WORLD FEDERATION OF EXCHANGES

Mr Gary Gensler
SEC Headquarters
100 F Street, NE
Washington, DC 20549

22 September 2021

Dear Mr Gensler

I write on behalf of the global exchange and CCP community concerning your study of US equity market structure. This study is an important opportunity to build on the success of America's capital markets in delivering for average investors. Exchanges in our membership particularly welcome your recent comments on the value of lit market price formation and take note of the debates concerning payment-for-order-flow (PFOF).[1]

We at the WFE believe strongly in the value that public markets, competitive lit quotes, and access to liquidity for all investors provides to the marketplace. Competitive public prices make it cheaper for investors to trade as well as making arbitrage more efficient. Exchanges provide a centralized and public marketplace that benefits investors, issuers and insurers – reducing costs of capital and helping to grow financial markets and their underlying economies.

Lit market price formation

The strength of US capital markets comes from a price formation process that matches the orders of buyers and sellers in an orderly, democratic, and transparent manner on public exchanges. We share your concern that the regulatory framework may be shaping a market structure that undermines some of the SEC ambitions for fair, orderly and efficient markets.

On many trading days, more execution in US securities takes place off-exchange than on-exchange. EU policymakers are facing similar challenges in reforming MiFID II/MiFIR, and are exploring ways to address the phenomena of systematic internalisers circumventing dark pool volume caps. We believe that lit markets that allow for competitive interactions between all investor types while also providing public price discovery and advertised liquidity, are the basis of the success of US capital markets.

Research indicates that a more level and inclusive playing field creates more competitive spreads and reduces unnecessary intermediation. This stands in contrast to current rules that allow some participants to offer sub-penny pricing (or enable them to fill orders in non-decimal increments), and to restrict and/or tier customer interactions without also paying for or contributing to price discovery on public markets. All this makes it harder for exchanges to compete. Additional price improvement of hundreds of millions of dollars is available on exchanges, but missed due to internalization of orders.

To the extent debates about market structure touch upon market data, it is worth noting that the reference price data used by alternative venues is enabled by the investments exchanges make in facilitating efficient price formation and guarding market integrity. When the regulatory framework facilitates wholesalers

[1] The World Federation of Exchanges (WFE) is the global trade association for regulated exchanges and clearing houses. We represent over 250 market infrastructures, spread across the Asia-Pacific region (~37%), EMEA (~43%) and the Americas (~20%). with everything from local entities in emerging markets to groups based in major financial centres. Collectively, member exchanges are home to nearly 53,000 listed companies, and the market capitalisation of these entities is over $95 trillion, while the 50 distinct CCP clearing services (both vertically integrated and standalone) collectively ensure that traders put up $1 trillion of resources to back their risk positions.

skimming flow from lit markets, these reference prices become less meaningful and spreads inevitably widen – exacerbating, in a vicious circle, the incentives to trade off-exchange.

Payment for Order Flow

Payment for order flow between retail brokers and wholesalers is widely subject to de facto or de jure bans outside of the US. Foreign regulators and industry experts recognize that retail-wholesale PFOF has the potential to create conflicts of interest and impugn the integrity of best execution.

In its 2014 study, the UK's Financial Conduct Authority said:

"PFOF arrangements create a clear conflict of interest between the clients of the firm, are unlikely to be compatible with our inducements rule and risk compromising compliance with the best execution rules."

More recently, the European Securities and Markets Authority has said:

"PFOF raises serious investor protection concerns. In light of these concerns and of the multiple requirements applying to PFOF, ESMA considers that in most cases it is unlikely that PFOF could be compatible with MiFID II and its delegated acts."

We wish to emphasize the important distinctions between payment for order flow as discussed above, and the practice of offering rebates to liquidity providers, e.g., proprietary market makers, on exchange. Exchange rebates are a fundamental building block of the deep and liquid markets that all US investors enjoy, and are consistent with the principles of best execution, given they facilitate open competition.

Regulatory action against rebates could deprive the public markets of this valuable liquidity. As the UK Government's 2012 *Foresight* study concluded it would likely be "harmful to prevent trading platforms from differentiating make/take fees since these fees can play an important role in equilibrating the supply and demand of liquidity" and that "they can increase the rate at which makers and takers are matched and as a result enhance social welfare." Indeed, the UK (alongside Canada) is an example of a jurisdiction that has eliminated PFOF while retaining the benefits of liquidity incentivization within the regulatory framework.

While the systems of exchange rebates are diverse (viz. exchanges with an inverted model), they are commonly non-discriminatory as between market participants, have been shown to improve spreads and depth, and are subject to transparent rules reviewed by the SEC. They exist in different forms across the globe, including in jurisdictions that ban PFOF. Whatever their structure, exchange rebates are designed to maximize liquidity in lit markets, thereby reinforcing their role in transparent price formation.

Conclusion

We share your view of the importance of transparent public markets to US investors and wish to support your efforts to implement reforms of benefit to end-investors. If you wish to discuss any of the themes in this letter in further detail, we remain at your disposal.

Best regards

Nandini Sukumar

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Chief Executive Officer