



**Response: to the U.S. Securities and Exchange Commission on S7-18-23
Volume-Based Exchange Transaction Pricing for NMS Stocks**

5th January 2024

Background

The World Federation of Exchanges (WFE) is the global industry association for operators of regulated exchanges and clearing houses (CCPs). This includes everything from local entities in emerging markets to international groups based in major financial centres, with 34% based in Asia-Pacific, 45% in EMEA and 21% in the Americas. Collectively, they run some 250 pieces of market infrastructure, which includes standalone CCPs as well as integrated exchanges-cum-clearing houses.

As of end-2022, around \$145 trillion (equivalent) in share trading annually passes through WFE members, who are home to over 55,000 listed companies, with an aggregate market capitalisation of over \$100tr. WFE member's 90 CCP offerings collectively ensure that risk takers post some \$1.3tr (equivalent) of resources to back their positions, in the form of initial margin and default fund requirements.

With extensive experience of developing and enforcing high standards of conduct, WFE members support an orderly, secure, fair and transparent environment for all sorts of companies and market participants wishing to raise capital, invest, trade, and manage financial risk.

Established in 1961 and headquartered in London, the WFE seeks outcomes that maximise financial stability, consumer confidence and economic growth. We also engage with policy makers and regulators in an open, collaborative way, reflecting the central, public role that exchanges and CCPs play in an internationally integrated financial system.

If you have any further questions, or wish to follow-up on our contribution, the WFE remains at your disposal. Please contact:

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Response

Dear Chair, Commissioners,

I am writing to you today concerning the Commission's proposed Volume-Based Exchange Transaction Pricing for NMS Stocks rule.

The exchange industry is always willing and able to work with the Commission to achieve the goals of investor protection, ensuring fair and orderly markets and helping to deliver capital formation. However, we are increasingly concerned about the lack of coherence surrounding the proposed rules in the last two years.

As we will note in this letter, the proposed rule on Volume-Based Exchange Transaction Pricing for NMS Stocks deals with those issues that need to be addressed under FINRA's best execution rules and/or the SEC's newly proposed rule on best execution – the interaction of which does not appear to be considered in the Commission's thinking. Nor does the Commission consider the further changes proposed to Reg NMS proposed late last year.

We would urge the Commission not to look at this rule proposal in isolation and instead consider the implications of how it fits in the broader rule-making agenda. Exchanges and CCPs in the industry would welcome an open and frank dialogue with the Commission on the best ways in which to help improve capital markets and would value further strategic thought considering the best way to achieve this.

In this letter we will set out how the SEC's proposal's on volume-based pricing are harmful to investors, harmful to fair, orderly and efficient markets and harmful to capital formation. We will look at the benefits of rebates before addressing the SEC's concerns and solutions. Finally, we respond to a number of the SEC's questions in an annex. But before that, it is important to address the issue of volume-based pricing more broadly.

Volume-Based Pricing is a Ubiquitous Concept Throughout the Global Economy

Volume-based pricing is a ubiquitous concept throughout the economy. Whether buying stationery for the office or bottled water from the supermarket, buying-in-bulk gets the customer a saving. The fact that the SEC would propose to try to eliminate this in financial services is concerning.

Indeed, banning volume-based pricing is normally undertaken when a product has negative externalities. For example, in Scotland, banning volume-based pricing of alcohol was enacted as a means to try to reduce the amount of alcohol consumed in a bid to improve public health.

It is strange then that the SEC would seek to use a solution that would normally be used to reduce consumption. Presumably, the SEC would like to see increased participation in capital markets for the benefit companies and investors alike rather than reduced participation.

Volume-Based Pricing is Ubiquitous Throughout Exchanges Globally

The United States is a global leader among market-based economies and it is particularly concerning that it would go so far as to require price controls in this regard. We are aware of no other economy, government or financial services regulator in the world that has a rule like this or is proposing something similar to this.

The Benefits of Rebates

The Commission's analysis of the benefits of its proposal, whilst lengthy, neglects to focus on the costs of eliminating rebates. Therefore, it is important to consider the benefits that rebates bring. Rebates to high-volume trading members has several benefits:

1. **Liquidity Provision:** High-volume trading members, such as market makers and proprietary traders, play a crucial role in providing liquidity to financial markets. They create a more efficient and liquid market environment by continually buying and selling securities. By offering rebates to these participants, exchanges incentivize them to increase their trading activities, which, in turn, leads to narrower bid-ask spreads and better pricing for all market participants. This helps maintain efficient markets and ensures end investors get value for money.
2. **Competition:** Rebates are a legitimate tool used for exchanges to compete with each other and with dark pools. Dark pools can also offer rebates and are subject to much less regulation and regulatory scrutiny.
3. **Market Quality:** When exchanges offer rebates, it attracts more high-frequency and high-volume traders to participate in the market, which enhances market quality. These traders often use sophisticated trading strategies and technologies, making markets more efficient and resilient.
4. **Attracting Market Makers:** Market makers play a critical role in maintaining orderly markets by continuously quoting both buy and sell prices for securities. Offering rebates can attract market makers to a particular exchange, which, in turn, results in more robust market depth and reduced price volatility.
5. **Efficient Price Discovery:** Rebates can lead to a more efficient price discovery process. When high-volume traders participate more actively due to rebates, it can help securities reach their fair market value more quickly, benefiting all market participants, including retail investors and increasing market efficiency.
6. **Encouraging Innovation:** High-volume trading firms often invest in cutting-edge trading technology and strategies. By offering rebates, exchanges can encourage innovation in financial markets, which can lead to the development of more efficient strategies that benefit all participants.
7. **Reduced trading costs:** Rebates reduce the cost of transactions. These savings can be passed on to end investors. Intermediaries would usually be expected to make a small profit off trades routed through them. Frequently, smaller broker-dealers will trade through a larger-broker dealer as secondary broker-dealers. Ultimately, the cost of trading through a second broker-dealer can be cheaper than a broker-dealer trading themselves. The increased trading costs that will be caused by the SEC's proposal will be passed on to end investors, including pensioners and retail investors. It is particularly bizarre that, in a high-inflation global environment, the SEC would take steps to make the cost of investing higher for ordinary citizens.

Rebates bring many benefits to markets which are not acknowledged in the SEC's analysis. The SEC's proposal fails to adequately engage with these ideas or even really accept that there is a trade-off between its stated aims and the benefits that rebates bring.

Addressing the SEC's Concerns

The Commission explains that it is concerned about three issues: competition amongst exchange members, conflicts of interest between exchange members and their agents and competition amongst exchanges themselves.

Competition Amongst Exchange Members

The competition amongst exchange members is driven through various means. Pricing tiers and rebates are not a particular driver of competitive behaviour in the sector. Instead, broker-dealers are more likely to be competing on their ability to optimise trade execution through analytical and technological innovation. Other drivers of this competition include quality of service, prime & stock loans, research, degree of specialization, technology used, customer preferences, market trends and whether a broker takes a direct feed rather than a securities information processor (SIP) among others.

Recent research conducted in the EU also points to the fact that customers with established relationships with their dealers are likely to get “substantially lower bid-ask spreads.”¹ The case study focuses on OTC markets but suggests that relationships between customers and dealers continue to play an important factor in business decision making. This could be a further consideration when smaller broker-dealers trade through larger ones.

Whether the SEC finalises this rule or not, larger broker-dealers will continue to have advantages over smaller ones and smaller ones will continue to trade through larger ones. This is because the Commission is attempting to solve an unsolvable problem. In a market-based economy, the market will never be perfect. Bigger players will always have systemic advantages over smaller players and smaller players will (almost) always be more nimble than bigger ones. The Commission cannot eliminate these advantages, through this or through other means.

Conflicts of Interest Between Exchange Members and Their Agents

The SEC's concern with regards to conflicts of interest is that they believe that exchange members may seek to route their trades through exchanges in order to benefit from the rebates rather than to find the best price for their agents. FINRA Rule [5310](#) already requires broker-dealers to meet best execution requirements. If firms are failing to meet these expectations then the SEC should present this evidence to FINRA for them to enforce.

The SEC has proposed its own best execution rule too. The rule has not yet been enacted but should it become law then the SEC would have cause to take action against any firm that engages in this behaviour. It is for this reason that we do not address the SEC's proposed alternatives below. The SEC already has a far more effective tool to deal with any conflicts of interest than any other proposal. Indeed, best execution requirements are found around the world.

Furthermore, it is worth considering that the Volume-Based Exchange Transaction Pricing for NMS Stocks rule would not address the majority of agency trades in the United States. Around half of trades in the United States are executed in dark pools and off-exchange. There is no price transparency and there are no transparency requirements surrounding these alternative venues. The SEC and FINRA's best execution rules are much better placed to address best execution across the whole market.

Competition Amongst Trading Venues

Broker-dealers have a great number of venues to execute their trades through. Many choose not to route them via an exchange and instead favour trading through alternative venues where there is a lack of transparency surrounding transaction costs. Not only is there a lack of transparency, but dark pools are free to discriminate based on volumes traded through them and the Commission does not intend to address this. Alternative Trading Systems (ATs) or dark pools are also free to discriminate on pricing through other means, another thing which exchanges are prohibited from engaging in.

By addressing solely exchanges, the SEC's solution to a problem that does not exist further creates a competitive advantage for dark pools. Rather than helping competition between trading venues, the SEC's proposal will further hurt competition between trading venues.

Finally, research also suggests that brokers preferentially route trades through their own ATS rather than seeking best execution for their clients. Therefore, the SEC's time may be better spent examining this question in more detail for the benefit of investors and fair, orderly, efficient markets.

The Commission's concerns are either unfounded, unachievable, discriminatory or all of the above.

¹ https://microstructure.exchange/papers/OTC_Relationships.pdf

Addressing the Commission's Solutions

As we have explained above, we do not believe that there is in fact a problem or a solvable problem that the Commission is trying to address. The proposed solution then is naturally something we disagree with. However, we also think its important to address the downsides of the proposed solution in terms of the Commissions objectives of investor protection, maintaining efficient markets and supporting capital formation.

As the proposed SEC solution only applies to agency or riskless principal orders and not proprietary orders, it puts retail traders at a disadvantage. This means that that instead of "levelling the playing field" the SEC's proposal gives a cost advantage to exchange members trading on their own account over end investors, including retail investors. Under the current market structure, whilst retail and smaller investors cannot hope to achieve the level of volume-based rebates of larger exchange members, they can somewhat share in these benefits.

By making trading and investing more costly, the Commission's proposals harm the objective of supporting capital formation. Exchange markets are particularly effective at helping support capital formation because there is less risk to investors of having their funds tied up for longer than they may wish. Deep, liquid markets mean that an investor can adjust their portfolio almost constantly depending upon their risk appetite. By banning volume-based rebates, the Commission makes it more unattractive for market makers to trade on exchanges, reducing liquidity and increasing risks to investors. This in turn, hurts capital formation.

With regards to further disclosure rules, the WFE welcomes transparency as a policy objective. Nevertheless, it questions why the SEC would target the most transparent pricing structures among trading venues. Alongside the strict disclosure requirements for exchanges, ATs should be subject to the same requirements. ATs should publish on their websites, in the federal register and have their transaction costs reviewed by the SEC much like regulated exchanges do in a bid to bring further transparency.

Conclusion

In conclusion, we are concerned about the lack of strategic thought in the Commission's proposed Volume-Based Exchange Transaction Pricing for NMS Stocks rule. Moving away from the ubiquitous concept of volume-based pricing is a mistake. The proposed rule puts retail traders at a disadvantage and undermines the objectives of fair, orderly, and efficient markets. Furthermore, the proposed rule adversely impacts capital formation by increasing trading costs. Finally, transparency in alternative trading systems ought to be further considered. Overall, we suggest the Commission re-consider the proposed rule in light of its potential negative consequences and would welcome a more collaborative and strategic approach to regulatory decision-making.

Annex 1 – Specific answers to questions

1. Do commenters believe that volume-based exchange transaction pricing impacts competition among members when competing for customers on an agency basis? Do sponsored access and direct market access arrangements contribute to these competitive effects when exchange members compete for customers? Why or why not? Does volume-based exchange transaction pricing impact competition among members when trading proprietarily? If there is an impact, is the impact greater for members when they are competing for customers or when they are trading proprietarily, or is the impact equivalent?

Volume-based exchange transaction pricing is a minor component and does not significantly impact competition among members when competing for customers on an agency basis.

When competing for customers on an agency basis, broker-dealers are more likely to be competing on their ability to:

- optimise trade execution through analytical and technological innovation
- offer a quality service
- prime & stock loans for financing costs
- offer quality research
- offer specialised expertise
- operate within their preferred technological parameters
- take a direct feed rather than a securities information processor (SIP) among others.

2. Do commenters believe that volume-based exchange transaction pricing exacerbates the conflict of interest between members and customers when members are routing customer orders, because of the member's desire to qualify for volume-based transaction tiers? Would complete pass through of exchange pricing to the member's customer eliminate that conflict? Why or why not? To what extent do members completely or partially pass through all exchange pricing to their customer? Do customers prefer pass through exchange transaction pricing or broker commissions, and for what reasons? Is the Commission's understanding correct that full and partial pass-through of exchange transaction pricing by members to their customers is less common? For sponsored access and direct market access arrangements, how common is pass-through of exchange transaction fees? What types of pass-through arrangements are most common and how much does the sponsoring member typically retain as compensation?

FINRA's current rule or the SEC's proposed rule on best execution should deal with any conflicts of interest. If firms are failing to meet best execution rules and are routing trades just to benefit from volume-based pricing then the SEC should pass this evidence on to FINRA for enforcement purposes.

3. To what extent does volume-based exchange transaction pricing impact competition among exchanges, and/or between exchanges and off-exchange venues, such as alternative trading systems ("ATs") and wholesaler broker-dealers?

It is a common misperception that there is a lack of competition in the market for trade execution. Investors can trade stocks on approximately 59 execution venues, including 12 exchanges and at least 37 broker-dealer operated venues, or dark pools. Furthermore, trades can be executed off venue altogether through either single dealer platforms that investment banks operate or principal dealers and central risk platforms.

Rather than impacting competition, volume-based exchange transaction pricing originates from the competitive landscape which exchanges are operating in.

5. To what extent is the ability of an exchange to attract order flow from specific types of members or customers through volume-based exchange transaction pricing or other forms of targeted pricing necessary to support competition between exchanges and off exchange venues? For example, if exchanges lack the ability to offer such pricing on agency-related order flow, could that potentially make off-exchange venues relatively more attractive as a destination for that flow? If so, should the Commission address such a competitive disparity? For example, should the Commission expand the scope of the prohibition on volume-based transaction pricing for agency-related volume in certain stocks to off-exchange venues such as ATSS?

As explained above, volume-based pricing has arisen as a result of the competitive pressures on exchanges. If exchanges lacked the ability to offer such pricing on agency-related order flow, that would make off-exchange venues relatively more attractive as a destination for that flow.

Off-exchange venues are already at a regulatory advantage over exchanges. Exchanges are subject to much stricter rules than ATSS. In the last ten years ATSS have come to dominate more and more of the execution market and, whilst they have their place, they generally do not offer lit trading or help price formation which occurs on exchanges. This in turn hurts the efficiency of markets.

If the Commission continues to pursue this policy then it should apply the same strict rules to ATSS to prevent further disparity in competition and reduce the effect on efficient price discovery.

8. Would the proposed prohibition on volume-based exchange transaction pricing in connection with the execution of agency or riskless principal orders in NMS stocks address the concerns the Commission identified about member competition and conflicts of interests between members and customers? Why or why not?

Across financial services and all types of business it is impossible to remove all conflicts of interest. Instead, conflicts must be managed. Broker-dealers ought to be managing these conflicts and providing best execution under current FINRA rules. If the brokers are failing to meet best execution requirements then the SEC should pass evidence of this to FINRA so that they might enforce.