KOR GroupLLC

HEALTHY MARKETS

December 22, 2014

Via Electronic Mail (rule-comments@sec.gov)
U.S. Securities and Exchange Commission
100 F. Street, N.E.
Washington, DC 20549-1049

RE: Release No. 73511; File No. 4-657: Proposed National Market System Plan to Implement a Tick Size Pilot Program On a One-Year Pilot Basis

Dear Ms. Murphy:

KOR Group LLC[1] ("KOR") appreciates the opportunity to provide insight and suggestions on the Securities and Exchange Commission's ("Commission") and SRO's Tick Size Pilot Proposal ("Pilot"). KOR is broadly supportive of the goals of this program – improving liquidity and market quality in underserved symbols by re-examining the one-size-fits-all approach to market structure. However, KOR has concerns around the pilot duration and design.

We have to question the basic premise of this pilot, although we do so with the understanding that Congress is pushing for this and our influence pales in comparison. That said, it must be clear that we should not revert back to the days of fully integrated banking / analyst / market making operations. Computerized and high-speed trading has revolutionized capital markets. Market making is now done predominantly by proprietary trading companies that have no banking capabilities and never will. The idea that increased market making profitability will lead to better research / analyst coverage and encourage more IPOs is an idea out of touch with modern markets post-Regulation NMS.

KOR believes that encouraging market maker profitability and reducing off-exchange trading will have a broadly beneficial impact on the market. This will, over the long run, encourage a greater variety of market making activity (due to increased profitability) and reduce adverse selection on lit markets (due to the decrease in off-exchange trading). This creates a virtuous cycle that will enhance market quality overall, and most importantly will reduce market and order book fragility. As markets become more efficient, stable and simpler, issuers will gain greater confidence would should lend to an increase of Initial Public Offerings "IPOs". While many analysts point to a successful year in terms of IPOs in 2014,

[1] KOR Group LLC is a research, analysis and consulting firm that works with industry participants on market-structure related issues. Our client base includes US exchanges, algorithmic trading firms, buy-side institutions, investment banks and broker/dealers. KOR Group's founders operate Healthy Markets (healthymarkets.org), a non-profit 501(c)-6 advocacy organization that promotes a platform of data freedom, increased transparency, competition and encouraging displayed price discovery. Healthy Markets brings together a diverse set of industry constituents to help foster positive market-structure change.

such a view is short-sighted. We have seen far fewer IPOs over the last several years, due to many factors, and a single good year does not a trend make.

We should not let one data-point distract us from the fact that there are far fewer listed companies today, and that markets must continue to improve and attract listings. Tick sizes are but a small factor in this decision, and KOR would prefer to see the Commission focus on other more important issues. Regardless, we are hopeful that a properly constructed pilot can demonstrate market quality improvements and can serve as a framework for how to properly conduct pilot programs.

When considering our comments, we urge the Commission to keep in mind our core principles and those of the Healthy Markets Initiative:

- Transparency: "Sunlight is … the best of disinfectants." – Supreme Court Justice Louis Brandeis
- Metrics: In order to evaluate any changes, a new set of metrics must be agreed upon and developed.
- Data Freedom: All recommendations and rulemaking must be data-driven; In addition to the Division of Economic & Risk Analysis "DERA", data should be in the provided to academics, researchers and the public.
- Displayed Liquidity: Displayed price discovery is one of the critical functions of the market and must be encouraged.
- Competition: Free and open competition for order flow is healthy for markets.

As such, our recommendations for changes to the pilot plan follow naturally from these principles.

KOR broadly agrees with the overall approach of segmenting Control and Test Groups – this is a scientific approach that is very sensible. We also believe that the additional metrics being collected as part of the Rule 605 improvement are a fantastic step in the right direction (and we want to take this opportunity to call for Rule 605 to be modernized and made relevant once again[2]). One overarching theme of our comments is to simplify the Pilot plan in order to make it easier on participants and to make the results more meaningful.

We believe the pilot would be substantially improved with the following changes:

1. **Increase Duration of Pilot**: One year is simply too little time for a pilot of this nature. If the Commission wants to analyze behavioral changes and their effect on market quality, one year does not make sense. Restricting the length of the pilot and having too many groups with too few symbols makes it too easy for firms to ignore the pilot, and does not provide an accurate representation of what the effects would be if the pilot is made permanent.
2. **Eliminate Test Group 1**: Group 1 is simply going to be a giveaway to internalizers and off-exchange trading. With no controls around trading increments, we will see a deterioration in market quality as more trading moves off-exchange, and lit market making is further disadvantaged.

[2] See: http://www.sec.gov/comments/s7-02-10/s70210-421.pdf

3. **Eliminate the Retail Trading Exemption**: Retail trades are the trades that market makers are seeking – these random trades demand immediacy and are generally profitable to trade against. The current level of price improvement (10% of the MPV) would move more retail trades off of exchanges (not that many reach them as it stands) and exacerbate Payment For Order Flow ("PFOF").
4. **Eliminate or Dramatically Reform Group 3**: The trade-at rule as constructed is overly complex and will lead to more market complexity, not less. The unintended consequences are difficult to tease out, and the incentives to game the rule are high. This rule should be simplified or the group eliminated, in favor of a proper test of the trade-at rule.
5. **Ensure Public Access to Data**: Public access to better data is absolutely **critical** and must be preserved.

Increase Duration of Pilot

We agree with other commenters that a single year pilot does not make sense. Furthermore, we think the Commission's broad approach of approving pilot programs with no intention of abiding by the limited duration of those pilots is a generally flawed approach. There are too many pilot programs that have become de facto permanent but are simply rubber stamped with continuous extensions. This market structure flux is not healthy for anybody. The Commission should take a stand that the Pilot will last 2 years, and that there will be no extensions. At each 6 month interval, data should be analyzed and reported upon, to see whether there are any changes happening over time that are not immediately obvious at the first 6 month report. At 18 months, the Commission should have sufficient data to analyze and propose whether to make one set of rules permanent.

Eliminate Test Group 1

As one of our guiding principles with KOR and the Healthy Markets Initiative is to incentivize displayed liquidity, we do not believe that Group 1 should be permitted in the Pilot. We are not clear on why such a group is even needed – there is broad industry consensus that as constructed, this group will simply divert flow from lit markets to dark pools and internalizers. This will damage the price discovery process, disincentivizing market making – the exact opposite of the stated goals of the Pilot.

KOR strongly believes that the Pilot design is overly complex, and would prefer to simplify it as much as possible. Eliminating Test Group 1 and increasing the number of symbols in the other Groups will help reduce the cost to the industry of implementing the Pilot and make the results more meaningful. We understand that this is a significant change to the construction of the Pilot, but believe that the benefits would be substantial and the downside nonexistent. Considering there is little disagreement on the impact of trading in Group 1, this would be a sensible step and would be well received by the industry.

Eliminate the Retail Trading Exemption

Once again, we must reconsider some of the Pilot design decisions in the context of the Pilot goals. One of the primary goals is to increase market maker profitability, under the assumption that this will improve market quality and encourage more companies to go public. As such, it makes no sense to exempt retail trades from the trading increment and trade-at requirements of Test Groups 2 and 3.

These trades are highly desirable and extremely profitable and will do more to encourage displayed liquidity than any other changes in the Pilot plan. While the lobbying influence of the firms who stand to lose out is very high (and several of them have undue influence on the Pilot design due to their ownership interests in one of the SROs), we cannot let such influence dissuade the Commission from taking the necessary, and admittedly difficult steps to design a Pilot that will succeed.

The Commission, FINRA and other regulatory / enforcement authorities are taking a close look at Payment-for-order-flow "PFOF" practices and retail broker routing decisions. It has been made clear, and admitted before a recent Senate Permanent Subcommittee on Investigations hearing, that several retail brokers route orders exclusively based on payments and rebates. The 10% MPV exemption in Test Groups 2 and 3 will only exacerbate this problem. With tick sizes at a penny, internalizers had little leeway in how much they could pay for orders, as they are generally only profiting at a fraction of the spread. By blowing out spreads but excluding retail trades at the midpoint, the result will be a dramatic increase in PFOF rates. This is of great concern to KOR and Healthy Markets, as we firmly believe that PFOF is having a detrimental impact on market quality and represents an intractable principle-agent conflict that brokers are not managing for their clients' benefit.

Retail trades should be subjected to the same conditions as any other trade, with execution requirements commensurate with the Group that they are in.

Eliminate or Dramatically Reform Group 3

While KOR and Healthy Markets are strong supporters of a trade-at rule, as explained in our comment letter on the Market Structure Concept release[3], the Healthy Markets Platform[4] and in meetings with Commission staff, we are disappointed at the form that this rule has taken in the Pilot plan. Furthermore, it was publicly stated by the Director of Trading and Markets, at a recent SIFMA panel, that this Pilot is not a test of the trade-at rule, and that if the Commission had wanted to test the trade-at rule, they would have written it themselves. At the same panel, he stated that "If you were going to do a trade-at pilot, [the smallest company segment] is not the segment of the market you do it in."[5] It makes no sense to have such a fundamental segment of this Pilot without the full support of the Commission.

The trade-at rule proposed by the SROs is needlessly complex, layering more Regulation NMS on top of the existing framework. It will be sure to spawn a new wave of complex order types and unintended consequences. While we fully support a trade-at rule, such a rule cannot exempt retail orders and must be simple. It must reexamine the need for Regulation NMS restrictions within the context of the new market environment that would be created. And it must take into account technology and routing

[3] https://www.sec.gov/comments/4-657/4657-32.pdf
[4] http://healthymarkets.org/Healthy%20Markets%20Coalition.pdf
[5] Dave Michaels & Sam Mamudi, Brokers Attack SEC's Plan as Trojan Horse, Bloomberg (Nov. 11, 2014), http://www.bloomberg.com/news/2014-11-11/brokers-attack-sec-s-plan-as-trojan-horse-designed-to-hurt-them.html

advances that did not exist in 2005 when Regulation NMS was written. The rule written by the SROs in the pilot proposal does none of this.

In addition, the trade-at rule cannot be a rule that is considered in isolation. It must be coupled with access fee reform, or the elimination of rebates. Without that, conflicts-of-interest are exacerbated and brokers are even less incentivized to act in their clients' best interests.

As such, we do not believe it makes sense to include a trade-at rule in this Pilot unless the Commission writes the rule and stands behind it. We still believe this is an opportunity for a test of a trade-at provision, and would be supportive of the Commission designing a rule that will reduce market complexity and enhance market quality. We believe that the trade-at rule in the Healthy Markets Platform is such a rule:

- Define "better price" to mean a minimum of one trading increment except when the difference between the best ask price and the best bid price is one trading increment. In such cases, the amount shall be a minimum of one-half of one trading increment.
- Permit the SEC to designate a minimum size for orders that are not displayed in a consolidated market display.
- Permit the SEC to designate a minimum size for block orders that must be displayed in a consolidated market display.
- Provide that an order entered on a marketplace must trade with visible orders on that marketplace at the same price before trading with dark orders at the same price on that marketplace.
- Require, subject to certain exceptions, an order entered on a marketplace that trades with an order that has not been displayed in a consolidated market display to either:
    - receive a better price, or
    - be for more than 50 standard trading units or have a value of more than $100,000.
- Mandate that retail price-improving orders may only occur at the mid-point of the NBBO spread at the time of order-execution.

As a further addition, based on the trade-at rule proposed by the SROs, we believe that venues should be permitted to full execute an incoming marketable order, even if it exceeds the displayed size at that venue (this is a clarification of bullet point #4 above). This will dramatically simplify rule implementation and reduce order routing complexity and inter-market linkage requirements.

If the Commission is not interested in testing trade-at in this Pilot, or does not believe that the rule should be reformed, then KOR would prefer it to be eliminated from the Pilot in lieu of a proper test of trade-at and access fee reform / rebate elimination.

Ensure Public Access to Data

The Commission has many questions in the notice regarding public access to data – whether it is worth the cost, and how the SROs should handle it. KOR urges the Commission to go as far as possible in pushing the SROs to provide open and free access to data about the pilot. KOR also believes that no order types should be excluded from the expanded Rule 605 metrics specified in Appendix B of the notice. Free and open access to data will help the Commission and SROs broaden analysis of the Pilot and provide far more perspectives on Pilot results.

Conclusion

KOR Group appreciates the opportunity to provide our perspective on the Tick Size Pilot Plan. We are hopeful that with the correct adjustments, this can be a worthwhile undertaking that provides an interesting set of data to analyze to better understand US equity market structure. Should you have any questions or prefer to discuss any of our comments in-person, please do not hesitate to contact us.

Sincerely,

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