Statement

Statement on Proposed Rule Regarding Order Competition

Commissioner Mark T. Uyeda

Dec. 14, 2022

Thank you, Chair Gensler. In 2005, the Commission adopted Regulation NMS, which promoted competition among venues for stock on the national market system. At that time, the Commission observed, "[c]onsistent with Congressional intent, these stocks are traded simultaneously at a variety of different venues . . . including national securities exchanges, alternative trading systems, and market-making securities dealers."[1] Market-making securities dealers, or wholesalers, are part of a competitive ecosystem in which customers and retail broker-dealers are all attempting to obtain good execution.

Since the adoption of Regulation NMS, the venue competition model has delivered significant benefits for retail investors. Spreads are tighter than ever. The costs of trading commissions have declined dramatically to the point where, today, a number of brokers offer commission-free trading. The elimination of minimum balance requirements, the ability to purchase fractional shares, and the development of user-friendly mobile apps and internet websites have made the markets more accessible to retail investors than at any point in history. Perhaps it is not surprising that Chair Gensler would state, at his confirmation hearing in March 2021, that "I believe our markets are the finest in the world."[2] And I concur with that observation.

What changed, such that the Commission now deems it necessary to upend—rather than simply refine—the existing regulatory structure and replace it with a new regulation that prioritizes, by mandate, order-by-order competition over venue competition? Today, the retailer/wholesaler broker-dealer model tends to provide a better deal for retail investors than those available from competing venues. The proposing release acknowledges that wholesalers do generally provide some price improvement relative to national securities exchanges.[3] So what is the need for the proposed rule, which significantly alters the existing regulatory approach?

The proposal asserts that retail investors would receive a better deal if there was order-by-order competition prior to wholesalers being permitted to execute trades, which is described as a "competitive shortfall." The proposal further asserts that "the current isolation of individual investor orders from order-by-order competition results in <u>suboptimal</u> price improvement for such orders."[4]

Unfortunately, the proposing release attempts to prove that the practices of wholesalers are suboptimal through circular reasoning. Specifically, the proposing release incorrectly claims that "[r]ealized spreads are a proxy for the potential economic profit that liquidity suppliers may earn on a trade."[5] Realized spreads, however, are not a proxy for potential <u>economic</u> profit. Realized spreads merely reflect the revenue received by the wholesaler on the trade after adjusting for adverse selection risk.

"Economic profit" is a term of art that implies a risk-adjusted rate of return over-and-above that which might be earned on other uses of capital and, where present, may be indicative of a lack of competition. Economic profits, however, must also account for the costs of the business. In equating realized spreads with potential economic profits, the proposing release expressly excludes pertinent costs by noting that "realized spreads … do not account for other costs … such as fixed costs for setting up their trading infrastructure and costs for connecting to trading venues and receiving market data."[6]

The proposing release then proceeds from this incorrect premise—that "realized spreads are a proxy for potential economic profit"—to argue that the higher realized spreads earned by wholesalers suggest that the individual investor orders routed to wholesalers result in higher economic profits relative to a venue, like an exchange, where market makers compete on an order-by-order basis.[7]

Here is the circular reasoning: the proposing release argues that the higher economic profits—which have not been demonstrated—are caused by the isolation of orders from order-by-order competition, and therefore order-by-order competition is needed to eliminate the economic profits that have not been demonstrated.

To be sure, the data suggests that realized spreads on trade executions tend to be larger for wholesalers than for exchanges, but exchanges and wholesale market makers are in fundamentally different businesses and their cost structures are not the same. Thus, nothing can be concluded regarding the presence or absence of economic profits from this difference in realized spreads.

This proposal's preference for order-by-order competition over venue competition appears myopic. Tomatoes do not compete in the market for tomatoes—businesses compete with one another to grow, source and provide tomatoes to consumers. This takes resources ranging from tractors to delivery trucks to grocery stores to employees, all enticed to this effort by profits. If there are economic profits to be had, then there should be further competition from new entrants. If revenues are not sufficient to cover costs in the long run, then the industry will exit. This is the very essence of competition. We are not operating in a world of orders seeking orders without some form of intermediation. Orders seeking orders have to find a place to meet. They have to find a venue, which has to make sufficient revenues to cover costs in the long run if the venue is to stay in business.

In the securities markets, orders do not compete; venues compete to facilitate transactions that their clients desire with best execution. Like any competitors in a marketplace, those venues have to make sufficient profits on the resources and infrastructure, which generate both variable and fixed costs, to continue to provide this service. A focus on order-by-order competition, without accounting for the costs of providing the venue that provides this service, may be fine in the theoretical world of academia, but will not work in the real world. The services provided by the retailer/wholesaler model evolved across a period of dynamic competition, with significant benefits to retail investors. This suggests that dynamic venue competition works. Mandating a particular order flow denies to the market the benefits of this competition.

For all of the changes contemplated by the proposal, will mandated order-by-order competition provide a better outcome for retail investors? The Commission simply does not know. It is quite possible that mandating order-by-order competition could result in inferior outcomes for retail investors, harm venue competition, and discourage further innovation, given the rigidity inherent in a mandated structure. Indeed, the new "qualified auctions" may encounter certain market failures that result in retail investors being made worse off in terms of spreads. For example, there may be a "winner's curse" problem in order-by-order auctions that could reduce retail investor welfare.[8]

We know today that there are many different venues through which retail investors can have their trades executed, and that, within the retailer/wholesaler model, retail investors are typically provided a better deal. This disintermediation of traditional brokerage services has been so profound that some have labelled it the "democratization" of investing and has brought the ability to invest in the stock market to millions of Americans.

What are the potential benefits? According to the proposing release, the so-called "competitive shortfall" is about 1 cent per one-hundred dollars traded.[9] But this estimate does not factor in the potential benefits associated with the proposed changes to Rule 605 and the tick size, which are intended to further facilitate competition and reduce realized spreads of wholesalers. Thus, retail investors may not even see a full penny of improvement.

And what are the risks associated with this significant change to the order execution system? What are the unintended negative consequences of the mandate? Are the risks of a negative outcome worth disrupting a current regime that works extraordinarily well? The reason that it may be better to rely on dynamic venue competition as opposed to mandated order flows is that the former allows market participants the opportunity to experiment, and through which the market learns, improves, and continues to increase in efficiency. Indeed, nothing currently prohibits a trading venue from implementing an order-by-order auction mechanism for executing trades. If such a system were superior to the existing framework, the market naturally would respond accordingly.

Given these significant risks and concerns, I am unable to support this proposal. I thank the staff in the Divisions of Trading and Markets and Economic and Risk Analysis as well as the Office of General Counsel for their efforts in working on the complicated issues raised in this proposal.

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[1] Regulation NMS, Release No. 34-51808 (June 9, 2005), available at https://www.sec.gov/rules/final/34-51808.pdf.

[2] Testimony of Gary Gensler before the Senate Committee on Banking, Housing, and Urban Affairs (Mar. 2, 2021), available at https://www.banking.senate.gov/imo/media/doc/Gensler%20Testimony%203-2-21.pdf.

[3] *See* Order Competition Rule, Release No. 34-96495 (“Proposing Release”) (Dec. 14, 2022), at 180, available at https://www.sec.gov/rules/proposed/2022/34-96495.pdf

[4] *Id*. at 9 (emphasis added).

[5] *Id*. at 211

[6] See *id*.

[7] *Id*.

[8] *See* Ernst, Thomas; Spatt, Chester; and Sun, Jian, *Would Order-By-Order Auctions Be Competitive?* (Nov. 23, 2022), available at SSRN: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4300505.

[9] Proposing Release, supra note 3, at 260.