

March 31, 2023

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

Re: *File No. S7-31-22*
Order Competition Rule

Dear Ms. Countryman:

My name is Jennifer Schulp, and I am the director of financial regulation studies at the Cato Institute's Center for Monetary and Financial Alternatives. I appreciate the opportunity to comment on the Securities and Exchange Commission's proposed "Order Competition Rule," which "prohibit[s] a restricted competition trading center from internally executing certain orders of individual investors at a price unless the orders are first exposed to competition at that price in a qualified auction operated by an open competition trading center."¹ The Cato Institute is a public policy research organization dedicated to the principles of individual liberty, limited government, free markets, and peace, and the Center for Monetary and Financial Alternatives focuses on identifying, studying, and promoting alternatives to centralized, bureaucratic, and discretionary financial regulatory systems. The opinions I express here are my own.

The Commission should withdraw this proposed rule. The proposal, which Chair Gary Gensler describes as requiring marketable orders of individual investors "to be exposed to competition on an order-by-order basis in qualified auctions,"² seeks to micromanage order routing in equities markets under the guise of promoting "a more competitive, transparent, and efficient market structure for NMS [National Market System] stocks, with resulting benefits to

¹ Notice of Proposed Rule ("Notice"), "Order Competition Rule," SEC Release No. 34-96495; File No. S7-31-22 at 1, available at <https://www.sec.gov/rules/proposed/2022/34-96495.pdf>.

² Gary Gensler, "Statement on Proposal to Enhance Order Competition," Statement (December 14, 2022), available at <https://www.sec.gov/news/statement/gensler-order-competition-20221214>.

investors.”³ By micromanaging order routing, however, this proposed rule is, itself, anticompetitive and may harm, rather than benefit, retail investors.

Section 11A of the Securities Exchange Act sets forth objectives for the Commission to facilitate a National Market System, including the “economically efficient execution of securities transactions,” and “fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets.”⁴ The statute, however, does not define what is meant by efficiency or competition.

Contrary to this proposal’s suggestion that competition requires order-by-order competition, competition often occurs in our securities markets at the level of the trading venue.⁵ This proposal, however, treats such competition as disfavored,⁶ and somewhat confusingly downplays the dynamic nature of venue-level competition at the same time the Commission proposes rule changes, such as its Best Execution rule proposal,⁷ aimed at fine-tuning broker obligations under such competition.

Importantly, by directing order routing and micromanaging the method by which retail orders interact, this proposal does not present a different view of competition, rather it is anticompetitive. The Commission recognizes that “there would likely be significant competitive effects associated with the introduction of qualified auctions.”⁸ While the Commission seems to believe that these anticompetitive effects are positive, “transferr[ing] revenue and profit from wholesalers to other market participants” and “weaken[ing] the competitive positions of retail brokers that are dependent on [payment for order flow],”⁹ the Commission’s substitution of its own judgement in place of the results of existing competition is anathema to the Exchange Act’s support for competitive marketplaces. This rule proposal will privilege exchanges qualified to support auctions (which is strictly limited by the restrictions in the proposal),¹⁰ prohibit

³ Notice at 5.

⁴ 15 U.S.C. § 78k-1(a)(1)(C).

⁵ See Hester M. Peirce, “Ordering Competition,” Statement (December 14, 2022), available at <https://www.sec.gov/news/statement/peirce-order-competition-20221214>; Mark T. Uyeda, “Statement on Proposed Rule Regarding Order Competition,” Statement (December 14, 2022), available at <https://www.sec.gov/news/statement/uyeda-order-competition-20221214>.

⁶ See Notice at 70 (“[t]he purpose of the order competition requirement is to expose segmented orders to competition to provide the best prices on an order-by-order basis and thereby minimize the transaction costs incurred by individual investors when they use marketable orders”).

⁷ Notice of Proposed Rule (“Best Ex Notice”), “Regulation Best Execution,” SEC Release No. 34-96496; File No. S7-32-22, available at <https://www.sec.gov/rules/proposed/2022/34-96496.pdf>.

⁸ Notice at 183.

⁹ *Id.*

¹⁰ See Notice at 88 (explaining threshold that an exchange would need to meet to be considered an open competition trading center able to host auctions); see also Notice at 304 (“The Commission acknowledges that Proposed Rule 615 might improve the competitive position of higher volume exchanges that offer qualified auctions and harm the competitive position of lower volume exchanges that do not.”).

competing exchange retail liquidity programs,¹¹ and set prices that administrators of qualified auctions may charge for their services.¹² Such command-and-control is not competitive.

Such anticompetitive effects are even more concerning where, as described in more detail below, the current market structure—including venue competition—has resulted in favorable conditions for the same retail investors that this proposal ostensibly seeks to help and the proposal’s benefits cannot be said to outweigh its costs when properly understood. For these reasons, the Commission should withdraw the proposed rule.

Existing Competition Model Serves Retail Investors Well

The Commission primarily justifies this proposed rule by pointing to purported benefits to individual investors: “opening up individual investor orders to order-by-order competition would lead to significantly better prices for those investors.”¹³ But data indicates that the U.S. equity markets have never worked better for retail investors who benefit from low-cost trading and efficient execution.¹⁴ The state of the equity markets for retail investors is the outcome of the current model of venue competition, which can be expected to continue to dynamically evolve to meet retail investors needs over time. Indeed, as Commissioner Mark Uyeda points out, “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.”¹⁵

The proposal takes aim at the use of wholesalers to execute retail orders, as well as the practice of payment-for-order-flow (PFOF) for retail orders. PFOF, while not a new concept, has gained notoriety over the past several years as supporting the zero-commission trading model adopted by many brokers who serve retail customers. While not all brokers offering zero-commission retail trading accept PFOF, the vast majority of retail orders are routed through wholesalers.

¹¹ Notice at 129 (“This prohibition would apply to many of the RLPs currently operated by national securities exchanges.”)

¹² Notice at 113 (“the proposed requirements for fees and rebates are designed to provide sufficient financial incentives for open competition trading centers to operate qualified auctions”); see also Notice at 115 describing that the 5 mils cap is “designed to be sufficient to provide reasonable compensation to an open competition trading center.” Notice at 257 (“the Commission believes that the proposed auction fee and rebate caps would help ensure that exchange and ATSS have sufficient incentives to operate qualified auctions.”)

¹³ Notice at 9.

¹⁴ See, e.g., Shane Swanson, “The Impact of Zero Commissions on Retail Trading and Execution,” *Coalition Greenwich* (February 25, 2020), available at www.greenwich.com/equities/impact-zero-commissions-retail-trading-and-execution; Charles Schwab, “U.S. Equity Mark Structure: Order Routing Practice, Considerations, and Opportunities,” *Charles Schwab* (2022), available at <https://content.schwab.com/web/retail/public/about-schwab/Schwab-2022-order-routing-whitepaper.pdf>.

¹⁵ Mark T. Uyeda, “Statement on Proposed Rule Regarding Order Competition,” Statement (December 14, 2022), available at <https://www.sec.gov/news/statement/uyeda-order-competition-20221214>.

The current market structure, which has brought benefits for retail investors, has evolved over time. While zero-commission trading is a significant innovation, it is important to place it in historical context: brokerage fees have been declining for almost 50 years as a result of regulatory changes and competition.¹⁶ In addition, retail investors today have easier access to the markets through lower account balance requirements, access to easy-to-use app-based trading platforms, and the ability to trade fractional shares.¹⁷

Retail participation in U.S. equity markets has been increasing, and multiple studies have confirmed that new retail investors represent a broader swath of the U.S. population than prior investors.¹⁸ While individual investor motivations for opening an account can vary significantly, it appears that new investors were enticed by, or took advantage of, innovations in the brokerage space that made trading easier or cheaper for them.¹⁹ Lowering per-trade costs has made investment more attractive and economical for retail investors with small amounts to invest.

Not only are more retail investors accessing the equity markets than before, but studies have also shown that they are, on the whole, receiving efficient execution, including favorable prices, for their trades. While PFOF creates a potential conflict between a broker and the retail investor because a broker may be incentivized to route the investor's order to a wholesaler who pays the broker more but provides worse trade execution, academic research has not shown systematically inferior execution quality where PFOF is paid.²⁰ Indeed, this research

¹⁶ Stephen Mihm, "The Death of Brokerage Fees Was 50 Years in the Making," *Bloomberg* (January 3, 2020), available at <https://www.bloomberg.com/opinion/articles/2020-01-03/how-nyse-went-from-quasi-cartel-to-zero-fee-stock-trading?leadSource=uverify%20wall>.

¹⁷ See Jennifer J. Schulp, "GameStop and the Rise of Retail Trading," *Cato Journal* (Fall 2021), available at <https://www.cato.org/cato-journal/fall-2021/gamestop-rise-retail-trading>.

¹⁸ *Id.*; see also Charles Schwab, "New Ariel-Schwab Black Investor Survey Shows Black Americans Continue to Trail Their White Counterparts in Building Wealth," *Charles Schwab* (2021), available at www.aboutschwab.com/ariel-schwab-black-investor-survey-2021; Broadridge, "Insights on the U.S. Investor," *Broadridge Investor Data Study* (2020), available at www.broadridge.com/_assets/pdf/broadridge-insights-on-us-investor-data-study.pdf; FINRA Investor Education Foundation and NORC at the University of Chicago, "Investing 2020: New Accounts and the People Who Opened Them," *Consumer Insights: Money and Investing* (February 2021), available at https://www.finrafoundation.org/sites/finrafoundation/files/investing-2020-new-accounts-and-the-people-who-opened-them_1_0.pdf.

¹⁹ In addition to the popularity of low or no balance accounts, the FINRA/NORC Study found that the majority of new investors opened accounts that offered zero-commission trading, nearly half accessed their accounts primarily through a mobile app, and one-third purchased fractional shares. FINRA Investor Education Foundation and NORC at the University of Chicago, "Investing 2020: New Accounts and the People Who Opened Them," *Consumer Insights: Money and Investing* (February 2021), available at https://www.finrafoundation.org/sites/finrafoundation/files/investing-2020-new-accounts-and-the-people-who-opened-them_1_0.pdf.

²⁰ See, e.g., Anne Haubo Dyhrberg, Andriy Shkilko, and Ingrid Werner, "The Retail Execution Quality Landscape," Fischer College of Business Working Paper No. 2022-03-014 (March 14, 2023), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4313095; Robert H. Battalio and Robert H. Jennings, "Why Do Brokers Who Do no Charge Payment for Order Flow Route Marketable Orders to Wholesalers," *SSRN*

squares with the Commission’s own findings that wholesalers likely compare favorably to other market access centers in terms of execution quality and other services provided to retail brokers,²¹ suggesting that PFOF does not have the distortionary effect on retail trading execution that some may posit.

That’s not to say that the current market structure is without room for improvement, but the Commission’s rule proposal would upend this entire system by mandating a particular order flow. While the Commission is dismissive that such a change will result in some brokers resuming charging commissions for retail orders,²² such a change remains a possibility. But even if brokers do not resume charging commissions, they are likely, as the Commission recognizes, to find other sources of revenue to offset any loss from PFOF.²³ Not only may such measures raise costs for individual investors for other services, discount brokers who provide fewer services—or are less able to cross-subsidize their lines of business—may not be able to make up that revenue shortfall. This could lead to fewer brokers competing to serve retail customers, either through the failure of current market participants or by raising barriers to new entrants. Rather than enhancing competition, then, this proposal may serve to concentrate retail brokerage services into larger players.

Finally, and importantly, the proposal’s restructuring of retail order routing overrides customer choice by allowing no exception for customers who would choose to direct their orders to particular wholesalers or other “restricted competition trading centers.”²⁴

The Costs of this Proposal, Properly Understood, Outweigh Its Uncertain Benefits

As noted above, the venue competition model generally works well for retail investors. That’s not to say that there is no room for improvement, but rather any change should be undertaken with great care and for great benefit, particularly in light of the potential for unintended consequences. However, the Commission’s analysis of the costs and benefits of this proposal does not show evidence of such care and suggests that any benefit is likely to be outweighed by the proposal’s costs.

At the outset, the Commission admits that there is considerable uncertainty in the benefits and costs of this proposal.²⁵ On the benefits side, the Commission claims that this proposal could

(December 14, 2022), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4304124; Christopher Schwarz, Brad M. Barber, Xing Huang, Philippe Jorion, and Terrance Odean, “The ‘Actual Retail Price’ of Equity Trades,” *SSRN* (September 14, 2022), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4189239.

²¹ Notice at 202-203.

²² Notice at 291; *see also* Notice at 299-302.

²³ Notice at 246.

²⁴ Notice at 104.

²⁵ *See, e.g.*, Notice at 180, 181, 182, 253.

save more than \$1.5 billion for retail investors,²⁶ but as noted above, academic research calls into question whether such savings could be realized.²⁷ But even if this savings could be realized, the Commission acknowledges that while the “net result would likely be improved execution quality, . . . the standard deviation of this execution would likely increase.”²⁸ It is not at all clear that this is a positive outcome, leaving execution quality more uneven and providing worse outcomes for some investors.

Moreover, the Commission’s analysis fails to consider that other rule changes—including those simultaneously proposed—may themselves result in savings to investors, decreasing the marginal benefit of this proposed order routing rule.²⁹ For example, the Commission’s analysis refers to as yet unimplemented changes to consolidated market data rules (“MDI Rules”), which, according to the Commission, “will change the NBBO as a benchmark for analysis of order execution quality at wholesalers.”³⁰ These rules will have implications for broker-dealer order routing practices, including by implementing a new round lot definition that will narrow the spread for most high-priced stock. Despite the fact that such a change may itself alter retail order execution pricing, the Commission does not consider postponing this proposed dramatic change to order routing practices until the MDI Rules have been implemented.

The same issue plagues this proposal inasmuch as it fails to consider both the combined effects of the four concurrently proposed rules and the individual effects of those proposals as alternatives to this rule proposal. For example, the Commission relies on order execution data reported pursuant to Exchange Act Rule 605 for its analysis of investor savings, but the Commission has simultaneously proposed modernizing Rule 605, calling into question whether Rule 605 provides adequate data for reaching such a conclusion. This modernization of Rule 605 may itself affect order routing (and increase competition) due to additional transparency to both brokers and retail investors, yet the Commission does not consider whether such impacts would decrease the potential cost savings to be garnered with the order routing rule proposal. Similarly, changes proposed to pricing increments are intended to effect the spread, like the MDI Rules, and may themselves affect both order routing practices as well as prices borne by retail investors. And the proposed new best execution rule also may have an impact on order

²⁶ Notice at 10; *see also* Notice at 180 (“the Commission preliminarily estimates that the Proposal could potentially result in a total average annual savings in individual investor transaction costs ranging from \$1.12 billion to \$2.35 billion”).

²⁷ *See also* Robert H. Battalio and Robert H. Jennings, “On the Potential Cost of Mandating Qualified Auctions for Marketable Retail Orders,” *SSRN* (March 28, 2023), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4403047.

²⁸ Notice at 291.

²⁹ Best Ex Notice; Notice of Proposed Rule, “Regulation NMS: Minimum Pricing Increments, Access Fees, and Transparency of Better Priced Orders,” SEC Release No. 34-96494; File No. S7-30-22, available at <https://www.sec.gov/rules/proposed/2022/34-96494.pdf>; Notice of Proposed Rule, “Disclosure of Order Execution Information,” SEC Release No. 34-96493; File No. S7-29-22, available at <https://www.sec.gov/rules/proposed/2022/34-96493.pdf>.

³⁰ Notice at 53.

routing practices, but the Commission fails to consider whether the impact of that rule weakens its justification for imposing this order routing rule.

In all, the Commission provides little clarity about what the overall changes to the market structure imposed by the over 1,600 pages of rulemaking proposed in December 2022 and how such changes would impact investors. In failing to do so, the Commission fails to fully examine the costs and benefits of this particular proposal. This is particularly problematic because changes of this magnitude to the market's structure have the strong potential for unintended (and unpredictable) consequences, especially where several significant changes being proposed at the same time. Such changes should not be undertaken without a robust understanding of how those changes will affect market participants and trading and whether the benefits could, under any circumstances, outweigh the costs of such changes. The justification that the Commission provides for this proposed rule change does not meet such a standard.

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Thank you for the opportunity to comment on this proposed rule, and I am happy to answer any questions or further engage on this topic.

Sincerely,

A handwritten signature in black ink, appearing to read 'J. Schulp', written in a cursive style.

Jennifer J. Schulp
Director of Financial Regulation Studies
Center for Monetary and Financial Alternatives
Cato Institute