CITADEL | Securities

January 5, 2024

Ms. Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549–1090

Re: Volume-Based Exchange Transaction Pricing for NMS Stocks (File No. S7-18-23)

Dear Ms. Countryman,

We write to express our concerns with the Securities and Exchange Commission's (the "Commission") misguided proposal to prohibit national securities exchanges from offering volume-based transaction pricing ("volume tiers") in connection with the execution of agency-related orders (the "Proposal").[1] The Proposal is another example of the Commission's recent trend of proposing radical changes to current equity market structure that risk negatively impacting liquidity and competition without identifying and substantiating a problem in the first place. Further, the Commission continues to refuse to consider the interplay among, inconsistencies between, and cumulative impact of, now five overlapping equity market structure proposals. As detailed below, the Proposal is fatally flawed and should be withdrawn in its entirety.

The Proposal to prohibit longstanding pricing structures employed in equities markets worldwide means that the Commission will effectively be engaging in price-setting in an unprecedented manner, contrary to the Commission's core statutory mandate and principles of reasoned decision making. Before embarking down this road, one would expect the Commission to have compelling evidence that prohibiting volume tiers for certain orders will have a beneficial impact on the market. However, the Proposal is completely devoid of data demonstrating that volume tiers harm investors or burden competition in the equities markets and, instead, the Commission relies on theoretical academic literature analyzing unrelated markets, such as the video rental and cable television markets. When the Commission finally turns to analyzing the actual impact of this Proposal on the equities markets, it identifies a number of significant costs resulting from the Proposal, including "mak[ing] the search for best price more costly,"[2] "harming execution quality in the market as a whole,"[3] and "result[ing] in a more fragmented market."[4] Thus, even the Commission's own insufficient cost-benefit analysis suggests the Proposal should never have been issued.

Furthermore, the Proposal suffers from several serious procedural flaws. *First*, the Proposal is plainly inconsistent with the Commission's December 2022 "Minimum Pricing Increments and

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[1] Volume-Based Exchange Transaction Pricing for NMS Stocks, 88 Fed. Reg. 76282 (Nov. 6, 2023).

[2] Proposal at 76321.

[3] *Id*.

[4] *Id*. at 76328.

Access Fees" proposal,[5] which proposed to *maintain* exchange volume tiers but sought to increase transparency of these tiers by requiring all exchange fees and rebates be determinable at the time of execution. It is nonsensical for the Commission, in one proposal, to require that volume tiers be revised such that they are forward-looking and known at the time of execution, while, in another proposal, prohibit volume tiers entirely. At a minimum, the Commission should withdraw these inconsistent proposals, develop a coherent proposed policy position with respect to volume tiers, and issue that proposal for public comment.

Second, a substantial portion of the Proposal is dedicated to discussing numerous alternatives the Commission could theoretically pursue. As such, the Proposal reads like a glorified concept release, rather than a serious rulemaking proposal. Certain of the suggested alternatives, including prohibiting volume tiers for proprietary orders (in addition to agency orders), would even more drastically reshape market structure, with profound implications for market liquidity and execution quality. Prohibiting volume tiers for all orders lacks any rational basis, cannot be supported by a mere two pages of "analysis" in the Federal Register, and would be arbitrary and capricious Commission action if it were to be further pursued.

Third, even with respect to agency orders, it is clear that prohibiting volume tiers will not provide the benefits the Commission claims. The Commission will be picking winners and losers – negatively impacting smaller customers that receive pricing benefits that are passed-through by larger exchange members – without fundamentally changing overall competitive dynamics at the exchange level. Fundamentally, this Proposal represents a risky, ill-conceived, and poorly designed experiment given that the Commission has previously acknowledged that it lacks "the information necessary to provide reasonable estimates of the economic effects" of a rule that alters exchange pricing structures.[6] Nothing in this Proposal suggests the Commission has any better idea of the ultimate impact of prohibiting volume tiers on overall market quality and functioning. The Proposal should be withdrawn in its entirety.

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[5] 87 Fed. Reg. 80266 (Dec. 29, 2022) available at https://www.govinfo.gov/content/pkg/FR-2022-12-29/pdf/2022-27616.pdf.

[6] *New York Stock Exchange LLC, et al., v. SEC*, No. 19-1042 (D.C. Cir. 2020) (citing Transaction Fee Pilot for NMS Stocks, 84 Fed. Reg. 5202 (Feb. 2, 2019) available at https://www.federalregister.gov/documents/2019/02/20/2018-27982/transaction-fee-pilot-for-nms-stocks).

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I. The Commission Fails to Provide Evidence of a Market Failure, and its Cost-Benefit Analysis Concedes the Proposal Will Negatively Impact Market Efficiency

Before proposing to micromanage price levels in a competitive market where exchange pricing is inextricably linked to liquidity provision, the Commission should have compelling evidence that any such change will promote efficiency, competition, and capital formation.[7] However, the Commission's economic analysis fails to demonstrate that volume tiers harm investors or burden intermarket competition and concedes that the Proposal will have clear negative effects. Given these harms, and the lack of substantiated benefits, the Commission should not move forward with the Proposal.

The Commission concedes that the Proposal could lead to wider spreads on exchanges, increasing transaction costs for all investors. For example, the Commission finds that "[w]hen volume-based discounts induce additional order flow from high-volume broker-dealers to convene on a dominant exchange, more liquidity reduces the cost of searching for the best execution and benefits the lower-volume broker-dealers."[8] In addition, the Commission concludes that a more even distribution of order flow across exchanges would result in "a more fragmented market" that will disperse liquidity and increase transaction costs.[9]

Despite these findings, it is clear that the overarching objective of the Proposal is to "more evenly" disperse order flow and set exchange market share at levels deemed acceptable to the Commission.[10] Interestingly, the Commission is unable to even substantiate that this would result from the Proposal – electing to conduct purely theoretical analyses of changes to exchange market share under different order flow concentration levels. The Commission, however, fails to reach a conclusion regarding how this Proposal will impact order flow concentration and its superficial analysis relies on implausible assumptions, such as that (i) exchange pricing schedules will not change as a result of the Proposal, and (ii) agency-related order flow concentration levels will decrease at least as much as principal order flow concentration levels increase.[11]

These flaws are symptomatic of the fact that the Commission is wildly uncertain regarding the effects of the Proposal and failed to obtain basic information necessary to support its claims. Other examples of the Commission's errors include failing to analyze the extent to which exchange volume tiers influence order routing decisions relative to other factors (differential pricing models, compliance with the order protection rule, best execution responsibilities, etc.), and failing to obtain basic information regarding market access arrangements in place today, including the extent

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[7] *See* 15 U.S.C. § 78c(f).

[8] Proposal at 76326.

[9] Proposal at 76328.

[10] *Id.* ("a reasonable expectation for the likely effect of the proposed rule would be to result in a marginally more even distribution of market share across stock exchanges, which may be representative of a more competitive market").

[11] *See id.* Certain of these assumptions are explicitly contradicted elsewhere in the Proposal (see, for example, "[t]he Commission believes an 'intermediate' price to be a likely outcome given the wide range of order volume across broker-dealers"). Proposal at 76316, n. 195.

to which broker-dealers are passing through volume-based discounts to their customers.[12] Instead, the Commission relies on academic studies of completely unrelated markets, such as studies of the video rental[13] and cable television industries,[14] to reach broad and inappropriate conclusions about competitive dynamics in the equities markets.[15]

The Commission's economic analysis is also noteworthy in the context of the Commission's abandoned Transaction Fee Pilot. In that final rulemaking, seeking to address substantially similar alleged concerns, the Commission determined it should pursue a pilot program to inform future decision-making because the Commission "lack[ed] the data necessary to meaningfully analyze the impact that exchange transaction fee-and-rebate pricing models have on order routing behavior, market and execution quality, and our market structure generally."[16] With respect to the rule's effect on efficiency, the Commission then conceded that "there is significant uncertainty regarding the effect, if any, that the [Rule] will have on liquidity and trading volume on exchanges," and that, as a result, it "is unable to determine *ex ante* the overall effects the [Rule] will have on the efficiency of capital allocation, price efficiency, or the efficiency of fees and rebates."[17] In fact, the Commission then also conceded that "if the reduction in rebates and Linked Pricing harms liquidity, or causes more informed order flow to be routed to off-exchange trading venues, then the [Rule] may temporarily impair price efficiency and the price discovery process."[18]

Nothing in this Proposal suggests that, in the intervening five years, the Commission has remedied the data gaps it identified in 2019. The Commission cites no subsequent Commission studies, roundtables, requests for comment, or any other new information to inform this significant rulemaking. It is therefore unclear how the Commission can suddenly now reliably predict the economic impact of its proposal to prohibit volume tiers for certain orders altogether.[19]

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[12] The Commission also suggests that volume tiers are anti-competitive by alleging that the exchanges with the largest market share have the most volume tiers. However, the Commission solely considered exchange market share at a single point in time (i.e., January 2023) and would have reached the opposite conclusion if it had tested its theory over a longer period of time. *See* Anna Kurzok, The SEC's Volume Tier Proposal: Will Its Design Be The Obstacle to Its Success? (Nov. 28, 2023).

[13] *Id.* at 76305.

[14] *Id.*

[15] The Commission's reliance on other markets to support the Proposal is particularly unfounded given its acknowledgment that equities markets are subject to unique considerations. For example, the Commission recognizes that equities markets are subject to an "order flow externality" whereby concentrating order flow on a dominant exchange reduces the cost of searching for best execution which is "absent in many traditional price discrimination settings." Proposal at 76326.

[16] Transaction Fee Pilot for NMS Stocks, 84 Fed. Reg. 5202 (Feb. 20, 2019).

[17] *Id.* at 5280.

[18] *Id.* at 5281.

[19] *See Encino*, 579 U.S. at 222 (any "unexplained inconsistency in agency policy" is a reason to hold agency action arbitrary and capricious).

II. <u>The Commission's Inconsistent Proposals Deprive Market Participants of a Meaningful Opportunity to Comment</u>

In December 2022, the Commission proposed to require all exchange fees and rebates be determinable *at the time of execution*.[20] By its own logic, the requirement for forward-looking fee schedules in the Minimum Pricing Increments and Access Fees proposal was "designed to increase transparency regarding the amount of volume-based discounts and other tiered fee structures available at the time of execution."[21] The Commission further explained that "although a broker-dealer could still choose not to pass along fee/rebate, the proposal would facilitate a customer's ability to ask more direct questions of its broker-dealer about how the broker-dealer handles fees and rebates, which could increase accountability of the broker-dealer, which in turn could lead to better order execution and more transparency regarding fee/rebates."[22] Thus, the Commission already directly addressed volume tiers in a prior pending rulemaking, but in a manner fundamentally inconsistent with this Proposal.

Clearly, these two proposals are inextricably linked. It is nonsensical for the Commission, in one proposal, to require that volume tiers be revised such that they are forward-looking and known at the time of execution, while, in another proposal, prohibit volume tiers entirely. The Commission must withdraw these inconsistent proposals, assess the interaction of this Proposal with all the other pending equity market structure proposals (including their "cumulative effect"),[23] put forward a coherent policy position with respect to volume tiers, and issue that proposal (and accompanying analysis) for public comment. At the moment, the various interlocking proposals are so contradictory and indeterminate that the public has not had a reasonable opportunity to comment on what the Commission is actually proposing as required by the APA.[24]

III. <u>The Myriad of Proposed Alternatives Deprive Market Participants of a Meaningful Opportunity to Comment and Lack a Rational Basis</u>

The Proposal describes seven different alternative rules that the Commission could theoretically pursue, all of which would significantly alter the scope and effects of the Proposal. In statements accompanying the Proposal, several Commissioners devoted unusual time and attention to discussing these alternatives rather than the rule being proposed, making it difficult for the public to discern the Commission's true intent.[25] Without basic notice of what the

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[20] Minimum Pricing Increments and Access Fees Proposal, *supra* note 5.

[21] *Id*. at 110.

[22] *Id*. at 109.

[23] *All. for Hippocratic Med. v. FDA*, 78 F.4th 210, 246 (5th Cir. 2023).

[24] See our comment letters on the "Minimum Pricing Increments and Access Fees" proposal for further detail, including the fact that all of the feedback provided in response to this earlier proposal was specifically provided on the basis that volume-based fee tiers were not being prohibited (https://www.sec.gov/comments/s7-30-22/s73022-307420-791242.pdf).

[25] *See* Statement on Exchanges' Volume-Based Rebates and Fees, Chair Gary Gensler (Oct. 18, 2023) available at https://www.sec.gov/news/statement/gensler-volume-based-rebates-and-fees-101823; Statement on Volume-Based Exchange Transaction Pricing for NMS Stocks, Commissioner Caroline Crenshaw (Oct. 18, 2023) available at https://www.sec.gov/news/statement/crenshaw-statement-volume-based-rebates-and-fees-101823.

Commission is actually proposing to do – notice required by the APA – the public cannot meaningfully participate in this rulemaking. At a minimum, given the scope and magnitude of alternatives considered (and the lack of accompanying economic analysis), the Commission must decide which of the alternatives (if any) it is actually going to pursue, re-propose a single proposal in a "concrete and focused form,"[26] and then re-solicit comments on *that* proposal.

It is troubling, however, that the Commission would even consider the proposed alternative of banning volume tiers for all orders (including proprietary order flow). This alternative would significantly increase the costs and harms of the Proposal. For proprietary orders, volume-based pricing encourages broker-dealers to provide liquidity, deepening an exchange's order book, enhancing price discovery, and improving market quality for all investors. These significant benefits of the current market structure are even acknowledged by the Commission in the Proposal's economic analysis.[27] As a result, prohibiting volume-based pricing for proprietary orders would increase the costs of trading for all investors. It would also increase the costs to broker-dealers of engaging in principal trading, disincentivizing firms from investing in the technology, connectivity and other resources needed to provide liquidity in a principal capacity.

Importantly, any purported conflicts of interests alleged by the Commission with respect to the routing of agency orders are not present for proprietary orders, as customers are not involved. Thus, the Commission would be increasing costs and reducing market efficiency, without even being able to allege customer protection benefits. This alternative thus lacks any rational basis and would be even more arbitrary and capricious than the current proposal.[28]

IV. <u>The Proposed Volume Tier Ban Will Reduce Competition and Harm Investors</u>

The Commission identifies three categories of purported beneficiaries of the Proposal, (1) smaller broker-dealers, (2) smaller exchanges, and (3) customers of broker-dealers executing in an agency capacity. First, the Commission states that the Proposal "may" improve smaller broker-dealers' ability to compete for order flow.[29] Second, the Commission states that the Proposal "may" increase competition among exchanges by enhancing the ability of smaller exchanges to compete for order flow.[30] Third, the Commission argues the Proposal "may" improve customer executions for agency orders by reducing potential conflicts of interest.[31] As we detail below, the

[26] *Home Box Off., Inc. v. FCC*, 567 F.2d 9, 36 (D.C. Cir. 1977).

[27] *See, e.g.,* Proposal at 76326 ("High-volume exchange members likely contribute substantially more to the depth of book on an exchange. When volume-based discounts induce additional order flow from high-volume broker-dealers to convene on a dominant exchange, more liquidity reduces the cost of searching for the best execution and benefits the lower-volume broker-dealers.").

[28] For similar reasons, the Proposal should not extend to options trading. Before considering the Proposal in the context of the options markets, the Commission must propose a separate and independent economic analysis of the impact of such a prohibition with an opportunity for public notice and comment.

[29] Proposal at 76285.

[30] Proposal at 76288.

[31] Proposal at 76287-88.

Proposal will not result in any of these benefits and, in fact, it will actually harm those it seeks to benefit.

As an initial matter, we note that many types of Commission registrants offer volume tiers. The Commission fails to explain why *exchange* volume tiers warrant disparate treatment. The focus on exchange volume tiers is particularly perplexing given that other forms of volume tiers are specifically designed to influence retail investor behavior. Rule 22d-1 under the Investment Company Act, for example, permits mutual funds to sell shares at prices reflecting scheduled breakpoints. Breakpoint discounts are also offered in the context of 529 Plans (qualified tuition plans), non-traded real-estate investment trusts and non-traded business development companies. Investment advisers registered with the Commission commonly offer volume-based management fee discounts based on the amount of assets under management with the adviser. And broker-dealers provide discounts to high-volume customers. To avoid being arbitrary and capricious, administrative actions must be consistent and predictable, following the basic principle that similar cases should be treated similarly.[32] The Commission fails to explain why its position to ban exchange volume tiers here is warranted given the prevalence of this practice across other categories of Commission registrants (as well as more broadly across the economy).

A. The Proposal Will Not Increase Competition Among Broker-Dealers or Benefit Smaller Broker-Dealers.

The Commission repeatedly suggests that the Proposal will improve the ability of lower-volume broker-dealers to compete with higher-volume broker-dealers for order flow. According to the Commission, this is because the gap in transaction pricing between the base tier and the top tier can make it more difficult for new and lower-volume members to compete for order flow, putting them at a competitive disadvantage.[33] The Commission also argues that this enables higher-volume broker-dealers to sell sponsored access and direct market access services, creating a self-reinforcing cycle whereby high-volume members attract additional order flow by offering customers "the same lower fees and higher rebates either directly through pass-through exchange transaction pricing or indirectly through lower commissions."[34] The Commission then wrongfully concludes that banning pricing tiers will increase competition among broker-dealers, on the basis that it will incentivize smaller broker-dealers to access exchanges directly at more favorable rates than they otherwise would receive if connecting directly today.

In fact, the Commission's claim that smaller-broker dealers and their customers will benefit from the Proposal is both illogical and irrational.[35] First, there are many reasons why smaller broker-dealers choose to access markets through larger broker-dealers that have nothing to do with volume tiers. Directly accessing markets requires significant investments in technological and operational infrastructure, as well as costly exchange memberships and data subscriptions. The

[32] *Grayscale Investment, LLC v. SEC* (D.C Cir 2023).

[33] Proposal at 76285.

[34] Proposal at 76285.

[35] We note this line of argument also ignores the various types of "agency" order flow – many of which do not involve one broker-dealer routing orders through another broker-dealer.

Commission fails to explain why the Proposal would change this dynamic at all, nor does it substantiate the implied assertion that volume tiers are the single most important factor driving market participant connectivity decisions. This is a critical flaw in the Commission's reasoning, as a plethora of additional costs and investments would be necessary for smaller broker-dealers to access exchanges directly.

Second, the Commission acknowledges that tiered pricing actually benefits smaller broker-dealers who access markets through larger broker-dealers because they are able to receive more favorable pricing through sponsored access arrangements,[36] but attempts to minimize this benefit by alleging that sponsoring members "typically do not pass along the entirety of their transaction pricing advantage."[37] Not only did the Commission fail to offer a quantitative analysis regarding the economics or terms of these arrangements, the Commission admits that it did not obtain information about these practices before issuing the Proposal, stating only that "the extent to which any such pass-through transaction pricing is provided to sponsored customers is uncertain because these arrangements are not disclosed."[38]

As a result, the most likely outcome of the Commission's Proposal is that smaller broker-dealers will continue to rely on high-volume broker-dealers for market access but lose any pricing benefits of such arrangements that are passed-through today. The Proposal is therefore unlikely to change broker-dealer routing behavior, and will only serve to *increase* customer transaction costs.

B. The Proposal Will Not Increase Competition Among Exchanges.

The Commission asserts that volume tiers based on percentages of consolidated volume "may" make it harder for some exchanges to compete for order flow. The Commission's concern, however, is not supported by data or commercial reality. The exchange market is highly competitive. Market participants can readily direct order flow to competing venues if they deem fee levels at a particular venue to be excessive. Sixteen different exchanges compete for order flow, and there have been several new non-listing exchanges that have registered with the Commission in recent years.

The Commission's claim that volume-based pricing results in competitive distortions fails to consider other more relevant factors that influence order routing. These include the quality of liquidity on a particular exchange, an exchange's net capture rate and fee model (e.g., maker-taker, inverted, flat, or no-fee), unique order types, and a broker-dealer's best execution responsibilities. The Commission provides no evidence supporting its position that prohibiting volume tiers for certain orders would materially affect broader exchange competitive dynamics.

Furthermore, since exchanges compete based on overall net capture rate, the Commission fails to explain why exchanges that currently offer volume-based pricing could not replicate similar economics by modifying fee structures in other ways that are not impacted by the Proposal. This

[36] *Id*.

[37] *Id*.

[38] *Id*.

goes to the heart of why it is deeply problematic for the Commission to wade into the price-setting arena in such an unprecedented manner – this Proposal is likely to negatively impact market participants handling agency order flow without fundamentally changing overall competitive dynamics at the exchange level.

C. Alleged Conflicts of Interest are Already Addressed by Existing FINRA Rules.

The Commission states that volume tiers "may" contribute to a conflict of interest between brokers and their customers when routing orders because they present an additional economic incentive to members when selecting an exchange for routing.[39] Specifically, the Commission speculates that volume tiers incentivize broker-dealers to route customer orders to exchanges that maximize broker-dealer revenues, rather than to exchanges that provide best execution.

The Commission's analysis fails to explain why existing FINRA rules do not address any such conflicts. Indeed, the Commission's 200-page proposal includes only a single conclusory statement that: "[w]hile some rules may seek to address conflicts of interest in the context of agency brokerage activity, this proposal seeks to mitigate the conflict specific to volume-based exchange transaction pricing at its source through the proposed prohibition."[40] Before taking the extreme step of banning volume tiers, the Commission must explain why existing rules or less drastic measures are inadequate to address such conflicts.

V. **The Proposal to Ban Volume-Based Pricing Would Exceed the Commission's Statutory Authority**

The Proposal also exceeds the Commission's statutory authority. As the Commission observes, exchange rules must provide for the "equitable allocation of reasonable dues, fees, and other charges among its members,"[41] must not be "designed to permit unfair discrimination between customers, issuers, brokers, or dealers,"[42] and must not "not impose any burden on competition not necessary or appropriate in furtherance of the purposes of" the Exchange Act.[43] Volume-based pricing is not inconsistent with any of these requirements, let alone on a *per se*, categorical basis. Exchange quality and competitiveness depend on a number of factors, including the quality of liquidity, the exchange's net capture rate and fee model (e.g., maker-taker, inverted, flat, or no-fee) and unique order types. The Commission cannot, in complete isolation from other more relevant factors, reasonably reject as inequitable, unfair, or discriminatory *all* volume-based pricing. In fact, as the above discussion demonstrates, volume-based pricing *enhances* competition and market quality. There is no lawful basis for the Commission's proposed ban.

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[39] Proposal at 76287-88.

[40] *Id.* at n. 42.

[41] Proposal at 76283 (quoting 15 U.S.C. § 78f(b)(4)).

[42] *Id.* (quoting 15 U.S.C. § 78f(b)(5)).

[43] *Id.* (quoting 15 U.S.C. § 78f(b)(8)).

VI. Conclusion

The Proposal is fatally flawed and should be withdrawn in its entirety. The Commission fails to identify any problems that justify its radical intervention in a highly competitive market. The Commission's own cost-benefit analysis identifies several significant harms that will likely result from the Proposal, suggesting it should never have been issued in the first place. Procedurally, the Proposal fares no better. It is glaringly inconsistent with the Commission's previously issued Minimum Pricing Increments and Access Fees proposal, as it is nonsensical for the Commission, in one proposal, to require that volume-based fee tiers be revised such that they are forward-looking and known at the time of execution, while, in another proposal, to prohibit volume tiers entirely. In addition, the Commission's numerous proposed alternatives lack a rational basis and deprive market participants of a meaningful opportunity to comment.

Fundamentally, this Proposal represents a risky, ill-conceived, and poorly designed experiment – all contrary to the Commission's core statutory mandate and principles of reasoned decision making. As the Commission itself has acknowledged, it lacks "the information necessary to provide reasonable estimates of the economic effects" of a rule that alters exchange pricing structures.[44] Nothing in this Proposal suggests the Commission has any better idea of the ultimate impact of prohibiting volume tiers on overall market functioning. For all of the reasons discussed above, the Proposal should be withdrawn.

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We thank the Commission for considering our comments.

Please feel free to call the undersigned with any questions regarding these comments.

Respectfully,

/s/ Stephen John Berger

Managing Director

Global Head of Government & Regulatory Policy

[44] *See* 84 Fed. Reg. 5202, *supra* note 6.