Council of Institutional Investors®
The voice of corporate governance

Via Email

May 10, 2018

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: File Number S7-05-18: Transaction Fee Pilot for NMS Stocks

Dear Mr. Secretary:

I am writing on behalf of the Council of Institutional Investors (CII), a nonprofit, nonpartisan association of public, corporate and union employee benefit funds, other employee benefit plans, state and local entities charged with investing public assets, and foundations and endowments with combined assets under management exceeding $3.5 trillion. Approximately 47% of those assets are invested in equity securities.[1]

Our member funds include major long-term shareowners with a duty to protect the retirement savings of millions of workers and their families. Our associate members include a range of asset managers with more than $25 trillion in assets under management.[2] Approximately 43% of those assets are invested in equity securities.[3]

The purpose of this letter is to express our enthusiastic support for prompt approval of the Securities and Exchange Commission's (SEC or Commission) proposed rule to conduct a Transaction Fee Pilot for NMS Stocks (Proposed Pilot).[4] Our support for the Proposed Pilot is consistent with our membership approved policies that state:

> We . . . have [a] . . . duty to communicate the interests and desires of the institutional investor community to regulators, to the public and to the industry regarding trading practices . . . .
> . . . [C]urrent brokerage industry practices . . . [that] make it difficult to break out the exact costs of services . . . may be antithetical to the fiduciary obligation of

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[1] *See* P&I Research Center (last visited Mar. 31, 2018), http://researchcenter.pionline.com/rankings/all/overview.
[2] For more information about the Council of Institutional Investors ("CII"), including its members, please visit CII's website at http://www.cii.org/members. We note that the IEX Group, Inc. is a non-voting associate member of CII, paying $12,000 in annual dues—less than 0.5% of CII's annual membership revenues.
[3] *See* P&I Research Center (last visited Apr. 5, 2018), http://researchcenter.pionline.com/rankings/all/overview.
[4] Transaction Fee Pilot for NMS Stocks, Exchange Act Release No. 82,873, 83 Fed. Reg. 13,008 (proposed rule Mar. 26, 2018), https://www.gpo.gov/fdsys/pkg/FR-2018-03-26/pdf/2018-05545.pdf.

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> obtaining best execution, and hold too much potential for conflicts of interest and abuses.
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> . . . .
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> Clarity and transparency of disclosure of all . . . brokerage arrangements is essential . . . .[5]

We approve the stated purpose of the Proposed Pilot to:

> Shed light on the extent, if any, to which broker-dealers route orders in ways that benefit the broker dealer but may not be optimal for customers. The data obtained from the proposed Transaction Fee Pilot would inform any possible future regulatory action that addresses these potential conflicts of interest to the ultimate benefit of investors.[6]

We share the concerns of "[a]cademics, market participants, regulators, and legislators . . . about how transaction-based fees have affected order routing decisions by broker-dealers and the execution quality obtained by customers."[7] We are particularly troubled by evidence cited by the Commission that "shows lower execution quality, in terms of reduced probability of execution or increased time to execution, for non-marketable limit orders on exchanges that pay high rebates [and] [t]hus broker-dealers may route orders to exchanges that have the best quoted prices but are suboptimal for customers in other ways because orders are either less likely or take longer to execute."[8] We note that such evidence indicates that broker-dealers may not be adhering to existing regulatory guidance that states "firms should not allow access fees charged by particular

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[5] CII, Policies on Other Issues, Guiding Principles for Trading Practices, Commission Levels, Soft Dollars and Commission Recapture (Mar. 31, 1998), https://www.cii.org/policies_other_issues#principles_trading_commission_softdollar.

[6] 83 Fed. Reg. at 13,039.

[7] *Id.* at 13,041; *see, e.g.*, Letter from O. Mason Hawkins, CFA, Chairman & CEO, Southeastern Asset Management, Inc. et al., to Brent J. Fields, Secretary, U.S. Securities and Exchange Commission 1 (Apr. 6, 2018) ("Exchange rebates, maker-taker and inverse (i.e. taker-maker) pricing, as well as other incentives have become a growing concern for investors."), https://www.sec.gov/comments/s7-05-18/s70518-3393100-162164.pdf; Ted Kaufman, "A Delawarean is Doing Great Things in the Trump Administration," *Delwareonline.com*, Mar. 30, 2018, at 1 ("It has been clear to objective observers for some time conflicts of interest were rampant among those involved in the buying and selling of investors' stocks [and] [b]y offering special transaction fees and rebates, the for-profit exchanges have created massive conflicts in the search for the best possible price for investors."), https://www.delawareonline.com/story/opinion/columnists/ted-kaufman/2018/03/30/delawarean-doing-great-things-trump-administration/472561002/; U.S. Department of the Treasury, "A Financial System That Creates Economic Opportunities, Capital Markets" 62 (Oct. 2017) (recommending a pilot program because of concerns "that maker-taker markets and payments for order flow may create misaligned incentives for broker dealers"), https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.

[8] 83 Fed. Reg. at 13,041-42 (citing Robert H. Battalio, Shane A. Corwin, and Robert H. Jennings, ''Can Brokers Have It All? On the Relation between Make-Take Fees and Limit Order Execution Quality,'' *J. Fin.* 2119–2237 (May 2016), *available at* https://onlinelibrary.wiley.com/doi/full/10.1111/jofi.12422).

venues to inappropriately affect their routing decisions, and, in general, a firm's routing decisions should not be unduly influenced by a particular venue's fee or rebate structure."[9]

In addition to all of the data to be provided from the Proposed Pilot facilitating a statistical analysis of the conflicts of interest that fees and rebates may present when making routing decisions, we also agree with the SEC that there are a number of other benefits that may accrue to investors during the Proposed Pilot.[10] Those benefits include: (1) "investors . . . may temporarily obtain better execution quality or price improvement for some securities that they would not otherwise obtain in the absence of the proposed Pilot;"[11] and (2) "[r]eductions to access fees and rebates could increase the transparency of the all-in costs of trading for investors."[12]

We believe it is critical that the Proposed Pilot include "Test Group 3" in which "equity exchanges generally would be prohibited from offering rebates, either from removing or posting liquidity . . . ."[13] We again agree with the Commission that:

> In light of the current debate surrounding transaction fees and the particular attention paid to the potential conflict of interest presented by the payment of transaction-based rebates, . . . the proposed Pilot would be substantially more informative with a no-rebate bucket than a pilot without one, because the no-rebate bucket would allow the proposed Pilot to gather data to test the effects of an outright prohibition on transaction-based rebates. Specifically, 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.[14]

As recently summarized by SEC Director of Trading and Markets Brett Redfearn, "we would be missing an important and unique opportunity to fully evaluate exchange pricing models without proposing this feature with the Transaction Fee Pilot's scope."[15]

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[9] FINRA, Regulatory Notice 15-46, "Best Execution, Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets" 6 (Nov. 2015), https://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_15-46.pdf.
[10] 83 Fed. Reg. at 13,057.
[11] *Id.*
[12] *Id*.
[13] *Id.* at 13,022.
[14] *Id.*
[15] Brett Redfearn, director, division of trading and markets, remarks at the Equity Market Structure Symposium sponsored by the University of Chicago and the STA Foundation 2 (Apr. 10, 2018), https://www.sec.gov/news/speech/speech-redfearn-2018-04-10; s*ee* Ivy Schmerken, "SEC Steers Pilot on Equity Trading Fees and Rebates amid Headwinds," Finextra, May 7, 2018, at 5, https://www.finextra.com/blogposting/15326/sec-steers-pilot-on-equity-trading-fees-and-rebates-amid-headwinds; *see also* Letter from O. Mason Hawkins at 1 ("It is integral that the Pilot contain a no-rebate bucket in order to maximize efficacy.").

Finally, we do not support allowing issuers "to opt-out of the proposed Pilot."[16] We again agree with the Commission that "it is preferable to proceed expeditiously with a broad transaction fee pilot because the data to be collected from the proposed Pilot, and the analyses that will follow, will help inform the Commission and the public on the potential impact of transaction fees and rebates across *all segments of NMS stocks*."[17] We believe that the representativeness of the results obtained from the Proposed Pilot could be negatively impacted if, for example, issuers of lower-priced and small-cap stocks were to opt-out.

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We appreciate the opportunity to comment on the Proposed Pilot. Please feel free to contact me with any questions regarding this letter.

Sincerely,

Jeff Mahoney

Jeffrey P. Mahoney
General Counsel

[16] 83 Fed. Reg. at 13,019.
[17] *Id.* (emphasis added); *see, e.g.*, Letter from O. Mason Hawkins at 2 (opposing an opt-out and arguing for broad stock coverage because "[i]n this way, the ultimate dataset will be meaningful across all types and sizes of companies").