June 11, 2018

VIA Email

Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C., 20549-1090

Re: Transaction Fee Pilot for NMS Stocks, Securities Exchange Act Release No. 82873 (March 14, 2018), 83 FR 13008 (March 26, 2018) (File No. S7-05-18)

Dear Mr. Fields:

I appreciate the opportunity to comment in connection with the SEC's proposal for an access fee pilot. I presently serve as an Associate Professor of Law with tenure at the George Mason University Antonin Scalia Law School. I also serve on the Investor Advisory Committee of the Securities and Exchange Commission and am a member of the Market Structure Subcommittee of that Advisory Committee. I am writing in my individual capacity, and my views are my own.

My views are however informed by my work as a Professor of Securities Law. My views are also informed by my recent experience as Senior Counsel and Chief Economist to the House Committee on Financial Services, where I took academic leave from my teaching position to serve from May 2013 until April 2015 as an advisor to Chairman Hensarling on a variety of financial regulatory issues.

Perspectives on the Transaction Fee Pilot

The popular book *Flash Boys* by Michael Lewis started a national discussion about alleged trading and fee practices at the dominant equities exchanges. The transaction fee pilot recently proposed by the SEC stands to develop the necessary data to measure the impact of practices alleged in the book. Jonathan Macey, a noted corporate and securities law professor at Yale Law School, has described this phenomenon as one in which:

> "Wall Street has developed a new way, clouded in obscurity, to fleece the hundreds of millions of Americans who have money invested in company pension plans, mutual funds and insurance policies... brokers routinely take kickbacks, euphemistically referred to as "rebates," for routing orders to a particular exchange. As a result, the brokers produce worse outcomes for their institutional investor clients."[1]

Professor Todd Zywicki similarly noted how rebate and other fee practices occasioned by some trading practices described in the recent book Flash Boys could be accurately described as rent-seeking

[1] *See* Jonathan Macey and David Swenson, Wall Street Profits by Putting Investors in the Slow Lane, New York

according to a school of economic thought described as the "Virginia School" or "public choice economics":

> "To put it another way, HFT spends huge (unbelievably huge, actually) amounts of money to make trades faster. Is this purely (or largely) to make a distributive gain to itself (rent-seeking) or does this increase social wealth by increasing the efficiency of markets?...HFT…seems to turn on *milliseconds* of trading speed — it is hard at first glance to see how that can really contribute to increasing market efficiency, or at least increasing market efficiency to a sufficiently great degree to justify the amount of social resources…put into making trades a millisecond faster."[2]

In that sense, the observations from the Exchanges in their comment letters describing the access fee pilot as a "price control" are entirely inaccurate. If Zywicki and Macey are correct, then the pilot will merely reduce the sharing of economic rents by the Exchanges with sources of order flow.

Furthermore, one might properly describe the Reg NMS regime as itself a decade-long experiment in price controls. The Exchanges appear comfortable when price controls on the liquidity taking side benefit their business models, but challenge the Commission's authority to implement what they describe as price controls when their own business models are negatively impacted.

In addition to the popularity of the Flash Boys book, robust economic studies have begun to inform this issue, including work by Battalio, Corwin and Jennings (2016) and by Wah (2016)[3] and Wah et al (2017)[4] offering strong empirical support for the access fee pilot and inclusion of the zero rebate bucket in that pilot.

Nevertheless, the Exchanges described in Flash Boys have submitted comment letters in which they threaten to sue the SEC if it moves forward with the transaction fee pilot. The thinly veiled threat contained in comment letters from the NYSE and NASDAQ to sue the SEC despite its cautious, evidence-gathering approach in the pilot call to mind Queen Gertrude's observation in Hamlet that "the lady doth protest too much, methinks."[5]

This letter will examine that litigious threat, and demonstrate that threat as little more than a paper tiger through an extensive review of prior case law.

<u>Lessons in Cost-Benefit Analysis and the SEC's obligation to consider investor protection, efficiency, competition, and capital formation</u>

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[2] See Todd Zywicki, Should High Frequency Trading Be Regulated? Washington Post, 4/16/2014. Available at https://www.washingtonpost.com/news/volokh-conspiracy/wp/2014/04/06/should-high-frequency-trading-be-regulated/?noredirect=on&utm_term=.5ae963136b20

[3] See Elaine Wah, How Prevalent And Profitable Are Latency Arbitrage Opportunities Across U.S. Exchanges?, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2729109.

[4] See Elaine Wah et. al, A Comparison of Execution Quality Across U.S. Exchanges, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2955297.

[5] See William Shakespeare, Hamlet, Act III, Scene II.

The oft- ignored Competition Mandate

The Exchanges correctly note that the Commission acts under a four-part efficiency, competition, capital formation, and investor protection mandate via the Exchange Act and which has served as the basis for prior cost-benefit analysis based challenges to Commission action.

One fact that strongly distinguishes this action from prior legal challenges to Commission action however is that the Commission is here executing its competition mandate. The Commission is the antitrust regulator for securities trading.

The access fee pilot includes a "zero bucket" with respect to rebates in order to test whether rebates are being utilized in a way that distorts competition in trade execution. It will no doubt prove relevant to consider by analogy that other antitrust agencies have successfully focused on rebate practices as illegitimate exercises of market power in other contexts.

Cost-Benefit Analysis Misunderstood

There are a number of observations in comment letters by NYSE and NASDAQ that demonstrate a flawed understanding of the economic, cost-benefit analysis requirements that the SEC operates under requirements contained in the Exchange Act and the Administrative Procedures Act.

For example, the NYSE letter in part suggests that the access fee pilot will be subject to legal challenge because it has "underestimated the costs of the proposal."[6] Yet differing estimates of costs is not a sufficient basis alone to challenge Commission action based on the history of cases interpreting the Commission's cost-benefit analysis mandate. Merely having a different estimate of costs from industry participants does not show that the Commission's cost estimate is arbitrary.

The NYSE letter suggests that the SEC underestimated costs to investors of $1 billion per year.[7] Yet estimates of costs to investors from practices which the pilot is designed to address (which would classify as benefits from any rulemaking informed by the access fee pilot) seem from available evidence to be in a reasonable range much larger than that estimated cost.

The NYSE suggests a potential for revenue shortfalls as a result of the pilot.[8] To the extent that those revenue shortfalls result from unfair practices that any regulation subsequently informed by the pilot is intended to address, then the revenue shortfalls are properly considered on the benefit side of the question, not the cost side.

This speaks to a flaw in NYSE and NASDAQ's reasoning in their comment letters. They tend to ignore the benefit side of cost-benefit analysis, and suggest differences of opinion with the Commission in its

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[6] *See* New York Stock Exchange, Transaction Fee Pilot Comment Letter, at 3. Available at https://www.sec.gov/comments/s7-05-18/s70518-3755194-162578.pdf

[7] *See* New York Stock Exchange, Transaction Fee Pilot Comment Letter, at 13. Available at https://www.sec.gov/comments/s7-05-18/s70518-3755194-162578.pdf

[8] *See* New York Stock Exchange, Transaction Fee Pilot Comment Letter, at 15. Available at https://www.sec.gov/comments/s7-05-18/s70518-3755194-162578.pdf

estimate of the particular costs. Yet the most significant benefit of the pilot is its potential to inform subsequent rulemaking. The potential information gained for any future rulemaking is likely the primary benefit of the pilot.

The mere presence of uncertainty in the Commission's estimates of potential costs and benefits does not by itself open the pilot program to challenge. The Commission's determination to pursue a pilot program, rather than a mandatory rule, in the face of present uncertainty is what dramatically distinguishes this action from prior actions challenged in *Chamber v. SEC* and *Business Roundtable v. SEC*.

The NYSE letter also suggests that the Commission has failed to consider less burdensome alternatives in its design of the access fee pilot.[9] This is categorically false, the Commission appears to have considered adoption of a mandatory rule to reshape market structure, and determined instead to take the more deliberative and less costly approach of an initial pilot program to generate more data from which it can determine a path forward on market structure reform.

The NYSE suggests that collection of data from broker-dealers is a feasible alternative to the access fee pilot.[10] NASDAQ also asserts that the Commission should simply use existing data contained in the Order Audit Trail System.[11] These are clearly not feasible alternatives, for reasons demonstrated by comment letters from Professor Angel and Professor Spatt. The comment letter from Professor Spatt notes that randomized trials generate stronger conclusions than cross-sectional regressions using existing data.[12] A randomized trial is far superior for the purpose of generating robust statistical analysis to inform subsequent rulemaking.

Further, without a zero-bucket rebate baseline the impact of rebates will not be fully appreciated. Professor Spatt is further correct that the increase in the size of the original EMSAC treatment group in the current pilot will generate far more likely statistically significant conclusions.[13] Thus while the pilot's increase in the size of the treatment group will increase the cost of the pilot, it will also increase the benefit of the pilot as well.

NASDAQ asserts there are liquidity effects of an access fee pilot.[14] This is no doubt true, but the Commission is merely held to make a reasonable estimate of those costs before adopting a pilot

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[9] *See* New York Stock Exchange, Transaction Fee Pilot Comment Letter, at 3. Available at https://www.sec.gov/comments/s7-05-18/s70518-3755194-162578.pdf

[10] *See* New York Stock Exchange, Transaction Fee Pilot Comment Letter, at 17. Available at https://www.sec.gov/comments/s7-05-18/s70518-3755194-162578.pdf.

[11] See NASDAQ, Transaction Fee Pilot Comment Letter at 4. Available at https://www.sec.gov/comments/s7-05-18/s70518-3718533-162485.pdf

[12] *See* Professor Chester Spatt, Transaction Fee Pilot Comment Letter, at 1. Available at https://www.sec.gov/comments/s7-05-18/s70518-3718530-162502.pdf

[13] *See* Professor Chester Spatt, Transaction Fee Pilot Comment Letter, at 2. Available at https://www.sec.gov/comments/s7-05-18/s70518-3718530-162502.pdf

[14] See NASDAQ, Transaction Fee Pilot Comment Letter at 1. Available at https://www.sec.gov/comments/s7-05-18/s70518-3718533-162485.pdf

program. It is not required to make a perfect estimate, nor must it cease the pilot if the costs to liquidity prove significant.

It merely must determine that, given existing evidence suggesting the distortive effect of practices in the market tied to rebates or access fees, a pilot program will provide sufficient information to inform potential future rulemaking. The Commission need only determine that the costs of the pilot, even if quite large, are outweighed by the benefits of the pilot.

NASDAQ asserts that, prior to conducting an access fee pilot, the Commission should instead proceed with recommendations contained in a prior report from the U.S. Treasury Department to clarify the duty of best execution or to reform Rule 606 disclosure.[15] That argument is precisely backwards. One of the benefits of an access fee pilot is that it could help to inform changes to the duty of best execution.

NASDAQ's comment letter suggests "The Proposal fails adequately to consider whether the action will promote efficiency, competition, and capital formation, making the rule arbitrary and capricious, and not in accordance with law. Prior Commissions have promulgated rules that violate the APA for failing to adequately perform a cost benefit analysis."[16] A careful reading of those successful legal challenges to SEC rules indicates that NASDAQ's assertion rests on an erroneous reading of their holdings.

Lessons from Chamber of Commerce v. SEC

In *Chamber v. SEC*, the SEC's cost estimate for a mutual fund independent Chairman requirement relied in part on a single survey of governance practices in the industry.[17] A contrast between that economic analysis, and the robust analysis contained in the pilot proposal, is a reminder of just how far the agency's economic analysis has evolved in the last ten years.

In *Chamber* the Commission was faulted for relying on a non-public and statistically unsound survey in a rush to adopt a final rule. By contrast, the empirical literature cited in the SEC's pilot proposal, and in the submitted Angel and Spatt comment letters, certainly provides strong empirical support for further analysis by way of data generated through a pilot study. In particular, work by Battalio, Corwin and Jennings (2016) and by Wah (2016)[18] and Wah et al (2017)[19] offers strong empirical support for the transaction fee pilot generally and inclusion of the zero rebate bucket in that pilot in particular.

The court faulted the SEC in *Chamber v. SEC* in part for rushing to re-release its rule in response to public pressure stemming from attention to practices in the mutual fund industry, and relying on evidence that

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[15] See NASDAQ, Transaction Fee Pilot Comment Letter at 4. Available at https://www.sec.gov/comments/s7-05-18/s70518-3718533-162485.pdf

[16] See NASDAQ, Transaction Fee Pilot Comment Letter at 3. Available at https://www.sec.gov/comments/s7-05-18/s70518-3718533-162485.pdf

[17] *See Chamber of Commerce v. SEC*, 412 F.3d 133 (D.C. Cir. 2005).

[18] See Elaine Wah, How Prevalent And Profitable Are Latency Arbitrage Opportunities Across U.S. Exchanges?, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2729109.

[19] See Elaine Wah et. al, A Comparison of Execution Quality Across U.S. Exchanges, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2955297.

was not considered in the record.[20] The procedural irregularities in that case stand in marked contrast to the approach taken with this pilot proposal, which is presently in the midst of a formal notice and comment process and which was informed by years of discussion at, and a proposal from, the Equity Market Structure Advisory Committee. It again bears reminding that the SEC has chosen to act via a pilot program rather than a proposal for a long-term rule.

The court in *Chamber v. SEC* further faulted the agency for its failure to consider an alternative proposal advanced by two dissenting Commissioners.[21] In this case, the clearest alternative against which this pilot proposal would be measured would be the alternative of rushing to mandatory long-term rulemaking in the absence of the data and conclusions that the access fee pilot program will ultimately produce.

Lessons from Business Roundtable v. SEC

The Court in *Business Roundtable v. SEC* faulted the agency in that it "failed to respond to substantial problems raised by commenters."[22] In the proxy access rule challenged in that case, the SEC failed to consider the problems poses by conflicted shareholders, which was one of the more common and forceful critiques raised about the rule during the comment process and indeed during congressional deliberations over the enabling legislation (including by the author of this comment!). That flaw is certainly not present in the pilot proposal, as the central concerns like the effect of the pilot on liquidity have been examined in depth in the initial proposal. Further, the agency has an opportunity to respond to additional concerns raised by the exchanges via the final rule for the pilot.

In *Business Roundtable v. SEC*, the court found that the underlying economic analysis regarding the proxy access rule relied on two studies unrelated to the question at issue.[23] Neither study spoke to the expected benefits of proxy access, but instead studied the generalized benefits of dissident directors on hybrid boards and another related to the benefits of proxy contests generally. By contrast, the empirical literature cited by the SEC and by commenters like Professor Spatt and Professor Angel, as well as work cited in this comment letter from Wah and Wah et al, is directly on point and speaks to the potential distortionary effects that the pilot program is designed to study.

The court also observed in *Business Roundtable v. SEC* that the agency failed to consider the marginal costs of regulatory change.[24] The economic analysis contained in this pilot proposal does not exhibit that failure. *Business Roundtable v. SEC* further turned in part on the SEC's failure to consider the impact of applying corporate finance regulations to the unique dynamics of investment companies.[25] That flaw is not relevant to this pilot proposal.

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[20] *See Chamber of Commerce v. SEC*, 412 F.3d 133 (D.C. Cir. 2005).
[21] *See Chamber of Commerce v. SEC*, 412 F.3d 133 (D.C. Cir. 2005).
[22] *See Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011).
[23] *See Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011).
[24] *See Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011).
[25] *See Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011).

It also bears noting that the SEC's approach to cost-benefit economic analysis has changed dramatically since the *Business Roundtable* case was decided. Since that time, the SEC has undertaken a massive investment in hiring new economists in the Division of Economic and Risk Analysis. It has made the Director of that Division a direct report to the Chairman of the SEC.

The Administrative Procedures Act requires that the SEC must "examine the relevant data and articulate a satisfactory explanation for its action including a rational connection between the facts found and the choices made."[26] The SEC still has an opportunity to address any arguments raised by the Exchanges and thereby fulfill this requirement. Furthermore, the SEC has uniquely designed the pilot program for the purpose of putting together the necessary data upon which to make a further determination to the extent that uncertainties remain.

The Court in *Business Roundtable v. SEC* faulted the agency in that it "failed adequately to quantify the certain costs or to explain why those costs could not be quantified."[27] Arguments by the Exchanges concerning the pilot proposal's failure to quantify costs are irrelevant, in so far as the proposal properly identifies where they might at present be unquantifiable and particularly where those unquantifiable costs relate to the data the pilot is intended to generate.

With respect to *Business Roundtable v. SEC*[28] and *Chamber v. SEC*, the facts are simply too dissimilar to draw any cogent comparison to the transaction fee pilot. For one thing, those two challenges both involved a final and long-term rule. This situation, by contrast, involves a proposal for a pilot program, which may or may not ultimately inform a future long-term rule proposal, which itself was proposed after years of deliberations by the SEC's Equity Market Structure Advisory Committee and it's ultimate recommendation for an access fee pilot.

There are many unanswered questions that can be informed by data generated through the Commission's transaction fee pilot. The one thing that is certain at this point is that a legal challenge to the pilot, grounded in cases like *Business Roundtable* and *Chamber*, is doomed to fail.

I thank you for considering this comment letter.

Sincerely,

J.W. Verret

Associate Professor of Law

George Mason University Antonin Scalia Law School

[26] See *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011).
[27] *See Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011).
[28] See *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011).