ACADIAN

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March 31, 2023

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

Re: Release No. 34-96495; File No. S7-32-22: Order Competition Rule

Dear Ms. Countryman,

Acadian Asset Management ("Acadian") appreciates the opportunity to submit this comment letter in regard to the proposed rule to enhance order competition for retail orders ("proposal"), as put forth by the Securities and Exchange Commission ("Commission").

Acadian is a global asset manager headquartered in Boston with wholly owned affiliates located in London, Singapore, and Sydney. We offer core equity investment strategies as well as customized investment solutions to institutional clients across the globe. As fiduciaries, we advocate on behalf of the long-term investment interests of our clients. This includes sharing our perspective with regulators on relevant market structure issues.

Acadian supports the Commission's mission to protect the interests of individual investors, and, for this reason, we are generally supportive of this proposal.

As is the case with many institutional investment managers, most of the assets that we manage represent the interests of individuals, via vehicles such as pension funds, retirement plans, and mutual funds. While the goal of the order competition rule, as written, is to improve trading outcomes for individual investors in the traditional sense, focusing on self-directed retail orders and orders entered by brokerage firms on behalf of retail investors, we too – as an institutional manager - represent the interests of individual investors. As such, we view the implications of this proposal for both retail orders and institutional orders to be equally important.

Retail Segmentation

The meteoric rise in retail trading volume over the past few years has been well documented. Today, industry estimates put retail trading at 20-25 percent of total U.S. equity volume – a significant increase from the 5-10 percent figure that we saw back in 2005 when Regulation NMS was enacted. As the Commission states in the proposal, retail investors primarily use marketable orders when buying and selling stocks, and virtually all of those orders are routed to one of only a handful of proprietary market-making firms, known as retail wholesalers. Retail wholesalers typically execute these orders in a principal capacity. In other words, they act as the liquidity provider, taking the opposite side of the trade with the intention of unwinding the position at some point in the future, ideally (from their perspective) for a profit.

In our view, a key problem with the wholesaler model is that retail order segmentation prohibits the broader ecosystem of market participants from interacting with retail flow directly. As is evidenced by the Commission's analysis, such interactions could serve to benefit both retail investors and those non-wholesaler market participants willing to interact with them in a liquidity-providing capacity. Unfortunately, the current market structure for retail orders precludes such interactions from taking place.

Inaccessible Volume Adds Uncertainty to Institutional Order Creation

Given the segmented nature by which retail orders trade in the U.S., the significant rise in retail volume as a percentage of the overall market has rendered an increasing percentage of consolidated volume virtually inaccessible to non-wholesaler market participants. This is problematic for investors, because a higher rate of inaccessible volume leads to increased implicit trading costs relative to what the costs would be if the same volume were accessible, as recent research suggests.[1 2]

From our seat, the positive correlation between elevated retail trading (inaccessible volume) and investor trading costs is intuitive. Many institutional investors use historical volume metrics (e.g., average daily volume, or "ADV") to help appropriately size orders. In addition, many managers use estimates of "volume" on implementation day to estimate total execution costs.

But as inaccessible retail volume has reached unprecedented levels, both sizing orders appropriately and estimating their implicit costs has become increasingly problematic. For example, if on the day of implementation, 50 percent of a stock's volume is represented by retail and traded via the wholesaler construct, then a 5 percent ADV order (based on historical volume) actually represents 10 percent of that day's *accessible* volume. All else equal, a 10 percent ADV order is more expensive to implement than a 5 percent ADV order.

Unfortunately, *ex post* delineation between inaccessible retail volume and accessible volume is not straightforward (nor should it be, in our view). One benefit of the Commission's proposal would be to reduce uncertainty in the institutional order creation process that is a byproduct of current market structure and that drives up trading costs.

Retail Segmentation Reduces Adverse Selection for Wholesalers, Increases it for Everyone Else

In trading vernacular, "adverse selection" is the degree to which an execution is subsequently accompanied by unfavorable price movement. As the Commission explains in their filing, segmented retail flow "impose[s] lower adverse selection costs on liquidity providers than the unsegmented order flow routed to national securities exchanges."[3] In other words, the (non-retail) orders routed to other market centers (e.g., exchanges) exhibit higher rates of adverse selection, comparatively speaking.

Because higher rates of adverse selection lead to higher execution costs, non-wholesaler market participants that trade on these "other" market centers incur higher trading costs than they otherwise would if they were able to interact with retail orders as an additional source of liquidity.

Said differently, if institutional investor orders had an opportunity to provide liquidity to the retail flow that is currently siphoned from the market by retail wholesalers, such interactions would serve to produce better execution prices for retail investors (as the Commission's economic analysis indicates) while also reducing the implicit trading costs of institutional investors.

Institutional Auction Participation

Industry research has challenged the findings of the Commission's own economic analysis as it relates to "quote fading."[4] Based on their own independent analysis, the researchers contend that the Commission underestimates the likelihood that retail orders could fall victim to fading quotes when routed to the proposed retail auctions. As a result, they argue, the Commission overestimates the inherent cost savings the proposed auctions would bestow on retail investor orders. To be clear, quote fading is not unique to the proposed auctions, but a phenomenon that traders experience daily. That said, we agree that quote fading is a legitimate concern should the auctions ultimately gain approval.

While their actual datasets are different, both the Commission and independent researchers use historical trade and quote data to estimate the degree to which retail orders routed to the proposed auctions will suffer the consequences of fading quotes. But these historical datasets are predicated on trade and quote behavior in the current market structure and do not account for what "would be" in the proposed future state.

Institutional investors do not typically quote continuously throughout the day because the timing and aggressiveness of our routing decisions is dictated by many factors (e.g., execution strategy, urgency, trading activity in other trading instruments, etc.). Thus, the preponderance of quotes used in the quote fading analyses previously mentioned are unlikely to represent institutional orders. But to assume historical quote fading behavior will accurately inform future quote fading behavior in a world that includes retail auctions is ill-advised in our view.

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[1] https://www.cowen.com/insights/retail-trading-whats-going-on-what-may-change-and-what-can-institutional-traders-do-about-it/

[2] See "BofA – Retail on the Rise" (attached)

[3] https://www.sec.gov/rules/proposed/2022/34-96495.pdf

[4] https://www.sec.gov/comments/s7-31-22/s73122-20161906-330732.pdf

Institutional investors have an incentive to consider all sources of liquidity at our disposal, especially mechanisms that provide access to liquidity that exhibits lower adverse selection. For this reason, we expect institutional investors to regularly participate in the proposed retail auctions, should they facilitate direct, unmediated interaction between institutional and retail orders.

In our view, institutional participation in retail auctions would increase the supply of liquidity willing to trade with incoming retail orders and mitigate fade risks highlighted in the studies referenced above.

Final Thoughts

Regulation NMS was implemented, in part, to address a lack of market center competition. Eighteen years later, we find ourselves in a similar predicament as it relates to the handling of retail order flow. As retail volume has reached previously unseen levels, the concentration among only a handful of market centers currently handling that flow is concerning.

We think that the current model for retail trading is overdue for an overhaul, and we applaud the Commission's desire to address it.

We thank the Commission for its efforts to reform this critical component of our public markets.

Sincerely,

Sean Paylor