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MARKET STRUCTURE

THE PFOF YOU DIDN'T KNOW EXISTED: EXCHANGE MARKETING & RESPONSE FEES

Options exchange fees that were designed to attract order flow from retail wholesalers create the same market structure issues as PFOF. These fees have created a pay to play situation that is more likely to reward affiliated MMs than the MMs that offer the best price.

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A prominent area of discussion within equity and equity options markets has been payment for order flow (PFOF). These are the payments the wholesaler of an affiliated market maker (MM) make to retail brokers that gives them the right to route and execute orders. These payments are a huge business, totaling $2.5 billion in 2020, including just over $1.5 billion for options execution.[1] There has already been sufficient debate around both the benefits and the potential for conflicts that these payments elicit.

The US options exchanges charge market makers what we at Optiver see as another form of PFOF. We believe this "exchange sponsored PFOF" merits further examination. This version of PFOF exists in two forms; marketing fees and response fees (otherwise known as "break-up fees"). These payments typically flow from exchange MMs to the wholesaler of an affiliated MM that route orders from retail brokers to the exchanges. Essentially, the proceeds from these fees subsidize the PFOF wholesalers pay to the retail brokers. This setup leads to the unaffiliated MM having a very different set of economics when trading on-exchange than a MM with an affiliated wholesaler.

These break-up fees further skew the playing field, as they force MMs to pay a premium for providing liquidity and price improvement for retail orders on-exchange.

Taken together, the combination of marketing and break-up fees – as well as reduced fees from volume-based fee tiering on transactional exchange charges – leads to the affiliated MMs paying a minimal amount for their trades and could raise a conflict of interest regarding how and where an order is routed.

This arrangement has led to a market dominated by just four firms who collectively route over 80% of the retail equity option market volume.[2] While heavy concentration alone is something to be aware of, we see this market structure contributing to an environment

[1] Congressional Research Service, "Broker-Dealers and Payment for Order Flow, "April 2, 2021; review of 606 order routing disclosures.

[2] A review of the eight of the options industry's more active broker-dealers 606 order routing disclosures for the 1st quarter of 2021.

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where maximum price improvement for retail investors may not be achieved. We believe this market structure can be addressed, but it will require an effort led by the SEC as exchanges are unable to coordinate a collective change due to anti-competitive restrictions.

MARKETING FEES

Prior to August 1999, a majority of listed options traded on a single exchange, which gave retail brokerages no choice with respect to where to send customers' orders. As a result, PFOF and internalization – a situation where a trade is executed between a wholesaler and an affiliated MM – were not relevant to order routing decisions in the options market.

Once multiple listings increased, exchanges became forced to compete for order flow, especially in the most active option classes, as retail brokerages had a choice of where to send customer options orders. In response, the exchanges introduced rebate programs in an effort to incentivize order routing brokerages to send them their retail order flow. The exchange marketing and break-up fees fund these rebate programs.

Currently all the options exchange groups (except the BOX Exchange) have adopted rules establishing these marketing fees on at least one of their exchanges. The exchange marketing fees require all MMs who trade with a customer order, which are mainly retail orders, to contribute to the cost of attracting order flow. The exchanges collect the fees and place them in a "marketing fee pool," which is then distributed at the discretion of the affiliated MM. There is no ability for a MM to opt out of these payments.

BREAK-UP FEES & CREDITS IN PRICE IMPROVEMENT MECHANISMS

In addition to marketing fees, wholesalers receive a fee credit by the exchange in the event the paired, affiliated MM response is broken-up by an unaffiliated MM winning auction response. These credits paid by the exchange to the wholesaler are funded by the high auction response fees that unaffiliated MMs must pay.

In order to fund these payments to the wholesaler, most exchanges charge a contra response fee[3]. For wholesaler affiliated MMs responses, exchanges charge $0.05 per executed contract. All other unaffiliated responses are charged $0.50 per executed contract.

This asymmetric fee schedule acts as a barrier to competition as it directly rewards those affiliated MMs who enjoy a cost advantage over their unaffiliated competitors.

[3] These contra fees are labeled as such on the exchange fee schedules. A contra may be the affiliated MM, but could be any firm that the wholesaler is sourcing for liquidity.

Additionally, the likelihood to achieve maximum price improvement on orders is diminished as it costs the majority of potential auction respondents nearly 10 times in fees what the affiliated MMs are charged. At best these cost features create a skewed playing field across MMs and, at worst, could result in wider spreads for retail investors.

BALANCE OF POWER

The level of concentration that the top four wholesalers have achieved for retail orders forces the exchanges to aggressively compete for their order flow by offering their affiliated MMs the majority of the marketing fees available. This market structure has led to exchanges being extremely dependent upon where wholesalers choose to route orders. Incentives such as marketing fees and break-up credits are offered to encourage routing to their specific exchanges.

In addition, the competition among the exchanges has created scenarios where an exchange can potentially lose money on transactions when a wholesaler brings an internalized trade to their venue. To offset these loss-leading mechanisms, the exchanges are reliant on transaction fees generated from market makers who do not have an affiliated wholesaler. If these fees were removed, exchanges could potentially lose money overall on transactions.

PROPOSED SOLUTIONS

- Simplify exchange fee schedules.
- Adjust the difference in fees for unaffiliated auction responses that offer price improvement.
- Eliminate exchange sponsored marketing fees.
- Require exchanges to provide transparency on the level of internalization rates.

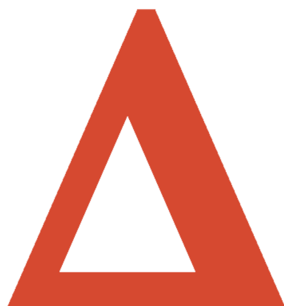
CONCLUSION

Exchange groups are dependent on wholesalers to bring retail flow to their exchange. The existing market structure incentivizes wholesaler's routing decisions with exchange sponsored PFOF through the distribution of marketing fee pools and break-up credits. MM firms without an affiliated wholesaler that provide price improvement operate at a cost and transactional disadvantage. They are only able to interact with retail orders by paying higher fees than the MM with the affiliated wholesaler arm. We believe that this asymmetry in trading fee economics puts a large number of unaffiliated MMs at a cost disadvantage and results in a far less competitive market.

These asymmetrical fees inherently lead to wider spreads and less liquidity for retail investors by reducing competition. The incentives exchanges offer should be re-aligned

to promote healthy competition. Optiver encourages a holistic review of industry fee schedules by the SEC including an examination of the removal of marketing fees and the alignment of break-up fees.

ABOUT OPTIVER



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