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PUBLIC INTEREST COMMENT

ADOPTING THE PROPOSED ORDER COMPETITION RULE WOULD DEGRADE EQUITY MARKETS FOR RETAIL TRADERS

ANDREW N. VOLLMER
Senior Affiliated Scholar, Mercatus Center at George Mason University

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This is a comment on the Order Competition Rule proposed by the Securities and Exchange Commission. The proposal would create an order-by-order auction method to execute orders from a certain category of retail investors (Proposal).[1]

I am a scholar with the Mercatus Center at George Mason University. I taught securities regulation at the University of Virginia School of Law, served as deputy general counsel at the SEC, and practiced securities law. The Mercatus Center is dedicated to bridging the gap between academic ideas and real-world problems and to advancing knowledge about the effects of regulation on society. This comment is not submitted on behalf of any other person or group.

INTRODUCTION

Adopting the Proposal would more likely degrade rather than improve the equity markets for retail investors. Three simple but demonstrable propositions argue against adoption of the Proposal:

- The Proposal failed to give adequate weight to the significant price improvement and execution benefits that private market participants generated for retail investors within the current regulatory regime and to the desirable alternative of allowing competition from private parties instead of new regulations to create further benefits.
- The Proposal's estimate of the potential benefit must be dramatically discounted because the maximum possible gain for retail investors that the SEC forecast is highly unlikely to be achieved. Even the SEC doubts that retail investors would see the predicted $1 billion to $2 billion of annual gain as a result of adopting the Proposal.

1. Order Competition Rule, 88 Fed. Reg. 128, 130 (proposed Jan. 3, 2023) (to be adopted at 17 C.F.R. § 242.615).

For more information, contact
Mercatus Outreach, 703-993-4930, mercatusoutreach@mercatus.gmu.edu
Mercatus Center at George Mason University
3434 Washington Blvd., 4th Floor, Arlington, VA 22201

- The costs of adopting the Proposal would be high and could be enormous because use of the proposed auction system would likely disrupt the secondary trading markets for equities in unpredictable but negative ways. The Proposal acknowledged the serious risk that, if the Proposal is adopted, retail brokers will begin to charge retail customers new commissions or fees.

The Proposal demonstrates that the SEC majority does not have a sturdy, empirical basis for reaching conclusions about the likely effects of adoption of the Proposal. The majority guesses about possible benefits, warns it does not know what will happen, and cautions that its new system for executing retail investor orders could cause serious disruption and harm in the market. It made the Proposal on a wing and a prayer, hoping that major problems could be fixed or that adoption would not damage the existing system, which has produced large benefits for all equity traders.[2]

Unelected officials in the federal government should not embark on such a risky experiment that jeopardizes the success and stability of the market for secondary trading of equities, one of the pillars of the U.S. securities markets. Adoption of the Proposal would not be prudent and would not be in the best interest of retail investors. The Proposal exalts rulemaking activity and more restrictive regulations over policies to benefit investors and securities markets.

THE WEAK NEED FOR A CHANGE FROM THE CURRENT SYSTEM OF EQUITY MARKET TRADING

Government intervention in the secondary equity markets for retail investors of the kind in the Proposal is not justified. The current system for trading equity securities provides sizable financial benefits to those investors. Private market participants are largely responsible for the benefits and could be expected to compete to generate more gains for retail investors in the future, yet the SEC failed to consider private market solutions as an alternative to more government regulation.

"Retail investors have it pretty good these days," said an academic observer who has studied the quality of retail executions. "There are no commissions and really low trading costs."[3] A 2010 study drew these conclusions:

> Virtually every dimension of U.S. equity market quality is now better than ever. Execution speeds have fallen, which greatly facilitates monitoring execution quality by retail investors. Retail commissions have fallen substantially and continue to fall. Bid-ask spreads have fallen substantially and remain low, although they spiked upward during the financial crisis as volatility increased. Market depth has marched steadily upward. Studies of institutional transactions costs continue to find U.S. costs among the lowest in the world.[4]

The quality measurements have improved since then. Greenwich Associates, a part of S&P Global, found in 2020 that retail investors have "never had it better." Among other things, "most of the largest brokerages recently dropped retail commissions to zero," "today's market makers are

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2. The Proposal is not for a pilot program, but it suffers from many of the same shortcomings that the court of appeals cited in NYSE LLC v. SEC, 962 F.3d 541 (D.C. Cir. 2020).
3. *As Gensler Pushes Market Structure Revamp, New Studies Signal Status Quo Is Working Pretty Well for Retail Investors*, CAPITOL ACCOUNT (Jan. 5, 2023) (subscription required), https://www.capitolaccountdc.com/p/as-gensler-pushes-market-structure.
4. James Angel et al., *Equity Trading in the 21st Century* 5 (May 18, 2010) (Marshall Research Paper Series, Working Paper FBE 09-10), http://ssrn.com/abstract=1584026.

providing execution quality at the highest levels," "payment for order flow amounts have shrunk year over year," and the focus on the best execution requirement has not been slackening.[5]

The SEC Proposal contained some measures of the significant benefits for retail investors within the current system. A table in the Proposal with execution quality data for marketable orders under $200,000[6] showed:

- Ninety percent of the orders for National Market System stocks routed to wholesalers from individual investors received prices better than the national best bid and offer (NBBO).
- Wholesalers executed 44.57 percent of the shares at the NBBO midpoint or better.
- The conditional amount of price improvement at wholesalers was 2.54 basis points. At that level, retail investors gained $2.64 billion on total dollars invested in one year[7] and $0.25 on an investment of $1,000.
- A different table showed that wholesalers provided a fill rate of 69.0 percent compared to 27.3 percent for exchanges.[8]

Recent studies independent of the SEC found that wholesalers provided retail investors with substantial price improvement and with prices better than those received from exchanges.[9]

Much of the analysis in the Proposal understated the price improvement wholesalers supplied. The Proposal relied heavily on data from Rule 605 reports to calculate the price improvement wholesalers provided[10] and to conclude that the amount of price improvement wholesalers furnished to marketable orders "does not fully offset the lower adverse selection costs."[11] Rule 605 reports suffer from significant limitations[12] and do not give a full picture of the price improvement wholesalers currently provide. Recent academic research finds that addressing shortcomings in the Rule 605 data increases the price improvement by 2.75 times.[13] The understatement of benefits provided by wholesalers set the SEC off on the wrong foot, even though it supplemented and supported its Rule 605 report data with data from the Consolidated Audit Trail.[14]

Besides lower execution costs, some retail brokers offer retail investors additional benefits. Retail investors pay no commissions or fees on equity trades, do not pay fees to maintain brokerage

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5. Shane Swanson, *The Impact of Zero Commissions on Retail Trading and Execution*, Greenwich Assocs. 4 (Q1 2020), https://www.greenwich.com/equities/impact-zero-commissions-retail-trading-and-execution.
6. Proposal, 88 Fed. Reg. at 192–93, table 7 (using Consolidated Audit Trail information).
7. The wholesaler share volume in the table is for one quarter. For total dollars invested in a year, I multiplied the volume for one quarter by 4.
8. Proposal, 88 Fed. Reg. at 190, table 6.
9. Robert Battalio & Robert Jennings, *Why Do Brokers Who Do Not Charge Payment for Order Flow Route Marketable Orders to Wholesalers?* 4 (Dec. 14, 2022) ("Orders that fill completely with the wholesaler(s) from wholesaler(s) inventory (i.e., fully internalized orders) receive an average of $0.0085 per share of price improvement, which demonstrates that the wholesaler(s)' betterment of the quoted price is more than de minimis. In fact, almost 46% of fully internalized trades occur at the order-receipt-time quoted spread mid-point price or better."), https://ssrn.com/abstract=4304124; Anne Haubo Dyhrberg et al., *The Retail Execution Quality Landscape* 3 (Charles A. Dice Center for Research in Financial Economics, Working Paper No. 2022-14) (Dec. 12, 2022) ("wholesalers provide substantial price improvement" over exchanges. At the wholesalers, an average retail order received "price improvement of 26% of the quoted spread. More strikingly, a retail order in an average S&P 500 stock receives price improvement of 54% of the quoted spread. By comparison, price improvement offered by exchanges is only 4% in the full sample and 6% in S&P 500 stocks.") (footnote omitted), http://www.ssrn.com/abstract=4313095.
10. Proposal, 88 Fed. Reg. at 188–89.
11. *Id.* at 189.
12. Id. at 191.
13. Battalio & Jennings, *supra* note 9, at 18–19.
14. Proposal, 88 Fed. Reg. at 191–92.

accounts, may open brokerage accounts without a minimum amount, and may trade fractional shares, which allows trading in small dollar amounts.[15]

The efficiencies and cost reductions made the equity markets more accessible to investors with lower incomes. The market improvements reduced costs for consumers and lowered barriers to participation in the market for the common stock of companies listed on stock exchanges. They opened the securities markets and equity securities ownership to a much larger part of the population and to people with less income and wealth than are typically associated with participation in the equity markets.[16] That has been a U.S. policy objective for a long time.

Contrary to statements in the SEC Proposal,[17] several studies determined that payment for order flow (PFOF) does not affect best execution. Greenwich Associates said: "Firms that do accept PFOF have strict best execution regimes that require them to send orders to the destinations providing best execution, whether market maker, exchange or dark pool, not simply where PFOF is highest."[18] Another study concluded "that retail brokers route orders to wholesalers even when they do not choose to charge wholesalers to interact with their marketable order flow because of the superior execution quality provided to these orders, which is commercially advantageous to retail brokers and is consistent with a retail broker[']s best execution obligations."[19]

THE BENEFITS OF THE CURRENT SYSTEM PRESENT AN ALTERNATIVE THAT THE SEC DID NOT CONSIDER

The SEC Proposal did not deny that the benefits developed under the current system exist, but it did not use them in an appropriate way. It should have discussed them as the basis for an alternative it did not consider: no change from existing regulations.

Competition among new and existing market participants drove down costs for retail investors and opened the markets to them. These developments are remarkable and are owed mainly to the creativity, ingenuity, and dynamism of private individuals who saw opportunities within the existing regulatory system.

The private markets have been improving the equity trading system and lowering costs for retail investors for many years. They would likely continue to do so absent government interference. History shows that, if the current regulatory structure remained in place, private parties would pursue ways to attract new retail customers with even lower transaction costs and eat further into the competitive shortfall discussed in the SEC Proposal.[20]

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15. *See generally* S.P. Kothari et al., *Commission Savings and Execution Quality for Retail Trades* (Dec. 2, 2021), https://ssrn.com/abstract=3976300 or http://dx.doi.org/10.2139/ssrn.3976300.
16. Christopher Schwarz et al., The "Actual Retail Price" of Equity Trades 1 (Sept. 13, 2022) ("Zero commissions have transformed the landscape for retail investors, bringing affordable investments to the masses."), https:// ssrn.com/abstract =4189239.
17. Proposal, 88 Fed. Reg. at 197.
18. Swanson, *supra* note 5, at 7; *see also id*., at 6 (wholesalers "compete intensely to win order flow from retail broker-dealers by delivering 'best execution'" and better prices to the end retail investor).
19. Battalio & Jennings, supra note 9, at 8 (Dec. 14, 2022); see also Schwarz et al., supra note 16, at 3 ("We find that PFOF explains almost none of the cross-broker variation in execution prices"), 6 ("we do not find a relation between PFOF arrangements and price execution.").
20. *See* Swanson, *supra* note 5, at 4 (Greenwich Associates stating, before the SEC Proposal: "We believe that retail investors will continue to receive tremendous attention from their providers, who will continue to enhance such services. Why do we believe this? Because the markets have decades of history that show increasing service and improving execution to retail traders.").

That pattern suggests an alternative to the order-by-order auction idea in the Proposal. The SEC could have proposed no changes to the National Market System as it now exists and continued to permit private market participants to compete to provide price and execution improvements. Relying on private market competition within a regulatory system has advantages over additional government regulation. It was an obvious alternative here, and the SEC did not consider it.[21] In a rulemaking, a federal agency has a duty to consider reasonable and responsible alternatives and to give adequate reasons for rejecting them.[22]

The failure to consider a private alternative to additional government regulation both ignored a key agency legal responsibility and took a path that reduces rather than preserves individual liberty. Limiting personal freedom is a genuine cost that must be part of a cost-benefit analysis.

The alternative of making no change to existing regulations should be appealing. It would impose no additional regulatory costs, and yet, if history is a guide, it would produce substantial benefits and efficiencies for equity trading by retail investors.

QUESTIONS ABOUT ACHIEVING THE BENEFITS THAT THE PROPOSAL ASSERTED

The SEC Proposal asserted that order-by-order auctions would produce significant benefits for the securities markets:

> The Commission estimates that the potential benefit to individual investors from this increased competition, the competitive shortfall rate, would range between an average of 0.86 bps to 1.31 bps for marketable orders that met the definition of a segmented order. Based on Commission estimates that between 7.3% to 10.1% of total executed dollar volume would be segmented orders that would be eligible to be included in qualified auctions, the Commission preliminarily estimates that this could potentially result in a total average annual savings in individual investor transaction costs, i.e., a total competitive shortfall, ranging between $1.12 billion to $2.35 billion dollars.[23]

The Proposal's estimated benefits were too optimistic. One recent study cast doubt on the benefits of order-by-order auctions and showed that they are less helpful with less liquid stocks. The study modeled two methods of executing segregated retail trades: broker's routing resembling the current market structure and an order-by-order auction. It found that an order-by-order auction system increased allocative efficiency because the best price for the retail order wins the auction, but market makers bid conservatively in an auction. Retail investor welfare can be lower, particularly when the market for a stock is volatile or illiquid. Market makers have lower incentives to participate in auctions for small stocks, which reduces liquidity for them. "Limited liquidity leads to less pressure from auction competitors, less aggressive bids, and larger profits for trading against retail orders."[24]

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21. See Proposal, 88 Fed. Reg. at 226–39 (considering various alternatives).
22. Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 48 (1983) (a known alternative way of achieving the objectives "should have been addressed and adequate reasons given for its abandonment"); *see also id.* at 50–51; Farmers Union Cent. Exch. v. FERC, 734 F.2d 1486, 1511 (D.C. Cir. 1984) ("It is well established that an agency has a duty to consider responsible alternatives to its chosen policy and to give a reasoned explanation for its rejection of such alternatives.") (footnote omitted).
23. Proposal, 88 Fed. Reg. at 205–206.
24. Thomas Ernst et al., *Would Order-By-Order Auctions Be Competitive?* 3 (Dec. 13, 2022), https://ssrn.com/abstract=4300505.

In addition, the Proposal planted its own seeds of destruction. By its own explanation, the SEC's estimated benefits were mostly hope and speculation. The Proposal conceded that assumptions supporting the possible benefit have a decent chance of not coming to fruition: "The Commission acknowledges considerable uncertainty in the costs and benefits of this rule because the Commission cannot predict how different market participants would adjust their practices in response to this rule."[25] The SEC should heed its own warnings and admit that possible benefits from the Proposal must be heavily discounted.

The Proposal contained a list of serious concerns about achieving benefits and instead causing a decline in execution quality.[26] One concern was that no auction host would materialize to conduct an auction for an investor order.[27] Another was that liquidity suppliers would not participate in a qualified auction or that a back-up wholesaler internalization would execute at an inferior price.[28]

A third concern was that the NBBO could move against an investor's order while an auction was in process.[29] The median execution time for internalized retail orders was 3.6 milliseconds, but the time period for a qualified auction would need to be no shorter than 100 milliseconds and no longer than 300 milliseconds.[30] Traders aware of an auction from the public notice could affect the market price during an auction by placing orders not subject to an auction and receiving executions.

A further uncertainty was the "potentially countervailing or confounding economic effects from the [Market Data Infrastructure] Rules." Those effects were not yet known but could be significant.[31]

The Proposal assumed that, to participate in auctions, wholesalers would reduce PFOF now paid to retail brokers and instead transfer that value into additional price improvement for individual investors.[32] That assumption is uncertain, and the consequences in the market of reduced PFOF are not known. To replace the receipt of PFOF, retail brokers might start charging retail customers commissions again or start charging other fees for execution services.[33] Any further costs imposed on retail investors would reduce the price improvement benefits from adoption of the auction Proposal or, even worse, reduce retail trading volume and the overall pool of liquidity.[34]

The Proposal assumed the auction system would attract new liquidity providers to compete to trade with orders from retail investors.[35] That assumption is entirely speculative. Institutional investors might have a variety of reasons, such as the damage from information leakage, for not participating in auctions.[36]

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25. Proposal, 88 Fed. Reg. at 203. The Proposal confessed uncertainty many times. See, e.g., *id.* at 178, 204, 206, 208, 217, 218, 220, 225.
26. *Id.* at 214, 216–17.
27. *Id.*
28. *Id.*
29. *Id.* at 214–15.
30. *Id.* at 158, 196.
31. *Id.* at 204; *see* 206 n.513.
32. *Id.* at 206 & n.514.
33. *Id.* at 203–204, 206 n.514, 216, 218; *see also* Dyhrberg et al., *supra* note 9, at 5.
34. Proposal, 88 Fed. Reg. at 221.
35. *Id.* at 204, 205.
36. *Id*. at 220.

The purpose here is not to repeat all the qualifications in the Proposal. It is only to convey the extent of the SEC's lack of confidence that adoption of the Proposal would produce the desired benefits. The next part of this comment describes a similar lack of SEC knowledge about the magnitude of the costs that could follow from implementation of the Proposal.

QUESTIONS ABOUT THE POSSIBLE COSTS OF THE PROPOSAL

The possibility that a regulatory proposal would not achieve all the desired benefits an agency describes is not necessarily fatal. Possible benefits always must be weighed against expected costs. A small or large estimated benefit of a new rule is desirable unless the likely cost to produce the benefit is higher.

The preceding section explained that the SEC's quantification of the possible benefit from the Proposal is in considerable doubt. Admissions in the Proposal itself provide grounds to question the likelihood that order-by-order auctions will generate the consumer gains the SEC posits. This section of the comment describes some of the many risks that the Proposal would cause overwhelming costs, again using information from the Proposal itself.

Adopting the Proposal would impose direct costs of compliance. The Proposal discussed those costs,[37] but they are not the biggest source of concern. The more worrisome and much larger cost is the uncertainty and disorder that a required order-by-order auction system would create in the equity trading system.

A major detraction of the Proposal is that the SEC does not know what would happen in the secondary equity markets for retail orders if it adopted the Proposal. It does not know the extent to which its new system would disrupt and impose large costs on the equity trading markets. "The Commission acknowledges considerable uncertainty in the costs that would arise from Proposed Rule 615, due to whether the current market practice of routing through wholesalers would persist."[38]

Although the SEC was not able to predict the market consequences of adopting the Proposal, it was concerned that use of the proposed auctions would likely have substantial disruptive effects on the businesses of wholesalers, retail brokers, and stock exchanges.[39] "The Proposal would likely cause wholesalers and some retail brokers to incur significant adjustment costs to their operations. It is unknown whether the current industry practice of routing nearly all retail order flow to wholesalers would persist were the Commission to adopt this rule, because wholesalers might charge for this service and retail brokers might find it more profitable to develop their own routing services."[40] The Proposal also noted "the possibility of exit" by a wholesaler, which could present "a risk of overall diminished efficiency" in the market.[41]

The unknown but possibly costly uncertainties are independent reasons not to adopt the Proposal. They also affect the already dubious potential benefits for retail investors. If the changes to the retail equity markets are too costly, the price improvements for retail traders are much less likely to materialize.

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37. *Id.* at 171–76, 212.
38. *Id.* at 179; *see generally id.*
39. *Id.* at 217–20, 222.
40. *Id.* at 203.
41. *Id.* at 226.

CONCLUSION

The Proposal raised serious questions about the advisability of a government-mandated order-by-order auction system for retail trades. It listed reasons why the forecast benefits for retail investors might not be realized. It stated explicitly that the SEC does not have a reasonable assurance that the likely effect of the Proposal on the operation of the equity market would be positive and that the SEC in fact saw ways the auction system could generate potentially serious harms to the market.

With these dangers present, a vote to convert to an auction system for retail orders does not seem responsible. The better course would be to make no change and allow private enterprise to continue to compete to provide retail investors with better transaction prices and other benefits.