Issuer Network

Corporate America's Leading Issuer Advocate
And Market Expert

Via Email

May 24, 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:

We write to you today regarding your proposed Transaction Fee Pilot for NMS Stocks with a mix of praise, concern and caution as well as a recommendation that you shelve the proposal for a short period of time.

First, the praise:

- Your proposal, all 267 pages of it, represents a remarkable body of work. It reflects countless hours of research and analysis. Its scope is extremely comprehensive and appears to address every conceivable consideration imaginable from a trader perspective. The proposed methods are likely to yield some clarity around trading incentives and best execution practices (although there is no evidence to support any thesis that best execution requirements are not currently being met).
- The dismantling of the Equity Market Structure Advisory Committee ("EMSAC"), which was both a success and a failure, was clearly a cogent move. This is no reflection upon the individuals who served on it, many of whom we know and well respect.

Our concerns and cautions:

- We labeled the EMSAC as both a success and a failure. Its narrow composition invalidates its recommendations. Here is our reasoning:

- The genesis of the EMSAC was a snap, emotional reaction to accusations made in a book – *Flash Boys*. The author made sensationalized allegations in the book and in the media by labeling the market as "rigged" and painted a picture of collusion between HFT's and the exchanges conspiring to deliberately rip off investors.
- The accusatorial tone of the book and the massive media that followed served to create a huge public distrust and hysteria the likes of which we have not seen since the great "*Alar Scare*" of 1989. Ironically both events used *60 Minutes* as their megaphone.
- The "speed bump" markets are now approaching their second year anniversary with less than 3% market share (overwhelmingly dark / non-transparent). If the *Flash Boys* claims were true, should we not have seen a massive shift in order flow to speed bump markets to reclaim the supposed billions of dollars being ripped off? Thus, one must conclude that these claims of massive theft were grossly overstated.
- Fool me once, shame on you; fool me twice…. One would think that given this colossal miscalculation of exaggerated pilferage, the EMSAC would be more cautious before casting such aspersions upon rebates (branding them as kickbacks in direct violation of existing best execution requirements).
- While properly declaring the markets "not rigged," the then-SEC Chairman proceeded to act precisely as if they were rigged by deliberately excluding the NYSE and Nasdaq from participation on the Committee. While this public shunning may have been viewed as therapeutic by some, it served to exclude from participation the proxy for one of the most important market constituencies: issuers.
- The NYSE and Nasdaq are paid (handsomely!) by issuers to represent their interests on all market-related matters. <u>Hence, our largest concern is that the genesis of the proposal, the EMSAC, deliberately excluded issuer representation</u>. This invalidates its recommendations!

- The exclusion of issuers from participation in the pre-proposal discussions renders the "Opt Out" option absolutely essential. Here is our reasoning:

- We noted several Comment Letters that did not support allowing issuers to opt-out of the Pilot. We disagree vociferously. As discussed in the Comment Letter submitted by Tim Quast, *Modern IR*, issuers have been largely left in the dark in terms of complex trading matters while the trading community argues over how to divide the profits. Now they want to eliminate the issuers' ability to opt-out of participation in an experiment in which their precious commodity (their stock) is used as a guinea pig. Outrageous!
- We have held discussions with numerous issuers on this matter. Despite the food fight that has raged within the trading community, there is scant awareness of this proposal in Issuerland. Those with whom we have discussed the proposal were very surprised by it and shared a universal concern for the potential liquidity impact upon their trading. Indeed, the radio silence has been deafening. There is clearly an acute need for greater transparency with the NYSE and Nasdaq listed companies. We wish to make clear that we are not blaming the listing exchanges for this situation. Remember – the EMSAC membership was cherry-picked and they were deliberately excluded! We have included a potential solution in the Recommendation section that follows.
- We also noted recent concerns expressed by ETF issuers (Reuters / *US ETF issuers cry foul over SEC's fee experiment*). They are concerned that virtually identical ETF's in differing buckets will be subject to price arbitrage. Again, the proposal lacks sufficient issuer involvement in its development.

- If excessive profitability due to unwarranted access fees is truly an issue, perhaps it is time to reconsider whether exchanges should remutualize? Here is our reasoning:
  - The concept of potentially excessive access fees does bring to the forefront the issue of excessive profitability. How would we know anything about their profitability? We don't see the numbers. As the leading issuer advocate in the country, I would like to raise the same issue with regard to listing fees imposed upon the issuer community. One of my clients famously commented, "It's about time that we as issuers got paid for providing the chips to the casino!" The simple fact of

the matter is that, at a minimum, full financial disclosure by major business line should be made publicly by all exchanges on a quarterly basis. Surely some modicum of transparency is clearly warranted.

  - Public ownership of the exchanges, and, in fact, Reg NMS itself, is predicated upon price competition as the antiseptic to drive lower cost to investors. In many, many respects it has worked very well. Hence, as we challenge supposed excessive access fees emanating from rebate conflicts, should we not require greater financial disclosure to ensure that these supposed excess profits truly exist?
  - If, in fact, it is determined that based upon this financial disclosure that these for-profit businesses cannot be trusted to operate fair markets with a fair return upon their investment, the solution becomes obvious. Remutualize!

- Conspicuous by its absence in the 267 page proposal is a risk assessment. Specifically, we are concerned about the “law of unintended consequences”. Our reasoning follows:
  - This pilot is not a theoretical exercise. These are live bullets! Yet, we see little discussion of “what can go wrong” and how do we “shut it down if a liquidity event of some kind occurs”.
  - While eight years later many theories abound regarding the root cause of the Flash Crash, surely one cannot deny that the absence of symmetry between exchange shut-off valves was a major factor. This dissymmetry created liquidity disparity. Clearly this risk could have and should have been identified with the roll out of Reg NMS. “What if” is an important question.
  - So too we strongly suggest greater risk analysis prior to launching the pilot. This would include ensuring symmetry between equity and derivative markets. It should also include establishing parameters for halting the experiment in the event of a liquidity event.
- We believe that there are two ancillary areas not referenced in your proposal that require consideration. Those are:
  - <u>Sponsor Directed order flow</u>: As we reflect upon the issue of exchange ownership, should the pilot also endeavor to evaluate the degree to which order flow is being directed to specific

exchanges due to intermediaries who have an equity ownership interest in the exchange to which they are directing the order? This smacks of conflict and cronyism well beyond any concerns about rebates. Surely the concept of "direct your order to the exchange or ECN in which I have an equity interest" does not sound like best execution to us.

- o <u>Short sale disclosure</u>: We are mystified as to how a Short Sale Disclosure Pilot, as required by Dodd Frank many years ago, has not taken precedent over the Access Fee Pilot. We realize that Dodd Frank failed to place a date on the Short Sale Pilot requirement, but this continuing delay is unacceptable. We have begged the exchanges for years to push for some modest level of short sale disclosure. We believe that the absence of any short sale disclosure whatsoever is an embarrassment to our capital markets. The size and scope of this abuse is clearly stated in the Comment Letter of Tim Quast of Modern IR (May 14, 2018), who wrote: "Today, nearly 45% of all market trading volume come from borrowed shares." We do not mean to suggest that short selling is not a vitally important contributor to liquidity in the market. It is! We do mean to suggest that, as is the case with long positions, there are logical thresholds for which disclosure is critical. What is it going to take for you to act in terms of requiring some modest level of short sale disclosure?

- Last but surely not least, the rancorous discussion surrounding the lead-up to this proposal has been devastating to investor trust and confidence. Your leadership in fostering a more civil discourse is sorely needed. Here is our reasoning:
  - o Investor trust and confidence is driven by more than simply potentially higher or lower stock prices on the horizon. As your own research indicates per your October 2017 "Economics Note: Investor Confidence" by Jeremy Ko (link: https://www.sec.gov/files/investor_confidence_noteOct2017.pdf), investor confidence rises following notable enforcement actions and falls with news of negative developments. In fact, on the chart on page 6 of Mr. Ko's *magnum opus*, one of the referenced negative news developments was the release of "*Flash Boys*" from which the thesis that the market is "rigged" was advanced. Investor trust and confidence promptly tanked.

- The frequency of serious uncorroborated written allegations serves to undermine investor trust and confidence. Running a “rigged” market (a la *Flash Boys*) is a serious allegation – in fact, it’s criminal. Calling a rebate a “kickback” (a la NYT OpEd by Macey and Swensen) is equally as accusatorial. A kickback, by definition, is a bribe – in fact, that, too, is criminal. While name-calling such as referencing the NYSE and Nasdaq as “the fox guarding the hen house” (a la *Themis Trading, circa 2014 plus magis*) is not criminal, it does serve to undermine investor confidence in a very big way. These well-documented *argumentum ad hominem* attacks of alleged criminal conduct require your oversight and firm hand.
- There is no doubt that many of these vicious claims are at least partially rooted in fact. For example, latency arbitrage is real. It needed to be addressed – and it has been. With the speed bump markets now operational for nearly two years, it is safe to say the degree to which latency arbitrage affected investors was greatly overstated. But to use such vitriol to so viciously attack an opponent while damaging investor trust and confidence is clearly wrong. The real cost of these attacks is borne by investors and issuers who face a higher cost of capital through lower stock prices.
- There was a time when former NYSE Chairman Richard Grasso had an opportunity to attack Nasdaq’s cherished book of tech listings following some regulatory lapses. I vividly recall him saying to me “I’m not going to do it, Pat. I refuse to undermine investor confidence in the market to advance my own agenda.” Where have you gone, Joe DiMaggio? Our nation turns its lonely eye to you!
- Disruption can be a very powerful and good thing. Destruction of trust merely for the purpose of disruption, however, can be fatal. We call upon you to be more forceful in raising the dialogue to a more constructive, supportive, civil tone. To date there has been no consequence to taking the low road despite a complete lack of any evidence of rigged markets or inferior executions. The discussion should begin, in our opinion, with how can we make the best markets in the world even better rather than to demonize every imperfection. The SEC needs to demonstrate some sorely-needed leadership here!

Our recommendations:

- Place the Access Fee Pilot on hold for 90 days while the Issuer Network (pro bono) gathers a Blue Ribbon Panel (BRP) of a dozen or so NYSE and Nasdaq listed company financial executives so that we might conduct a comprehensive review of your proposal. We have made this recommendation to both the NYSE and Nasdaq who have declined for obvious reasons. They want no third parties playing in their sandbox! We have multiple issuers ready to get on board with the BRP as soon as you agree.
- Give issuers maximum flexibility in opting in or out of participation in the Access Fee Pilot.
- Use the above referenced 90-day hold to conduct a more extensive risk assessment and contingency plan in the event of some adverse market condition.
- Immediately require full quarterly financials by business line (market segment) for all exchanges and ECN's. These should be published on the SEC website.
- Immediately commence a Short Sale Disclosure Pilot as required by Dodd Frank now many years ago.
- Flex your muscle as the SRO over these market participants. While you have no control over the content of books, academic editorials or other media sources, you have complete control over the conduct of market participants. Investor trust and confidence require your firm hand.

We thank you for the opportunity to provide our thoughts and candid comments. We apologize if we have been excessively blunt. We welcome the opportunity to assist you in implementing any or all of our recommendations.

Thank you,

Patrick J. Healy, Founder and CEO
Issuer Network

Corporate America's Leading Issuer Advocate and Market Expert