GROUP ONE
TRADING

January 10, 2024

Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

Re: Release No. 34-98766; File No. S7-18-23

Dear Ms. Countryman:

Group One Trading, L.P. ("Group One", the "Firm") appreciates the opportunity to comment on the Securities and Exchange Commission's (the "Commission") proposal to prohibit national securities exchanges from offering volume-based transaction pricing in connection with the execution of agency-related orders in certain stocks (the "Proposal"). Group One is a proprietary option market-making firm that is currently a member of all seventeen registered U.S. equity option exchanges. Group One executes a majority of its trades directly on exchanges as a principal but routes some option orders and almost all equity hedging orders through other broker-dealers. Those orders, while principal orders originated by Group One, are executed by those brokers in an agency capacity. Group One is not a wholesaler of options order flow and does not itself operate an agency routing business. Given the Firm's position in the market and the impact of volumed-based transaction pricing ("tiers" or "volume tiers") on the Firm, Group One believes it is well informed on the subject and is submitting this comment letter to express its views that all volume-based transaction pricing offered by exchanges is anti-competitive and to request that the Commission adopt the Proposal and expand it to prohibit all volume-based transaction pricing on both equity and option exchanges.

Tiers result in unfair discrimination.

The Securities and Exchange Act of 1934 ("the Act") mandates that exchanges create an "equitable allocation" of fees among members, explicitly stating in 15 U.S.C. 78f(b)(4) the requirement that the rules of an exchange provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities; in 15 U.S.C. 78f(b)(5) the requirement that the rules of an exchange not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers; and in in 15 U.S.C. 78f(b)(8) the requirement that the rules of an exchange not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Securities Exchange Act.

The question of whether tiers are discriminatory does not seem to be in debate; as a matter of exchange rules, different market participants of the same class are being charged different rates for the same service. Rather, the relevant question seems to be whether the discrimination is fair, justified, beneficial, or perhaps not objectionable enough to strike down. Group One believes that exchanges rely on volume tiers to incent selected market participants to route orders to their exchange and grow their market share, and that the current balance has shifted away from the statutory mandate that rules not be designed to permit unfair discrimination and towards the pursuit of profits at the expense of a segment of exchange members. Group One does not seek to block exchanges from the pursuit of profit but does seek a re-examination of whether exchange rules as applied in practice today provide an equitable allocation among members, particularly among members of the same class.

Exchange volume tiers are set in a manner that heavily favors the "wholesaling" business model. The majority of market making firms that qualify for exchange volume tiers run complementary agency execution businesses out of technically separate but affiliated broker-dealers. Those market makers are typically referred to as "wholesalers" or "wholesale market makers" and their affiliated broker-dealer routes order flow to exchanges on behalf of customers. Firms that operate as wholesalers therefore secure a dual-sided advantage. In general, the wholesaler business model incents those market makers to provide liquidity to and take the other side of orders routed by their affiliated broker-dealers, and various execution mechanisms and execution entitlements are designed by exchanges to ensure that wholesalers are able to interact with a specified percentage of volume routed by those affiliates. These mechanisms and entitlements also have the desired effect of ensuring that the more volume routed by an affiliate, the more volume the wholesale market maker has access to trade. Exchanges count volume from affiliated entities as combined for many purposes, including volume tiers. Both sides of the business—the market maker and the affiliated order router—enjoy the advantages of each other's volume to achieve higher tiers. As a result, non-wholesale market makers like Group One do not compete only against other market makers who enjoy better fee treatment because they trade more volume. Group One also competes against that market maker affiliate's volume that is being routed on behalf of other broker-dealers and end customers.

Wholesalers and their affiliates help deliver retail order flow to the marketplace, and in turn provide a valuable service. Group One does not deny that those wholesalers and their affiliates should be compensated for that service. However, that service should be priced separately and explicitly. Order routing and market making are two separate businesses conducted by separate broker-dealers and should be treated as such. The existence of tiers that combine volume of affiliated entities obviously permits unfair discrimination between the class of dealers because dealers without an order routing affiliate have no realistic ability to achieve certain tiers.

Tiers impose a burden on competition.

Group One believes that volume tiers are deployed in a way that directly contradicts the mandate that the rules of an exchange not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Securities Exchange Act. The existing structure favors larger and incumbent market participants and places a direct burden on smaller and newer market participants. Volume tiers are typically a function of the participant's executed volume on the exchange in relation to total consolidated volume (the total volume executed by all market participants). This is an inherent advantage for larger firms that have the infrastructure in place to make markets across all listed options and an inherent disadvantage for smaller firms that target specific products or segments of the marketplace. If, for example, a smaller firm only has the resources to trade products that account for 1%

of total consolidated volume, that firm has no ability to reach the highest tiers because there is not enough volume in in that segment of the market to support it. Group One does not believe that it serves the marketplace for transaction costs to favor larger, incumbent market participants and reduce the competition they face from smaller firms and new entrants.

Additionally, volume tiers enable exchanges to place a thumb on the scale of competition. In fee proposals, the exchanges often highlight the competition among exchanges as evidence that there is no burden on intermarket competition and argue that market participants can execute their transaction on other venues if they deem fee levels on other venues to be more favorable. This argument seems based on the premise that all participants can control where a trade happens, something that exchanges know is not the case. Market makers provide passive liquidity and will only trade if they deploy that liquidity on venues where other market participants are seeking to transact. Those other market participants will execute on venues for a variety of reasons but the cost of execution is often a significant driver of that decision. As an example, if Group One's cost of execution on Exchange A is .25/contract but is .27/contract on Exchange B, Group One would obviously prefer to transact on Exchange A. However, Group One has no ability to direct where other market participants route orders. Those market participants that are routing orders are commonly the affiliates of wholesale market makers. If an affiliate of a wholesaler is directing orders to Exchange B because their cost of execution is lower by virtue of reaching higher volume tiers, Group One's choices are to either attempt to deploy liquidity on Exchange A but never trade, or trade on Exchange B and absorb the higher execution costs. At the same time, the wholesale market maker is also relying on having reached those same volume tiers to lower their cost of execution. The exchanges' method of attracting order flow and building market share is to use volume tiers to impose higher transaction costs on the lowest volume market participants that have no alternative.

The transaction cost differences resulting from tiers that are currently in place are massive. Market maker liquidity adding transaction costs are frequently multiples higher for those in the lowest tier compared to those in the highest. In penny classes, for example, the lowest tier for market maker liquidity adding transactions can be as expensive as $.28/contract and as cheap as $.03/contract in the highest tier. The rates are clearly not equitable, and Group One asserts that a difference of more than 9x qualifies as "burdensome." Even on the volume profile of a firm that lands in the lowest volume tier, the current difference in transactions costs can translate to millions of dollars per year. Group One understands that there are plenty of industries that offer discounts for volume-based pricing, but the operation of a registered securities exchange is different. The biggest difference being that registered securities exchanges operate under a mandate from Congress that their rules do not impose any unnecessary burden on competition.

Group One supports the Commission's Proposal to increase transparency in pricing.

Fee proposals submitted by exchanges make the claim that volume tiers are not discriminatory because the tiers are available to all members and any exchange member could theoretically achieve the tiers. Group One does not share this interpretation and believes that the plain and much more obvious meaning of the word discriminatory is more applicable. There is widespread belief that many of the tiers are achievable only by a small number of firms, and some of the tiers are so specific in their requirements that they seem to be plainly targeted at specific market participants. Group One believes that limited availability or perhaps bespoke design is evidence of a discriminatory intent. Group One fully supports the Commission's proposal to require exchanges to disclose how many participants qualify for each tier and urges the Commission to consider eliminating tiers entirely.

The anticipated counterargument to the Proposal has a major flaw.

It is anticipated that the exchange members who benefit from achieving high volume tiers will argue that, in a world without tiers, those firms will incur cost increases and that those cost increases would impair their ability to provide competitive markets and price improvement, and that ultimately those increased costs would be borne by the American investor.

Group One is skeptical of that claim. The competitive pressures that have paved the way for the current equilibrium will still be present in a world without tiers. The exchange members that currently enjoy the benefits of high volume tiers will still be the same members that have the power to direct order flow, and the exchanges will still operate in an incredibly competitive environment that continuously demands lower fees and better execution. Group One believes the economics of this relationship between exchanges and their members will mean that the elimination of tiers will result in a compression of exchange margins on a subset of exchange customers rather than an increase in costs to all public investors. The expectation is that the smallest members, and current highest margin customers, of the exchanges will most stand to benefit from the compression of exchange margins. Group One expects that this will result in both more exchange members and more competition in pricing among members, leading to tighter markets to the benefit of investors. In addition, the Firm predicts that the elimination of tiers will result in an increase in competition between exchanges on features and functionality other than price and those benefits should accrue to the public investor. As stated earlier, Group One does not seek to block exchanges from the pursuit of profits, but Group One simply does not support those profits coming at the expense of a targeted group of the exchange's members that lack real alternatives.

If volume tiers are unfair in one aspect, they are unfair everywhere.

Group One advocates for as flat of a fee structure as possible, making the market equally accessible for all participants. In the Proposal, the Commission offers possible distinctions between principal and agent, and between stocks and options. Group One asserts that volume tiers are counterproductive to the goals of the Exchange Act regardless of distinction.

Additionally, it should be noted that volume tiers do not just impact transactions costs. Exchanges also offer volume tiers on fixed costs such as physical and logical connectivity to the exchange. Those higher costs on lower volume market participants carry all of the same implications described above. They're by definition discriminatory, and their existence imposes a burden on competition.

Conclusion

One of the Commission's expressed concerns in the Proposal is that the existence of volume tiers could induce an agent to pursue tier status at the expense of seeking the best possible execution for its customers. Group One agrees that there is a theoretical potential for a conflict of interest, but also has observed that the landscape for wholesaling order flow is very competitive. Group One believes that the market for order flow is efficient and that the order originating firms can and will redirect order flow away from wholesale market makers that would put their own interests ahead of best execution obligations.

However, while Group One is not worried about this specific problem raised by the Commission, the Firm does have other, broader concerns. The existence of tiers creates an uneven playing field, and that has costs that impact the entire industry, and that is true across agents and principals and applies to both stocks and options. Group One believes that a better market is one with fairer access.

Tiers don't exist in furtherance of the purposes of the Securities Exchange Act; rather, they're present because exchanges are responding to competitive dynamics in an effort to build market share. Exchanges are certainly free to pursue such an end, but they also have a statutory responsibility to keep markets fair. By leveraging volume tiers to build market share, exchanges are actually building a more inefficient market. Tiers help create a market where the necessary operating scale is huge, and Group One predicts that the result is that the industry will come to be dominated by a smaller number of large companies—to an even larger extent than it already is. As stated above, Group One urges the Commission to adopt the Proposal and expand it to prohibit all volume-based transaction pricing on both equity and option exchanges because the Firm believes that exchanges should operate in a way that removes as many impediments to price discovery as possible and they should not have the authority to arbitrarily dictate which market participants are entitled to a lower cost of execution and therefore a competitive advantage over other market participants.

Sincerely,

John Kinahan

John Kinahan,
Chief Executive Officer
Group One Trading, L.P.