January 5, 2024

Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Volume-Based Exchange Transaction Pricing for NMS Stocks (File Number S7-18-23); 88 Fed. Reg. 76282 (Nov. 6, 2023)

Dear Ms. Countryman:

Better Markets[1] appreciates the opportunity to comment on the above-captioned Proposed Rule ("Proposal" or "Release")[2] that would prohibit national securities exchanges from offering volume-based transaction pricing in connection with the execution of agency-related orders in NMS stocks. The use of volume-based transaction pricing harms competition by preventing smaller exchanges from competing with larger exchanges and by preventing smaller brokers from competing with larger brokers. Because the rules of a national securities exchange must not permit unfair discrimination between brokers and must not impose any unnecessary or inappropriate burden on competition, the Proposal is a necessary measure to bring exchange pricing models into compliance with the law and to foster competition in the markets.

Competition both among exchanges and among brokers is essential for investor protection. Exchanges that need not compete for order flow "can charge high fees for each transaction."[3] And brokers that need not compete for customer orders can "undermine investor choice."[4] Investors "have varied preferences regarding how they wish to trade,"[5] but investors may not be able to trade in their preferred manner if large brokers are able to take advantage of preferential pricing to curtail the ability of smaller brokers to compete and therefore offer investors more choices. As a result, "[r]egulatory policy has also sought to solve the problem of investor choice by encouraging the creation of multiple exchanges."[6] "Without a few competing venues, there would be little incentive for dominant exchanges to reduce their prices or to create conditions that offer varied

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1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

2 88 Fed. Reg. 76,282 (Nov. 6, 2023).

3 Yesha Yadav, *Oversight Failure in Securities Markets*, 104 CORNELL L. REV. 1799, 1829 (2019).

4 *Id.*

5 *Id.* at 1829-30.

6 *Id.* at 1832.

services to investors."[7] For this reason, "SEC rulemaking has deliberately favored competition as a policy preference in market design."[8] The Proposal similarly favors competition.

BACKGROUND

National securities exchanges offer members lower fees or higher rebates as the number of shares the member executes on the exchange reaches successively higher levels.[9] This volume-based pricing raises competitive concerns among exchanges and among exchange members.[10] With respect to competition among exchanges, an exchange's volume-based pricing is designed to entice members to route orders to that exchange over other exchanges by lowering fees or increasing rebates as the member reaches certain volume thresholds.[11] So other exchanges that do not already have a significant percentage of the member's order flow may not be able to compete for the member's remaining order flow as it will not be able to offer competitive pricing.[12]

With respect to competition among exchange members, members with lower exchange volume will not qualify for the more favorable pricing available to higher volume members.[13] The gap in transaction pricing between base fees and rebates and top-tier fees and rebates can make it more difficult for new and lower-volume members to offer competitive pricing to their customers.[14] These lower volume members may find it difficult to compete for customer order flow because they will be unable to pass through to customers the favorable exchange pricing available to bigger brokers.[15] Volume-based pricing confers a substantial benefit on an exchange's highest volume members.[16] Without that benefit, lower volume members may be unable to compete with higher volume members for the order flow volume necessary to reach the higher tiers.[17]

The inability of lower volume members to obtain the favorable pricing available to higher volume members can create a cycle that stifles competition even further. Lower volume members may seek to route some or all of their order flow through higher volume members to qualify for better exchange pricing.[18] Lower volume members thus become the customers of the higher volume members with whom they are supposed to be competing for customer order flow. This dynamic leads to order flow becoming increasingly concentrated among a small number of higher

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7 *Id.*
8 *Id.*
9 Release at 76,284.
10 *Id.*
11 *Id.* at 76,288.
12 *Id.*
13 *Id.* at 76,284.
14 *Id.* at 76,287.
15 *Id.* at 76,284.
16 *Id.* at 76,285.
17 *Id.*
18 *Id.* at 76,284.

volume members, who then qualify for even better pricing as a result of their ever-increasing volume.[19] That further solidifies and perpetuates their advantage over the smaller members.

The incentive to route orders to a particular exchange in order to qualify for that exchange's advantageous volume-based pricing also harms customers. The economic incentive to route customer orders to a particular exchange to achieve volume tiers on that specific exchange can present a conflict of interest between members and customers when members do not fully pass through the favorable exchange pricing to their customers and instead retain the benefits of that pricing for themselves.[20] The broker may be induced to route order flow to an exchange not because it offers the best execution quality for the customer but because it benefits the broker to route the order to the exchange that offers the broker more favorable pricing than other exchanges.

In this respect, the economic incentives that volume-based pricing present may exacerbate the ever-present conflict of interest that members face between routing order flow in a manner that best serves their customers' interests or best serves their own interests at the expense of inferior executions.[21] Volume-based pricing may incentivize members to route customer order flow to certain exchanges for the purpose of reaching volume thresholds and achieving preferential pricing, which may harm customers if it comes at the expense of execution quality.[22]

SUMMARY OF THE PROPOSAL

The Proposal has three main components:

- First, the Proposal would prohibit equities exchanges from offering volume-based exchange transaction pricing in connection with the execution of agency or riskless principal orders in NMS stocks. The Proposal would not prohibit exchanges from offering volume-based pricing for member proprietary volume where the member is trading solely for its own account and not in connection with filling an order for a customer.[23]

- Second, the Proposal would require equities exchanges that have volume-based pricing for member proprietary volume to adopt rules to require members to engage

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19 *Id.*

20 *Id.* at 76,285.

21 *Id.* at 76,288.

22 *Id.*

23 *Id.* The Proposal would define a riskless principal transaction to mean "a transaction in 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." *Id.* at 76,289. Like agency orders, riskless principal orders are a way for a member to fill a customer's order. *Id.* at 76,290. Because orders executed in the capacity of agent and riskless principal both are done to file a customer order, the Proposal treats riskless principal orders the same as agency orders for purposes of the proposed rule. *Id.*

in practices that facilitate the exchange's ability to comply with the prohibition on volume-based pricing in connection with the execution of agency orders. Exchanges would also have to enforce written policies and procedures that are reasonably designed to detect and deter members from receiving volume-based pricing in connection with the execution of agency orders.[24]

- Third, the Proposal would require equities exchanges that have volume-based pricing for member proprietary volume to submit electronically to the Commission disclosures of the number of members that qualify for their volume-based pricing.[25]

COMMENTS

I. The Commission should adopt the Proposal to prevent volume-based pricing from stifling competition among exchanges and among exchange members.

The Commission should adopt the Proposal so that existing exchanges cannot impede competition by using volume-based discounts to capture order flow that might otherwise go to other exchanges and so that higher volume members cannot take advantage of volume-based discounts to obtain customer orders that might otherwise go to other brokers. The Securities Exchange Act of 1934 provides that the rules of a national securities exchange must "provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities."[26] It provides further that the rules must not be "designed to permit unfair discrimination between customers, issuers, brokers, or dealers."[27] And it provides that the rules must not "impose any burden on competition not necessary or appropriate in furtherance of the purposes of" the Exchange Act.[28] One of the purposes of the Exchange Act is to ensure "fair competition among brokers and dealers" and "among exchange markets."[29] The Proposal ensures fair competition among exchange markets and among brokers and dealers by preventing exchanges from using volume-based pricing to stifle competition.

A. Volume-based discounts act as a barrier to entry for competing exchanges.

Volume-based discounts stifle competition by allowing established exchanges to offer preferential pricing to their existing customers so long as those customers send the exchanges an increasingly large volume of order flow. This preferential pricing prevents newer or less established exchanges from obtaining the customer order flow necessary to grow their businesses. Volume-based discounts therefore present a barrier to entry for competing exchanges.

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24 *Id*. at 76,288.
25 *Id.* at 76,289.
26 15 U.S.C. § 78f(b)(4).
27 15 U.S.C. § 78f(b)(5).
28 15 U.S.C. § 78f(b)(8).
29 15 U.S.C. § 78k-1(a)(1)(C)(ii).

The impact that volume-based discounts have on the competitiveness of a market cannot be disputed. Volume-based discounts "have the potential to harm the competitiveness of a market by requiring entry on a large scale or preventing smaller rivals from reaching economies of scale that would permit them to act as a meaningful constraint on a dominant incumbent."[30] A seller that faces competition may capture sales by offering volume-based discounts.[31] Volume discounts "nudge customers to commit, to the detriment of rivals." [32] The increased sales that result "come at least in part at the expense of its rivals" such that rivals faced "with declining sales or an inability to penetrate the market" may be unable to compete.[33] Locking in customers "preserves market share as well as thwarts the new entrant."[34] So volume discounts "may be employed by a dominant firm to pursue anticompetitive exclusion."[35]

The Proposal is designed to prevent this exact scenario in the context of exchanges. Exchanges use volume-based discounts to capture order flow that might otherwise go to competitors. The exchanges use volume-based discounts to incentivize customers to continue directing their order flow to them rather than other exchanges.[36] Absent volume-based discounts, brokers might direct their order flow to competing exchanges.[37] So exchanges, particularly those with members with a high volume of order flow, employ volume discounts to prevent the loss of order flow to other trading venues.[38] The Proposal ensures that all exchanges are able to compete for order flow regardless of the volume of order flow that members send.

B. Volume-based discounts prevent discrimination against smaller brokers.

The Proposal also ensures that exchanges do not discriminate against smaller brokers. The preferential pricing that results from volume-based discounts prevents smaller brokers from competing with larger brokers for customer orders because they will not be able to pass on the savings from volume-based discounts to their customers. So the Proposal fosters competition by preventing smaller brokers from being unable to offer their customers competitive pricing.

In addition to promoting competition among brokers for customer business, the Proposal's prohibition on volume-based pricing for agency orders is also intended to mitigate the conflict of interest between brokers and customers that volume-based pricing exacerbates. This conflict exists by virtue of the fact that a broker may benefit from its choice of exchange venue execution for

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30 Daniel A. Crane, *Optimizing Private Antitrust Enforcement*, 63 VAND. L. REV. 675, 709 (2010).

31 Roger D. Blair and Thomas Knight, *Bundled Discounts, Loyalty Discounts, and Antitrust Policy*, 16 RUTGERS BUS. L. REV. 123, 125 (2020).

32 Rafi Mohammed, *When It's Wise to Offer Voume Discounts,* HARV. BUS. REV. (Oct. 25, 2023), https://hbr.org/2013/10/when-it-is-wise-to-offer-volume-discounts.

33 Blair and Knight, supra note 31, at 125.

34 Mohammed, supra note 32.

35 Blair and Knight, supra note 31, at 124.

36 *See* Mohammed, supra note 32 (stating that volume discounts incentivize customers to place more or larger orders).

37 Release at 76,300.

38 *Id*.

customer orders. The proposed rule would eliminate the incentive for a member to route a customer order to a particular exchange in order to reach a threshold to qualify for preferential pricing when doing so might not be in the customer's interest.[39]

In this regard, the Proposal further incentivizes brokers to fulfill their duty of best execution to their customers. The duty of best execution "requires a broker-dealer to execute customers' trades at the most favorable terms reasonably available under the circumstances, and customers benefit from broker-dealers' robust considerations of execution opportunities that may provide customers with the most favorable terms."[40] So "promoting the best execution of customer orders is of fundamental importance to investors and the markets, and is an important aspect of investor protection."[41] However, practices such as payment for order flow (PFOF) force brokers to choose "between accepting PFOF and faithfully exercising their duty of best execution."[42] The Commission's proposed Regulation Best Execution should be adopted as a means to curb the use of PFOF. Similarly, the Proposal should be adopted as a means of curbing the use of volume-based pricing so that brokers fulfill their duty of best execution and obtain the best execution for their customers.

II. The Commission should reject the objections to the Proposal that have been raised.

One objection to the Proposal that has already been raised is that volume-based pricing "is ubiquitous" in both the securities industry and "countless other industries around the world."[43] But the fact that the practice may be ubiquitous in the securities industry does not mean it is meritorious or consistent with the law. And the fact that the practice may be ubiquitous in other industries is irrelevant. As discussed above, the securities laws require that the rules of an exchange provide for the equitable allocation of reasonable dues, fees, and other charges among exchange members; not permit unfair discrimination between customers, issuers, brokers, or dealers; and not impose unnecessary or inappropriate burdens on competition. Thus, members of the securities industry must comply with statutory mandates that do not apply to other industries. The Proposal brings exchange pricing structures into greater alignment with these statutory mandates and it should be adopted regardless of whether other industries use volume-based pricing.

Another objection is that the Proposal "differs from other recent SEC proposals related to equities, which have been designed to encourage routing orders to exchanges."[44] Under this view,

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39 Release at 76,290.

40 *Regulation Best Execution*, 88 Fed. Reg. 5440, 5441 (Jan. 27, 2023).

41 *Id.*

42 Better Markets, Comment Letter re: Regulation Best Execution (Mar. 31, 2023), https://bettermarkets.org/wp-content/uploads/2023/03/Better_Markets_Comment_Letter_SEC_Regulation_Best_Execution.pdf, at 9.

43 Nasdaq, Inc., Comment Letter re: Volume-Based Pricing for NMS Stocks (Dec. 20, 2023), https://www.sec.gov/comments/s7-18-23/s71823-319639-830942.pdf, at 1.

44 Charlie Sommers, Andrew Blake, and Michael Ogershok, Volume-Based Transaction Pricing Proposal Raises Questions, Law360 (Dec. 19, 2023),

because the Commission recognizes that the Proposal *could* reduce incentives to route orders to some exchanges by increasing the relative cost of executing on an exchange, the Proposal is not intended to encourage exchange trading.[45] It is true that other proposed rules aim to reverse the trend of routing orders to off-exchange wholesalers rather than to exchanges.[46] But the Proposal is not inconsistent with those proposed rules. Rather, the Proposal aims to make trading on the exchanges more competitive, which should ultimately increase the attractiveness of exchanges.

Finally, some commenters question whether the rule will enable smaller brokers to compete with larger brokers. According to them, many smaller brokers currently route their orders through larger brokers to obtain the preferential pricing available to larger brokers as a result of their volume-based discounts and may not invest the resources necessary "to support a broader customer business that might migrate from larger broker-dealers to smaller broker-dealers."[47] But the fact that smaller brokers currently route their orders through larger brokers to obtain preferential pricing is exactly the type of problem that the Proposal seeks to address. The Commission recognized that when smaller brokers route their orders through larger brokers rather than to the exchanges, the resulting concentration of customer order flow "impacts customers by reducing the number of exchange members capable of offering them competitive exchange transaction pricing."[48] So the Commission was "concerned that volume-based exchange transaction pricing may have the effect of ensuring that high-volume members retain a persistent competitive advantage over lower-volume exchange members."[49] The Proposal aims to eliminate this competitive advantage, and the fact that smaller brokers face other obstacles to growing their business to compete with larger brokers is not a reason to allow this advantage to persist and harm smaller brokers and customers.

III. The Commission should consider expanding the Proposal to cover proprietary trading and trading on off-exchange venues such as alternative trading systems ("ATSs").

As discussed above, the Proposal would continue to allow exchanges to offer volume-based pricing in connection with members' proprietary trades. Although the Proposal's prohibition on volume-based pricing for agency orders would be beneficial for competition and the markets,

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45 *Id.*; *see also* Nasdaq, supra note 43, at 2 (stating that because the SEC has recognized the need to reverse the trend of order routing to off-exchange venues, and the Proposal could raise some costs for brokers that currently take advantage of volume-based discounts, the Proposal "is irrational").

46 Better Markets, Comment Letter re: Regulation Best Execution, supra note 42, at 6.

47 Sommers, Blake, and Ogershok, supra note 44; *see also* Nasdaq, supra note 43, at 2 (stating that the Proposal "may leave brokers worse off than they are now" because small- and medium-sized brokers "currently rely upon arrangements with larger brokers to access better pricing and technology infrastructure").

48 Release at 76,284.

49 *Id.*

proprietary trading represents a large amount of members' trading volume. As a result, to maximize the competitive benefits of the Proposal, the Commission should consider prohibiting volume-based pricing in connection with members' proprietary trades in the final rule as well.

The Proposal also applies only to trading on national securities exchanges. However, a large percentage of trading today occurs on off-exchange venues such as ATSs. As a result, the Commission should also consider expanding the Proposal to prohibit volume-based pricing on off-exchanges venues such as ATSs, so that ATSs and exchanges are on equal footing in that respect.

CONCLUSION

We hope these comments are helpful as the Commission finalizes the Proposal.

Sincerely,

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