MEMO# 35499

October 31, 2023

SEC Issues Proposal on Prohibition of Exchange Volume-Based Transaction Pricing for Certain Agency-Related Orders

[35499]

October 31, 2023

TO: Equity Markets Advisory Committee RE: SEC Issues Proposal on Prohibition of Exchange Volume-Based Transaction Pricing for Certain Agency-Related Orders

On October 18, 2023, the Securities and Exchange Commission (SEC or "Commission") issued a proposal ("Proposal") to prohibit exchanges from offering volume-based transaction pricing in connection with agency-related orders in certain stocks.[1] The SEC describes this practice as an exchange's assessment of different fees and offering of different rebates and other incentives to different members for executing orders with identical terms (symbol, price, size, side, order type, etc.) based on volume executed. The SEC characterizes such pricing as "increasingly complex" to the point that it is difficult to comprehend and comment on when proposed.[2] More importantly, the SEC further believes that these pricing schemes presents competition problems between exchange members (as well as between exchanges) and conflicts of interest problems with customers.

Comments on the proposal are due 60 days after publication in the Federal Register. We will hold a Zoom member call on Monday, November 6 from 1-2 pm ET to discuss the proposal and a potential ICI response. If you did not receive the Outlook calendar invite, please contact me or Jean Zadeh (jean.zadeh@ici.org) if you would like a copy of the Zoom link.

Competition

According to the SEC, exchange members with lower exchange volume have more difficulty qualifying for certain pricing tiers than members with higher exchange volume, which affects their ability to compete for customer order flow. Specifically, high-volume broker-dealers may incur lower trading costs, which allows them to charge lower commissions or fees to customers.[3]

Disadvantaged members may then look to partake in those cost savings by routing their orders through high-volume members, which further concentrates order activity among a small number of firms.[4] High-volume members may also consolidate their advantage by selling sponsored access and direct market access (DMA) services to customers, which allows them to count those customer volumes to qualify for pricing tiers.[5]

The SEC also believes that these such pricing tiers can impact competition among exchanges. For example, members may be incentivized to route to certain exchanges towards the end of the month to achieve tier targets, which distorts competition for order flow.[6] Further, it also believes that volume-based transaction pricing may distort competition between exchanges that base pricing for an auction, trading session, or special program on volume submitted during regular trading hours outside that auction, trading session, or program.[7]

Conflicts of Interest
According to the SEC, pricing tiers may distort order routing by incentivizing members to route orders to one exchange over another to qualify for certain pricing tiers (for both agency-related and proprietary order flow), albeit possible at the expense of customer execution quality.[8] Further, members may not fully pass through the cost savings or rebates obtained to their customers—in the SEC's view, a conflict of interest.[9] Given the complexity of pricing schedules, the SEC believes that customers may have difficulty understanding and assessing the impact on routing decisions as a means of mitigating those conflicts.[10]

Prohibition on Volume-Based Transaction Pricing for Agency-Related Volume
To address these two areas of concern, the SEC proposes to prohibit exchanges from offering volume-based transaction fees, rebates, or other incentives related to execution of agency or riskless principal[11] orders in NMS stocks.[12] The prohibition would apply where a member is filling a customer order and not trading for its own account. "Customers" could include other members, non-member broker-dealers, institutions, an affiliate for a member, natural persons or any person that uses the member to access an exchange. The scope of this prohibition would not extend to proprietary trading, but the proposal would require greater transparency of the number of members whose proprietary trading qualifies for each tier and related information.[13]

As an alternative to the proposed prohibition, the SEC is considering the following relevant alternatives:

- a broad prohibition that would apply to both agency-related trading and principal trading;
- a broad prohibition except for registered market makers providing displayed liquidity in their assigned symbols;
- a broad requirement requiring greater transparency for volume-based transaction pricing instead of a prohibition; or
- a prohibition only on the tying of closing auction pricing to intraday trading volume.

Costs and Benefits of a Prohibition
The SEC believes that a prohibition would provide benefits by (1) allowing lower-volume members to better compete against higher-volume members if they are subject to the same pricing for agency-related flow; and (2) leading to a greater proportion of collected rebates to be passed through, which would benefit investors even if the total amount of

price savings available to be passed through decreases. The SEC also believes that investor execution quality could increase if distorted routing incentives are eliminated; specifically, the "untying" of closing auction fees to member volume could increase intraday trading competition among exchanges (away from the listing exchange) and also lead to routing to exchanges that offer better execution quality. Further, the SEC asserts that investors would benefit from a more diverse and available array of competitive broker-dealers, the smaller ones of which may offer certain specialized benefits.

However, the SEC also recognizes that a prohibition may increases costs for investors through higher pricing, which may reduce the amount of displayed order flow routed to exchanges, and even increase principal trading flow, which would increase systemic risk across broker-dealers. Further, the SEC states reduced order flow to exchanges could lead to loss of exchange market share to off-exchange venues, which could ultimately lead to less displayed liquidity and broader market fragmentation that increases trading costs.

The SEC requests comment on the proposed prohibition, including whether its underlying concerns are valid. The SEC also requests comment on

- whether a complete pass-through to a customer would eliminate the conflicts of interest and whether customers prefer pass-through exchange transaction pricing or broker commissions (with pass-throughs being less common), as well as how such arrangements work with sponsored access or DMA;
- whether volume-based transaction pricing practice is necessary to support competition between on-exchange and off-exchange trading venues;
- whether this pricing practice affects liquidity taking orders different from liquidity providing orders;
- whether the SEC should also prohibit such pricing for proprietary trading activity, and if so, whether there should then be a carve-out for displayed liquidity adding orders from registered market makers for their respective symbols; and
- whether tiered pricing should instead be allowed only if a certain percentage or number of exchange members (e.g., greater than 50% or 4 members) could qualify for a given month.

Nhan Nguyen
Assistant General Counsel, Securities Regulation

Notes

[1] Volume-Based Exchange Transaction Pricing for NMS Stocks, Exchange Act Release No. 34-98766 (Oct. 18, 2023) ("Proposal"), available at https://www.sec.gov/files/rules/proposed/2023/34-98766.pdf.

[2] The Commission highlights that exchange pricing proposals are considered "rules" of an exchange and must be filed to the SEC and publicly posted on the exchange's website. Id. at 6 n.6-7.

[3] The SEC does acknowledge that broker-dealer concentration may also be attributable to other factors, such as the ability of high-volume broker-dealers to offer better tools and technologies (e.g., smart order routers) that promote execution quality or the ability to offer bundled execution services. As an example, the SEC cites a 2021 institutional investor

survey where 28% of buy-side asset managers anticipate doing more business with high-volume broker-dealers, compared to only 10% who expect less. Id. at 99.

[4] The SEC acknowledges that lower-volume broker-dealers do not become exchange members and instead rely on other broker-dealers that are exchange members due to the "substantial fixed costs" associated with exchange connectivity and data. They recognize that these fees and membership costs have "increased substantially in recent years and can be significant enough to raise entry cost concerns." Id. at 104 (citing a 2020 buy-side market participant comment letter).

[5] In some cases, the SEC believes a DMA provider may offer the service at low cost (0.5 to 2 mils per share) or for free based on the high level of rebates that it could qualify for. Id. at 102-03.

[6] The SEC hypothesizes that pricing tiers incentivize the concentration of order flow and increase market share. Based on January 2023 CAT data, the SEC finds that maker-taker exchanges with a higher number of pricing tiers are not only larger, but they also have a higher proportion of their members executing a plurality of their order flow on their platforms; these members also constitute a greater proportion of trading volume on these exchanges. Id. at 83. Further, the SEC states that its analysis shows that an exchange's market share is more closely associated with the number of pricing tiers than they are with the exchange's base fee or rebate.

[7] The SEC cites a specific example of a primary listing exchange that bases its closing auction pricing on the volume that a member executes during regular trading hours outside of the auction. Proposal at 21-22. It attributes the "high and growing" participation demand in closing auctions to index funds and ETFs that seek to minimize tracking error, which is tied to the daily closing price set by these auctions. Id. at 79. It also suggests that this practice is a form of tying or conditional pricing that could have anti-competitive effects. Id. at 80-81.

[8] Execution quality metrics include fill rates, time to execution, availability of better-priced liquidity, and the likelihood of being adversely selected, each of which may vary across exchanges. Id. at 92.

[9] However, the SEC notes that a member may be able to attract additional order flow from customers because it can offer customers the same lower fees and higher rebates either directly through pass-through exchange transaction pricing or indirectly through lower commissions. Id. at 18. To the extent that it does pass through large proportions of those cost savings, then customers may end up better off. Id. at 92.

[10] However, the SEC understands that it is common for some institutional customers to monitor their broker-dealers on a trade-by-trade basis as a means of mitigating the effects of this conflict of interest. Id. at 94.

[11] The SEC defines "riskless principal" as "a transaction, which after having received an order to buy from a customer, the broker or dealer purchased the security from another person to offset a contemporaneous sale to such customer or, after having received an order to sell from a customer, the broker or dealer sold the security to another person to offset a contemporaneous purchase from such customer." The SEC emphasizes that the proposed definition, which mirrors the SEC's definition in other contexts, does not require the principal leg and customer leg to occur at the same price.

[12] The proposed prohibition also includes an anti-evasion provision that requires equity exchanges that offer such pricing for proprietary orders to have a rule requiring its members to help facilitate the exchange's ability to comply with the prohibition (e.g., by marking orders)

[13] As proposed, every exchange that offers volume-based transaction pricing would be required to submit to the SEC monthly information on the number of members that executed proprietary orders in NMS stocks on the exchange for the member's account. Further, such exchanges would be required to disclose a structured data table that shows how each tier applies among members. The SEC states that exchanges would also be prohibited from counting agency-related volume towards any volume-based pricing tiers applicable to the members' proprietary volume. Proposal at 29.
