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March 30, 2023

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

Re: Equity Market Structure Proposals (File Numbers S7-31-22 & S7-30-22)

Dear Ms. Countryman:

Interactive Brokers LLC ("IBKR") submits this comment to the Securities & Exchange Commission (the "Commission") with respect to the Commission's December 2022 equity market structure proposals (the "Proposals").

IBKR has been an SEC-registered, FINRA-member broker-dealer since 1994. We cater to individual customers, smaller hedge funds, registered investment advisors, proprietary trading groups, and introducing brokers, and execute more than two million trades per day on behalf of our customers.

We are in favor of changes that promote a level playing field among brokers – and trading venues – and do not benefit one participant or category of participant over another. And we agree with the Commission that order-by-order competition between liquidity providers is the best way to ensure that investors get the best possible price when they trade. **Indeed, IBKR believes this so deeply that it has used this technique to seek better executions for its customers' NMS stock and option orders for years.**

Indeed, our focus has always been to obtain the best-available execution for our customers on an order-by-order basis. Our smart order routing technology accesses a wide variety of both lit and dark market centers, selecting the best market center at which to execute each customer order using real-time market data and indications of interest.

For NMS stocks, we operate the IBKR ATS, in which nearly a dozen of the leading professional market marking firms – as well as a number of large institutional brokers representing their own customer agency flow, a variety of hedge funds, and any other IBKR customer that wishes to – participate to rest price-improving trading interest in the hopes of the opportunity to interact with IBKR's marketable retail flow.

For marketable customer options orders, IBKR has been operating an analog of the Commission's proposal for years: upon receipt of a marketable US options order from a customer, IBKR solicits two-sided trading interest from nearly 20 leading options market making firms (and we also provide a mechanism for any other IBKR customer who is interested to be able to participate). If one or more of those participants responds with contra-side interest, IBKR pairs the best received response with the customer's marketable order in order to initiate an on-exchange price improvement auction, gaining the customer a *second* opportunity to have liquidity providers compete to interact with their marketable order.

In other words, we broadly support the Commission's proposals and its goal of enhancing execution quality for all investors, and its pursuit of that goal by encouraging order-by-order competition, particularly for segmented orders. By moving retail flow onto the exchanges, where a variety of market participants can compete for them, we hope the Commission will succeed in creating opportunities for better price improvement for retail flow as well as enhanced execution quality for institutions, who currently have no opportunity to compete to interact with the vast majority of that flow.

But we believe that the proposed rules could be better aligned with that goal – and with the goal of enhancing execution quality for **all investors**, including institutional investors who often, indirectly, themselves represent the interests of small, individual investors – by making the changes we suggest and/or addressing the concerns we raise below.

Order Competition Rule

We believe that the proposed definition of what constitutes a segmented order creates the opportunity for gaming by more active traders by ignoring the possibility that traders might divide their order flow across multiple brokers.

Specifically, the definition of "segmented order" in the Order Competition Rule proposal limits the set of customers whose orders could qualify to those who average fewer than 40 executed trades in NMS stocks per day. However, individual brokers have no visibility into the activity that their customers engage in through other brokers. **This will lead active traders who might not otherwise qualify for segmented order treatment (if they did all their trading at one broker) to spread their activity across multiple brokers, in order to obtain more favorable pricing to which they are not entitled.**

This may lead to increasing the toxicity / adverse selection of the segmented order pool. **The result of that increased toxicity is likely to be less favorable pricing for segmented orders in the aggregate.** In other words, active traders cheating by spreading their flow amongst multiple brokers will essentially be able to expropriate value from true "segmented customers". This possibility should not be tolerated.

There is a simple solution to this problem, however: while brokers have no visibility to their customers' activity at other brokers, the Commission and FINRA both do, in the form of the CAT data. Accordingly, we recommend that FINRA provide a list to each member firm each month of all customers of that broker with fewer than 40 trades per day at that broker but greater than 40 trades per day across the CAT data from all brokers. This would allow brokers to avoid mistakenly and unfairly marking those customers' orders as segmented.

Auctions in a Fast-Moving Market

Under the proposed rule (**and unlike in price improvement auctions as they now operate on the options exchanges**), **it is possible for an auction to result in no execution even if the limit price submitted on the auction-initiating order is equal to the far side of the NBBO** and eligible to trade against a displayed contra-side order at that open competition trading center as of the time of submission.

Thus, in a fast-moving market, a broker with a marketable segmented order faces a dilemma -- by the time an auction terminates, the market could have faded away from the auction limit price, resulting in no execution. **This would leave the customer worse off than if the broker had simply submitted an order to take liquidity at the far-side of the NBBO instead of starting an auction.**

In other words, in a fast-moving market brokers will be forced to choose between (i) abandoning the search for price improvement for their segmented orders or (ii) incurring substantial risk of slippage (which essentially amounts to price *dis*improvement).

Indeed, the Commission recognized this quandary that brokers will face in its Proposing Release:

> One potential example of when such a direct route could be consistent with best execution is a fast market when prices are moving rapidly away from a segmented order (prices increasing for buy orders and prices decreasing for sell orders). In this example, a broker-dealer could determine that obtaining a better price in a qualified auction than a displayed quotation is unlikely, and the broker-dealer could route a segmented order directly to execute against the best available price available at a national securities exchange or an open competition trading center.[1]

We propose to address this problem by allowing open competition trading centers to continue to operate their retail liquidity pools (and allowing open competition trading centers that do not already have such pools to create them) and operating the auctions within those pools. In other words, market participants will be able to rest hidden trading interest ("Retail Pool Orders") that is only eligible to execute against segmented orders (whether the segmented orders are submitted in an auction initiating order or otherwise). An "available retail liquidity flag" will be disseminated in the consolidated market data feed indicating resting Retail Pool Orders inside the NBBO in an open competition trading center (and indicating the center).

Resting Retail Pool Orders would have priority over auction responses at the same price level. By employing this scheme, liquidity to execute segmented orders will increase, liquidity providers responding to auctions will have even greater incentive to increase their offered price improvement (because they will know that there is resting liquidity that they will have to outcompete), and the likelihood of auctions failing will be reduced.

A related problem is that for fairly low liquidity stocks, submitting an order into an auction for a size materially larger than the displayed size of the opposite side of the NBBO creates an invitation to high-frequency-traders to take out the opposite side quote during the auction in order to profit from the likelihood that the auction will fail and the originating broker will be forced to take liquidity at the touch at a worse price.

We propose the Commission address this flaw by <u>not</u> indicating in auction announcement messages the side of the auction initiating order. Since traders would be unable to determine on which side the originating broker is seeking to take liquidity, they will be unable to effectively front-run the originating broker. Meanwhile, firms interested in competing to interact with the segmented order can submit auction responses on either or both sides. The open competition trading center would simply discard any auction responses that are not on the opposite side of the auction originating order.

The Originating Broker Should Not Be Disclosed

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[1] Proposing Release at 129.

Under the proposed rule, segmented orders submitted to an open competition trading center for auction may identify the originating broker.

In order to promote competition for segmented orders as a whole, we recommend that originating broker identifying information not be permitted to form part of an auction initiation message. The fact that the initiating order is segmented should be sufficient for participants to evaluate their appetite to interact with it: two investors submitting identical segmented orders at the same time to the same open competition trading center should expect the same fill, regardless of the broker that submitted or originated the order.

The NBBO Will Widen Unless Responding to An Auction Requires the Responder to Be Resting an Order at the NBBO

We perceive a risk that the proposed Order Competition Rule may substantially reduce displayed liquidity at the NBBO.

At present, a very small portion of retail marketable order flow ever makes it to the national securities exchanges. Thus, exchange trading primarily results in institutions interacting with each other. But under the terms of the proposed rule, **a wide variety of institutions will now have the opportunity to interact with segmented flow, which poses far less adverse selection risk than interacting with institutional flow**.

For the segmented flow this is good. **But it presents a risk: what if institutions, preferring not to interact with other institutional flow, and perceiving that there is now plenty of segmented flow to interact with on open competition trading centers, simply opt not to rest displayed limit orders on exchanges, and instead prefer to submit the vast majority of their passive trading interest as responses to segmented auctions?**

The result is likely to be a reduction in liquidity at the NBBO, and, in many cases, widening of bid-ask spreads.

We propose a solution to this – **a firm may not submit an auction response on behalf of itself or a customer unless the firm or its customer (as applicable) is displaying an order, as of the time of the auction initiation message, for at least one round lot, on the same side of the NBBO as the submitted auction response.** This could be enforced via surveillance of the CAT data.

Tick Size Changes

As we expect other market participants already have or will comment, we believe the proposed tick-size increments are too small for most stocks and will lead to substantially increased fragmentation of liquidity over several price levels. **We fear that the result will be that the NBBO, which the Chairman has already lamented may not be very meaningful,[2] will simply become less meaningful still.**

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[2] Chair Gary Gensler, "Market Structure and the Retail Investor": Remarks Before the Piper Sandler Global Exchange Conference (June 8, 2022), *https://www.sec.gov/news/speech/gensler-remarks-piper-sandler-global-exchange-conference-060822*.

Because only the top-of-book on each exchange is currently protected under the Order Protection Rule of Regulation NMS,[3] this fragmented liquidity will require diligent market participants (and market data consolidators) to work much harder to consume (and distribute) significantly greater volume of market data updates. It will also require market data participants to consume and consider far more price levels from the depth of book data.

In addition, a number of academic and industry studies[4] suggest that substantially reduced access fees (and therefore substantially reduced rebates for making displayed liquidity) also result in wider spreads as incentives to compete for the NBBO disappear. **This will in turn harm institutional investors at minimum and may ultimately harm all investors.**

This strengthens our above-stated view that the opportunity to compete in an auction should be contingent on participation in the NBBO, in order to mitigate these spread-widening effects.

Final Points

Widening spreads will also act as a confounding variable in any attempt by the Commission to measure the effects of these rule changes on execution quality, particularly of segmented marketable orders. The Commission relies heavily on benchmarks that are measured with respect to the NBBO. **If the NBBO widens, those benchmarks may all appear to improve without any actual economic benefit to segmented orders while hurting institutional orders.**

For example, if bid-ask spreads go from 5 cents wide to 8 cents wide, but effective spread stays steady at 3 cents, the observed EQ for segmented orders will go from 60 to 37.5 (and price improvement will go from 1 cent/share to 2.5 cents/share), but segmented orders will be getting the same executions they always got, while institutional orders will do worse (because they will be subjected to the wider spread). **Indeed, in the example above, EQ and price improvement may appear to improve even where the effective spread deteriorates (so long as the NBBO deteriorates more).[5]**

We conclude our comments as we began them: market structure improvements must be designed to improve the quality of markets for *all* investors – not for one category at the expense of another.

Sincerely,

Milan Galik
Chief Executive Officer
Interactive Brokers Group

[3] Rule 611, *codified at* 17 C.F.R. § 242.611.
[4] *See, e.g.*, Phil Mackintosh, A Data-driven Summary of the SEC's New Proposals (Feb. 13, 2023), *https://www.nasdaq.com/articles/a-data-driven-summary-of-the-secs-new-proposals*; Kevin Tyrell & Steve Poser, Transaction Fee Pilot – an impact assessment (May 25, 2020), *https://www.nyse.com/data-insights/transaction-fee-pilot-an-impact-assessment*.
[5] For example, if bid-ask spreads widen from 5 cents to 8 cents, and effective spread widens from 3 cents to 4 cents, EQ will still *appear* to have improved from 60 to 50 and price improvement will go from 1 cent/share to 2 cents/share, **while both segmented and institutional orders in fact fair worse economically**.