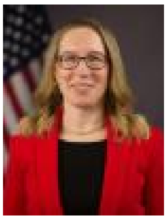
Statement

Ordering Competition



Commissioner Hester M. Peirce

Dec. 14, 2022

Thank you, Mr. Chair. Too often in its history, the SEC has sought to order competition rather than facilitate orderly competition. This latest effort to order competition threatens to create disorder in the capital markets, the functioning of which is so important to the rest of our economy. Accordingly, I cannot support this proposal.

In 1975, after some prodding by the Commission, Congress directed the Commission "to facilitate the establishment of a national market system for securities."[1] Under that directive, we adopted Regulation NMS, including the infamous order protection rule. We are proposing to adopt today's order competition rule under the same authority. Though couched in the language of competition, both override, rather than facilitate, a national market system.

Equity markets are not perfect, but they work quite well now, so changes in regulation must be clearly justified and carefully analyzed. We have not done the work necessary to justify the extensive changes we are considering. The release explains that "Proposed Rule 615 is designed to benefit individual investors by promoting competition and transparency . . . to enhance the opportunity for their orders to receive more favorable prices than they receive in the current market structure" and to allow other investors to interact with retail orders. The proposed rule would replace the common practice of routing individual investors' orders to a few wholesalers who trade with many of these orders bilaterally with a new practice, namely routing them to auctions accessible to the broader market.

The mandatory rewiring of the retail equity markets raises several concerns. First, retail brokers are not choosing among wholesalers on an order-by-order basis, which means that, in the words of the proposal, there is a lack of "contemporaneous competition among wholesalers." Instead, they direct retail order flow to wholesalers based on backwards-looking execution quality reviews. The release suggests that a market with these arrangements is, by definition, not competitive. However, competition need not be order-by-order to be real. We see this phenomenon in other markets. Given the season, consider, for example, my family's long Ohio driveway, which is in frequent need of snowplowing. One option is to sign a snowplow contract for the season. You are not competing out the job every time it snows, but, at the end of the season, you take stock of the reliability, timeliness, price, and quality of the year's snowplowing. The next season, you consider your options—you can hire the same company or look for another. The market is competitive, even though you do not put the job out to bid every time it snows. A phone app allows you to order a snow plowing service on a one-off basis—order-by-order competition—but many customers prefer season-by-season competition, and absent compelling evidence of abuse or conflict, who are we to say they are wrong?.

Second, the Commission's analysis about the forgone price improvement, the so-called "competitive shortfall," ignores the fact that the current market is not static. Although the technological barriers to entry are high, new competitors are entering the market to compete with the largest wholesalers. As new competitors come into the markets, retail orders will likely enjoy even more price improvement than they already do, and wholesalers' profits will fall. If the market for retail order flow is as profitable for wholesalers as the proposing release suggests, we should expect to see more entrants.

Third, although allowing a broader set of market participants to interact with retail order flow is a goal of the proposal, institutional investors may not expend much effort to participate regularly in auctions. The proposed rule would integrate auction responses in a qualified auction with the order book of the trading venue holding the qualified auction, which means that institutional investors with displayed or undisplayed orders resting in the order book also effectively would be participants in the auction. Still, there is no guarantee that any of these orders will be resting on the order book of the particular trading venue holding the auction. Even if wholesalers participate in these auctions, the order-by-order nature of these auctions will allow them to be much more selective about the stocks they want to trade.

Fourth, although the release points to the objective of "minimiz[ing] the transaction costs incurred by individual investors when they use marketable orders" and anticipates annual cost savings of $1.12 billion to $2.35 billion, it instead may increase their costs. The proposal fails to grapple seriously with the possibility that retail customers will pay higher commissions than they do now. The Commission "acknowledg[es] there is substantial uncertainty in the eventual outcome," and notes that "while bidders in qualified auctions may not provide as much consistency as wholesalers, some orders could receive improved execution quality while others would receive reduced execution quality (relative to wholesalers)."

Fifth, even if the problem we are trying to solve is real, the proposed solution could create even bigger problems. It will reroute existing pipes through which retail orders are executed, impose new costs on any firm that handles retail trades, and add new steps to the execution of retail orders. In addition to other detailed prescriptions about auction design and participant behavior, the proposed mandate would come with its own fee caps—another instance of government price setting, the inevitable consequence of routing mandates. Complex undertakings like the one proposed here always have unpredictable effects, and unintended consequences often arise at inconvenient times. Even if the order competition requirement improves execution quality for some retail investors in normal times, we may not be able to anticipate how it will affect liquidity in more volatile market conditions when wholesalers can play an outsized role in providing liquidity and mitigating market volatility.

The Commission has a habit of trying to micromanage the markets, a habit that is on full display today. Absent a compelling justification, government regulation should not override buyers' and sellers' judgments about where to buy and sell. As talented as our staff are, they are not omniscient and omnipresent; any regulator, no matter how sophisticated, lacks the on-the-spot knowledge and the money on the line that motivates market participants to make nuanced choices on a high volume of transactions. Regulation has a role in ensuring that market participants have information and that markets are orderly, but issuing decrees about how each order should be routed is outside of that role.

To return to snowplowing for a moment, when I was growing up, the plowing service was my father. He had rigged up a rickety old truck with a fuel tank balanced precariously on the roof and a plow that did double service as the brakes. One day when he was gone, I had to do the plowing. Dropping the plow to brake is not as easy in practice as it sounds in theory, and I ended up in the ditch. I hope that the Commission's proposal to wrest the reins of the equity markets from the people who live them every day, does not end up similarly driving the equity markets into a ditch. The stakes are a lot higher.

With all that said, I am grateful to the staff in the Division of Trading and Markets who have been working tirelessly to try to make this market-wide experiment that the Commission has ordered up as effective as possible and to minimize its adverse consequences. That job has not been easy, but you have approached it zealously and without complaint. Along with the staff, I am awaiting the invaluable input of commenters who will help us conduct much-needed further analysis of this proposal.

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[1] Securities Exchange Act §11A.