Via Electronic Mail (rule-comments@sec.gov)

May 24th, 2018

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

Re: Transaction Fee Pilot (File No: S7-05-18)

Dear Mr. Fields:

Babelfish Analytics, Inc ("BFA") is submitting this comment letter to express our support for the Transaction Fee Pilot for National Market System stocks proposed by the Securities and Exchange Commission.

For context, we founded BFA[1] in 2017 after over two decades of working with institutional investors to help them better their trading implementation strategies by reducing transaction costs. We are among the foremost industry experts at understanding market microstructure and operate an independent consultancy devoted to helping the institutional investment community and their execution partners through education and quantitative analytics. Our firm collects routing data from over 25 of the largest brokers in the pursuit of helping our clients improve their algorithmic trading strategies, improve relationships with their broker partners, protect their clients, and ultimately, improve investment returns.

Over the years, we have observed the impact of market microstructure changes through the lens of quantitative analysis and have specifically focused on analyzing routing data for the past four years. Unlike almost all of the research discussed in the public arena, our work is based on actual client routing data requested by each of our institutional investor clients. This data is provided by their executing brokers, which enables us to view actual routing practices and the exact impacts instead of speculative beliefs and estimations based on generalized datasets. We also see the "parent order" information, which results in a complete and accurate accounting of the impact of different routing strategies on overall fund performance.

Those clients that specifically instruct brokers to remove rebate-driven trading behaviors from their algorithms achieve significantly lower trading costs that result in higher returns to their investors. Unfortunately, most firms do not perform routing analysis on a regular basis and consequently, bear the burden of these costs simply because they are unaware that they are contained in their broker-provided algorithms.

---

[1] To learn more about Babelfish Analytics, Inc, please visit our website, www.babelfishanalytics.com

As part of a research report that BFA completed[2] demonstrating the ability of sophisticated counterparties to identify specific broker algorithms from static trading activity, we provided insight into the prevalence of rebate seeking behavior. This important work demonstrated how, just by knowing the first four routes sent by a liquidity seeking algorithm, a counterparty can uniquely identify an algorithm. Conversely, we were unable to find distinct "fingerprints" for "maker/taker" algorithms, such as VWAP and TWAP. This is because rebate seeking routing sequences[3] are so prevalent that many algorithms share the same predictable, rebate seeking behavior,[4] giving priority in the routing sequence to the highest rebate exchanges and then routing a disproportionate proportion of volume to those high rebate destinations.

The problem is exacerbated further because VWAP performance uses a flawed benchmark that hides the true cost to the investor. For example, an algorithm that seeks to achieve VWAP can show flat or even positive performance to that benchmark even when the client buys the stock at a much higher price (or sells at a much lower price) than when the order was received. A frequently realized scenario is that flow sent solely to a high rebate destination waits in queue, often winds up canceled because price moves away, and then receives an inferior price upon the eventual execution. This worse price becomes "baked in" to the VWAP because it is reflected as market movement and not impact. When this happens thousands and thousands of times a day, which is not unusual in the context of a large order, impact can become substantial and the overall consequence to investor return is significant.

Further evidence that rebates are a disincentive to minimizing transaction costs was presented in Clearpool Group's[5] recently published a paper on this topic, "Clear Perspective - Choosing the Appropriate Incentive to Trade Matters". [6] Using a robust data set comprised of the experiences of brokers in their network when using fee sensitive configurations versus fee agnostic configurations when utilizing VWAP algorithms.[7]

Clearpool found that a fee sensitive VWAP algorithm executed during volatile times incurred seven times as much cost as fee agnostic algorithm.   There is no greater demonstration of the depths of the

---

[2] https://www.babelfishanalytics.com/news/2018/5/2/breaking-stealth-or-i-can-name-that-algo-in-four-notes
[3] For example, posting on the highest rebate exchange and placing on the next highest rebate exchange and so on until a fill is received
[4] Due to the predictable nature of maker/taker algorithms identifying the specific algorithm is not essential for a counterparty to profit when a buy side firm is using one.
[5] Clearpool Group provides a cloud based solution that allows brokers to offer algorithms to their buy side clients
[6] http://info.clearpoolgroup.com/blog/clear-perspective-choosing-the-appropriate-incentive-to-trade-matters
[7] Note that when a broker creates an algorithm using Clearpool, after selecting an algorithm class, they are presented with three templates based on explicit cost to the broker:

1.   Fee sensitive - designed to minimize execution fees to the broker
2.   Fee agnostic - designed to achieve best execution
3.   Blended – attempts to balance the trade-off between the two.

This enables proper algorithm classification.

problem than brokers using a "fee sensitive" template without considering the impact on execution quality.

It is also important to understand that the origin of the rebate system stems from a legitimate purpose – to reward those that are willing to provide liquidity, therefore exposing themselves to potential adverse selection. However, the universal provision of rebates, even in situations when a reward for liquidity provision is not necessary, is resulting in an increase in implicit cost for institutional investors.
In turn, the question isn't whether maker/taker is necessary, but under what circumstances is it required. When a stock is liquid and a broker chases rebates, they are more likely to end up deep in a queue and either not receive a fill or receive a fill right as the price is changing. Because the assumption is that all stocks require incentive to provide liquidity, a quantitative approach to which stocks require liquidity support and how much the incentive has not been widely studied.

As such, in the absence of an analysis-driven solution, the access fee pilot is a necessity. It is important that a robust data set be gathered, which should take two years. We do not think the pilot should automatically sunset after one year as the technological changes required to routing and algorithm logic for some firms are a hurdle that could require significant time to implement.   It is also important to cover stocks across all types and sizes to test the argument that rebates are required to promote liquidity provision in illiquid stocks.

We caution that while it is important for the proposal to require the disclosure of basic order routing data by exchanges, this information is insufficient to understand the impact of the pilot. The true success or failure will be measured from the perspective of the investor, which means that investors should be encouraged to perform their own routing analysis to evaluate whether or not their execution partners appropriately sourced rebates. BFA looks forward to analyzing the data from the pilot period on behalf of our clients and supporting them in their endeavors to understand the impact.

We appreciate the opportunity to comment on our support for the Transaction Fee Pilot and we believe that this endeavor will help to achieve the objective of improving market efficiency.

We would welcome the opportunity to meet with Staff of the Division of Trading and Markets to discuss this pilot further.

Best regards,

Linda M. Giordano   Jeffrey M. Alexander
Co-Founder & CEO   Co-Founder & President