GRASSO PLUMBING LLC
LIQUIDITY SOLUTIONS SINCE 1992

Richard P Grasso
Grasso Plumbing LLC
755 Secaucus Road
Secaucus, NJ 07094

October 1, 2018

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

Dear Mr. Fields:

Grasso Plumbing LLC appreciates the opportunity to provide comments to the U.S. Securities and Exchange Commission on the proposed Transaction Fee Pilot for NMS stocks.

I know what you are thinking – there's no way that the real Dick Grasso would come off the bench to write a letter on this proposed fee pilot – and you are right. My name just happens to be Richard Grasso, and I bear no relation to the person you might be thinking of. I did have a brief background in financial services: I used to be a stock broker, until my brokerage adopted technology that automated my job, bringing efficiency, streamlining workflows, saving money, and unfortunately making my job unnecessary.

Don't worry about my stock broker job though: I found even greater success solving liquidity problems as a plumber. Today, I have a team of plumbers and fleet of trucks working for me, and I like to think I bring more value to the world than I did when I was a stock broker. There are thousands of ways to invest your money that will do slightly better or worse than average, and as long as FINRA and the SEC can root out the frauds, competition has made sure fees are lower than they've ever been.

But when you need a toilet unclogged, or a leaky pipe fixed, it's an urgent problem, you need someone who is physically close, and most likely it's going to happen off-hours when overtime kicks in. I don't make it that way, that's just how it is – more people flush toilets in their homes at night, I work during the day. I bring a lot of peace to very stressed out people, and while my margins aren't quite like selling low latency connectivity and market data, they are decent.

You might be wondering why a plumber would be commenting on this Transaction Fee Pilot, and that's an interesting story in itself. You see, over the years as a stock broker, I was confused with the real Dick Grasso so many times, that I actually wound up looking him up, reading about him, and in the process, following the evolution of US equity markets.

It's been so long since the real Dick Grasso was running the New York Stock Exchange, that I bet a third of people reading this letter will need to consult the internet to remember who he was. Those of you old enough to remember, know he was a controversial figure: the guy who ran one of the world's great markets, represented the interests of his members, guided the

NYSE through 9/11, and protected the New York's market position until it was no longer tenable.

For a while there, the name Grasso was synonymous with scandal. Dick had an unbelievable $140 million pension, Spitzer ran a crusade on that. The pension was not appropriate for the NYSE, a non-profit, a utility, phrases we sometimes hear today. "If only the exchanges were utilities, then things would be right again".

Old timers remember that we used to have markets that were run as utilities, the technology was antiquated, the market structures were closed, and there were a lot of concerns about unfair dealing by insiders. No one thinks of today's equity markets as antiquated, all the complaints are that there is too much technology in the space, which is hilarious if you take the long view. Too little tech, too much – who decides? The exchange landscape now involves multiple public companies, all with a profit incentive, which you would think was a good thing.

Dick's other big scandal was the specialist fines. All those specialists abusing their privileged positions, led to over $200 million in fines and precipitated the changes under Reg NMS, which revolutionized equity markets. Now, $200 million seemed like a lot of money at the time, but not so bad compared with the aggregate of recent ATS and broker fines. However, the follow-through differs wildly: the specialist fines led to the holistic market makeover that was Reg NMS, whereas beyond the headlines, lost jobs and big checks – what has come of the ATS fines?

Even within the last few weeks, while regulators obsess about exchange transaction fees that increasingly approach net near-zero, we see fines where brokers were lying to their clients, touting fake analysis for system optimization, overcharging for phony premium products, operating unfair or manipulated systems, and favoring high volume clients. But instead of figuring out how to harmonize the message from enforcement with the rule making arm of the SEC, we get the Transaction Fee Pilot, ludicrously designed to make brokers honest by eliminating the potential for them to make fee-based decisions when routing to exchanges.

The choice of SEC priorities is telling – sure, approve the improved ATS-N disclosures, and try pivot to enhanced 606 – but the order of these actions look like cover for a process running backwards. ATS-N forces pricing to be transparent, 606 forces broker routing conflicts to be published, and between them, the fee pilot's stated purpose becomes unnecessary.

Given how vocal brokers have been in support of the fee pilot, how much they stand to benefit from lowered trading expenses, and how incongruent this pilot is with the last several years of SEC enforcement, issues of whether regulatory capture has been turned on its head must also be considered. Has the pendulum shifted so far against the incumbent exchanges that we are now blind to conflicts of interest running the other direction?

Surely we can appreciate some irony – a decade after Reg NMS effectively crushed the NYSE monopoly, and make/take fees shifted power to the hands of the customer, the new NYSE is one of the most fervent defenders of the current fee structure.

*　　　　*　　　　*

Competition is transforming the exchange landscape, driving consolidation to four companies, no matter how many books they operate. The consolidation of exchanges is a great example of the benefits of competition. Exchanges largely compete on price, and transaction margins have been trending lower for years. This has been a net positive for brokers and investors, as the cost to trade has dropped steadily for decades. But while Europe focuses on the agency conflict inherent in broker bundling of trading and research payments, the US focuses on the conflict of broker product quality and pricing to their institutional clients, but to be solved by regulating exchange pricing to zero.

The obsession with exchange fees is worth contemplating, as exchange transaction pricing is a good example in financial services where vigorous competition is mostly working. The exchange fee model is quite honest on its own: the fees are paid according to the choices consumers make in each leg of the transaction, and the person who takes a small risk to set a price gets a small reward. The conflict at the heart of the pilot is that brokers may not properly price their services for their institutional clients reflective of these discounts.

Potential solutions to this conflict abound. Institutional investors could ask for commission disclosure and then negotiate commissions to reflect the fees that brokers are keeping; investors can switch to brokers who use high fee strategies or can demonstrate these conflicts are not an issue; or investors can move to a pass-through model, where they decide how much fee-seeking they want to tolerate, as the pass through fees could now contribute to their investment return. Any of these choices would eliminate the agency conflict, but public discussion continues as if such alternatives don't exist.

* * *

The main difference between each exchange today are fees, and the market has evolved where those fee differences allow traders to deploy strategies that leverage economics for trading. It was striking to see Commissioner Jackson recently lecturing on sub-optimal rebate-driven decisions by brokers, when a more honest critique might start by admitting that the SEC has no idea how institutional orders are routed because there is no systematic data available.

Are broker fee decisions irrational? Surely not all brokers in all cases, and when we consider the utility of how an honest broker might handle fee choices, the benefits of the system become clear. Perhaps you are the only buyer or seller willing to display an order at a price – that arguably merits a reward, rather than waiting for someone else to show a price first. Perhaps you have low confidence about future prices for a large order and don't mind if the order trades slowly while you accumulate shares – waiting for a rebates may be fine. Perhaps you have a desire to execute quickly, and the ability to pay a fee for increased priority on an inverted venue at any time is a feature you appreciate. They key here is that consumers have choices.

Let's follow this logical path - if one agrees that fees are the primary differentiator between exchanges, then:

1. If there were no gradations in fees, or smaller gradations, then there would not need to be so many exchanges.

2. Without so many exchanges, there would be longer queue times at the fewer places available to trade.

This is the reality in other asset classes, such as futures, where market structure prevents exchange competition, and speed to a single order book is absolutely paramount.

The idea that flattening of exchange fees would make everyone better off, by levelling out the time to trade, seems like a fantasy. The opposite would probably be true, like a bakery in a communist country: "Under capitalism, there were many exchanges, and you had a choice – you could wait and earn a rebate, or pay to trade faster. Under price controls, there were fewer places to trade, and they all had longer lines." Probably as true for buying shares of stock as for chocolate babkas.

* * *

When you take a 50-year view, the main outcome of exchange pricing seems to be that it forces exchanges to compete for customers. This keeps their margins tight and gives them incentives to improve the quality of their offerings. There is such cut throat competition for exchange transaction pricing today that a pilot on exchange fees for the purpose of competition is inconceivable, hence we instead get the justification of agency conflicts.

Some people say exchanges don't compete for connectivity and market data – and they are correct, to the point where you have to wonder why we have a formally proposed fee pilot and not market data reform. Real market data reform could take a lot of different avenues. While it is popular to criticize the SIP as being slow and inadequate for serious usage, the reality is today's SIP is now processed in microseconds and undoubtedly workable for most broker applications.

For folks saying "the SIP pricing isn't competitive" or "you can't do depth of book routing without expensive direct feeds," there are potential industry solutions here as well, such as creating competition for the current SIP, and creating a multi-price level SIP. Less latency sensitive firms, who typically don't need the benefit of direct feed data, could use the top of book and multi-price SIP. More latency sensitive firms could use the incremental advantage of a direct feed at a higher price as a single-market monopolies.

What is also worth considering about exchange data and connectivity is that such offerings are consistent quality, described publicly, priced publicly, and provided on a level playing field to anyone who wants them, which stands in stark contrast to most broker or ATS offerings. As numerous fines demonstrate, being a premium brokerage client is no guarantee clients will actually get the product, quality or service levels described.

If we take a step back from this debate, the area where transparency and competition are still relatively lacking is in broker trading itself, the same broker trading we would be rescuing from fee-based agency conflicts under the pilot. Consider: if brokers were required to describe their systems in public, regulatory filings; if brokers were required to price transactions for all clients in a transparent and public manner, fairly disclosed to all participants; if institutional investors were able to select a broker tier of service based on explicit transaction fees; in short, if brokers were required to operate as exchanges currently do, agency conflicts would be eliminated.

* * *

The key question for regulators around the Transaction Fee Pilot remains: are we setting an environment in which firms are free to compete vigorously and ethically with one another? Setting exchange transaction fees to an absolute value near zero does not seem to pass that test, because exchanges lose one of the primary ways in which they differentiate themselves for the purpose of competition.

Back when I used to get a printed newspaper – remember those? – my wife and I used to clip coupons. We thought we were pretty clever for all those coupons, of course now we just buy everything on Amazon. I wish I could have all that coupon clipping time back, and I sometimes wonder why it made sense for me to do so. The only explanation that makes sense to me is to put it in time-value terms: if I had chosen to not use coupons, I could save time and effectively pay a higher price to shop faster if I wanted, like an inverted market. The key is, spending time collecting coupons (a rebate) was my choice, based on my marginal value of a dollar.

The issue for investors today is that their brokers are making the marginal value decision on rebates for them, and not necessarily in the investor's best interest, but it does not logically follow that because some brokers make poor choices around order placement, that we should therefore eliminate the utility of differential exchange fees.

If we truly believe the rhetoric, that brokers are conflicted and cannot be trusted to manage order placement for their clients, then what the industry is really trying to say, but unable to find the words, is that after a wave of fines against brokers, we should rationally expect the SEC to use regulation to ensure brokerage is transparent and fee-competitive, similar to how exchanges operate today. (And we can beef up competition for the SIP and direct feeds while we are at it.) ATS-N is a start, but not far enough – if rebate-seeking order placement decisions are at fault, then those systems and behaviors must also be in scope.

Unfortunately, in today's climate a statement as above is crazy talk, which tells you about what you need to know to understand today's regulatory priorities.

Sincerely,

Richard P Grasso
Grasso Plumbing LLC