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Morgan Stanley

June 14, 2018

Via E-Mail: rule-comments@sec.gov

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

Re: Securities Exchange Act Release No. 34-82873 (File No. S7-05-18)
Transaction Fee Pilot for NMS Stocks

Dear Mr. Fields:

Morgan Stanley & Co. LLC ("Morgan Stanley") appreciates the opportunity to provide comments to the U.S. Securities and Exchange Commission ("SEC") on its proposal to conduct a transaction fee pilot ("Pilot") for NMS stocks (the "Proposal").[1] While Morgan Stanley is supportive the SEC's efforts to review the current access fee cap, we believe that a broader Regulation NMS review is warranted in light of market structure, trading and technological changes that have occurred over the last decade. For many years, Morgan Stanley has urged the SEC to address certain fee avoidance practices that have impacted the manner in which client orders are routed and executed, many of which are driven by a fee cap that has led certain market participants (including certain exchanges) to avoid paying exchange fees.[2]

The U.S. equity marketplace is generally robust and functions well. We therefore caution the SEC against making any drastic, sudden changes to the fee cap, even as a pilot intended to study the impact of such changes on order routing behaviors and any associated conflicts. While we do support a reassessment of the fee cap, Morgan Stanley does not see the rationale behind the fee cap reductions suggested by the SEC of 50% and 85% (from the current $0.0030 per share to $0.0015 and $0.0005 per share). Morgan Stanley instead advocates for a more gradual, uniform approach to a fee cap review that allows the SEC to ultimately make a data-driven decision without potentially impacting individual

[1] Securities Exchange Act Release No. 34-82873 (Mar. 14, 2018), 83 FR 13008 (Mar. 26, 2018) ("Proposing Release"). Morgan Stanley commends the SEC on undertaking the Proposal as an SEC rulemaking rather than delegating it to the U.S. exchanges to craft as an NMS Plan, thereby eliminating some of the conflicts that have resulted with past NMS Plans when buy-side and sell-side firms did not have a formal voice in shaping them.

[2] See Morgan Stanley's comment letters, presentations and statements on various equity market structure topics, including broker order handling practices, available at http://www.morganstanley.com/institutional-sales/mset-regulatory-communications. *See* Morgan Stanley Presentation to the SEC, Discussion on Order Handling Practices & Disclosures, dated Mar. 4, 2011 (https://www.sec.gov/comments/s7-02-10/s70210-328.pdf) (stating that "[o]rders being intercepted (via IOI solicitation or blind ping) while enroute to exchanges may hurt price discovery.... [r]educing the 30 mils cap to 5-10 mils should eliminate many of these practices and may incentivize more liquidity to lit markets; creates a more level economic field among exchanges and dark liquidity providers").

issuers, market volumes/liquidity and capital formation. We also believe that the goal(s) of the Pilot and objective measurement criteria to determine an appropriate fee cap must be well defined in advance so that there is upfront transparency to all market participants – these have not been clearly articulated in the proposed Pilot.

Finally, we suggest two alternative approaches to the proposed Pilot:

1. A gradual reduction of the current fee cap across all stocks is a more deliberate way of collecting data and uniformly assessing the impact of each reduction on all stocks if the SEC is looking to retain a single fee cap for all stocks.

2. A more comprehensive, longer-term solution would be to consider the implementation of dynamic, stock specific tick sizes with transaction fees capped at a certain percentage (*e.g.*, 10%) of the tick size.

I. Alternative Approaches for Consideration

Gradual Reduction of the Current Fee Cap Across All Stocks – Assuming that the SEC is looking to retain a single transaction fee cap for all stocks, a gradual reduction of the current fee cap across all stocks periodically (*e.g.*, every 6 months or longer) – for example, from $0.0030 to $0.0025 to $0.0020, etc. – is a better approach than the proposed Pilot structure. Whether done as a pilot or a rule change, the gradual walk down approach allows the SEC to collect data and to observe order routing behavior changes, while applying the same economics to all stocks uniformly. This approach eliminates concerns about issuers being subject to disparate treatment due to the inherent arbitrary nature of the test group selection. It also eliminates concerns that the Pilot results will not reflect the actual outcome if such changes are applied more broadly to all stocks outside of the Pilot.

Given that this approach would not provide for a contemporaneous control group for comparison purposes, the SEC could require that market participants provide it with relevant order routing data for a period of, for example, 6 months to a year prior to the initial fee cap reduction as a measure of current environment in a $0.0030 fee cap regime. Any volatility events during each fee cap reduction period would have to be normalized to provide an apples-to-apples comparison. However, if a control group is necessary for comparison purposes, we would recommend a 50-50 split, whereby 50% of the stocks are tested at the reduced fee cap and the other 50% remain status quo as the control group (*e.g.*, 50% of the stocks with a fee cap of $0.0025 per share as the test group for the first gradual reduction and 50% of stocks with the current fee cap of $0.0030 per share as the control group). While this would not eliminate concerns regarding arbitrary selection of test group stocks, it does provide an alternative method for comparison and eliminates the complexity associated with having three separate test groups with different fee caps.

Dynamic, Stock Specific Tick Sizes with Related Transaction Fee Caps – A more comprehensive market structure solution to address the current fee cap would be to not have a single cap across all stocks. Access fees, stock price and tick size are inherently linked. The SEC should consider

implementation of dynamic, stock specific ticks with transaction fees capped at, for example, 10% of the tick size (*e.g.,* $0.0010 per share if a penny tick; $0.0050 per share if a nickel tick).[3]

It is important to recognize that the percentage of off exchange trading is higher for low-priced stocks,[4] arguably because a penny tick size coupled with a $0.0030 per share transaction cost makes it expensive to trade them on exchange. On the other hand, the current $0.0030 per share cap could be considered too low for some high-priced stocks. If the SEC were to increase (and decrease) the tick size based on characteristics of individual stocks (*e.g.,* stock price, average daily trading volume, market capitalization, etc.), it could then provide a uniform single transaction fee cap threshold for all stocks by making it 10% of the tick size. There is already precedent for quotations under $1.00 under Rule 610 of Regulation NMS, whereby the access fee cannot exceed 0.3% of the quotation price per share. This approach may also help alleviate concerns around regulatory ratemaking/price setting that are more commonly associated with applying multiple different fee caps to stocks. While a heavier lift, it may be a more ideal solution to the "one-size-fits-all" current access fee cap.

II. Comments Specific to the Proposed Pilot

Need Well Defined Goal(s) and Objective Measurement Criteria – Regulatory changes should be supported by rationale and data. Before a pilot is put in place, two important things must be well defined – (1) the goal(s) of the pilot, and (2) the objective measurement criteria to determine an appropriate fee cap. Without clearly defining these objectives, collection and review of any data under such a pilot structure is less meaningful. We do not think that the goal(s) and objective measurement criteria of the proposed Pilot have been clearly articulated – "to study the effects that transaction-based fees and rebates may have on, and the effects that changes to those fees and rebates may have on, order routing behavior, execution quality, and market quality more generally"[5] – and are ambiguous at best. It is important to know upfront how the SEC will ultimately decide what the appropriate fee cap is based on the data collected. Objective measurement criteria could include performance of the overall parent orders (*i.e.*, all-in-cost to retail and institutional investors) and changes in quoted spread and available top and depth of book liquidity.

Control and Three Test Groups Structure Not Ideal – The control group and three test group structure of the Pilot creates concerns around different economic incentives for trading similar stocks or

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[3] *See also* U.S. Department of the Treasury Report, A Financial System that Creates Economic Opportunities Capital Markets, dated Oct. 2017 at pp. 60-61 (https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf), recommending dynamic tick sizes for the U.S. equity marketplace.

[4] From June 1, 2017 to May 30, 2018, the percentage of off exchange trading was as follows: 53.3% for stocks priced at $1.00-$1.99, 43.4% for stocks priced at $2.00-$5.00, 38.7% for stocks priced at $5.01-$10.00, 38.3% for stocks priced at $10.01-$15.00, 37.4% for stocks priced at $15.01-$20.00 and 34.6% for stocks priced at more than $20.00. Source: Morgan Stanley, Reuters and NYSE TAQ data.

[5] *See* Proposing Release at 13008. Morgan Stanley agrees with the SEC's rationale to not include alternative trading systems ("ATSs") in the Pilot. ATSs do not display protected quotations and many broker-dealers operators of ATSs generally charge clients an overall commission rate (rather than an access fee) for a bundle of services, including access to their ATSs. In addition, Morgan Stanley agrees with the SEC's rationale to expand the fee cap for the advent of inverted exchanges that charge a fee to post orders on their platforms. Finally, Morgan Stanley does not support a Trade At requirement to force more order flow back to the exchanges.

exchange-traded products ("ETPs") that could potentially have significant impact on issuers, on their stock prices, on their liquidity and ultimately on their investors. Furthermore, as previously stated, the fee cap reductions to be tested appear to be arbitrary, drastic cuts without any supporting rationale. If an illiquid, small cap company stock, for example, is placed in the "No Rebates" test group, liquidity concerns will be further exacerbated because liquidity providers will have less incentive to trade the stock in the absence of a reward for liquidity provision. Moreover, if two ETPs with similar underliers or that track the same index are placed in two different test groups, the Pilot would inevitably determine winners and losers. This type of pilot structure (*i.e.*, a control group and one or more test groups) can be used effectively by individual market participants because they can immediately intervene to change or stop a pilot if they see material impact or unintended consequences. The SEC, however, would not have this ability when experimenting with the entire U.S. equity marketplace absent some sort of ability to step in, and even then, practically speaking, that would not necessarily allow for an immediate, on-the-spot action. If the SEC does proceed with the Pilot and a control and test group(s) structure, however, it should incorporate into the Pilot the ability, in its sole discretion, to terminate such Pilot via an emergency order with sufficient notice to market participants (*e.g.*, 30 days) to undo changes made to comply with the Pilot.

Rebate Ban Will Not Eliminate Conflicts – With respect to the "No Rebates" test group, while some market participants may question the legal and/or regulatory authority to ban rebates and/or to set pricing beyond access to top of book protected quotations, the more relevant question to ask is what the ban is intended to accomplish. If the rationale is to appease those who believe that rebates create conflicts for brokers who route orders, that conflict will not be eliminated by a rebate ban. So long as venues can offer different fees or can offer other economic incentives to route orders to them (*e.g.,* lower market data or connectivity fees), there will be concerns voiced about order routing conflicts. Therefore, it is important to define the problem that we are trying to solve for because elimination of rebates without introducing a better alternative to incentivize liquidity provision could lead to wider spreads, less liquidity and increased costs for retail and institutional investors.

Access to Pilot Data and Confidentiality – Any raw data gathered from the Pilot should solely be provided to and used by the SEC. Raw data in the hands of for-profit exchanges that compete with their broker-dealer members is unacceptable given the proprietary nature of order routing decisions. It is also not practical or realistic to expect that the raw data can be ring fenced to certain exchange employees even with a "use for regulatory purposes only" mandate. Furthermore, any data that is made public should be aggregated and anonymized in a manner that it cannot be deciphered to ascertain market participant identities or reverse engineered into order routing and trading strategies.

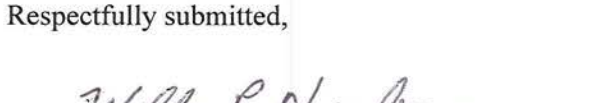
Conclusion

Morgan Stanley commends the SEC on its initiative to reassess the current access fee cap. We recommend that the SEC clearly define its goal(s) and objective measurement criteria upfront and also reevaluate its proposed method for collecting data to get to a more appropriate fee structure for today's environment.

Morgan Stanley believes that any fee cap change should only be made after careful consideration of the potential impact to retail and institutional clients, issuers, market participants and to the U.S. equity

marketplace as a whole. Morgan Stanley welcomes the opportunity to discuss the Pilot and its alternative approaches further with the SEC.

Respectfully submitted,



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