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September 20, 2023

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

Re: **File No. S7-30-22; Release No. 34-96494; Regulation NMS: Minimum Pricing Increments, Access Fees, and Transparency of Better Priced Orders**

Investors Exchange LLC ("IEX") is submitting an additional comment letter on the above-referenced set of proposals ("NMS Proposals")[1] to express its views on the need for Commission action to regulate the rebate tier system that is used by all the major maker-taker exchanges. The Commission did not include in the NMS Proposals a proposal to regulate rebate tiers, but it has included a notice of possible rulemaking on this topic in its latest Regulatory Flexibility Act Agenda.[2]

The Need For Reform of Rebate Tiers

IEX has previously published an opinion piece entitled "Why Rebate Tiers Are Anti-Competitive", attached to this letter, which explains the pressing need for the Commission to address this issue.[3] Also, in its earlier comment letter on the NMS Proposals, IEX published data detailing the substantial disparity in the rebate rates available to exchange members, based on the use of Total Consolidated Volume ("TCV") measures and other highly targeted and restricted tier pricing, and the resulting disparity in allocation of fees, which result in subsidy payments that favor a small number of firms.[4]

The Commission's notice indicates that a purpose of the anticipated rulemaking is to "mitigate conflicts of interest and facilitate competition among broker-dealers by prohibiting volume-based pricing by exchanges for agency-related volume." For the reasons laid out in the attached document, IEX strongly believes that any rulemaking in this area should apply to the use of TCV and other highly targeted pricing tiers covering all trading volume, not only volume that is labeled as "agency".

First, we believe addressing rebate tiers that affect only trading that results from agency orders misperceives the nature of the problem as solely or primarily one of agency conflicts. We agree that tiered pricing could exacerbate routing conflicts for brokers acting in an agency capacity for clients, but we believe that a separate and highly-impactful problem with current tiered pricing

[1] See Securities Exchange Act Release No. 96494 (December 14, 2022), 87 FR 80266 (December 29, 2022) ("Proposing Release").

[2] See https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202304&RIN=3235-AN29.

[3] https://www.iex.io/article/why-exchange-rebate-tiers-are-anti-competitive.

[4] Letter from John Ramsay, Chief Market Policy Officer, IEX, to Vanessa Countryman, Secretary, SEC, dated March 20, 2023, at 24-25.

methods is that they restrict competition among firms that act as market makers or otherwise trade in a principal capacity. This serves to reinforce existing competitive advantages for the small number of firms that are able to receive outsized subsidies and stifles competition by small and medium sized market makers that are subject to a structural disadvantage. Applying restrictions and greater scrutiny only to agency orders would, we believe, continue to leave these concerns involving fair competition among market makers unaddressed.

Second, an approach that targets only orders identified as agency orders would create significant practical difficulties in identifying orders that originate from investors rather than other participants. Orders sent to exchanges that are identified as “agency” may, and often do, originate from other brokers, which may in turn be trading for other participants or for their own account. Exchanges do not presently have the ability to determine whether individual orders marked agency originate from investors or from other participants, creating the potential for a regulatory loophole that could easily be exploited.

Further, some firms trading for clients often engage in “customer facilitation” trades by which they send principal orders into the market to manage their risks in executing orders directly with customers. While those orders do not meet the strict definition of “riskless principal”, since the trades with clients are not executed simultaneously with the related principal trades, they still are driven by client-facing orders. An approach that differentiates between orders marked as principal or agency could provide an unwarranted advantage to firms that are better able to execute client orders in this way, or it could create an unfair divide between firms allowed to commit capital and those that must solely trade on an agency basis.

Additional Data

IEX has conducted additional research that is relevant to the (anti-)competitive impact of the rebate tier system as it is used today. In the table below, we show, as of August 2023, the volume required to qualify for the highest standard “displayed adding” tier rates on various exchanges[5], as well as the portion of exchange volume that represents.

	Arca	BZX	EDGX	MEMX	MIAX	Nasdaq
August 2023 Market Share	8.9%	4.5%	5.8%	3.0%	1.7%	15.1%
Added TCV Requirement	0.70%	1.00%	0.65%	0.45%	0.40%	1.50%
Implied Tier 1 %	7.9%	22.1%	11.2%	14.8%	23.0%	9.9%

This data suggests that the TCV requirements to qualify for the top tier rates can be extremely onerous and restrictive, often requiring liquidity-providing volume on a single exchange to surpass 0.5% of all market volume and over 10% of that exchange’s volume (in two cases, over 20% of such volume).

[5] This analysis provides the TCV requirement for the highest displayed adding rebate. In some cases, exchanges offered alternative criteria for a similar rebate (such as cumulative TCV rather than adding TCV), but IEX utilized the “adding TCV” metric for consistent comparisons. The New York Stock Exchange is excluded from the comparison, since its requirements are expressed as a portion of Tape A volume, rendering cross-venue comparisons more difficult. However, IEX believes that its tier pricing is structured in substantially similar ways, raising the same concerns.

Second, we reviewed the difference between each of the top five tier payout levels and the base rebate payment for standard displayed adding rebates for the same exchanges. In addition, we looked at the differences in the TCV thresholds required to qualify for each of the same top five tiers. The results are shown in the chart below:

	Arca	BZX	EDGX	MEMX	MIAX	Nasdaq
Tier 1	-29	-31	-29	-33	-35	-30.5
Tier 2	-28	-30	-27	-32.5	-34.5	-30
Tier 3	-27	-29	-25	-31	-31	-29.5
Tier 4	-24	-27	-20	-29		-29
Tier 5	-21	-23		-27		-28
Base	-19	-16	-16	-15	-24	-15
Tier 1 vs Tier 2	1	1	2	0.5	0.5	0.5
Tier 1 vs Tier 3	2	2	4	2	4	1
Tier 1 vs Tier 4	5	4	9	4	35	1.5
Tier 1 vs Tier 5	8	8	29	6	35	2.5
Tier 1 vs Base	10	15	13	18	11	15.5

Example: On Nasdaq, an extra 0.5 mils/share requires a participant to add an additional 0.55% of total market volume – equating to 58mm shares/day in Aug 2023.

	Arca	BZX	EDGX	MEMX	MIAX	Nasdaq
Tier 1	0.70%	1.00%	0.65%	0.45%	0.40%	1.50%
Tier 2	0.50%	0.60%	0.22%	0.25%	0.25%	0.95%
Tier 3	0.30%	0.35%	0.18%	0.20%	0.08%	0.70%
Tier 4	0.20%	0.25%	0.15%	0.15%		0.65%
Tier 5	0.15%	0.20%		0.08%		0.45%
Tier 1 vs Tier 2	0.20%	0.40%	0.43%	0.20%	0.15%	0.55%
Tier 2 vs Tier 5 / Lowest Tier	0.35%	0.40%	0.07%	0.18%	0.17%	0.50%

What the results show is that the difference in the per share rebate payment from one tier to the next lowest tier is often extremely small, in some cases as little as one "mil" (one-hundredth of a cent per share) or one-half mil. At the same time, the differences between the TCV thresholds required are typically largest between tier 1 and tier 2. For example, on Nasdaq, the difference between the top and next rebate tier level is just one-half mil. But the difference in TCV required to qualify for each of those two tiers is equal to 0.55% of total market volume. Based on trading data for August of this year, that difference would equate to average daily trading volume of approximately 58 million shares. This volume by itself is higher than the entire trading volume of all but six alternative trading systems and higher than the total volume of six exchanges.

Based on our conversations with market makers, it is clear that these per share differences, which may seem small, have a significant impact on the competitive position of individual firms, given their need to compete on volume, speed, and other factors. This would be akin to giving a one-meter head start to a runner in a 100-meter dash – an advantage that may seem small on its face but is huge when you understand the margins that determine success or failure.

IEX believes this data helps to show that, from a market maker perspective, very small differences in rebate payouts can be very meaningful to the competitive position of individual firms. This, in turn, helps to demonstrate that the existing rebate tier structure plays an outsize role in picking winners and losers in today's equity markets, and in limiting the competitive opportunities for firms that cannot possibly approach the trading volumes needed to qualify for higher rebate payouts. To truly foster competition, these types of structural advantages need to be limited as much as possible.

Conclusion

Under the Securities and Exchange Act of 1934 (the "Act"), exchanges are supposed to be held to strict standards, to help achieve the Act's public interest objectives. This includes the mandate that exchanges create an "equitable allocation" of fees among their members and other persons, and a separate mandate that exchange rules "do not impose any burden on competition not necessary or appropriate in furtherance of the purposes" of the Act. When looking at the details behind the tiered pricing used by large exchange companies today, it is hard to understand how these methods could be described as "equitable". It is equally hard to explain why they do not burden competition, or why the burden is justified by some other purpose. The Commission has an opportunity to address this issue in a way that promotes pricing that is fairer and more consistent with healthy competition, which can only benefit investors.

Sincerely,

John Ramsay
Chief Market Policy Officer, IEX

PERSPECTIVES / Jun 27, 2023

Why Exchange Rebate Tiers Are Anti-Competitive

JOHN RAMSAY
Chief Market Policy Officer

The existing system of rebate tiers fails the smell test. As the SEC examines competitive inequities in the stock market, here's an explainer on how exchanges' rebate tiers are used to stack the deck for a small number of firms.

In recent months, there has been a vigorous debate about market competition, as it impacts the handling of retail orders. Another aspect of competition, involving exchange market makers, has received much less attention. Yet, there is glaring evidence that the business of making markets has grown increasingly more concentrated and less competitive over time. There is also clear evidence that the exchange fee structure helps to keep it that way. As the SEC considers areas needing reform, this is one that cries out for it.

Seeking Liquidity from a Shrinking Pool

It is well understood that the number of firms that compete to make markets and provide liquidity on exchanges has long been trending downward. It is also well known that the fixed costs of making markets have steadily increased. These include rising costs of exchange market data and technology and the costs of managing risks from quoting simultaneously on a multitude of trading venues, among others.[1] What is not well appreciated is the way that exchange pricing tiers keep the playing field tilted in favor of a small number of firms by heavily subsidizing their costs, but not those of most trading firms.

The Role of Rebate Tiers

The large "maker-taker" exchanges use rebates partly to compensate liquidity providers for the high costs of making markets, and they fund the rebates from access fees that are pegged by regulation at a limit of $0.003 (30 mils) per share. Exchanges argue that rebates are needed to attract market makers. Others, IEX Exchange included, believe that rebates help to foster the complex system that drives up costs that rebates are used to reduce, in a self-reinforcing cycle. For present purposes, though, the issue is not whether rebates are needed but how their method of allocation affects competition.

While the large exchanges generally fix access fees at the maximum rate, rebates are highly tiered, such that the maximum rebate rate per share typically exceeds the maximum access fee. The top rebate rate is substantially (up to two times or more) higher than the base rate. Tiers are generally set based on total consolidated volume (TCV), a measure of each firm's volume on the exchange, compared to total market-wide volume by all participants, on or off-exchange.

For example, 1.4% of TCV, the top adding rebate tier for Nasdaq as of February of this year, equals about 3 billion shares, a level that topped the volume conducted on most individual exchanges and all but one alternative trading system (out of 32) that month.[2] Based on IEX's analysis, meeting the top rebate tiers across all exchanges would require a firm to trade solely based on liquidity providing orders, more than 9% of all exchange volume.[3] And because they are based on a percentage of total market volume, the best rates will always be highly restrictive, regardless of changes in market conditions.

Clearly, these are not simply volume discounts of the type common in many businesses. We are not aware of another example in which a provider of essential services – in this case, access to an exchange–grants highly favorable pricing to select customers that can meet a threshold of business measured in relation to all market-wide volume in that business sector. And, of course, a stock exchange is not just any other business, but one that is held to strict obligations to deal fairly with all its members and to act in ways that serve public investors.

Further, the same exchanges offer specialized "bespoke" volume tiers with formulas that are so specific, they can appear to be specifically designed to benefit one or a few firms,[4] and it is widely assumed that some are. The exchanges do not admit that these highly tailored pricing paths are individually negotiated, but there are no clear regulatory standards around how tiers are set, and no transparency around how many firms qualify, or could conceivably qualify, for a particular tier.

The Impact on Competition

Considering that total rebate payouts by all exchanges last year topped $3.5 billion, the payout to individual firms can dramatically impact their costs and profits. Extrapolating from the top rebate rates and minimum share volumes, our analysis concludes the potential benefits to individual firms could easily amount to hundreds of millions of dollars annually. One exchange executive, at a public forum in 2018, revealed that 5 of the market's top 10 trading firms received a check from the exchange at the end of each month, representing a net payout after accounting for all exchange charges and rebates, including fixed costs of market data, technology, and infrastructure.[5]

But that is only true for the select few that receive the lion's share of the benefits. Payouts to most trading firms will do much less to compensate for their fixed costs, which do not scale in proportion to their trading volume. The upshot is that the use of TCV and tailored-tier rates seems to have the effect, if not the purpose, of allowing the highest-volume firms that already have a competitive edge to keep it. Therein lies the problem.

If the system were just about incentivizing liquidity providers, you might assume exchanges would spread rebate benefits more evenly, giving a bigger incentive for more firms to compete. The problem is that an individual exchange that did so might encourage some firms to increase their participation over time, but only at the cost of driving away orders from the firms that matter most now. That is what makes it a structural impediment to competition, one that requires intervention. The firms that are short-changed by the system – competing market makers, would-be competitors, and those that would simply benefit from more competition – understand this impediment. The American Securities Association (ASA), which represents some of them, made the point clearly in a recent letter:

> **It should concern the SEC that rebate benefits are so heavily concentrated among certain market participants. The current tiered rebate pricing scheme imposes a burden on market competition that impacts every other exchange member that cannot trade the volume needed to obtain the highest rebate tiers. Eliminating this discriminatory practice would force exchanges to come up with an alternative pricing method that fairly allocates exchange fees among all of its members, as is required by law.[6]**

We agree.

What Standards Apply and What is the Solution?

There are various laws that target anticompetitive practices in general. Using the lexicon of those laws, the rebate tier system might be called a "restraint of trade." In non-legal terms, you might just say it smells bad.

Still, market participants need not look to the antitrust laws for relief or just suffer to hold their noses. The Securities Exchange Act of 1934 (Exchange Act) includes a set of relevant core principles that govern exchange practices. For one, exchanges may not allow "unfair discrimination" among their members. They also may not "impose any burden on competition not necessary or appropriate" to meet the purposes of the Exchange Act. And they must provide for an "equitable allocation of reasonable dues, fees, and other charges."

Exchanges must file their fee and rebate schedules with the SEC. Although fee filings do not need pre-approval to take effect, the Commission can suspend them if it decides they don't meet these standards or that the exchange has not clearly shown why they meet the standards. And the fact that fees of a certain type have been previously allowed does not shield the exchanges from greater scrutiny going forward, as the agency has shown in its review of market data fees in recent years.

The justifications offered in rebate and tier filings have tended to be thin. They include statements that exchanges use fees and rebates to compete with each other for order flow but do not address at all the disparate impact on members and their ability to compete. The exchanges maintain they don't unfairly discriminate because the benefits apply equally to all firms that meet the required conditions. Yes, and the Met Gala is open to anyone who can pay $50,000 for a plate, or whose name is Kardashian. It seems hard to credit that "equitable allocation" means much of anything, if it means exchanges can adopt fee structures with no regard for the relative impact on their members' business. And it is hard to understand how the restraint on competition is "necessary or appropriate" to advance any goal of the Exchange Act.

There are various actions the Commission could take to make exchange pricing fairer and promote competition. For one, it could adopt a rule that prohibits the use of pricing methods that by their nature are anti-competitive, including tiers based on TCV or that are individually negotiated. If any exchange wants to argue that it must use those methods to attract sufficient liquidity, we would be interested to hear that argument.

The Commission could also require exchanges in their filings, based on full disclosure, to affirmatively demonstrate why any specific pricing tiers are fair and non-discriminatory and don't hurt competition. Disclosure could include the number of firms that presently qualify or could potentially qualify under changed criteria, based on trading data available to the exchange. If a tier is only available to a few firms, the exchange should be required to clearly show why it does not burden competition, or else why the burden is necessary to achieve some other purpose.[7]

Conclusion

The fact that exchanges compete vigorously with each other should not obscure the point that their pricing practices can unfairly discriminate and hinder competition among their members. The Exchange Act is meant to prevent them from doing so. On its face, the existing system of rebate tiers fails the smell test. As the Commission examines competitive inequities in the equities markets, this is an area it should not overlook.

1. See IEX, "The Rising Tick of Broker Costs and the Shrinking Pool of Competitors" (June 8, 2021), avail. at https://www.iex.io/article/the-rising-tide-of-broker-costs-and-the-shrinking-pool-of-competitors

2. Based on NYSE TAQ Data and FINRA ATS Data

3. Letter from John Ramsay, Chief Market Policy Officer, IEX, to Vanessa Countryman, Secretary, SEC, dated March 202. 2023, at 23-25 avail. at https://www.sec.gov/comments/s7-30-22/s73022-20160364-328968.pdf

4. See RBC Capital Markets, "Complexity of Exchange Pricing and Corresponding Challenges to Transparency and Routing" (October2018), at 3, avail. at https://www.sec.gov/comments/s7-05-18/s70518-4527261-176048.pdf

5. Statement of Chris Concannon, President and COO of Cboe Global Markets, Transcript of SEC Roundtable on Market Data Products, Market Access Services, and Their Associated Fees (October 25, 2018), at 74-75, avail.at https://www.sec.gov/spotlight/equity-market-structure-roundtables/roundtable-market-data-market-access-102518-transcript.pdf

6. Letter from Christopher A. Iacovella, President & CEO, American Securities Association, to Vanessa Countryman, Secretary, SEC, dated March 31, 2023, at 5, avail. at https://www.sec.gov/comments/s7-32-22/s73222-20163332-333215.pdf

7. We note that the Commission has very recently suspended tier filings by two affiliated exchanges and is seeking further information to determine whether they have been adequately justified, which we view as a positive sign of increased focus on these issues. See Securities Exchange Act Release No. 97406, 88 FR 28641 (May 4, 2023); Securities Exchange Act Release No. 97437, 88 FR 30181 (May 10, 2023).