight into the relationship between fees, rebates, and order routing. The Commission should also consider examining and rectifying potential deficiencies within the

⁷ See letter from Douglas Cifu, Chief Executive Officer, Virtu Financial Inc., to Brent J. Fields, dated May 23, 2018 ("As history has unequivocally shown, disclosure and transparency are far better at fostering competitive and healthy markets than restricting the free forces of supply and demand via government intervention").

current Best Execution regime that it believes neither the Reg ATS Amendments nor the Order handling Disclosure Proposal would address.⁸

Nasdaq believes that the Reg ATS Amendments and Order Handling Disclosure Proposal, once implemented, will further reduce the already weak need for the Price Constraint Proposal. The Commission and market participants will have substantial new information from ATSs that will inform and likely cause them to modify their current routing and trading behaviors.⁹ This information and the changes the information triggers could lead the Commission to conclude (as Nasdaq and others have already suggested) that any Price Constraint Proposal must include ATS, and other platforms, which represent forty percent of the market.¹⁰

The Commission might also conclude that the gains from implementing the Reg ATS Amendments and Order Handling Disclosure Proposal change the cost-benefit analysis of the Price Constraint Proposal, allowing the Commission to spare issuers and the industry the potential harm and added costs of the Price Constraint Proposal. Therefore, the Commission should delay or withdraw the Price Constraint Proposal until after the Reg ATS Amendments and the Order Handling Disclosure Proposal have been fully implemented and the Commission has had an opportunity to assess whether they address the potential conflicts that motivate the Price Constraint Proposal.

Third, on June 25, 2018, the Supreme Court of the United States issued *Ohio v. American Express*, 585 U.S. ____ (2018), which stands for the proposition that the regulation of two-sided platforms must consider the competitive and economic circumstances of both products produced by the single platform. In *American Express*, the Court assessed the competitive impact of pricing of merchant services and shopper services produced on two-sided transaction platforms operated by major credit card companies. The Court ruled that the relevant market for such two-sided platforms must include both products rather than just one. Exchanges, like credit card companies, operate two-sided platforms that must attract two sets of customers purchasing two related products the pricing of which is inextricably linked. The Commission failed to account

⁸ See letter from David Mechner, CEO, Pragma Securities to Brent J. Fields, dated May 14, 2018 (“execution quality of passive orders, along with bid-ask spread, is the major determinant of execution quality for the large, low-urgency trades through which institutional asset managers such as mutual funds represent ordinary investors. It is these passive orders which market quality metrics fail to address; where the conflicts of interest brokers are subject to are the greatest; and where existing best-execution guidance for brokers is least clear.”)

⁹ See letter from Mehmet Kinak, Global Head of Systematic Trading & Market Structure, T. Rowe Price, to Brent J. Fields, dated June 12, 2018 (“We agree with other commenters that the SEC should take action on two outstanding proposals before proceeding with the Pilot, namely: the disclosure of order handling information and the amendments to Reg ATS. This will help provide the market with additional information regarding changes to order routing, potential conflicts, or incentives programs”).

¹⁰ See, e.g., letter from Tyler Gellasch, Executive Director, Healthy Markets Association, to Brent J. Fields, dated May 24, 2018.

for the two-sided nature of exchange platforms when proposing and assessing the competitive impact of the Price Constraint Proposal.

Fourth, the Price Constraint Proposal could harm U.S. public markets and investors, which may undermine the engine of the U.S. economy at a uniquely challenging time when Congress is attempting to sustain economic growth; the Federal Reserve is working to control inflation; and the Executive branch is negotiating a wide array of trade relationships. The Proposal risks reducing the quality and depth of \$70 trillion of U.S. market liquidity per annum. Reducing the primary incentives exchanges use to encourage lit liquidity runs the real risk of diluting public quotations, widening spreads, and reducing quoted depth, especially for smaller companies where natural liquidity can be insufficient to generate a competitive two-sided quote. This will increase the economic advantages of dark orders, driving up costs not only for large asset managers trying to trade on exchange, but also for those using off exchange venues which are also required to match lit market prices. It is unclear whether the Commission has considered fully the impact of the Price Constraint Proposal under the prevailing, turbulent market and economic conditions.

Finally, Nasdaq is compelled to correct the record regarding its equities transaction fees net of rebates. Page 159 of the Price Constraint Proposal incorrectly states that: “[u]sing the statements of income from Form 10-K filings for 2016 capturing the net (of rebates) transactions-based revenues, the Nasdaq exchanges (Nasdaq, BX, and PSX) earned \$564 million.” This is inaccurate. The Commission’s calculation improperly included \$290 million of Section 31 fees that Nasdaq remitted to the SEC in 2016, as Nasdaq explicitly noted in footnote 2 on page 36 of its 2016 10-K filing. Nasdaq further explained on page 37:

Section 31 fees as cash equity trading revenues with a corresponding amount recorded as transaction-based expenses. We are assessed these fees from the SEC and pass them through to our customers in the form of incremental fees. Since the amount recorded as revenues is equal to the amount recorded as transaction-based expenses, there is no impact on our revenues less transaction-based expenses.

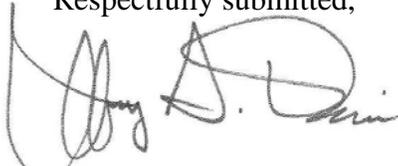
The Price Constraint Proposal also failed to exclude pass-through fees levied by other exchanges amounting to \$19 million of the \$309 million that Nasdaq disclosed at footnote 2 on page 36 of 2016 Form 10-K. Excluding Section 31 fees and other pass-through fees, Nasdaq’s net transaction-based revenue for 2016 was \$255 million as stated on page 36. Notably, the Section 31 fees that Nasdaq remitted to the SEC exceeded Nasdaq’s net equities transaction revenue by \$290 million to \$255 million.

In conclusion, Nasdaq believes that these recent developments further undermine the justification for the proposed Price Constraint Proposal. Nasdaq respectfully urges the Commission to suspend or withdraw the Price Constraint Proposal until such time as it can: (1) implement the Reg ATS Amendments; (2) adopt and implement the Order Handling Disclosure proposal; (3) determine the impact of those actions on the potential conflicts it purports to address via the Price Constraint Proposal; and (4) refine the cost-benefit analysis set forth in the Price Constraint Proposal. These actions will further demonstrate that the Price Constraint

Brent J. Fields
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Proposal is neither necessary nor prudent, particularly at this sensitive moment in our economic history.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Jeffrey S. Davis". The signature is fluid and cursive, with the first name being the most prominent.

Jeffrey S. Davis

cc: Chairman Jay Clayton
Commissioner Robert J. Jackson, Jr.
Commissioner Hester M. Peirce
Commissioner Kara M. Stein
Director Brett Redfearn, Division of Trading and Markets