



March 27, 2018

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

Re: Petition for Rulemaking to Amend Rule 10b-18

Dear Mr. Fields:

I am writing on behalf of Investors Exchange LLC (“IEX”) to petition the Securities and Exchange Commission (“SEC”) to modernize Rule 10b-18 (“Rule”) under the Securities Exchange Act of 1934 (the “Act”) by allowing executions priced at the midpoint of the national best bid and offer (“NBBO”) to qualify for the safe harbor treatment provided by the Rule. We believe that this narrowly targeted amendment is important to prevent a specific form of price-gaming and exploitation that occurs in today’s marketplace because of the Rule’s price restrictions.

### **Introduction**

The use of corporate buybacks has been controversial in recent years in the context of a broader debate about whether public companies give too much importance to short-term profits. Although the broader discussion on buybacks is worthy of debate, this letter concerns a separate and distinct issue. In particular, the change we are seeking is about protecting companies that have *already* made the decision to buy back their stock from being disadvantaged by the current market structure, which makes large orders, especially buyback orders seeking to comply with the Rule’s safe harbor, easily identifiable and a source of profits for a narrow group of short-term traders.

This unnecessary cost imposed on corporate buyback orders will only be compounded by recent tax law changes that increase the availability of corporate funds for buybacks and other purposes.<sup>1</sup> As a result, the importance of modernizing Rule 10b-18 to protect the interests of corporate issuers is an increasingly pressing issue.

### **What is Rule 10b-18 Safe Harbor?**

Rule 10b-18 provides a “safe harbor” that allows issuers to purchase their shares in the open market without the concern that their market activities could later be deemed to be manipulative

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<sup>1</sup> See CNN Money, February 9, 2018, avail. at <http://money.cnn.com/2018/02/09/news/companies/tax-cut-bonuses-buybacks/index.html>.

under the law. One of the requirements of the Rule is that brokers buying stock for an issuer must buy at a price that is no greater than the higher of the last independent bid price or the last sale price (the “zero plus tick requirement”). For example, if the last sale of a security is \$10.00, and the national best bid and offer is \$10.00 x \$10.01, a company cannot buy shares at \$10.01 in reliance on the Rule, unless another participant does so first. In general, the Rule was meant to minimize the market impact of an issuer’s repurchase activity and ensure that prices would be set by *independent market forces*.<sup>2</sup>

Although compliance with the Rule is not mandatory, because it provides the only regulatory assurance that buyback activities will not be questioned under the anti-manipulation provisions, in practice, all buyback programs are structured to comply with the Rule. Further, failure to meet any of the conditions under the Rule, even if the failure relates to a single transaction, means that none of the issuer’s purchases on that day are covered by the safe harbor.

While the zero-tick requirement was intended to make sure purchases are not made in a way that could artificially raise the price of the issuer’s stock and would be based on independent market forces, it has the ironic effect of allowing manipulation by making corporate buyback orders predictable, easy to detect, and easy to exploit, thus opening the door for short-term traders to take advantage of these orders for short-term profit.

Using the prior example, a broker acting as agent for a company cannot bid more than \$10.00 unless another trader first purchases shares at \$10.01. This common pattern for buyback orders – placing orders at the bid price, followed by purchases at the offer price only after another participant pays that price – makes those orders easily identifiable and slow moving, thus allowing them to be targeted by traders that can use faster, more sophisticated strategies to manipulate upward the price of the security, which then increases the prices that issuers must pay. This type of detection is further enabled because the corporation must announce in advance its intention to buy back stock (a requirement that we believe provides transparency to the market and serves a greater good). For example, a short-term trader that has identified a pattern that shows the existence of a buyback purchaser in the market may accumulate shares at the offer price without competition from the issuer, which is restricted by the rule, and then resell the same shares to the issuer, which is forced to pay successively higher last sale prices to meet its buyback objectives.

This problem is well-known in the industry and undermines the ability of a corporate issuer or broker acting on its behalf to properly construct a trading strategy to effectively purchase shares with minimal detection at the best prevailing prices. As the global head of trading at a large asset manager put it:

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<sup>2</sup> Securities Exchange Act Release No. 48766 (November 10, 2003), 68 FR 64952, 64593 (November 17, 2003).

*“When it comes to handling the corporate buyback, what’s painfully obvious to us is that the corporate buyback is probably the most gameable order in the marketplace. If you pursue liquidity in a corporate buyback algorithm, other participants can easily sense how the algorithm is going to react and try to trade in front of it.”<sup>3</sup>*

We are in full agreement with this statement.

### **Midpoint Pricing as a Solution**

The 10b-18 safe harbor was put in place in 1982. In the past 36 years, the markets have evolved considerably. Most notable is that traditional stock exchanges have transformed their businesses from non-profit utilities to for-profit companies focused on selling high speed data and technology to increase revenue and benefit a narrow group of high-speed participants.

Long-term investors have sought out solutions to this high-speed exchange arms race. One of their most viable protections in an increasingly high-speed market is the use of midpoint order types. Midpoint order types place the responsibility to determine the most accurate price of the stock on the exchange where that order is sent. Because they execute at a neutral price between the best bid and offer, they don’t signal to traders that there is a large buyer in the market. However, under the existing Rule 10b-18 safe harbor, the use of midpoint orders to protect against exploitative trading strategies is not an available option for corporate buyback orders.

Pegged order types that are priced up to the midpoint of the NBBO are not displayed and trade primarily at the midpoint price. Most important in this context, trading at the midpoint does not impact the price of a security because the order will never execute against any shares at the best prevailing offer or higher, and thus cannot be used to artificially inflate the price of a security, consistent with the purpose of the antimanipulation provisions.

Amending the Rule to allow purchases at or below the midpoint of the NBBO to satisfy the zero plus tick requirement will help to modernize the Rule by allowing tools commonly used to protect the trading interests of long-term investors to also be available to protect the trading interests of corporate issuers.

### **Prior SEC Proposal**

In 2010, when the Commission proposed amendments to Rule 10b-18 (the “2010 Proposal”), it acknowledged that since the Rule was adopted in 1982, changes in the use of automated trading systems and technology had complicated the ability of issuers to rely on the Rule.<sup>4</sup> In that proposal, the Commission specifically vetted the idea of a midpoint exception to the Rule’s price

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<sup>3</sup> See Letter from Howard Meyerson, General Counsel, Liquidnet, Inc., to SEC, dated March 7, 2011, page 2, avail. at <https://www.sec.gov/comments/s7-04-10/s70410-19.pdf>.

<sup>4</sup> Securities Exchange Act Release No. 61414 (January 25, 2010), 75 FR 4713, 4714 (January 29, 2010).

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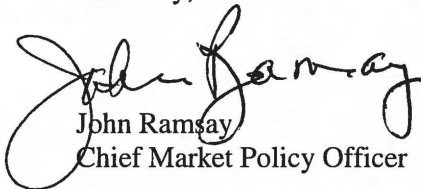
restrictions, and this aspect of the proposal drew favorable comment.<sup>5</sup> Unfortunately, the 2010 Proposal was issued just weeks before the May 2010 Flash Crash, which rightfully changed the Commission's prioritization of market structure improvements. Eight years later, however, the need to update the Rule and address its unintended consequences has become more urgent, especially considering the potential increase in buyback-driven volume.

We note that the Commission also proposed to allow the use of a volume weighted average price ("VWAP") method as an alternative means of complying with the pricing condition of the Rule. Although we do not object to a VWAP alternative in principle, we believe that the specific alternative contained in the 2010 Proposal would be less useful to issuers and brokers and more complicated to administer than a midpoint exception, and it would not as effectively address the market integrity concerns described above.

### Conclusion

Rule 10b-18 in its current form represents a clear example of regulation leading to unintended consequences when it fails to keep pace with evolving market conditions. Although there may be some merit to a broader "rethink" of the Rule, a more ambitious effort would necessarily take much longer to complete. Amending the Rule to add an exception to allow purchases at or below the midpoint of those bid and offer prices that are immediately executable under Commission rules would be a targeted and straightforward way to address a tangible problem that undermines market integrity and increases costs to corporate issuers. We therefore appreciate your consideration to this request.

Sincerely,



John Ramsay  
Chief Market Policy Officer

cc: Hon. Jay Clayton, Chairman  
Hon. Kara Stein, Commissioner  
Hon. Michael Piwowar, Commissioner  
Hon. Robert Jackson, Jr., Commissioner  
Hon. Hester Peirce, Commissioner  
Brett Redfearn, Director, Division of Trading and Markets

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<sup>5</sup> See, e.g., Letter from P. Mats Goebels, Managing Director and General Counsel, Investment Technology Group, Inc., to Elizabeth Murphy, Secretary, SEC, dated March 1, 2010; and Letter from Ann Vlcek, Managing Director and Associate General Counsel, SIFMA, to Elizabeth Murphy, Secretary, SEC, dated April 9, 2010, both avail at <https://www.sec.gov/comments/s7-04-10/s70410.shtml>.