May 25, 2018

**Via E-Mail (rule-comments@sec.gov)**

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

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

Dear Mr. Fields:

Citigroup Global Markets Inc. ("CGMI")[1] appreciates the opportunity to comment on the above-referenced Proposed Rule: Transaction Fee Pilot for NMS Stocks (the "Transaction Fee Pilot" or "Pilot") issued by the U.S. Securities and Exchange Commission (the "SEC" or "Commission") on March 14, 2018.[2]

In August 2014, CGMI submitted a comment letter in which we made five Equity Market Structure recommendations, including a recommendation to reduce the cap on access fees to less than 10 mils.[3] We also stated then that "the appropriate cap may need to vary depending on the security, its share price, volume and/or market capitalization," and we provided data to support that view. *From our August 2014 Comment Letter:*

"By way of background, Regulation NMS (National Market System) somewhat arbitrarily established a cap on access fees that can be charged to access liquidity on exchanges at 30 cents per 100 shares, a.k.a. 30 mils. At the time this cap was chosen by the SEC (circa 2004), average spreads were much wider than they are today, and average commission rates were much higher. Because of several positive developments in equity market structure – both commercial and regulatory – spreads have significantly narrowed

[1] Citigroup Inc. is a diversified global financial services holding company whose businesses provide a broad range of financial services to consumer and corporate clients as well as governments and other institutions. Citi has some 200 million client accounts and does business in more than 100 countries. Citi's primary U.S. broker-dealer subsidiary, Citigroup Global Markets Inc., is registered as a broker-dealer in all 50 states, the District of Columbia, Puerto Rico, Taiwan and Guam, and is also a primary dealer in U.S. Treasury securities and a member of the principal United States futures exchanges. CGMI's affiliate, Citigroup Derivatives Markets Inc., is actively engaged in U.S. options market making. Additional information may be found at www.citigroup.com or www.citi.com.

[2] https://www.sec.gov/rules/proposed/2018/34-82873.pdf

[3] https://www.sec.gov/comments/s7-02-10/s70210-416.pdf (our "August 2014 Comment Letter").

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and commission rates have dramatically declined, to the benefit of investors. As a result, today's 30-mil cap on access fees that the exchanges can charge to access liquidity on their venues represents a more significant percentage of the economics of each trade."

While most market participants seem to agree that a reduction in access fees is warranted at this point,[4] some have argued that running a pilot is unnecessary. We agree with the Commission's proposal for a pilot, including a no-rebate group to test the impact of a complete ban on linked pricing. Further, we commend the Commission for its proposal for direct rulemaking rather than operating the Pilot as a National Market System (NMS) Plan, as with the SEC's Tick Size Pilot which has been in operation since October 2016. We believe that by allowing the for-profit exchanges to operate the Tick Size Pilot, the results of that pilot were compromised by some key decisions that were influenced by commercial rather than public interests.

We also agree that alternative trading systems ("ATSs") should not be included in the Pilot. The original premise behind regulators getting involved in price setting in the first place was that, because Rule 611 of Regulation NMS (the "Order Protection Rule") required market participants to access the quotes of protected venues (the for-profit exchanges), a cap was necessary to prevent these venues from having potentially monopolistic pricing power. ATSs are not protected venues, and thus free market competition among them constrains their pricing power. *Again from our August 2014 Comment Letter:*

"For illiquid securities, a primary consideration is to manage the trade-off between market impact and information leakage about one's order flow and trading strategies. To that end, seeking an off-exchange print in dark pools can help minimize information leakage and result in reduced market impact, which is a primary driver of the popularity of off-exchange venues. If there is a desire on the part of the Commission to encourage more order flow to gravitate to the exchanges, then lowering the cap on access fees is one potential way to accomplish that goal."

That said, while ATSs should not be directly impacted by the Pilot, we do believe that there will be indirect impacts on off-exchange trading. Accordingly, we also encourage the SEC to adopt its two pending transparency proposals on Regulation of ATSs[5] and Order Handling Information[6], with certain modifications thereto.[7] Once adopted and implemented, these initiatives, in concert with the data from the Pilot and the

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[4] Including the Securities Industry and Financial Markets Association (SIFMA) letter dated May 24, 2018 (available here: https://www.sec.gov/comments/s7-05-18/s70518-3706424-162467.pdf), to which we contributed significantly.

[5] https://www.sec.gov/rules/proposed/2015/34-76474.pdf

[6] https://www.sec.gov/rules/proposed/2016/34-78309.pdf

[7] https://www.sifma.org/wp-content/uploads/2017/12/SIFMA-Letter-to-SEC-on-Near-Term-Priorities.pdf

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forthcoming Consolidated Audit Trail (CAT), will provide an unprecedented level of transparency around order handling that should significantly benefit investors.

Lastly, we agree that a "Trade-At" Rule should not be part of this Pilot, as it was a part of the Tick Size Pilot. *From our August 2014 Comment Letter:*

"If the cap on access fees is reduced, there would not be a need for a 'sledgehammer' approach in the form of a Trade-At Rule to force more order flow to gravitate back to exchanges. A reduction in the cap, especially in lower-priced and smaller market cap securities, would naturally move more executions back to exchanges. A reduction in the access fee cap is a relatively simple measure that could be taken, with corresponding data analysis to determine whether it is having the anticipated and desired result."

## METRICS

In its June 10, 2016 Recommendation for an Access Fee Pilot, the Regulation NMS Subcommittee of the SEC's Equity Market Structure Advisory Committee ("EMSAC") suggested measurement criteria for its proposed pilot. The stated general intent was to attempt to measure the impact of lower access fees on liquidity provisioning (bid/ask spreads, market depth, order routing behaviors, ratio of hidden liquidity vs. displayed liquidity on the exchanges, quoting behavior) and to measure the impact of lower access fees on liquidity taking (ratio of on vs. off exchange trading, order routing behaviors, price impact, slippage/realized spread, trade volume).[8]

The suggested measurement criteria included: quoted spreads; effective spreads; realized spreads; displayed liquidity (changes at the inside, depth at 3, 5, 10 cents beyond the NBBO); volatility (stock-level changes; number of price changes at the NBBO); hidden liquidity (off-exchange market share; mid-point exchange executions and exchange dark liquidity); changes in trading volume; behavioral routing changes as evidenced by market share shifts among trading venues, on- vs. off-exchange trading levels, and TRF vs. internalization levels; changes in the levels of price improvement in the marketplace; percentage of time the market is locked/crossed; slippage and price impact; retail and institutional commission pricing; shifts among exchange order type usage; and significant behavioral changes in pricing from ATSs and/or exchange reserve quantities.

Inevitably, the success or failure of this Pilot may be subject to interpretation and point of view, often driven by business model. It seems apparent to us that spreads may widen as a result of reduced or eliminated incentives in the form of rebates. However, we do not anticipate a material widening for the most liquid names (where rebates aren't necessary to incentivize liquidity providers) or the most illiquid names (where rebates

[8] https://www.sec.gov/spotlight/emsac/emsac-regulation-nms-recommendation-61016.pdf

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aren't sizable enough to incentivize liquidity providers). Perhaps the Commission may want to consider actually increasing the access fee cap (and thus the corresponding rebates) for the most illiquid securities in our markets, but that would only further entrench regulators in price setting, which seems suboptimal to us. We anticipate a likely outcome of increased spreads for the middle tier of securities, where rebates have perhaps kept spreads artificially narrow. The real question will be whether that is an acceptable outcome relative to the benefits of removing regulators from price-setting and eliminating or mitigating conflicts in the markets, whether actual or perceived.

The things that we will be looking to analyze include:

- How will spreads, queue size at top of book, and depth of book change? Do the largest queues still congregate on the highest rebate venues, or is there a price point where this distribution fundamentally shifts (or even normalizes)?

- Will the different test groups respond differently? On some level, the economics should be the same; there is no material difference between a 28/30-mil rebate/take structure (with a net of 2 mils) vs. a 3/5-mil ratio to the executing venues (same 2-mil net). So in theory, profitability should be the same, unless the larger rebate is seen as important to some market participants, leading them to pull their liquidity out of the market.

- Will overall volumes decrease in the U.S. market as a result of the Pilot? If the reduced rebates are truly important to some market participants, we would expect them to trade less often in aggregate.

- Will ATS volume decrease? We have maintained that the two biggest reasons for off-exchange trading are economics (it is generally less expensive to trade off-exchange than on-exchange) and confidentiality (there is generally less information leakage when trading in ATSs). As a result of this Pilot, the delta between off-exchange and on-exchange cost structures will narrow, so it may become less desirable to trade in an ATS, especially for smaller-sized orders. Are increases in executions against hidden on-exchange liquidity observed?

- Do changes in pricing impact different segments of securities differently, in terms of average daily volume, stock price and market capitalization? Are there disparate impacts on single stocks vs. ETFs vs. ADRs?

- Will retail wholesalers need to increase pricing to retail clients? Or will electronic market makers step in and take passive flow that may have previously been sent to larger rebate exchanges? If in the early stages of the Pilot, the data clearly demonstrates a significant degradation in execution quality for investors (and in particular, for retail investors), then the Commission may want to consider including a kill switch of some sort, that would allow the Pilot to be ended early.

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- Will the Pilot spur a wave of new order types? The Pilot may lead to some complexity around pricing within the exchanges, and maybe some ATSs attempting to stay competitive. This could make an already overly complex market structure even more so.

- We note that each pricing experiment needs to be in place for a sufficient length of time to enable the firms to adjust their routing logic. Cost-sensitive firms may be able to more quickly adapt to new pricing, while liquidity-based routers may need time to collect a new sample set to adjust their routing logic. Therefore, data in the weeks closer to the conclusion of the Pilot may more accurately reflect the state of the market and what the implications would be if implemented long-term.

- What will be the operational costs to market participants to run this Pilot? This Pilot is the most significant change to Equity Market Structure since Regulation NMS was adopted in 2005, and as such, will carry considerable cost in development terms to implement. The Commission could mitigate these costs by limiting the scope of the Pilot, as we recommend below.

## SPECIFIC RECOMMENDATIONS

In our view, the Commission could likely address a significant amount of industry concern by making just three changes to the Pilot:

(1) **Limit the scope of the Pilot by reducing the number of securities in each test group from 1,000 to 500 or fewer.** A total of 3,000 securities in this Pilot is a significant percentage of all NMS names, and starts to look more like a radical change rather than a discrete pilot. Is there material incremental benefit by including 1,000 rather than 500 securities in each test group, or do we start to see diminishing returns at some point? We encourage the Commission to weigh this incremental benefit against the operational costs inherent in implementing a pilot of this size and scope. Presumably at the conclusion of the Pilot, the Commission will make a determination whether to proceed to permanent rulemaking and likely adopt one of the three test groups as permanent. In that case, the costs of unwinding the experiment increase substantially as the number of securities increases. Additionally, certain issuers are highly likely to object to the inclusion of their securities in one or more test groups, especially the no-rebate group. While we do not support the ability for issuers to opt out of inclusion in the Pilot, it does seem advisable to limit the number of impacted issuers by reducing the number of overall impacted securities in the Pilot.

(2) **Distinguish between agency vs. principal flow.** One of the stated aims of the Pilot is to evaluate the impact of transaction fees and rebates on order routing behavior, execution quality, and market quality in general. Embedded

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within this goal is a suspicion that broker-dealers may be conflicted in their routing decisions based on desire to capture rebates. While these conflicts – whether actual or perceived – are clearly problematic for agency orders on behalf of an underlying customer, no conflicts exist when a broker-dealer is routing its own principal orders for its own account (e.g., when trading out of a position assumed to facilitate a customer's order). By failing to differentiate between agency vs. principal order flow, the Pilot data may paint a skewed picture where there may appear to be conflicts when none actually exist. Further, this data should also be tied to the forthcoming final SEC rule regarding Order Handling Information, as that, in addition to capacity, would also require data on an order's intent.

(3) **Protect the confidentiality of firms' trading strategies by curtailing the ability of all market participants to access the data.** Many broker-dealers are concerned that with the amount of data that will be gathered in this Pilot, it may be relatively easy to reverse engineer some of their commercially-sensitive order handling processes. We encourage the Commission to protect the confidentiality of the Pilot data by limiting its disclosure exclusively to the SEC, with further analysis only by academics and exchange members with a valid need to know who each agree to some form of Non-Disclosure Agreement. There is some precedent for this in the Commission's two pending transparency proposals on Regulation of ATSs and Order Handling Information.

## BASIS POINT PRICING

Though no specific request for comment was made in the Pilot proposal regarding basis point pricing, we do think it is a worthwhile exercise to explore the possibility of a move to basis points in the U.S. markets, to correspond with the way pricing is handled in many other jurisdictions worldwide. Under such a construct, transaction fees would be based on the price of the security traded, with a per-share fee cap. This approach could greatly reduce execution costs for lower-priced stocks, and it is particularly pertinent for very high-priced stocks – especially in today's environment where issuers have shown increasing reluctance to split their stock. Short of mandating stock splits once an issuer's stock reaches a certain value, we think that basis point pricing could be an effective means to simplify pricing structures, reduce complexity and eliminate potential conflicts.

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We sincerely appreciate the opportunity to comment on this proposal and all equity market structure issues, and we welcome feedback from all market participants on our above recommendations. Citi looks forward to discussing these matters further with the Commission and its Staff. If you have any comments or questions, please do not hesitate to contact me at [redacted] or [redacted].

Sincerely,

Tim Gately
Managing Director,
Head of Americas Equities

cc: The Honorable Jay Clayton, Chairman
The Honorable Michael S. Piwowar, Commissioner
The Honorable Kara M. Stein, Commissioner
The Honorable Robert J. Jackson, Jr., Commissioner
The Honorable Hester M. Peirce, Commissioner

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