BETTER MARKETS

SEC

FACT SHEET

The SEC's Proposed Market Structure Reforms are Essential to Protect Retail Investors and Industry Cries for More Cost-Benefit Analysis Must Not Stand in the Way

In January 2021, the frenzied trading in GameStop, AMC, Bed Bath & Beyond, and other "meme stocks" raised critical questions about the fairness of our markets and the treatment of retail investors. The volatile market activity during this time period highlighted issues such as the increasingly fragmented state of our markets, harmful practices such as the payment for order flow, and the need to ensure that broker-dealers obtain the best execution for their clients. The market breakdowns during this volatile time period damaged public confidence in our markets and inflicted hundreds of millions, if not billions, of dollars of losses on everyday investors.

The passage of time since the GameStop frenzy should not diminish the urgency of addressing these issues, and the SEC has proposed a series of reforms intended to improve the way securities trades are routed and executed. These proposals include: Minimum Pricing Increments, Access Fees, and Transparency of Better Priced Orders; Order Competition; Regulation Best Execution; and Disclosure of Order Execution Information. Taken together, these proposed reforms have the potential to improve the fairness and transparency of our securities markets and ensure retail investors are not unfairly exploited by their brokers and other financial intermediaries.

Nonetheless, the financial industry opposes rules that will protect and benefit investors by exaggerating if not fabricating the costs of regulation and trying to force agencies to engage in needless quantitative cost-benefit analysis for each rule that they promulgate. Repeated efforts to impose onerous quantitative cost-benefit analyses have also surfaced over the years in Congress and the executive branch. The industry's use and abuse of cost-benefit analysis should be rejected—especially where the cost they fear the most is losing the right to make huge predatory profits at the expense of retail investors. Cost-benefit analysis is inaccurate, biased in favor of industry, a huge drain on agency resources, and more than anything an industry tool for setting rules up for challenge in court. It must not dissuade the SEC from finalizing its essential market structure reforms any more than it should dissuade the SEC from adopting other rules designed to prevent fraud, abuse, and systemic instability in our securities markets.

The SEC's Market Structure Reforms

The SEC's proposed rules, once finalized, will have four main consequences for securities trading:

1) they will reduce the minimum trading increments or “tick sizes” to help improve buy and sell prices, and will also reduce the fees that create harmful trade-routing incentives;
2) they will ensure that most retail orders are sent through public auctions where they will be exposed to open and competitive bidding;
3) they will strengthen a broker’s obligation to get the best available prices for clients; and
4) they will increase transparency by expanding the reporting requirements that shed light on the quality of trade executions that brokers have achieved for their clients.

Minimum Pricing Increments

Longstanding SEC rules prevent exchanges from displaying prices for most stocks in increments—or “ticks”—below a penny. This minimum trade size established twenty years ago is now outdated with advances in technology and increases in trading volume. As a result, although market forces appear willing and able to price certain stocks in increments of less than one penny, investors are not able to trade in the increments that would enable them to get optimal prices. In other words, the current rules prevent bid-ask spreads from becoming narrower than one cent, meaning that traders may not be getting as good a deal as they should. Meanwhile, in off-exchange trading venues known as “dark markets,” sophisticated traders are freely able to make sub-penny trades, affording them unique benefits denied to most ordinary investors. The SEC’s proposed Minimum Pricing Increments rule would alleviate this issue by reducing the minimum tick size to less than a penny, which would improve the trading environment for retail investors.

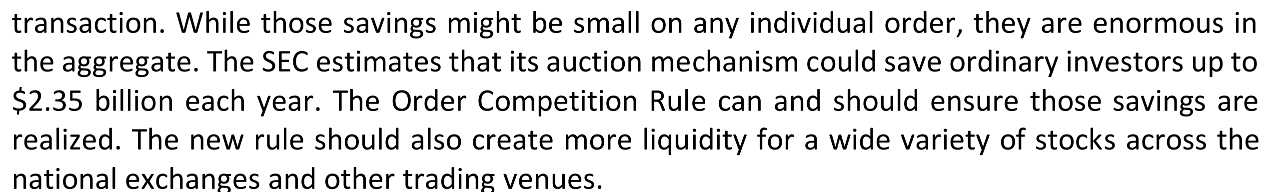
The SEC’s proposal would also reduce access fees from the current level of $0.003 per share to $0.001 per share. Technology and financial markets have evolved dramatically over the past two decades since Regulation NMS was first adopted, but the rules have not kept pace. The current access fee levels of $0.003 are long outdated and fail to correspond to any reasonable approximation of the relative costs incurred by exchanges. Updating these fees is a commonsense approach that will save investors money and increase market transparency.

Read our full Comment Letter here.

Order Competition Rule

When an ordinary investor asks his broker to buy or sell stock, that broker has the option of sending the order to one of several venues to be executed. Most investors probably expect their brokers to send orders onto the well-known national securities exchanges like the NYSE or NASDAQ. But, in fact, a small group of powerful high-frequency trading firms, called “wholesalers,” scoop up and execute the vast majority of orders from retail-focused brokers. The wholesalers do this largely through “payment for order flow,” or PFOF, given to the brokers; they don’t necessarily earn that order flow by always executing the investor’s order at the best price. The SEC’s proposed Order Competition Rule requires that stock orders submitted by retail investors to their brokers be sent to public auctions where market makers, institutional investors, and others can compete to provide the best price.

The auction mechanism in the Order Competition Rule would ensure that wholesalers face price-based competition for retail orders, and that competition will produce better prices for each



transaction. While those savings might be small on any individual order, they are enormous in the aggregate. The SEC estimates that its auction mechanism could save ordinary investors up to $2.35 billion each year. The Order Competition Rule can and should ensure those savings are realized. The new rule should also create more liquidity for a wide variety of stocks across the national exchanges and other trading venues.

Read our full [Comment Letter here].

Regulation Best Execution

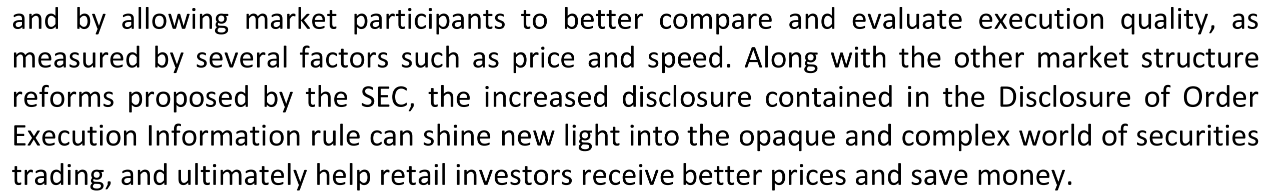
The U.S. financial markets have become enormously fragmented and largely opaque, including 24 exchanges, dozens of alternative trading systems or “ATSs,” and a cadre of wholesalers—market participants that, for their own benefit, attract and execute a huge percentage of retail order volume. As a result, finding the best prices poses challenges. There are huge conflicts of interest in play when it comes to order execution, and that profit motive induces some market participants to route orders for execution in ways that do not yield best execution for clients. Specifically, sophisticated market participants such as the wholesalers can game the system through the process of PFOF—paying brokers for retail order flow, executing those orders internally at prices that reflect apparent price improvement over the NBBO benchmark, and then, in turn, engaging in offsetting trades at better prices for their own gain. The SEC’s proposed Regulation Best Execution would establish a duty of best execution under the SEC’s own rules, requiring broker-dealers to execute customer orders at the most favorable price given market conditions. This proposal would root out the most egregious instances of broker-dealers acting against the best interests of their customers in executing their customers’ trades.

The proposed rule represents an important step forward in the effort to ensure that retail investors obtain something closer to the best available prices for their securities trades. However, it is not sufficient by itself to address the problems surrounding retail order execution and it therefore cannot be viewed in isolation. The proposed reduction in tick sizes and the order competition rule must also be adopted in order to maximize the improvements to retail order routing and execution practices that the Commission is appropriately seeking to achieve.

Read our full [Comment Letter here].

Disclosure of Order Execution Information

Rule 605 of Regulation NMS and the reports it requires have not had a substantive revision for over twenty years ago. During that time, the technological nature of trading has changed immensely. The simple fact is that in today’s securities markets, many investors—especially retail investors—are not getting the best available prices for their orders to buy and sell stock. One main reason is a lack of transparency regarding the way orders are routed in today’s complex and fragmented markets, where incentives and conflicts of interest between brokers, wholesalers, and other market participants abound. The SEC’s proposed Disclosure of Order Execution Information rule seeks to expand the quantity and quality of disclosure pursuant to Rule 605 of Regulation NMS by, among other things, requiring that certain broker-dealers disclose information on a monthly basis about how investor orders are actually executed in the markets



and by allowing market participants to better compare and evaluate execution quality, as measured by several factors such as price and speed. Along with the other market structure reforms proposed by the SEC, the increased disclosure contained in the Disclosure of Order Execution Information rule can shine new light into the opaque and complex world of securities trading, and ultimately help retail investors receive better prices and save money.

Read our full Comment Letter here.

A CLOSER LOOK: THE USE AND ABUSE OF COST-BENEFIT ANALYSIS

The financial services industry has fought long and hard to nullify or weaken new rules by claiming that federal agencies must engage in an exhaustive and quantitative cost-benefit analysis for each rule they promulgate. In reality, requiring agencies to conduct quantitative cost-benefit analysis in their rulemaking process does more harm than good, especially in the regulation of the financial markets.

Quantitative cost-benefit analysis has many drawbacks: It is an inaccurate and unreliable methodology; it unfairly emphasizes industry costs over often more difficult to quantify but immensely important benefits; it consumes enormous agency resources; it sets the stage for industry challenges to final agency rules in court premised on alleged shortcomings in the agency's cost-benefit analysis; and it induces agencies to dilute their own rules as they brace for those industry challenges. It also rests on the false premise that regulation threatens to impose crushing burdens on industry. These claims have consistently proven to be false throughout the history of financial regulation. Rather, strong regulation is what ensures investor confidence in the markets, robust participation in the capital formation process, and sustained economic growth.

Here is an overview of the major flaws in quantitative cost-benefit analysis, which can prevent regulators from issuing the rules we need to protect investors and markets from a wide range of threats, from fraud and abuse to financial crises.

THE COSTS OF QUANTITATIVE COST-BENEFIT ANALYSIS

Cost-benefit analysis is inaccurate and biased. Cost-benefit analysis is unworkable because it is inaccurate and biased against the public interest and in favor of the regulated industry.

- It relies heavily on predictions and assumptions about a complex array of variables.
- It assumes the availability of complete and accurate data that frequently doesn't exist or is exclusively in the hands of the industry.
- It tends to undervalue many benefits of regulation or omit them entirely from the calculation because they can be difficult to quantify.
- It is biased because quantifying industry cost is far easier than quantifying all of the public benefits that follow from regulation.

- It focuses narrowly on individual rules, typically ignoring the need to assess the value of rules holistically, with each one serving as part of a collection of rules that work together in preventing fraud, abuse, and potentially catastrophic financial crashes.

Cost-benefit analysis is costly and burdensome. Rather than promoting strong rules that protect the public, cost-benefit analysis raises obstacles to effective rulemaking:

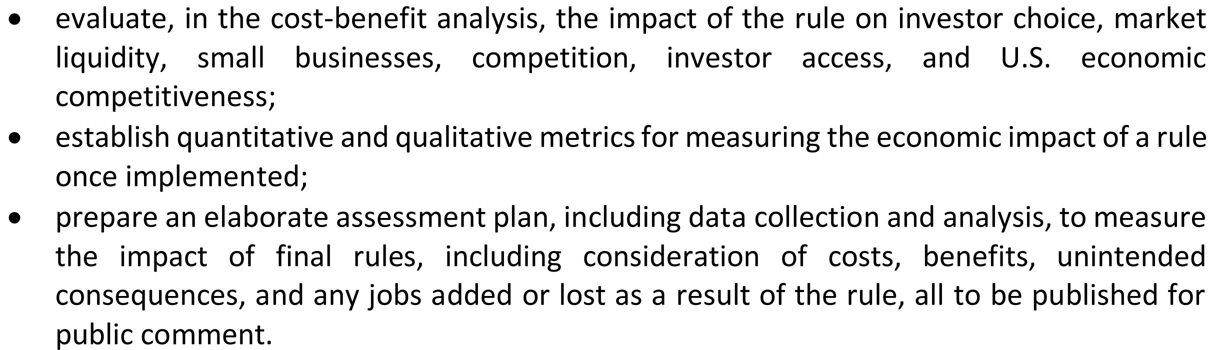
- It drains agency resources by mandating the laborious process of economic analysis by scores of economists.
- It slows the rulemaking process through extremely time-consuming analysis.
- It sets the stage for successful challenges in court due to its inherent imprecision.
- It fosters weaker rules as agencies must anticipate rule challenges in court.

Cost-benefit analysis rests on a false premise. The superficial appeal of cost-benefit analysis is largely based on the false premise that regulation constantly threatens to overburden the financial services industry, stifle innovation, and even harm consumers by reducing their "choices." In fact, history has shown time and time again that such draconian claims are false.

- For example, a century ago, when securities regulation first emerged at the state level, Wall Street railed against it as an "unwarranted" and "revolutionary" attack upon legitimate business that would cause nothing but harm. However, in the years following this early appearance of financial regulation, banks and their profits grew handsomely.
- Similarly bold yet false claims were launched against a long list of important financial reforms, including the federal securities laws, deposit insurance, the Glass-Steagall Act, mutual fund reform, and the national market initiatives of the mid-1970s.
- On the other hand, de-regulation has famously led to financial disaster, from the stock market crash of 1929 to the financial crisis of 2008.

Cost-benefit analysis has been widely deployed as a de-regulatory weapon. Cost-benefit analysis has a long history of use by industry as a weapon to defeat regulation. Through court challenges, executive orders, and attempts to pass innumerable bills in Congress, the financial services industry has fought to entrench rigorous and quantitative cost-benefit analysis at all federal agencies so it can use the record of that analysis to upend rules in court if they are not satisfied with the agency's final product. Throughout this campaign, they have exploited the intuitive yet deceptive appeal of cost-benefit analysis as a reasonable and useful approach to rulemaking. Some of the most heavy-handed, unrealistic, and ultimately damaging requirements that have surfaced in efforts to impose cost-benefit analysis on the financial regulators include the duty to:

- assess all of the quantitative and qualitative costs and benefits of a rule;
- assess all of the costs and benefits of available alternatives to a rule;
- prevent rules unless the agency can determine that the quantified benefits outweigh the costs;
- evaluate whether a rule is tailored to impose the least burden on society, market participants, individuals, and businesses of differing sizes;
- evaluate whether a rule is inconsistent or duplicative of other federal rules;



- evaluate, in the cost-benefit analysis, the impact of the rule on investor choice, market liquidity, small businesses, competition, investor access, and U.S. economic competitiveness;
- establish quantitative and qualitative metrics for measuring the economic impact of a rule once implemented;
- prepare an elaborate assessment plan, including data collection and analysis, to measure the impact of final rules, including consideration of costs, benefits, unintended consequences, and any jobs added or lost as a result of the rule, all to be published for public comment.

If these or similar requirements were actually foisted on the financial regulators, their ability to promulgate new rules would be severely compromised, and virtually every new rule would face a court challenge with an uncertain outcome at best. Investors, markets, and the economy would all suffer.

FOR MORE INFORMATION

- *The Ongoing Use and Abuse of Cost-Benefit Analysis in Financial Regulation,* BETTER MKTS. (Mar. 23, 2023), https://bettermarkets.org/analysis/the-ongoing-use-and-abuse-of-cost-benefit-analysis-in-financial-regulation/.
- *Setting the Record Straight on Cost-Benefit Analysis and Financial Reform at the SEC,* BETTER MKTS. (July 30, 2012), https://bettermarkets.com/sites/default/files/Setting%20The%20Record%20Straight.pdf.

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Better Lives | Better Communities

Better Markets is a public interest 501(c)(3) non-profit based in Washington, DC that advocates for greater transparency, accountability, and oversight in the domestic and global capital and commodity markets, to protect the American Dream of homes, jobs, savings, education, a secure retirement, and a rising standard of living.

Better Markets fights for the economic security, opportunity, and prosperity of the American people by working to enact financial reform, to prevent another financial crash and the diversion of trillions of taxpayer dollars to bailing out the financial system.

By being a counterweight to Wall Street's biggest financial firms through the policymaking and rulemaking process, Better Markets is supporting pragmatic rules and a strong banking and financial system that enables stability, growth, and broad-based prosperity. Better Markets also fights to refocus finance on the real economy, empower the buyside and protect investors and consumers.

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