Securities Regulation Daily Wrap Up, EXCHANGES AND MARKET REGULATION—SEC backs proposal to limit volume-based transaction pricing for NMS stocks, (Oct. 18, 2023)

Securities Regulation Daily Wrap Up

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By Suzanne Cosgrove

Along with prohibiting volume-based pricing for agency-related order flow, the SEC proposal would require exchanges to disclose the number of members that qualify for different pricing tiers.

By a 3-2 vote, the SEC on Wednesday cleared the way for public feedback on a proposed new rule that would prohibit national securities exchanges from offering volume-based transaction pricing in connection with the execution of agency or riskless principal orders in National Market System (NMS) stocks (*Volume-Based Exchange Transaction Pricing for NMS Stocks*, Release No. 34-98766, October 18, 2023).

If exchanges offer volume-based transaction pricing for members' proprietary orders, the proposed rule 6b-1 would compel them to file information monthly on the number of members that qualify for each transaction pricing tier and to create written policies and procedures designed to detect and deter members from receiving volume-based transaction pricing in connection with agency-related orders.

"We have heard from a number of market participants that volume-based transaction pricing along with related market practices raise concerns about competition in the markets," said SEC Chair Gary Gensler in a release. "I am pleased to support this proposal because it will elicit important public feedback on how the Commission can best promote competition amongst equity market participants."

Gensler reminded the commissioners that Congress amended the Exchange Act in 1975 to address anticompetitive practices by market intermediaries. "Congress added the word "competition" to the Exchange Act 20 times" in those provisions, he said.

Broker discrimination. Current exchange rules, the SEC said in its outline of the proposal, may not be sufficiently competitive in line with the Exchange Act's objectives. Through increasingly complex transaction pricing schedules, many exchanges offer their broker-dealer members lower fees or higher rebates when the number of shares the member executes on the exchange reaches higher predefined volume-based tiers. The large number of pricing tiers, and the possible combinations of some tiers, make exchange transaction pricing schedules difficult to understand, the SEC said.

The purpose of the new rule is to level the broker-dealer playing field, which is currently "unlevel," said Gensler. "Mid-sized and smaller broker-dealers effectively pay higher fees than larger brokers to trade on most exchanges. This is because exchanges generally charge brokers net trading fees or pay rebates back to brokers that vary depending on the brokers' trading volume." As a result, brokers with the largest trading volume receive the largest rebates and so pay the lowest net fees.

"Sometimes, large brokers get rebates that are even larger than the fees they paid -- leading to a situation where the exchange actually pays on net large brokers for their order flow," Gensler noted.

Volume-based transaction pricing also allows larger trading firms to offer customers more favorable transaction prices than smaller brokers, Gensler said. "This has contributed to a practice whereby mid-sized or smaller brokers -- in an effort to capture higher rebates -- route their orders through a handful of the largest brokers." The largest brokers are then able to collect a fee for that service and use that volume to qualify for even better tiers for themselves and other customers.

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In addition, some suggest that there might be "information leakage" to the largest brokers due to these routing practices, Gensler said.

Commissioners dissent. SEC Commissioner Mark Uyeda disagreed with the proposed measure and voted against it, along with Commissioner Hester Peirce. "When wholesalers give volume discounts to retailers … they do it because moving items in bulk may be more efficient," he said in a statement. "In competitive markets, customers benefit from these volume discounts."

Further, the proposal excepts proprietary traders, meaning that exchange members who are trading for their own accounts could continue to receive volume-discounts, while those that facilitate transactions of customers could not, Uyeda said.

Also weighing in, Commissioner Peirce said the SEC needs more evidence before taking "the extreme step" of imposing an outright ban on a particular approach to pricing. "An unsubstantiated *fear* that there *could* be problems does not justify adding an onerous and potentially ineffective rule to an already over-prescriptive equity market-structure ruleset," she added.

Exchange Act mandates. Voting in favor of the proposal, Commissioner Jaime Lizárraga said that while volume-based discounts "may be a common feature in the broader world of commerce, current practices under existing exchange rules lack transparency, are anti-competitive, and run counter to the equitable allocation of fees and the prevention of unfair discrimination required by law."

In addition to leveling the playing field, "the prohibition addresses an inherent conflict of interest that exists when a broker-dealer has an incentive to route a customer order to a particular exchange for the broker-dealer's own benefit, at the expense of its customer," Lizárraga said.

As the proposed rule 6b-1 explains, the Exchange Act requires that exchange pricing proposals, among other things, provide for the "equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities" that "are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers."

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