December 21, 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 submit additional comments, to supplement my prior letter, in connection with the SEC's proposed reforms to Regulation NMS, in particular its proposal to reduce access fees to 10 mils. 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 as senior counsel and chief economist to the Chairman.

Issues at the Intersection of the Private Non-Delegation Doctrine and Exchanges as SROs

The private non-delegation doctrine, a cornerstone of constitutional and administrative law, mandates that essential regulatory powers vested in a federal agency cannot be delegated to private entities. This principle is particularly relevant in the context of Self-Regulatory Organizations (SROs), like stock exchanges, that operate at the intersection of private management and public regulatory functions.

The private non-delegation doctrine limits the ability of private entities in exercising the force of government regulatory power to instances in which private entities are subordinate to a federal government agency. In the recent case *National Horseman's Benevolent and Protective Association v. Federal Trade Commission* (the "NHBPA case"), a congressional delegation of self-regulatory authority to a horseracing trade association was struck down for violation of the private non-delegation doctrine.[1]

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[1] NHBA at 1.

The NHBPA case involved the creation by Congress of the Horseracing Integrity and Safety Authority, which was granted self-regulatory powers or "SRO" status and housed under the general authority of the Federal Trade Commission (the "FTC") with limits on the FTC's ability to review its rules.[2] The SRO was able to propose rules to the FTC, which the FTC was required to approve if those rules were consistent with the authority granted to the SRO, limiting the FTC's authority to only proposing modifications of the SRO's rules.[3]

These restrictions on the FTC's ability to review, modify, or abolish rules of the Horseracing Integrity and Safety Authority were ultimately what led the Fifth Circuit to strike down the organization's self-regulatory authority under the private non-delegation doctrine. And while the FTC was granted the ability to adopt interim final rules under a "good cause" standard, this limitation actually bolstered the court's ruling that the statute violated the private non-delegation doctrine.

The court looked at who was really "in the saddle" when making policy judgments and setting industry fee programs and found the construct did not follow the clear hierarchy mandated by the constitutional private non-delegation doctrine.

The limitations on the FTC's authority in the NHBPA case bear a remarkable similarity to the limits on SEC review of stock exchange fees and trading practices that certain exchanges have alleged exist in various comment letters regarding the recent proposed market structure rules related to SRO fees. And indeed, one of the types of rules at issue in the NHBPA case were fee assessments promulgated by the horseracing SRO, which furthers the precedential import of this case for the exchange SRO rules at issue, which also regulate fee practices.

Ultimately, the manner in which the delegation of power to a private SRO was struck down in the NHBPA case complicates the threat from large exchanges to challenge the SEC's market structure reform proposals on access fees and the more recent volume-based rebate tier reform proposal. In short, as recent case law has highlighted, SROs are only allowed to exist as self-regulatory organizations that wield regulatory privileges, consistent with the Constitution, so long as that role acts as an aid to a government agency, allowing the agency to retain substantial discretion to modify or disapprove of an SRO's fee structures. The arguments that the large exchanges have made happen to be inconsistent with these constitutional parameters, as has been brought to light in the disallowance of a similar private-agency construct in the horseracing industry.

The stock exchange SROs have argued in comment letters that the SEC is limited in its ability to adopt these rules with a description of those limits that is eerily similar to the limits that were the death knell for the horseracing SRO.

[2] NHBA at 3.
[3] NHBA at 3.

For example, in a comment letter NASDAQ argues:

"Even if changes to exchanges' costs of trading was a valid basis for reducing the access fee cap, the Commission still fails to establish what is the actual cost to an exchange of a trade, the level of access fee cap that would constitute a reasonable relationship to that cost, and most importantly, that the SEC's proposed reduced fee caps do, in fact, bear a reasonable relationship to the actual costs to an exchange of a trade. The tasks of determining such costs and setting appropriate rates based upon those costs are inherently difficult, especially in an industry with diverse participants and business models; these are tasks that a government agency like the Commission is ill-suited to tackle and from which it should refrain."[4]

NASDAQ's description of the SEC's role in reviewing the access fees set by exchanges is entirely inconsistent with what is required of SEC oversight of exchanges by cases like NHBA pursuant to the private non-delegation doctrine, as well as U.S. Supreme Court cases dating back to the 1930's, such as *Carter v. Carter Coal Co.*, and the many cases that have since followed.

Conferring regulatory powers to private entities mandates the adherence to the private non-delegation doctrine, which requires the regulatory agency to independently review, assess, and modify the actions of the private SRO, particularly when it comes to determining equitable fee structures where cronyism and regulatory conferred oligopoly power is enjoyed.
NASDAQ further argues:

"*the SEC merely assumes that rebates present a conflict of interest to brokers that is harmful to investors, and that the harmful effects of that conflict are substantial enough and costly enough to justify the Proposal's drastic reductions to the existing access fee caps. That type of unsubstantiated assumption is insufficient to justify a rulemaking that has the potential to upend the way in which exchanges incentivize market quality.*"[5]

In so arguing, NASDAQ makes two critical mistakes. It once again fails to appreciate the constitutional framework necessitated by the private non-delegation doctrine for SEC review of stock exchange SROs like NASDAQ. And NASDAQ further fails to appreciate that the multi-factor test created by the 75 Act amendments allows fairness considerations to alone justify exchange fee rules independently of economic analysis.

The fact that the FTC "can't review" the SRO's rules was dispositive, and the court held that "[a]n agency does not have meaningful oversight if it does not write the rules, cannot change them, and cannot second-guess their substance."[6] The arguments made of large exchanges in the comment letter process thus far amounts to an argument that, when it comes to stock exchanges access fees and rebate tiers, the SEC does not write the rules, cannot change them, and cannot second guess their substance.

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[4] See https://www.sec.gov/comments/s7-31-22/s73122-20162299-331153.pdf at page 22.

[5] https://www.sec.gov/comments/s7-31-22/s73122-20162299-331153.pdf at page 26.

[6] NHBA at 3.

The FTC was granted the ability to adopt interim final rules under a good cause standard, a limitation which the court found as part of the reason the statute violated the private non-delegation doctrine.[7]

This case, and the line of cases that it followed, at a minimum has implications for the economic cost benefit analysis and for the fairness/statutory factor analysis required of the SEC, and will act to shift the strong burden created by *Business Roundtable v. SEC* away from the Commission and toward a challenging exchange SRO plaintiff.

If the exchanges are correct about their arguments, then the private non-delegation ruling in NHBA v. FTC will dismantle the existing exchange SRO model. Nevertheless, at a minimum, the NHBA case will shift the burden in challenging registered exchange fee rules to the exchange SROs.

While the NHBA case recognized that the SEC's oversight of FINRA has been upheld under the private non-delegation doctrine, that doesn't mean that the type of deferential relationship that dominant stock exchanges seem to think they enjoy with the SEC will be upheld under the private nondelegation doctrine as well. Indeed, the relationship some exchanges seem to believe they enjoy with the SEC is remarkably similar to the design struck down in NHBA v FTC. FINRA has survived private non-delegation scrutiny because the SEC retains authority to "abrogate, add to, and delete from" FINRA rules "as the [SEC] deems necessary or appropriate.[8] FINRA survives private non-delegation because FINRA's role is "'in aid of' the SEC, which has the final word on the substance of rules."[9]

Either this framing is true with respect to exchange rules regarding access fees and rebates, in which case the SEC's proposals will survive challenge by the exchanges and the exchanges will face a heavy burden in their challenge. Or it's not, in which case the exchange SRO model itself may come crashing down.

Reducing Access Fees to 10 mils

The proposed NMS reform to reduced access fees to 10 mils is grounded in sound economic principles and empirical analysis that highlight the market distortions created by existing fee structures and rebate systems employed by national exchanges. Access fees charged to broker-dealers and other market participants simply to access liquidity on certain exchanges often greatly exceed the actual costs associated with providing that liquidity access.

The Commission's proposals to lower the access fee cap closer to levels reflective of actual access costs, as seen on competing ATS trading platforms, combined with judicious adjustments

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[7] NHBA at 12.

[8] NHBA at 30, citing Aslin v. FINRA.

[9] NHBA at 30.

to reign in abusive volume-based rebate practices, will collectively help realign market incentives.

The Commission has rightly justified these reforms based on the multiple ways in which unchecked exchange access fees and incentives from rebates ultimately undermine efficient markets. From an economic standpoint, trading fees that greatly exceed the actual costs of liquidity access act as a tax on trades that raises trading costs for investors. Estimates suggest that excess trading fees charged by exchanges amount to billions of dollars in the last 15 years compared to trading fees charges on competing ATS platforms. This effective regulatory tax on trades routed to exchanges due to market structure rules distorts order routing decisions and results in higher trading costs passed down to the end investor.

Mancur Olson's *The Logic of Collective Action* describes the problem of concentrated benefits but distributed costs, and how that dynamic leads the beneficiaries to have sharper incentives for push to maintain their benefits where the costs of those transfers results from dispersed groups that find it more difficult to engage collectively. This problem of collective action has been exhibited in government taxation and spending, but it can also be exhibited in regulation.

And in market structure, this problem of concentrated benefits but distributed costs is compounded by the skillfully hidden nature of those benefits and costs. The retail investor sees that the direct commission paid on a trade is low or zero, but they do not see the actual cost of a trade because of the regulatory tax of above-market access fees for flow that is required to go to exchanges functions as a hidden regulatory tax on their trades.

In terms of calculating that cost, one way is to compare access fees across platforms. I have come to a rough estimate of $30 billion in above market economic rents enjoyed by exchanges as a result of above market access fees. This number is derived by looking at exchange volumes from Jan 2008 – August 2023, then estimating what portion of exchange volume was executed where the remover paid 30 mils/share. Then, taking that volume and multiplying it by 20 mils (since that is the difference between the 30 mils paid and the 10 mils that would've been paid, had that been the access fee decided).[10]

The Commission's proposed access fee cap to 10 mils combined with sensible constraints around disproportionate rebates offered in a more recent proposal merely brings equilibrium and fairness back to exchange fee structures set by exchanges that enjoy the privilege of government conferred licenses, trading flow mandates and SRO regulatory power.

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[10] **Calculation details:**

- The amount of venue-by-venue market volume is publicly known, so I aggregated on-exchange daily volumes from 2008 thru 2023 YTD. The volume for which 30 mils to access liquidity is charged takes place on "maker-taker" exchanges (BZX, EDGX, MEMX, MIAX, Nasdaq, NYSE, NYSE Arca, Nasdaq PSX). Some portion of volume on these venues comes from auctions, and some small percentage does not pay 30 mils. I assumed that 10% of the "eligible" volume is from auctions, and, of the remaining 90%, 95% pays 30 mils. I then multiplied the remaining "eligible" volume by 20 mils (the difference between 30 mils paid and what would've been paid if access fees were 10 mils) – the number is $30bn from 2008 to 2023 YTD.

Sincerely,

J.W. Verret