HMA | HEALTHY MARKETS ASSOCIATION

A MEMBER ORGANIZATION

August 1, 2023

Via Electronic Mail

Hon. Gary Gensler, Chair
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: SEC Spring 2023 Agency Rule Agenda (RIN: 3235-AN29);[1] Regulation NMS, Minimum Pricing Increments, Access Fees, and Transparency of Better Priced Orders (File No. S7–30–22)[2]

Dear Chair Gensler:

The Healthy Markets Association[3] welcomes the agency's long-overdue reconsideration of certain now-common discriminatory practices in exchange pricing.

As we have repeatedly highlighted to the Commission in recent years, the Commission and staff have allowed national securities exchanges to adopt some pricing practices that appear to be facially inconsistent with the plain language of the Securities Exchange Act of 1934.[4]

Unfortunately, while the Potential Proposal could address a subset of those practices for some market participants, it would likely create significant new complexities and profound negative impacts on investors and other market participants.

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[1] *Rulemaking Agenda, Spring 2023*, SEC, RIN 3235-AN29, *available at* https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202304&RIN=3235-AN29 (last viewed July 19, 2023) ("Potential Proposal").

[2] *Regulation NMS: Minimum Pricing Increments, Access Fees, and Transparency of Better Priced Orders*, SEC, 87 Fed. Reg. 80266 (Dec. 29, 2022), *available at* https://www.govinfo.gov/content/pkg/FR-2022-12-29/pdf/2022-27616.pdf.

[3] The Healthy Markets Association is a not-for-profit member organization focused on improving the transparency, efficiency, and fairness of the capital markets. Healthy Markets promotes these goals through education and advocacy to reduce conflicts of interest, improve timely access to market information, modernize the regulation of trading venues and funding markets, and promote robust public markets. Its members include public pension funds, investment advisers, broker-dealers, exchanges, and data firms. To learn about HMA or our members, please see our website at http://healthymarkets.org.

[4] *See, e.g.,* Letter from Tyler Gellasch, HMA, to Vanessa Countryman, SEC, at 10, Mar. 31, 2023, *available at* https://healthymarkets.org/wp-content/uploads/2023/03/Market-Structure-Comment-Ltr-to-SEC-3-31-23-Final.pdf,

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Based on the plain language of the Exchange Act, an individual market participant should not be able to secretly negotiate its own bespoke pricing from an exchange. Nevertheless, it happens routinely.

We continue to urge the Commission to clarify that exchange pricing discrimination based on *who* sends an order to an exchange is prohibited, regardless of the mechanism through which an exchange identifies and distinguishes between the parties.

Unfortunately, rather than do that, the Potential Proposal would focus narrowly on one common tactic for implementing discriminatory pricing – implementing aggregate volume-weighted pricing tiers – but even then only for a subset of orders and market participants (i.e., agency orders).

As detailed below, this approach would materially exacerbate discriminatory pricing between different market participants, and could likely lead to several unintended consequences, including greater information leakage on exchange trading, and more dark trading by large, institutional investors. Further, if combined with other market structure reforms proposed in December 2022, it could drive even significantly greater consolidation of order flow to the largest volume traders. While aggregate volume-based pricing schemes are anti-competitive, the piecemeal approach suggested by the Commission's agenda would be materially worse.

The Commission should simply exercise its clear statutory authority to protect investors and other market participants from exchanges offering preferential deals to the largest, most connected traders. That should include offering guidance (and perhaps a new rule to clarify) that exchange pricing should not be determined on the basis of who is sending the order, but rather the characteristics of the order itself.

Background

The Exchange Act demands that rules of national securities exchanges:

- "provide for the equitable allocation of reasonable dues, fees, and other charges;"[5]
- not be "designed to permit unfair discrimination";[6]
- "not impose any burden on competition not necessary or appropriate in furtherance of the purposes of" the Act;[7] and

[5] 15 U.S.C.§ 78f(b)(4).
[6] 15 U.S.C.§ 78f(b)(5).
[7] 15 U.S.C.§ 78f(b)(8).

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- be designed “to protect investors and the public interest.[8]

Nevertheless, since the adoption of Regulation NMS, the Commission has stood idly by as exchanges have adopted ever-increasingly sophisticated mechanisms to discriminate between their different customers to maximize the exchanges’ revenues.

A common discriminatory mechanism used is to offer differential pricing based on traders’ aggregate volumes. The aggregate volume-based pricing arrangements effectively serve three purposes for exchanges.

First and foremost, the form and levels of the tiers are intended to identify specific firms. Exchanges need to know who may qualify and how much trading qualifies for the specific beneficial pricing tiers. This is extremely important, in part, because many of the top tiers offered by exchanges cause them to lose money on trading. The exchanges simply can’t offer these benefits to the masses. That is why the mechanisms for identifying the beneficiaries of preferential access are often compound, complex criteria. Not surprisingly, the largest, most connected trading firms essentially custom-negotiate their pricing schedules with the major exchanges.

Second, aggregate volume-based pricing arrangements are intended to entice the largest, most-connected traders to send orders to the exchange offering the benefits. Order flow begets order flow, and if an exchange can buy order flow from some traders, that can force other traders to come to the venue to interact, even if they don’t enjoy the beneficial pricing. In fact, they may be commercially or regulatorily compelled to trade at that exchange, even if they are forced to pay materially higher fees or obtain materially lower rebates.

Third, by their nature, aggregate volume-based pricing tiers seek to “lock up” trading volumes for specific exchanges. If a trader needs to trade on a particular exchange in order to hit a pre-set preferential pricing tier, it will likely choose that venue over others - irrespective of the potentially negative impacts on investors.

The differential between an exchange’s “standard” fee or rebate for an order and the rates that the largest, most connected traders are able to negotiate are profound – and growing.

A few years ago, we shared with the Commission the below pricing sheet from one large bank broker-dealer.

FIGURE 1: Broker A Exchange Pricing

[8] 15 U.S.C.§ 78f(b)(5).

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	Tape A (NYSE)		Tape B (AMEX & Other)		Tape C (NASDAQ)	
	Taking	Providing	Taking	Providing	Taking	Providing
ARCA	0.00300	(0.00300)	0.00280	(0.00230)	0.00300	(0.00300)
BATS	0.00300	(0.00310)	0.00300	(0.00310)	0.00300	(0.00310)
NYSE	0.00250	(0.00180)	0.00250	(0.00180)	0.00250	(0.00180)
NASDAQ	0.00300	(0.00295)	0.00300	(0.00295)	0.00300	(0.00295)

Since then, however, the pricing has become even more discriminatory and the access has become even preferential for the privileged few.

For example, on NYSE ARCA, at least one broker has subsequently negotiated a rebate of a whopping 32 cents per 100 shares traded for adding liquidity in a Tape B name, guaranteeing that the exchange is losing money on that trade (because the fee is capped at 30 cents). However, the “standard” rebate given to the vast majority of brokers for the exact same orders is just 20 cents.

Put another way, if a regional broker-dealer sent a 100 share order in a Tape B security to the exchange it would make 20 cents, whereas this particular unnamed broker would be paid 60% more for the exact same trade.

This phenomenon isn’t unique to NYSE ARCA. BATS has recently negotiated to pay at least one broker a rebate of 32 cents per 100 shares traded for adding liquidity in Tape A securities, but its “standard” rebate given to the vast majority of brokers for the exact same orders is just 16 cents. So, the unidentified broker is twice as profitable on the exact same trade as a regional broker-dealer would be.

Multiply this by thousands of orders per day across different exchanges, and the impacts on individual firms and the markets are profound.

It strains credulity to assert that this burden on competition between different exchange participants is “necessary” or “appropriate.” Similarly, how is it in the public interest to make some traders – often the largest, most connected banks and proprietary trading firms in the world – twice as profitable per share traded as all others?

Importantly, when adopting these extremely different pricing models for favored customers, the exchanges have undertaken no economic analysis of the impact of these differences on their different members or the markets overall. We are similarly unaware of any Commission or staff analysis of how these different pricing tiers on the same exchanges impact different brokers, principal traders, investors, or the markets overall.

Markets Developed a "Work Around" that Consolidates Trading at Largest Volume Firms

In response to these dynamics, over the past few years, the largest, most-connected banks and trading firms have taken to essentially selling their preferential access to the exchanges to smaller, less-connected trading firms.

For example, one large, connected trading firm routinely sells its preferential access to other brokers for a standard 1 cent per 100 shares fee.

Here's how it works. The standard rebate for adding liquidity in a Tape B security on Nasdaq today is 18 cents per 100 shares. That bank, however, has negotiated a rebate of 34.5 cents per 100 shares for those orders.[9] It has offered to sell its exchange-granted and Commission-permitted preferential access to other brokers.

Thus, in return for the smaller broker routing its order (whether principal or agency) to that bank for execution on the exchange, the smaller broker will capture an effective rebate of 33.5 cents per 100 share, and let the bank keep 1 cent per 100 shares as an economic rent.

Of course, this may introduce latency and risks to the trades, as it interposes an intermediary for no other purpose than to get more favorable exchange pricing.

At the same time, the bank that negotiated with the exchange for the preferential access will also get access to the other broker dealers' order information and additional trading volumes with which to negotiate even more preferential pricing with both that exchange and other trading venues.

In recent years, this market dynamic has been replicated over numerous exchanges every month, helping to consolidate the vast majority of order flows into the hands of the largest, most-connected banks and trading firms – even though the underlying orders may originate from many different market participants.

Overview of Existing Pricing Tier Impacts

In 2018, Cboe's CEO said on stage in the Commission's auditorium that his exchange wrote checks to 5 of its 10 largest volume traders each month.[10] Since then, while there has been no material update of these statistics across the market, it appears as though

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[9] Cite to filing.

[10] Remarks of Chris Concannon, Cboe Global Markets, before the SEC Roundtable on Market Access and Market Data, Oct. 25, 2018, Transcript at 74-75, *available at* https://www.sec.gov/spotlight/equity-market-structure-roundtables/roundtable-market-data-market-access-102518-transcript.pdf.

the pricing gap between the fees and rebates to the largest, most connected trading firms, and the rest of the markets has grown.

The very largest, most connected traders' payments, along with the rest of the costs of operating the exchange and its profits, are *paid by all of the other market participants in the forms of worse transaction pricing, and essentially monopolistic market data costs*. As a result, the costs or rebates per share traded on an exchange are often orders of magnitude worse for smaller volume traders than the largest, most connected competitors.

Worse, as described above, the massive pricing advantages awarded to the largest, most connected trading firms actually drives their competitors to trade with them – awarding them pure economic rents (at the expense of competition, and increasing risks of market integrity and market stability).

Put simply, the economics created by preferential access for the largest, most-connected trading firms drives consolidation, increases costs on many market participants, and increases risks to both investors and the markets.

Lastly, assuming that the exchanges are offering discriminatory, preferential access to the largest, most-connected trading firms in order to garner more order flow, these practices help exacerbate the concerns raised by investors and other that brokers may route orders in ways that are intended to maximize their profits, versus obtain their customers the best executions.

Potential Proposal

The Commission's agenda suggests that the Potential Proposal would be for:

> a new rule under the Securities Exchange Act of 1934 to address concerns with national securities exchange volume-based transaction pricing in NMS stocks by requiring exchanges to make periodic public disclosures about those pricing models to facilitate greater transparency of their impact and to mitigate conflicts of interest and facilitate competition among broker-dealers by prohibiting volume-based pricing by exchanges for agency-related volume.[11]

Analysis of the Potential Proposal

The Potential Proposal would exacerbate the anti-competitive impacts of discriminatory pricing models and preferential access adopted by many exchanges.

[11] Potential Proposal.

At face value, the Potential Proposal would not attempt to solve the problem of the largest, most-connected trading firms getting preferential pricing over everyone else. It would not attempt to solve the problem of smaller, less connected firms being forced to subsidize the handful of largest, most-connected firms' trading. It would not even solve the narrow problem of brokers' conflicted order routing practices.

However, the Potential Proposal would (1) codify "permitted" discrimination that is facially inconsistent with the Exchange Act, (2) eliminate the abilities of smaller, less-connected firms to at least attempt to reduce the discriminatory impact by accessing the better pricing awarded to their more connected competitors (albeit, subject to unnecessary rents and greater risks), and (3) introduce significant market complexities that would likely change the nature of on-exchange trading and drive institutional order flow further away from exchanges.

The Commission Would be Codifying Discriminatory Pricing in Contravention of the Exchange Act

The Exchange Act expressly demands that an exchange's rules:

- "provide for the equitable allocation of reasonable dues, fees, and other charges;"[12]
- not be "designed to permit unfair discrimination";[13] and
- "not impose any burden on competition not necessary or appropriate in furtherance of the purposes of" the Act.[14]

The Commission has never adopted a clear rule to implement those requirements with respect to exchange transaction pricing. What is "unfair discrimination" or an unnecessary or inappropriate burden on competition? When are costs distributed inequitably?

In the absence of Commission rules, guidance, or interventions, the exchanges in recent years have begun to compete with other exchanges and market centers by offering customized, preferential pricing to the largest, most connected traders.

[12] 15 U.S.C.§ 78f(b)(4).
[13] 15 U.S.C.§ 78f(b)(5).
[14] 15 U.S.C.§ 78f(b)(8).

Even when a pricing tier is obviously customized to fit the trading of a single large, connected firm, the firm is not identified in the exchange filing.[15] Nevertheless, the Commission has generally not interjected.

Without Commission rules, guidance, or actions to block exchange pricing tier filings, the boundaries of this passively "permitted" discrimination are undefined and unclear, as demonstrated by the Commission staff's recent suspensions of pricing tier filings by the Cboe family of exchanges.[16]

The Cboe Pricing Tier filings appeared to be largely consistent with previously permitted pricing tier filings across several exchanges.[17] However, while aggregate volume-based pricing tier filings are – as a matter of practice – negotiated with individual firms, they are generally prospective. In theory, any firm that could meet the custom-tailored thresholds of the filing could qualify. Of course, that is simply form over substance. HMA objected to the filings.[18]

Regardless, the two Cboe family exchange filings that were suspended by the Commission staff dispensed with the pretense of its pricing being "open" to anyone, and instead simply selected activity that was achieved at a fixed time in the past. Thus, while the exchanges didn't specifically name the firms covered by the filings, it could have done so. While that is economically not materially different from existing pricing tier

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[15] In fact, due to a quirk in the requirements for filings, only *prior written communications* about the filing with other market participants need to be disclosed. Our experience is that discussions between exchange executives and the largest, most connected trading firms about pricing changes often occur over steak dinners, between golf shots at industry conferences, over the phone, and in other non-written manners. And so no disclosure is typically made in the filings. As we have written before, the Commission should require disclosure of all related communications between exchange executives and trading firms regarding fees related to filings, not just written communications.

[16] Suspension of and Order Instituting Proceedings to Determine Whether to Approve or Disapprove Proposed Rule Change to Amend the EDGX Equities Fee Schedule to Eliminate and Modify Certain Growth Tiers and NonDisplayed Step-Up Volume Tiers, Modify a Retail Growth Tier, Introduce New Fee Code DX and Modify Fee Code DQ, SEC, April 28, 2023, *available at* https://www.sec.gov/rules/sro/cboeedgx/2023/34-97406.pdf and Suspension of and Order Instituting Proceedings to Determine Whether to Approve or Disapprove Proposed Rule Change to Amend the BZX Equities Fee Schedule to Add and Modify Certain Step-Up Tiers, Add a Non-Displayed Step-Up Tier and Modify Certain Fee Codes, SEC, May 4, 2023 *available at* https://www.sec.gov/rules/sro/cboebzx/2023/34-97437.pdf

[17] See, *Notice of Filing and Immediate Effectiveness of a Proposed Rule Change to Amend its Fee Schedule*, SEC, Exch. Act Rel. No. 97108, Mar. 10, 2023, *available at* https://www.sec.gov/rules/sro/cboebzx/2023/34-97108.pdf; *Notice of Filing and Immediate Effectiveness of a Proposed Rule Change to Amend its Fee Schedule*, SEC, Exch. Act Rel. No. 97042, Mar. 3, 2023, *available at* https://www.sec.gov/rules/sro/cboeedgx/2023/34-97042.pdf.

[18] Letter from Tyler Gellasch, HMA, to Vanessa Countryman, SEC, May 26, 2023, *available at* https://healthymarkets.org/wp-content/uploads/2023/05/CBOE-Pricing-Tiers-May-2023-1.pdf.

filings, the Commission appears to have objected on the basis of the specificity of the targeting of the beneficiaries of the pricing changes.

Rather than let the process play out with the Commission, the Cboe Pricing Tier Filings were withdrawn.[19]

On the one hand, the filings appeared to be facially inconsistent with the Exchange Act. On the other hand, they also appear to be consistent with previously permitted pricing schedules from Cboe and other exchange families. A filing that identifies a specific firm using only nominally objective criteria from the past is not economically materially different from existing pricing tiers that similarly identify a specific firm using only nominally objective criteria.

Under the Exchange Act, an exchange presumably can't adopt a rule that says "we will pay JPMorganChase twice the rebate and charge half the fee per share traded as everyone else." The Commission staff seemed to recognize that when it suspended the Cboe Pricing Tier Filings. However, the current pricing tier structures and the majority of national securities exchanges are economically similar to that.

If a Miami restaurant is statutorily prohibited from discriminating between its customers, and then offers discounts to only 7-time Super Bowl winning quarterbacks, it's pretty clear that only one potential customer could qualify for the discount. Whether or not the restaurant names Tom Brady by name should be irrelevant to the analysis. The restaurant is breaking the law.

If the Commission were to finally break its decades of silence on transaction pricing discrimination to offer a new rule to address the preferential access offered to the largest, most connected trading firms, it should not simply prohibit one form of the practice, while expressly permitting others.

For example, if the Commission were to adopt a rule that applied pricing awarded to agency transactions only, as opposed to principal transactions, the Commission would be either implicitly or explicitly condoning the very same discrimination that it would be addressing elsewhere. Similarly, if the Commission were to prohibit "aggregate volume-based discrimination," but not discrimination generally, the Commission would be leaving open an unlimited number of opportunities for exchanges and their largest, most-connected firms to achieve the same results as exist today.

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[19] *Notice of Withdrawal of a Proposed Rule Change to Amend its Fee Schedule*, SEC, Exch. Act Rel. No. 97782, June 21, 2023, *available at* https://www.sec.gov/rules/sro/cboebzx/2023/34-97782.pdf; *Notice of Withdrawal of a Proposed Rule Change to Amend its Fee Schedule*, SEC, Exch. Act Rel. No. 97764, June 20, 2023, *available at* https://www.sec.gov/rules/sro/cboeedgx/2023/34-97764.pdf.

What would prevent, for example, the exchanges from negotiating discriminatory, preferential access terms with the same large, connected trading firms under the auspices that they are based on other parameters?

The Potential Proposal Would Exacerbate Pricing Disparities Between the Largest, Most-Connected Traders and Everyone Else

As mentioned above, many smaller broker-dealers and trading firms currently route their orders (whether agency or principal) to the largest, most connected traders so that they can “share” some of the advantages afforded to their competitors.

However, if the Potential Proposal were adopted, these smaller traders would not be able to benefit from that pricing, as the brokers accessing the exchanges would be acting in an “agency” capacity.

Further, the distinction between “principal” and “agency” trades may be exceedingly blurry. For example, a bulge bracket bank may be able to rest purportedly “principal” orders on an exchange as part of its “central risk book”, but those orders may be effectively agency trades. Put another way, the largest, most connected trading firms have the means to rest orders in exchanges, garner rebates, allocate the trades based on their customers’ (and other brokers’ customers’ orders) and collect preferentially negotiated rebate checks for their trading at the end of the month; which is simply impossible for most market participants.

As a practical matter, banks are already supposed to clearly market principal vs. agent trades. It isn’t well-policed. However, allowing exchanges to differentiate pricing based on agency and principal would likely lead to much greater incentives for principal trading activity vis-a-vis the agency activity. This difference would strongly incentivize banks to (1) shift as much trading to quasi- “riskless principal” or “principal” trading, and (2) mismark trading activity.

The Potential Proposal Could Lead to Greater Costs for Investors and Significant Changes in On- and Off-Exchange Trading Characteristics

There are also several potential market-wide consequences of the Potential Proposal’s bizarre distinction between principal and agency trades.

By expressly blessing significant pricing discrimination for principal traders, but not agency trading firms, would be making it more likely that all traders would interact with principal traders on exchanges, and less likely to interact with “naturals,” who would not be able to benefit as much from passive trading strategies. This would likely skew the current market structure towards even more disintermediation by principal trading firms,

with associated costs to all market participants – including greater risks for information leakage and higher execution costs

Further, it's important to acknowledge that if exchanges can save costs by lowering rebates for agency trades, they would likely reallocate those saved costs into continuing to compete more aggressively for order flow in other areas – such as providing even more discriminatory, preferential pricing to the largest, most connected principal traders. This could mean that the variance in pricing for the same order sent to an exchange could perversely grow.

Lastly, as we have previously shared with the Commission, today, firms reconcile their trading volumes and types with the exchanges each month at enormous cost. In addition to the concerns with shifting order flow from agency to principal basis and encouraging mismarking of trades (discussed above), a new principal versus agency distinction would likely exacerbate the complexity and burdens of this process.

Investors May Discriminate Based on Brokers' Fees and Rebate Tiers

We applaud the Commission for separately proposing to improve exchange pricing practices so that more investors may be able to implement "pass through" pricing models with their brokers.[20] As we have said before, "pass-through" pricing may reduce brokers' conflicts of interest in order routing. However, it is currently impossible for many investors to adopt because of many peculiarities of exchange pricing models. The Commission's proposal to ensure that brokers know the fee or rebate at the time of the execution for a particular trade would make "pass through" relationships more possible, and should be implemented without delay.

However, if the Potential Proposal were adopted, investors with "pass through" pricing would likely drive even more of their trading to the handful of firms with the most beneficial pricing (aka, the largest banks and traders).

For example, a hedge fund that has implemented a "pass through" pricing model with its brokers has repeatedly shared with the Commission that it actively discriminates against all but the handful of largest brokers because those brokers do not have the most beneficial pricing rates from exchanges.

Considerations and Recommendations for Economic Analysis

While the Commission has recognized that the largest, most-connected traders enjoy preferential access to the exchanges, it has undertaken no public legal or economic

[20] See, *Regulation NMS: Minimum Pricing Increments, Access Fees, and Transparency of Better Priced Orders*, SEC, 87 Fed. Reg. 80266, 80292-293 (Dec. 29, 2022), *available at* https://www.govinfo.gov/content/pkg/FR-2022-12-29/pdf/2022-27616.pdf.

analysis of the extent of the preferences or the impacts on different market participants or the markets overall.

A simple review of the filings of the exchanges shows the clear discrimination. For example, it's easy to see that at least one trading firm enjoys a rebate of 34.5 cents per 100 shares of adding liquidity on Nasdaq for Tape B securities, while the "standard" rate for nearly every other market participant is 18 cents per 100 shares for the same securities.

But while market participants do not have the publicly available data with which to quantify the actual impact of these and other preferential pricing differences, the Commission does.

For example, the Commission should examine the top pricing tiers offered by each of the major exchanges and identify to the public how many firms qualify for that pricing.

The Commission should use the CAT data to extrapolate – in hard numbers – the differences between what a large, connected trader paid for taking liquidity and was paid for providing liquidity, on a per share basis, compared to other traders. This should be performed for each of the largest, most connected firms across each of the major exchanges.

The Commission should identify the vig charged by large, connected traders for using their better, customized pricing tiers (often 1-2 cents per 100 shares) and use the Consolidated Audit Trail data to quantify the explicit economic rent extracted by those firms from other market participants.

The Commission should identify the different costs, risks, and latencies created by having large, connected traders with extremely preferential access to exchanges.

None of these concerns or analysis are dependent upon whether the traders are acting as principals or agents.

Unfortunately, the secondary Impact on agency-based routing decisions is much harder to identify and assess (as the Commission discussed in the Transaction Fee Pilot).

If the Commission proposes implementing a principal versus agent distinction for pricing discrimination, how could it justify stopping the discrimination for agents, since the same issues above would apply equally with principals? Any language or analysis from the Commission used to make a principal versus agency distinction would appear to fundamentally weaken any legal or economic analysis underpinning the rule going forward. The distinction would be arbitrary and capricious, or otherwise inconsistent with the logic of underpinning the action.

Put simply, we urge the Commission to quantitatively and qualitatively evaluate the extent to which custom-tailored exchange pricing targeted at the largest, most connected firms is inconsistent with the Exchange Act, which shall include:

1. the extent to which the largest, most connected trading firms benefit from exchange's preferential pricing practices; and
2. The extent to which other market participants (including regional broker-dealers) suffer from existing preferential pricing awarded by the exchanges to the largest, most connected firms.

Impact on Fee Cap Changes

As the Commission has previously acknowledged, the vast majority of rebates appear to be funded by the transaction fees assessed on the other sides of the trade. Thus, the 30 cents per 100 shares fee cap means that while rebates are not capped at 30 cents per 100 shares, rebates tend not to materially exceed that level for most brokers.

Under this system, a broker may have a rebate of 20 cents per 100 shares or more greater than the "standard rate" offered to other brokers on the exchange.[21]

Thus, if the Commission lowers the transaction fee cap, as it has proposed, the absolute difference in rebate tiers between most-favored brokers and everyone else is likely to narrow.

That said, a few brokers and trading firms already receive rebates from some exchanges that exceed the fees collected on the other side of those trades – ensuring that the exchanges lose money on those trades. Those trades are effectively subsidized by other trading and revenues – including market data revenues.

Accordingly, the relative advantages of the most-favored traders versus everyone else may expand. Put simply, a "standard" rebate may fall from 16 cents per 100 shares to 2, while the top rebate may fall from 32 cents to 12 cents. So while the absolute price differential narrowed from 16 cents to 10 cents, the relative price differential increased from the favored broker receiving *only* 200% better pricing to receiving 600% better pricing than its smaller competitor.

Again, how are any of these massive differences consistent with the Exchange Act requirements for exchanges?

The Exchange Act, Fair Access, Investor Harm, and the Transaction Fee Pilot

[21] See, e.g., Nasdaq, Tape C securities.

The Commission's analysis of whether and under what circumstances an exchange can discriminate between brokers under the Exchange Act is not dependent upon any investor harm. The Exchange Act provisions cited above aren't solely about investor harm (as investors aren't mentioned at all). Rather, those requirements are intended generally to ensure fair access by trading firms to exchanges. That's clearly not happening today.

Of course, as you well know, investors have long expressed concerns with how transaction pricing may impact the routing of their orders. When the Commission adopted the Transaction Fee Pilot, the agency broadly asserted that it simply didn't know enough about the impacts of exchange rebates to ban them.

The Commission instead proposed a complex rule of different fee structures and a proposal to require more basic disclosures of exchanges' basic fee structures.[22] Oddly, even that disclosure would have nevertheless ignored significant variation in exchange fee schedules.

Notably, that discussion was based on concerns with conflicts of interest created by rebates and fees generally on brokers' order routing of their customers' orders. It did not address differentials between different types of trading firms at all.

To be clear, the Commission would not have to declare all types of rebates (or fees) or any differences in them to be "good" or "bad" for investors in order to determine that some types of discrimination are inconsistent with the Exchange Act. In fact, the Commission need not make any findings about the impacts on investors (although it should) in order to find that certain types of discrimination are inconsistent with the law.

Conclusion

In sum, many exchanges have implemented non-transparent, discriminatory pricing that benefits the largest, most connected traders to the detriment of everyone else. The Commission should adopt a rule to clearly end these pricing practices, which are facially inconsistent with the exchanges' obligations under the Exchange Act. While that should include aggregate volume-based pricing tiers, it should include any other methods that could be used to implement such discrimination. Put simply, an exchange shouldn't be able to use ostensibly "objective" means to clearly identify and discriminate in favor (or against) specific firms.

If the Commission were to only focus on one such mechanism (aggregate volume-based pricing tiers), other ostensibly "objective" discrimination mechanisms would be quickly identified. Identifying a party is the same whether you name them or

[22] Transaction Fee Pilot Proposal, at 13029.

use ostensibly objective criteria to get to the same result. You can identify Tom Brady by his name; or you can say “anyone who has won 7 Super Bowls;” or you can say “anyone with more than 600 NFL touchdown passes” – they all get you to the same place. That’s identifying a party.

Further, if the Commission were to only focus on agency trading, it would – for the first time – either implicitly or explicitly be codifying discrimination that benefits the largest, most connected traders while simultaneously seeking to restrict the same practices in other contexts. This approach is internally inconsistent, contrary to the law, and contrary to any stated objectives for the rule.

Put simply, as described, the Potential Proposal would not only fail to solve the problems of discriminatory pricing practices by exchanges, but make them much worse.

Thank you for the opportunity to highlight our concerns contained within the Potential Proposal. Should you have any questions or seek further information please contact me at (202) 909-6138.

Sincerely,

Tyler Gellasch
President and CEO