

November 16, 2022

Via Electronic Mail

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

Re: Transaction Pricing Practices

Dear Chair Gensler:

The Healthy Markets Association (“HMA”)¹ appreciates the opportunity to supplement our thoughts on potential reforms to routing incentives and transaction pricing fees. Ending inequitable, discriminatory, and anti-competitive pricing practices by exchanges that disadvantage most market participants to benefit the largest banks and market makers should be one of the Commission’s top priorities in its anticipated equity market structure modernization package.

To promote fair, orderly and efficient markets, as well as better protect investors, we recommend the Commission:

1. Ensure that all transaction pricing is known and assessed at the time of the routing decision, and disclosed (including to investors) with the trade confirmation;
2. Ensure that all pricing tiers (i.e., incentive payments or fee levels) are based upon the characteristics of the orders themselves (i.e., whether taking liquidity or not, whether a limit order, etc.), as opposed to the characteristics of the parties sending the orders (i.e., aggregate volumes of the firms sending the orders);
3. Ensure that the details of all pricing tiers, including numbers of transactions, firms who qualified, and dollars paid for each tier are publicly disclosed on a monthly basis; and
4. Prohibit brokers acting as agents from considering payments received or fees charged to them (i.e., that are not passed through to their customers) when making routing decisions.²

¹HMA is a not-for-profit member organization of public pension funds, investment advisers, broker-dealers, exchanges, and market data firms focused on reducing conflicts of interest and improving the transparency, efficiency, and fairness of the capital markets. To learn more about HMA or our members, please see our website at <http://healthymarkets.org/about>.

² This may be best addressed as part of separately-adopted rules and guidance regarding brokers’ best execution obligations.

Fee and rebate levels that are determined based upon the characteristics of the party sending the order (such as aggregate volume-based pricing tiers), as opposed to the characteristics of the order sent, are generally inconsistent with the law and public policy, and should be prohibited. HMA would be deeply concerned with any continuation of customer-specific (as opposed to order-specific) variable pricing by exchanges.

To the extent that the Commission may continue to permit exchanges to vary pricing based upon the characteristics of the parties sending orders, we question how the Commission would be able to justify them as both (1) consistent with the Exchange Act and (2) not arbitrary and capricious.

We recognize that the Commission has, since the implementation of Regulation NMS, permitted exchanges to explicitly favor very large volume traders at the expense of others through the passive acceptance of an ever-expanding list of fee and rebate tiers.³ On some exchanges, a single firm may enjoy rebates that are ten, twenty, thirty percent or more than the rebate that many other customers would receive for the exact same orders. How is that an “equitable”, “non-discriminatory,” or not an “undue burden on competition”, which is what the Exchange Act demands?

The Commission has never publicly justified or reconciled the facial inconsistency between these customer-based pricing tiers and the law. It must. As the Commission is currently learning in the area of digital assets, its failure to aggressively enforce the law has profound impacts on the capital markets and investors. Moreover, the Commission’s failure to fulfill its responsibility to enforce the law years ago does not justify continuing to do so now.

Lastly, we recognize that the Commission may wish to go further to address brokers’ conflicts of interest in order routing. One way that this could be accomplished would be to ensure investors engaging brokers in an agency capacity could opt to have fees and rebates passed back to them.⁴

³ For the first time in history, the Commission staff recently permitted an exchange to offer preferential pricing to market data services, based upon the customers’ aggregate trading volumes. In the past, the Commission had rejected such proposals as inconsistent with the law and public policy. See, e.g., *Order Disapproving a Proposed Rule Change to Link Market Data Fees and Transaction Execution Fees*, SEC, Exch. Act Rel. No. 65362; Sep 21, 2011, available at <https://www.sec.gov/rules/sro/nasdaq/2011/34-65362.pdf>. The Commission has not attempted to justify its changed position.

⁴ While this solution could eliminate the conflicts of interest of agents, it would not address the competitive distortions created by different pricing levels. Further, implementation could be challenging for investors who may have different customers and funds aggregated for multiple order executions spanning different times and venues. In particular, investment advisers may need regulatory relief to ensure that they may aggregate and allocate any incentives or fees that would be passed through to them appropriately across different customer accounts and funds. Further, if this principal versus agent distinction is made, the Commission should include “riskless principal” trades as “agent” trades to reduce complexities and potential gaming risks.

Background on SEC Review of Exchange Rule Proposals

The Commission is obligated to review SRO filings and determine that those filings are consistent with the Exchange Act,⁵ including that an exchange's rules:

- “provide for the equitable allocation of reasonable dues, fees, and other charges;”⁶
- not be “designed to permit unfair discrimination”;⁷
- “not impose any burden on competition not necessary or appropriate in furtherance of the purposes of” the Act;⁸ and
- be designed “to protect investors and the public interest.”⁹

Making these findings is not an easy task. There are well over one thousand self-regulatory organization filings each year. Many of these filings are extremely complex. Many receive no public comment. Many are immediately effective upon filing, and many are approved without any public findings by the Commission. A significant portion of these filings do not contain sufficient information to make the determinations. Many include boilerplate language that has been recycled from filing to filing. Many contain typographical errors.

Nevertheless, the difficulty in wading through the massive volume of filings does not relieve the Commission of its legal obligation.¹⁰ The Commission must review all exchange filings, including those related to market data, connectivity costs, and transaction fees and rebates.

⁵ See *Susquehanna Int'l Grp., LLP v. SEC*, 866 F.3d 442 (D.C. Cir. 2017) (“The SEC “shall approve” a self regulatory organization’s proposed rule change only “if it finds that such proposed rule change is consistent with” provisions of the Exchange Act.”). *Accord*, Remarks of Brett Redfearn, SEC, before the SEC Roundtable and Market Access and Market Data, Oct. 26, 2018, *available at* <https://www.sec.gov/news/public-statement/statement-redfearn-102518> (declaring that in order for the Commission to “meet our obligations under the Exchange Act, we also need to ensure that the fees that are being charged for such important market services are fair and reasonable, not unreasonably discriminatory, and do not impose an undue or inappropriate burden on competition.”).

⁶ 15 U.S.C. § 78f(b)(4).

⁷ 15 U.S.C. § 78f(b)(5).

⁸ 15 U.S.C. § 78f(b)(8).

⁹ 15 U.S.C. § 78f(b)(5).

¹⁰ *Susquehanna Int'l Grp., LLP v. SEC*, 866 F.3d 442 (D.C. Cir. 2017) (“We do not reach them because, as Petitioners also argue, the SEC’s Order approving the Plan fails in a more basic respect: the Commission did not itself “find[]” or “determin[e],” that the Plan met any of those requirements. Instead, the SEC effectively abdicated that responsibility...” (citations omitted)).

Background on Exchange Pricing Tiers

Variable transaction pricing tiers are common across exchanges, where they serve as powerful incentives for brokers and market makers to route orders to particular venues.

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The Commission is well aware of concerns that these pricing tiers, whether for incentives paid or fees assessed by trading venues, may distort how brokers route orders for their customers. Whether retail brokers or institutional brokers, order routing incentives may skew their decision-making. In 2014, a TD Ameritrade executive testified that his firm virtually always routed its customers' orders to market makers that paid his firm the most. Similarly, institutional investors have spent over a decade raising concerns that their brokers were routing orders to exchanges based on those brokers' economics, as opposed to what may be best for those brokers' customers.

The inherent conflict of interest created by different pricing tiers may also impact how brokers treat their own customers in a way that isn't quite as transparent as simply chasing the higher rebate or lower fee venue. For example, a broker with a less-sophisticated customer may send orders to a venue so that the firm would reach a certain tier threshold, despite the broker's awareness that executions on that venue may result in inferior execution outcomes to investors. However, the same broker, if faced with the same order from a more-sophisticated customer, may not. Put simply, brokers in an environment rife with conflicts of interest posed by routing incentives are constantly tempted to forsake their duty of best execution for their customer in pursuit of greater revenues for themselves.

But there is also an important side effect of this competition for order flow: the competition between different brokers and trading firms. To the extent that different competitors fall into different pricing tiers, it will directly impact the competitive balance between those firms.¹² As a result, pricing tiers not only impact the competition between venues for execution, but also the competition between brokers and other market participants.

Despite the Exchange Act's mandate that exchange fees be reasonable, equitably allocated, not be unfairly discriminatory, and not lead to undue burdens on competition, each firm is subject to whatever rate it can convince an exchange (presumably for

¹¹ We do not urge the Commission to simply mandate one pricing tier for each exchange.

¹² Remarks of Joe Wald, Clearpool Group, before the SEC Roundtable on Market Access and Market Data, Oct. 25, 2018, Transcript at 198, *available at* <https://www.sec.gov/spotlight/equity-market-structure-roundtables/roundtable-market-data-market-access-102518-transcript.pdf>. *Accord*, Remarks of Tyler Gellasch, Healthy Markets Association, before the SEC Roundtable and Market Access and Market Data, Oct. 26, 2018, Transcript at 280-281, *available at* <https://www.sec.gov/spotlight/equity-market-structure-roundtables/roundtable-market-data-market-access-102618-transcript.pdf>.

business reasons) to grant. This is left to the whims of the exchange and the market participants.

Those without market power (e.g., smaller firms or those with less order volume) can generally be expected to obtain the worst deals. Further, over time, as order flow has aggregated to the largest firms, this has increased their ability to garner for themselves even better rates; further expanding the gap between themselves and the smaller firms. Today, we observe that some exchanges have adopted rebates for their highest volume customers at levels that exceed the permissible fee caps, essentially ensuring that the exchanges lose money on those transactions. At times, it appears as though some exchanges have explicitly negotiated “bespoke” pricing tiers with individual firms, and customized them so that no other firm would be positioned to access those tiers.

In practice, we see that pricing tiers serve as a one-two punch against fair competition between firms who route orders to the exchange--and a powerful force for order flow and industry consolidation. The first punch is that pricing tiers -- by design -- offer cheaper trading for larger firms with greater order volumes. This puts smaller firms at a competitive disadvantage on order and execution prices. A smaller firm’s trading costs for any given trade on an exchange may be 30% or more of the costs of a larger competitor--for the exact same trade.

As one smaller broker-dealer told the Commission in 2018, the interactions between market data costs and pricing tiers combine to create significant barriers to entry and disadvantages for smaller firms

First, is there a disproportionate impact of the current market data and market access regime on smaller broker-dealers and does this act as a barrier of entry to innovation? From what we have experienced, through the high costs for market data and the complex and opaque tiering structure established by the exchanges for transactional fees, smaller broker-dealers end up subsidizing many of the costs for larger firms.

In fact, this disproportionate impact of pricing tiers on different market participants was expressly highlighted to the Commission by the President and COO of Cboe Global Markets, who explained that:

This is just our top 10 firms across our four exchanges by market share. So presumably, they're making a lot of money, given the size of their market share. There are four investment banks and six HFTs. Five out of the top 10 get a check from us after the costs of their connectivity and market data. So we are cutting them a check monthly after their costs.

...

[At the same time, the] top 10 firms on our exchange eat up 50 percent of the capacity on our exchanges.¹³

If the top 10 firms comprise more than half the volume, and half of them are getting checks at the end of the month, who's actually paying for the exchange operations (and the checks to the largest volume traders)?

In many instances, we know of exchange pricing tiers, including those offered by NYSE or MEMX, where the rebates paid may exceed the fees taken in on the other side of the trade. To whom are those rebates being paid? None of those details are known. Who is subsidizing their trading (and paying the exchanges' operating costs)? Again, those details are unknown. In fact, even the number of pricing tiers is unknown, much less who qualifies for them. However, given the public statements of exchange executives, we suspect that it is not smaller volume traders.¹⁴

Put simply, some of the largest volume traders may be trading at dramatically reduced costs--or even for a profit--while smaller customers may pay significant sums for the exact same trade execution. This seems to be the opposite of an equitable allocation of reasonable fees, dues and charges.

Second, several larger trading firms will then use their lower rates to attract greater order flow--consolidating order flow at the largest trading firms. For example, below as Figure 1 is an excerpt from a pricing sheet from one large bank broker-dealer that is a few years old.

FIGURE 1: Broker A Exchange Pricing

	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)

Similarly, Figure 2 is another "price sheet" from another broker-dealer from around the same time period. Interestingly, the email enclosing Figure 2 noted the "tier improvement" to reflect Broker B had negotiated better rates.

Figure 2: Broker B Exchange Pricing

¹³ 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>.

¹⁴ Concannon, at 74-75.

Description	Current Rate	New Rate
NASDAQ Make non-NBBO	-0.00295	-0.00305
NASDAQ Make NBBO	-0.0031	-0.00315
NASDAQ MidPoint	-0.0014	-0.0017
EDGA Make	0.0005	0.0003
Arca Make Tape A	-0.0029	-0.0032
Arca Make Tape B	-0.0022	-0.0025
Arca Make Tape C	-0.0029	-0.0032

These private advertising sheets, and many others like them, are often used by those who negotiate customized beneficial tiers to solicit greater order flow from other, likely smaller, brokers who are unable to negotiate the better rates.

The ability to negotiate a better pricing tier with an exchange or set of exchanges has become a point of competition among brokers--leading to unfair and anti-competitive practices. As we have previously articulated to the Commission:

In recent years, the number of brokers has declined. These economics may have nothing to do with the quality of service the smaller brokers provide, but rather their abilities to qualify for what are essentially volume discounts--notwithstanding the facts that the discount providers (the exchanges) are obligated by the Exchange Act to not discriminate between customers.¹⁵

Various pricing tiers create facially discriminatory pricing practices for exchanges, and may create significant market distortions. For example, larger brokers often have very different pricing tiers, and thus dramatically different costs and revenues, than smaller brokers on the same exchange for what would otherwise be the same order.

Lastly, currently, many of the pricing tiers are based on characteristics of the party sending the orders to the trading venue. One common practice is to base fee and rebate levels on the aggregated trading volumes of the party sending the order on a monthly basis. This means that larger volume traders often have lower fees and higher rebates than smaller volume customers.

Moreover, these volumes are often assessed retroactively. This means that a broker may not know the transaction rebate or fee that will be assessed on a trade at the time it makes an order routing decision, and instead won't learn that information until days or weeks later. This precludes the broker from disclosing this information to its customer at the time of the trade, which, in turn, precludes many institutional investors from

¹⁵ Letter from Tyler Gellasch, Healthy Markets Association, to Brent J. Fields, SEC, at 22, May 24, 2018, available at <https://www.sec.gov/comments/s7-05-18/s70518-3704495-162465.pdf>.

effectively negotiating to eliminate the conflict of interest through adopting “cost plus” relationships with their brokers.

Recommended Pricing Tier Parameters

At root, any effort to address the market distortions imposed by variable pricing tiers should address two distinct problems: (1) harm to investors arising from their brokers’ conflicted order routing incentives, and (2) harm to smaller brokers and investors by impeding fair competition in broker services.

In that vein, we recommend the Commission adopt the following principles:

1. Ensure that all transaction pricing is known, disclosed, and assessed at the time of the trade;¹⁶
2. Ensure that all pricing tiers (i.e., incentive payments or fee levels) are based upon the characteristics of the orders themselves, as opposed to the characteristics of the parties sending the orders;
3. Ensure that the details of all pricing tiers, including numbers of transactions, firms who qualified, and dollars paid for each tier are publicly disclosed on a monthly basis;¹⁷ and
4. Prohibit brokers acting as agents from considering payments received or fees charged to them (i.e., that are not passed through to their customers) when making routing decisions.¹⁸

There should be no aggregated volume-weighted pricing tiers, as they are, by definition, anti-competitive, undue burdens on competition, and inequitable distributions of fees. Again, to the extent that the Commission will continue to permit differential pricing, any transaction pricing distinctions should be dependent upon the order’s characteristics, and not the characteristics of the party sending the order (whether large or small, retail or institutional, or otherwise). The Commission should stop continuing to bless inequitable, discriminatory, and anti-competitive transaction pricing that favors the bulge

¹⁶See, Letter from Tyler Gellasch, HMA, to Hon. Gary Gensler, SEC, Oct. 29, 2021, *available at* <https://www.sec.gov/comments/sr-cboeedga-2021-017/srcboeedga2021017-9360012-261666.pdf>. This would include ensuring that exchange fees and rebates are applied based on past activity, and not future activity, so that they are known at the time of the trade, and can be calculated and reported to the brokers’ customers. This would, in turn, enable many investors, including mutual fund investors, to consider adopting “cost plus” pricing with their brokers, so as to eliminate brokers’ conflicts of interest in order routing.

¹⁷ In the interest of providing the most useful feedback to you, we are supplementing our prior suggestions to provide greater specificity on the precise needs.

¹⁸ As noted above, this limitation could be readily implemented as part of the Commission’s separate consideration of a “best execution” rule. Notably, the existing FINRA Best Execution rule and related guidance assert that brokers cannot allow receipt of incentives to unduly influence their routing decisions. That language is inadequate with respect to incentives, but also does not address fees, which may also improperly influence broker routing decisions.

bracket banks and very large market makers – at the expense of everyone else. They are both inconsistent with the Exchange Act and public policy.

We are aware of no evidence to support claims that discriminatory customer-based pricing by exchanges promotes market efficiency.

If the Commission has robust analysis as to the pricing and impacts of large volume traders promotes efficiency, we haven't seen it. Likewise, we are aware of no academic research suggesting that there is a net increase in market efficiency arising from discriminatory, and often custom-designed pricing tiers.

However, we are aware of many dozens of brokers and other market participants who often receive materially lower rebates or pay materially higher fees per trade than their larger competitors as a direct result of the discriminatory pricing by exchanges that the Commission has passively blessed, despite the law.

We also note that it was only recently that the Commission permitted an exchange – for the first time in modern history – to discriminate the pricing for market data products based on customers' separate aggregated transaction volumes.¹⁹ This Commission's decision to not intervene to stop the aggregated volume based discrimination reversed the Commission's prior policy of rejecting such discrimination as contrary to the Exchange Act.²⁰

We understand that some might be tempted to prohibit aggregated volume-based pricing for brokers acting as agents or in a "riskless principal" capacity, while continuing the discrimination for so-called "proprietary" trades. This would not work. As an initial matter, it would still mean that some proprietary trading firms would be materially disadvantaged versus their larger competitors. Again, the fees would remain facially inequitable, discriminatory, and burdens on competition, in apparent violation of the Exchange Act. Further, the distinction between agency and proprietary trading can be blurred materially by the same market makers and large banks that are the current beneficiaries of the discriminatory pricing. Lastly, regulators have had significant problems ensuring that brokers are properly marking trades for decades. This proposal would create a massive new financial incentive to encourage mis-marking trades.

At least today, smaller agency brokers could route through their larger competitors to split the more advantageous pricing. However, if there were an agency versus principal distinction regarding aggregate volume based pricing, the larger firms would no longer

¹⁹ *Notice of Filing and Immediate Effectiveness of a Proposed Rule Change to Amend its Fees Schedule in Connection with Migration*, SEC, Exch. Act Rel. No. 34-87304, Oct. 15, 2019, available at <https://www.sec.gov/rules/sro/cboe/2019/34-87304.pdf>, (subsequently withdrawn and replaced at least six times). See, *Notice of Filing and Immediate Effectiveness of a Proposed Rule Change to Amend its Fees Schedule in Connection with Migration*, SEC, Exch. Act Rel. No. 34-89826, Sept. 10, 2020, available at <https://www.sec.gov/rules/sro/cboe/2020/34-89826.pdf>.

²⁰ See, e.g., *Order Disapproving a Proposed Rule Change to Link Market Data Fees and Transaction Execution Fees*, SEC, Exch. Act Rel. No. 65362; Sep 21, 2011, available at <https://www.sec.gov/rules/sro/nasdaq/2011/34-65362.pdf>.

be able to split their better pricing with their smaller competitors. As a result, perversely, this approach would very likely exacerbate – not reduce – the competitive advantages of the largest banks and market making firms over all other, smaller, trading firms (both agency brokers and principal traders).

The Commission should consider whether more aggressive protections against brokers' conflicts of interest are warranted, and may wish to prohibit brokers acting as agents²¹ from accepting or keeping any payments for orders they are routing for others. That said, simply prohibiting brokers acting as agents from accepting rebates could well prove to be facially inadequate. To the extent that the Commission makes distinctions between agency and principal trades, it must preclude the former from being considered in the pricing of any goods or services provided by exchanges to trading firms. For example, if a large trading firm executes one million shares on an agency basis and another on behalf of itself, the incentive pricing it receives on the latter, should not, in any way, account for the one million shares of the former. To do otherwise would be to allow for an easy work-around the rule, and dramatically alter the competitive landscape between brokers and proprietary trading firms.

Conclusion

Thank you for the opportunity to offer suggestions on how to address the market distortions created by exchange pricing tiers. Should you have any questions or seek further information please contact me at (202) 909-6138.

Sincerely,



Tyler Gellasch
President and CEO

cc: Hon. Hester Peirce
Hon. Caroline Crenshaw
Hon. Mark Uyeda
Hon. Jaime Lizarraga
Jessica Wachter, Director, Division of Economic and Risk Analysis
Haoxiang Zhu, Director, Division of Trading and Markets

²¹ If the Commission chooses to distinguish between brokers acting on a principal versus agency basis, it should be sure to treat “riskless principal” trades as agency trades.