September 20, 2023

VIA Email

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

Re: Regulation NMS: Minimum Pricing Increments, Access Fees, and Transparency of Better Priced Orders, Release No 34-96494; File No. S7-30-22

Dear Ms. Countryman:

I appreciate the opportunity to comment in connection with SEC's proposed reforms to Regulation NMS. I presently serve as an Associate Professor of Law with tenure at the George Mason University School of Law. I also recently served on the Investor Advisory Committee of the Securities and Exchange Commission and was the chairman 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.

I write to express my support for the proposed amendments to Reg NMS rules related to minimum pricing increments, access fees, and transparency of better-priced orders (the "Reg NMS" proposal or "Tick Size" proposal). In addition to the Proposal's consistency with the core principles of individual choice, free markets, and minimal government intervention, I urge the SEC to prioritize the implementation of this proposal as it stands more independently compared to the other three market structure proposals the SEC released in December of 2022. The NMS Proposal can provide an essential foundation for future reforms, while the other proposals are more interdependent with each other and themselves rely on the Reg NMS proposal being finalized.

I. Reg NMS reform stands alone among the four Dec 2022 market structure proposals

In December 2022, the SEC introduced four proposals related to securities market structure and exchange regulation. As a concerned market participant, I would like to emphasize the importance of adopting the first proposal, the Reg NMS proposal, as the least controversial, most widely supported, and most independent proposal among the four. This proposal focuses among other priorities on decreasing the price ceiling on exchange access fees and harmonizing trade quotations with tick sizes.

I open with the most important argument in the Regulation NMS proposal's favor. Of the four market structure proposals released in December 2022, this proposal is the least controversial and the least interdependent on the other three, and so is the easiest one for the Commission to move forward after the close of the comment period. Among the four proposals introduced by the SEC, the NMS proposal, which focuses on decreasing the price ceiling on exchange access fees and updating trade quotations and tick sizes, has garnered the most consensus and support from various market participants.

The proposal addresses a critical issue in the market structure, targeting the fees that exchanges charge, which has a direct impact on market participants and investors. By lowering the access fee cap and updating trade quotations, the NMS proposal can contribute to enhancing transparency, promoting competition, and ensuring a more equitable market. Indeed the Reg NMS proposal was able to secure a 5-0 vote to put the proposal out for public comment unlike the auction or best execution proposals.

The SEC's Reg NMS proposal builds on a wealth of prior work by the Commission in the form of a pilot tick size study, comments submitted to the SEC regarding the transaction fee pilot, and numerous roundtables and proceedings of the SEC's Investor Advisory Committee and the SEC's Equity Market Structure Advisory Committee.

Some aspects of the Reg NMS proposal, such as the size of specific tick increments selected, have generated more criticism than other aspects of that proposal. The SEC included sufficient flexibility into its proposed rule to utilize comment process feedback toward a reasonable and coherent set of revised rules. The temperature of feedback on the Regulation NMS proposal is far more modest overall, and coalescing toward specific choices within the range of options presented by the initial rule proposal such as a half-cent tick size for some stocks, a minimum ten cent increment, tier rate reform and faster implementation of odd lot fixes.

In comparison, the other three proposals may face more opposition and debate, as they involve more complex and potentially controversial aspects of market structure and regulation. These proposals touch upon issues such as the duty of best execution, the creation of a new auction platform, and the requirement for more disclosure about execution quality. The execution and auction proposals have generated more disagreement and scrutiny from market participants and stakeholders.

The NMS rule was released during the same month as three other market structure reforms. Some of the public commentary and congressional discussion about the four rules treats them collectively, and indeed many comment letters submitted as part of the Reg NMS reform mention concerns about other proposals though they are filed with a batch of comment letters that are supposed to respond only to the Reg NMS proposal.

Though there are interdependencies among the four market structure proposals, the Reg NMS proposal is unique in that it can move forward without the other three. They are built on top of it, and not the other way around. Though interdependency analysis may need to be further honed for the other three proposed rules, this rule could if necessary be put into operation on its own.

Below is a list of ways in which the other three proposals (Best Execution Proposal, Auction Proposal, and Disclosure Proposal) are interdependent with each other, in ways that also highlight how the Reg NMS Proposal is independent of the other three:

1. Best Execution Proposal and Disclosure Proposal are interdependent:

The Best Execution Proposal requires broker-dealers to perform a more comprehensive analysis of execution quality and to consider additional factors when routing orders. The Disclosure Proposal, which mandates the enhanced transparency of broker-dealers' routing decisions, provides the necessary data for broker-dealers to make better-informed decisions about best execution. These two proposals are interdependent, as the success of the Best Execution Proposal depends on the data transparency facilitated by the Disclosure Proposal.

The disclosure proposal's amendments to Rule 605 would facilitate more informed execution quality comparisons by market participants. These comparisons would be affected by the best execution proposal, as it aims to improve the overall execution quality through amended order handling and routing obligations. The auction proposal would introduce new competitive auction processes that could impact execution quality. Consequently, the disclosure proposal's reporting requirements would need to account for this new process in execution quality comparisons.

2. Auction Proposal and Best Execution Proposal are interdependent:

The Auction Proposal aims to increase transparency and competition in the opening and closing auctions conducted by exchanges. The Best Execution Proposal, meanwhile, seeks to improve the quality of order execution. The increased competition and transparency in auctions, resulting from the Auction Proposal, would directly impact the best execution analysis performed by broker-dealers. Thus, the two proposals are interdependent, as the effectiveness of the Best Execution Proposal would be influenced by the changes introduced by the Auction Proposal.

The best execution proposal focuses on amending broker-dealers' order handling and routing obligations, which would be influenced by the introduction of qualified auctions under the auction proposal. The auction proposal's new Order Competition Rule would necessitate changes in broker-dealers' routing practices to ensure they consider qualified auctions as part of their best execution obligations.

3. Auction Proposal and Disclosure Proposal:

The Auction Proposal's goal of increasing transparency and competition in auctions is complemented by the Disclosure Proposal, which requires greater transparency in order routing practices. By providing more information about how orders are routed and executed, market participants can better evaluate the quality of auctions and make more informed decisions, making these two proposals interdependent.

The disclosure proposal expands the scope of entities required to produce execution quality reports and modifies the information that must be reported, including new summary statistics. This directly impacts entities operating qualified auctions under the auction proposal. The best execution proposal's amendments to broker-dealers' order handling and routing obligations would also impact the reporting requirements under the disclosure proposal, as the enhanced reporting would enable better comparison of execution quality across different entities.

The auction proposal's introduction of the Order Competition Rule would create a competitive auction process for marketable orders, thereby affecting the best execution proposal's objectives of enhancing the execution quality of customer orders. The disclosure proposal's aim to improve transparency in the market by modifying reporting requirements would complement both the best execution and auction proposals, as enhanced transparency would facilitate more effective competition and informed decision-making by market participants in meeting those other obligations.

4. Interdependency of the Other Three Proposals Contrasts With The Independence and Primacy of Reg NMS proposal:

The combination of the Best Execution Proposal, Auction Proposal, and Disclosure Proposal creates a comprehensive framework that aims to enhance market transparency, competition, and order execution quality. These three proposals work together to address various aspects of market structure, and their effectiveness is amplified when implemented together.

On the other hand, the Reg NMS Proposal is independent of the other three proposals. Or at the very least the other three are dependent on it, and therefore a number of commentors have argued that it must go first before they can be considered and adjusted to changes to the Reg NMS proposal. The Reg NMS focus on adjusting minimum pricing increments, lowering access fee caps, and increasing transparency of better-priced orders primarily affect the quoting and trading of stocks. These adjustments are aimed at improving market efficiency and fairness, addressing issues in the market that are distinct from those targeted by the other three proposals.

The NMS changes are the most concrete and build upon an established framework. The auction proposal is a novel concept, the best execution reform is a principles-based rule that takes as a given the system design choices made in the Regulation NMS proposal, and disclosure reforms similarly those design choices as given. Consequently, the Reg NMS Proposal can be effectively implemented without relying on the other three proposals, making it an independent and primary initiative.

The other three rules have overlap with each other and with this Reg NMS proposal in ways that might require reworking them after the Reg NMS piece is finalized. The SEC may come to a determination that it is unable to move forward with all four of them at the same time. The path of least resistance for the SEC in that case, given the broad coalition of support on the Reg NMS proposal and the stand-alone nature of its reforms, should then be to move forward with the Reg NMS proposal to final rule first before moving on any of its other three market structure proposals.

The adoption of the Reg NMS Proposal can set the stage for the other three market structure proposals by providing a more level playing field for all market participants, promoting fair competition in the marketplace, and enhancing overall market efficiency. Once the Reg NMS Proposal has been successfully implemented, the SEC can then proceed with the other proposals in a coordinated manner, ensuring that the regulatory environment evolves cohesively to meet the needs of market participants and investors.

Prioritizing the implementation of the proposed amendments to Reg NMS rules regarding minimum pricing increments and access fees is a logical and strategic approach. The NMS Proposal is less interdependent with the other three market structure proposals the SEC has released, and those three other proposals are more interdependent with each other and dependent on the Reg NMS proposal. By focusing on the NMS Proposal first, the SEC can lay a strong foundation for future market structure reforms that will lead to a more competitive, transparent, and efficient market landscape.

Considering the four proposals, the Reg NMS proposal stands out as the least controversial and most widely supported. Adopting the Reg NMS proposal would be a more efficient path forward for the SEC, as it addresses a pressing concern in the market without getting entangled in the complexities and controversies of the other proposals.

II. <u>Free Market Perspectives on the Access Fee Reduction</u>

As a proponent of law and economics grounded in the classical Chicago school of economics or "free market economics," I believe the proposed changes align with the core principles of individual choice, free markets, and minimal government intervention. I urge the SEC to adopt the Reg NMS Proposal as it will foster a more competitive and efficient market landscape that benefits both market participants and investors.

The proposed amendments to Rule 610 reduce and set a more market aligned access fee cap. By acknowledging the impact of technological advancements and market evolution, the SEC's proposal aims to promote a fair and competitive market by adjusting access fees in line with current market conditions. This reduces the potential for artificial barriers to entry, thus encouraging more participants to enter the market and improving overall market efficiency.

Discussions about the 30 mil access fee unavoidably bring up questions about exchange rebates. 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 could be accurately described as rent-seeking according to a school of economic thought described as the "Virginia School" or "public choice economics":

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[1] *See* Jonathan Macey and David Swenson, Wall Street Profits by Putting Investors in the Slow Lane, New York Times, 7/18/2007. Available at https://www.nytimes.com/2017/07/18/opinion/wall-street-brokers-rebates-kickbacks.html

> "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 arguments that lowering the access fee cap constitutes a "price control" are not a perfect description. If Zywicki and Macey are correct, then Reg NMS reform to the access fee cap will merely reduce the sharing of economic rents by the exchanges with sources of order flow. Economic work by Battalio, Corwin and Jennings (2016) and by Wah (2016)[3] and Wah et al (2017)[4] offer empirical support to this discussion as well.

This is a more complex arrangement than the simple label of "price control" would suggest. Exchanges obtain overwhelming market advantages from the combination of their coveted license as a registered stock exchange and from the protected quote routing requirements. And for some exchanges, high access fees serve as a pool of money they can use to buy customers through rebates that are highly structured to price discriminate between different customers.

Even assuming the argument from critics who describe this as a price control, this situation bears some similarity to situations where price controls are appropriate. Free market economics emphasizes the importance of individual liberty, limited government intervention, and free-market principles to create a society that fosters innovation, economic growth, and overall prosperity. In an ideal free market, competition drives organizations to constantly innovate, improve their products and services, and offer competitive prices to attract consumers. However, when an organization obtains monopoly or oligopoly power, it can undermine these principles by restricting consumer choice, stifling competition, and potentially leading to higher prices and reduced market efficiency.

Market power can result from various factors, such as barriers to entry, economies of scale, or government intervention through licensing and regulation. In the case of stock exchanges, the government's role in licensing and regulating these organizations and routing mandates arising from protected quotes can inadvertently contribute to the development of monopolistic behavior. This concentration of market power presents a challenge to the efficient functioning of a free-market system and may necessitate regulatory measures to counterbalance the negative effects of monopoly power.

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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.

In this section I will elaborate on the efficiency of price controls in the context of market power, drawing on free-market economics. Additionally, I will argue that the access fee cap should be lowered from 30 mils to 10 mils to better align with the fees charged by alternative trading systems (ATS) platforms and represent a fair pricing model based on the "cost plus reasonable return" methodology common to public utility regulation.

Price controls can be an efficient mechanism to counteract the distortions caused by monopoly power. In certain situations, organizations such as utilities or licensed exchanges may obtain a monopoly or near-monopoly status.

Price controls, such as an access fee cap, can be a useful tool in mitigating the adverse effects of monopoly power on market efficiency and consumer welfare. By limiting the fees that stock exchanges can charge traders for access, the government can ensure that these organizations do not exploit their market power to extract excessive profits at the expense of consumers or subsidize price discrimination via rebate tiering.

Moreover, price controls can encourage monopolistic organizations to focus on improving their services and efficiency, rather than relying on inflated fees to generate revenue. This can lead to a more competitive and dynamic marketplace, as organizations are driven to innovate and differentiate themselves to attract traders and investors. In this way, price controls can serve as a counterbalance to the natural tendencies of oligopolies to reduce competition and consumer choice.

In the case of licensed stock exchanges, the government's role in licensing and regulating these organizations creates a unique set of circumstances that can contribute to monopolistic behavior. In this context, price controls such as an access fee cap can serve as a targeted and efficient mechanism to counteract the negative effects of monopoly power, promoting a more competitive and efficient market that aligns with free-market principles.

I propose that the access fee cap should be lowered from 30 mils to 10 mils, which is more in line with the fees charged by most ATS platforms. This adjustment would better reflect a fair pricing model based on the "cost plus reasonable return" methodology. By setting the cap at 10 mils, the SEC can ensure that exchanges charge a fee that adequately covers their costs while providing a reasonable return on investment.

Free markets setting access fee prices are the optimal approach, the protected order system has drawbacks as the Atkins/Glassman dissent argued at the time of the last major wholescale reform of Reg NMS.[5] And to the extent that the SEC can consider reasonable exceptions and exemptions to protected quotes the Commission should continue to do so.

Yet for the most part protected quotes are here to stay. Given that and given that exchanges get license privileges from the orders that are routed to them, price regulation of access fees makes sense. In a situation where regulatory barriers to entry and regulatory created market power exist, price controls

[5] See https://www.sec.gov/rules/final/34-51808-dissent.pdf.

are appropriate. Where monopoly power is unavoidable, as in the case of many public utilities or where, as here, the government has conferred substantial market power through exchange licensure and regulation that encourages use of exchanges, price regulation is an unavoidable result.

On best practice in utility rate regulation is to regularly update a price cap to ensure that the price is being set efficiently. This update to the price ceiling for exchange access is useful to that end, and resets to the price ceiling should probably be considered by the SEC on a more regular schedule in the future.

Finding the appropriate price ceiling in this instance is somewhat more complicated than in analogous utility regulation. In that context, the goal is an efficient price that both provides the utility with cost recovery and with a market rate of return to encourage optimal provision of services.

In this instance the Commission should also be mindful of the second order impacts of access fees. Access fee revenue is associated with distortive rebate tiers. Access fee revenue is funneled back to some of the largest customers to incentivize order flowing to the exchange to engage in price discrimination and obtain more of the consumer surplus from matching trades. This price discrimination was the subject of unanimous concern in a recommendation from the SEC's Investor Advisory Committee.[6] And yet too low an access fee and exchanges will be incentivized to engage in and promote among customers more zero-sum high speed trading races by selling preferential access to exchange information.

There is thus a Goldilocks challenge in this specific context, too high an access fee and it creates a pool of funds that is being used to distort markets through rebate induced conflicts of interest. Too low, and exchanges have incentives to create artificial zero-sum speed races that lead to more opportunities to obtain inefficient economic rents from information access hierarchies.

The 10-mil access fee cap seems to be just the right temperature for the porridge in question, though the SEC should continue to study the access fee cap and adjust as appropriate in subsequent review of access fees. 10 mils seems the Goldilocks solution, not too hot and not too cold. It seems to match market sensitive prices set on ATS platforms, which give an idea of what a true free market "cost+reasonable non-monopoly profit" model used in utility fee regulation would generate.

Alternative trading systems (ATS) platforms have emerged as viable alternatives to traditional stock exchanges, providing increased competition and often charging lower fees to traders. Regulation ATS platforms are able to charge substantially less than the access fee cap, which comments have suggested is closer to 10 mils and who operate in a trading environment that is more competitive and less distorted by the competitive advantages that exchanges enjoy.

This 20 mil disparity between ATS platforms and exchange platforms persists despite the fact that both utilize similar technology to execute trades. This both suggests that the 30 mil fee at exchanges is at least in part a result of regulatory advantages that they enjoy and suggests that something closer to 10

[6] See https://www.sec.gov/spotlight/investor-advisory-committee-2012/exchange-rebate-tier-disclosure.pdf

mils will better approximate what a reasonable access fee in a competitive trading environment among registered exchanges would look like.

In the context of stock exchanges, lowering the access fee cap to 10 mils would better reflect the "cost plus reasonable return" methodology with Reg ATS platforms as the benchmark for estimating that baseline. This change would ensure that exchanges charge a fee that covers their operational and infrastructure costs while providing a reasonable return on investment, without exploiting their market power to charge excessive fees or to use price discriminatory rebate tiering to distort trade flows.

By lowering the access fee cap from 30 mils to 10 mils, regulators would create an environment in which stock exchanges would need to compete on the quality of their services and the efficiency of their platforms. As a result, exchanges would be incentivized to invest in innovation and technological advancements to attract and retain customers. This increased competition would drive the development of new trading tools, improved data analytics, and faster execution times, ultimately benefiting all market participants.

High access fees can act as barriers to entry for new market participants, particularly smaller trading firms and retail investors. By lowering the access fee cap to 10 mils, regulators would reduce these barriers, promoting a more competitive and diverse market landscape. This increased competition would foster more innovation, better pricing, and improved services, ultimately benefiting investors, traders, and issuers alike.

Lowering the access fee cap from 30 mils to 10 mils would have a significant positive impact on small and retail investors. High access fees can disproportionately affect smaller investors, as they may not have the financial resources to access premium trading services and market data and which may not be able to access rebate tiers (which are subsidized currently by high access fees). By reducing the access fee cap, regulators would ensure that a broader range of investors can access essential trading services, promoting greater participation and diversity within the market.

Lowering the access fee cap from 30 mils to 10 mils would create a more equitable, transparent, and competitive market environment. By encouraging market transparency, fostering innovation, reducing barriers to entry, and promoting the interests of small and retail investors, regulators can create a healthier and more dynamic marketplace that benefits all participants. This approach would ensure that the market operates efficiently and effectively, promoting fair competition and the long-term interests of all stakeholders.

III. APA Review

Under the prior administration, the SEC undertook an exchange fee pilot program which was designed to study the effect of fees and rebates on execution quality. That pilot program was challenged and successfully overturned by the DC Circuit, in part because the SEC did not have direct delegated authority to adopt the pilot but instead relied on its general exemptive authority, and in part because the SEC openly admitted it did not know the anticipated result of the pilot on market competition.[7]

The SEC's assertion in its fee pilot that it was unable to ascertain the economic impacts of the pilot program was a further nail in the coffin of the rule. The case suggests that if the SEC had instead simply made a reasonable assessment of the costs and benefits of its action, harnessing existing economic data and published work, the action would have survived judicial scrutiny.

Judge Pillard's concurring opinion makes clear that the SEC would, with reasonable evidence, have authority to set different rates or to prohibit rebates. The concurrence was more amenable to SEC concerns regarding exchange rebates and suggests that if the SEC simply adopted a stronger rule to address conflicts of interest, and defended that rule with economic analysis, it would more likely withstand scrutiny by the DC Circuit.

Indeed, Judge Pillard compares the voluminous record supporting the SEC's concern developed by the Equity Market Structure Advisory Committee, to the SEC's more limited justification for the pilot, to demonstrate that the SEC's limited defense of the pilot was an avoidable course of events.

Contrary to assertions in a comment letter from NASDAQ that the rule is "arbitrary and capricious," this approach matches with the concurring opinion in the fee pilot case which urged the SEC to take action rather than just do a pilot.

The concurrence written by Judge Pilard closed with a point of candor that the SEC's defeat in that case was a consequence of its failure to justify is action and a failure to take more direct action in response to an articulated problem. The SEC has done both of those things in this rule proposal.

Judge Pilard wrote:

> I accordingly join the court in holding that the Commission acted outside its authority when it promulgated Rule 610T because it acted without a regulatory agenda—meaning without declaring the problem it perceived with the existing regulatory regime. I believe the Commission came very close to acting within its compass. The Commission's Rule 610(c) enabled the equity markets' existing fee-and-rebate structure. As part of its oversight of the markets, the Commission has an obligation to ensure that the existing regime is not harming investors. The potential problems with the current fee structure are apparent from the face of the record. If, on remand, the Commission seeks to continue with the Pilot or otherwise regulate affecting the current fee cap, it must stake a position that there is a problem within its regulatory ambit that it has sufficient reason to think exists and that—at least without contrary evidence accessible through its planned informational intervention—it has grounds to believe continuing the status quo will do more harm than good.

Despite the SEC's loss, this suggests that at least one of the judges on the majority opinion recognized what the SEC was trying to accomplish and recognized the market distortions caused by a combination

[7] N.Y. Stock Exch. LLC v. SEC, 962 F.3d 541, 545 (D.C. Cir. 2020).

of high access fees and tiered rebates, but the court was disappointed that the SEC was not taking more decisive action and defending that action.

It would be tempting to assume that because the SEC lost a prior challenge to a rule affecting exchange fees via a pilot, a future challenge to a rule like Reg NMS might have stronger odds. That assumption misses the subtext of the majority opinion and the more forceful admonitions in the concurrence that the SEC simply needs to take more decisive action with respect to access fees and justify that action to withstand scrutiny in the DC Circuit.

In conclusion, I believe that the proposed amendments to Reg NMS rules regarding minimum pricing increments and access fees support the core principles of free market economics and will lead to a more competitive, transparent, and efficient market landscape. I encourage the SEC to adopt the Reg NMS Proposal and continue striving for market-driven solutions that benefit all market participants.

I thank you for considering this comment letter.

Sincerely,

J.W. Verret