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Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
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Re: Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Modify the IEX Fee Schedule, Pursuant to IEX Rules 15.110(a) and (c), to Charge a Fee of $100 Per Month for Each Logical Order Entry Port in Excess of Five Per User, Securities Exchange Act Release No. 86626 (August 9, 2019), 84 FR 41793 (August 15, 2019) (SR-IEX-2019-07)

Dear Ms. Countryman:

The Nasdaq Stock Market LLC ("Nasdaq") appreciates the opportunity to comment on the above-captioned rule change, a proposal by Investors Exchange LLC ("IEX") to charge, for the first time in its history, a fee for connectivity to its market. Specifically, IEX proposes to provide market participants with five free order-entry port connections, while charging $100 per port for each order-entry port in excess of five. Nasdaq has no objection to the proposed port fee, since IEX, like Nasdaq and other exchanges, operates in the fiercely competitive market to attract and execute orders.[1] However, an order-entry port serves no purpose other than enabling the entry of orders, so the fees charged for the port should be viewed as one aspect of the market to attract and execute orders, rather than, as IEX asserts, a "natural monopoly" over connectivity controlled exclusively by IEX.[2] Simply put, no one would want to

1 *Net Coalition v. SEC*, 615 F.3d 525 (D.C. Cir. 2010).

2 We note that IEX is misusing the term "natural monopoly," which is defined in common economic parlance as a business operating in an industry where a single provider can serve the entire market at a lower cost than could two or more firms. Such a cost structure can create a barrier to competitive entry. What IEX is actually asserting is that it controls direct access to its matching engine and prevents other firms from providing such access. The situation might be analogized to a health club that controls its lockers and parking facilities and charges a fee for their use. While the health club has a "monopoly" over its lockers and parking lot, it does not have a monopoly over providing health club services. Plainly, since it cannot use its control over lockers and parking spaces to prevent competitive entry, it lacks monopoly power. Similarly, it should be clear that exchange control over access services does not prevent entry by competing exchanges and alternative trading facilities, which

connect to IEX unless wishing to trade on its exchange,[3] and no one would want to trade there unless the exchange attracted other orders. Moreover, if the overall cost of doing business with an exchange – inclusive of entry port fees – is higher than the cost of doing business with other exchanges, without offering value commensurate with the additional costs, economically rational actors in the market will do what they can to minimize their interactions with it.

The more perplexing aspect of IEX's filing is its voluntary, but ultimately misleading, foray into public utility style ratemaking, wherein IEX states that $1,508,976 is its "aggregate annual cost" to provide order entry ports. In the study from which this statement is drawn,[4] IEX finds that its cost to provide "market data infrastructure" is about the same – $1.79 million – while the cost of its physical connectivity infrastructure is about $800,000. According to its Form 1, however, IEX's total operating expenses for the fiscal year ended December 31, 2018 were $50,561,830, or more than 12 times higher than the costs that it attributes to the provision of connectivity and market data infrastructure.[5]

IEX's exchange operations are limited to providing a cash-equities matching engine, providing connectivity to that matching engine, and disseminating data produced by that matching engine. Put another way, IEX's exchange operates as a trading platform in competition with other trading platforms, and all of its operations and associated costs derive from the operation of a matching engine and IEX's efforts to attract orders to it. If IEX did not incur the costs associated with running its matching engine, it would not have market data to distribute, nor would market participants have any reason to connect to it. Similarly, if IEX opted not to incur the costs that it attributes to data and connectivity infrastructure, market participants would not have the ability or willingness to connect to it and provide it order flow. As a result, IEX's allocation of its overall costs to particular aspects of its operations is inherently and unavoidably arbitrary, since all of its operations are different facets of the unified business of attracting and executing orders. Its cost disclosure is no more meaningful than a rancher allocating the cost of raising and slaughtering cattle between beef and hides.

Another notable aspect of the filing is IEX's disclosure that its expected revenues from the proposed fee allegedly will be *lower* than its purported costs. If connectivity to IEX could be meaningfully analyzed as a separate market distinct from the overall market for order flow, one might conclude that IEX's behavior was either economically suicidal or an effort at predatory

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have proliferated in the past two decades and continue to do so. Moreover, the fact that, as detailed in IEX's filing, service bureaus can acquire order entry ports and spread their cost across multiple market participants demonstrates that exchange control over the ports does not prevent a form of "resale" competition in which third parties can undercut exchange fees and add value for their customers.

3 Or, as is the case with service bureaus, wishing to facilitate trading by others.

4 IEX, "The Cost of Exchange Services" (Jan. 2019) (available at https://iextrading.com/docs/The%20Cost%20of%20Exchange%20Services.pdf).

5 These costs in turn reflect a substantial increase over IEX's total operating expenses for the fiscal year ended December 31, 2017, which were only $38.6 million.

pricing. Neither conclusion is, however, correct since the proposed fee is just one aspect of the means by which IEX seeks to compete for order flow, recoup its overall costs, and earn a profit. According to its Form 1, during fiscal year 2018, IEX had net revenues of $77,059,183, comprised primarily of fees for the use of its matching engine and its routing broker and data revenue from its participation in national market system plans. Examining an exchange's net revenues, together with its trading volumes, allows one to determine the all-in cost to trade on the platform, while comparing total revenues with total costs, including joint costs, allows one to determine an exchange's margin. Since we would expect that the vast majority of persons using connectivity and market data also trade,[6] we believe that such an analysis is a more appropriate basis for assessing the competitiveness and rate of revenue growth of the relevant market – the market to attract and execute orders – than focusing on each fee in isolation.

As Nasdaq's Chief Economist Phil Mackintosh has previously shown, when you analyze the all-in costs to trade on IEX, IEX is actually the most expensive exchange to interact with, on a per-share basis.[7] All else equal, the fee that IEX is proposing here only serves to increase its all-in cost. While the order routing decisions of market participants are undoubtedly influenced in the short run by the regulatory factors of the duty of best execution and the order protection rule, in the long run exchange customers make economic rational decisions to optimize their expenses within the constraints imposed by regulation. In our view, that is one of the factors that explains why, in a competitive market for order flow, IEX's market share has been in the low single-digits since its inception.

IEX's effort to allocate its costs and revenues with a false precision only underscore how misguided it would be for the Commission to require others to follow in IEX's footsteps. Since there is no economically meaningful method of allocating the joint costs of running an exchange between the different components of the business, if exchanges were forced to tie particular fees to particular costs, each exchange would choose an allocation methodology that best suits its purposes, or would be driven by regulatory fiat to adopt an arbitrary method selected by the Commission. Similarly, the usefulness of cost data in ascertaining whether the portion of joint costs defrayed by a particular product are "too high" is quite limited. Taking IEX's disclosure at face value, one might say that its transaction fees are "too high," since they "subsidize" the "cost" of its order entry ports. But since the customers who buy ports to enter orders are also paying the fees associated with executing those orders, that would be no more meaningful than saying that money from one pocket is subsidizing purchases out of another pocket.

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6 The converse is not necessarily true: in our experience, not all traders purchase connectivity directly from each exchange, nor do they purchase a full array of market data products. Rather, they select the suite of products that is best suited to the needs dictated by their business model.

7 Mackintosh, "Is Free Fair to All" (Jan. 29, 2019) (available at https://www.nasdaq.com/article/is-free-fair-to-all-cm1089369).

We also note that in its recently floated guidance on fee filings,[8] the Division of Trading & Markets asserted that connectivity imposes "fixed" costs on customers, and that if these costs are "high," exchanges should assess the burden that such a fee structure places on, for example, smaller broker-dealers. As IEX's filing demonstrates, connectivity costs are not in fact fixed, but rather vary with the volume of order flow and firms' actual needs and can be reduced if firms reconfigure their connections to achieve greater efficiency.[9] Moreover, attempting to assess whether a particular fee is "high" requires the sort of arbitrary cost allocation exercise that undergirds IEX's filing. If the Commission chooses to embrace this approach, the agency and those that it regulates will become mired in an endless cycle of micromanaging fees to allocate and reallocate exchange revenues and market participants costs among different products and different constituencies.[10] Even worse, the Commission may opt to make the sort of regulatory decisions that IEX has long advocated – creating a one-size-fits-all template for service offerings and fee structures – to tip the scales of competition. And to what end? The market for order flow is fiercely competitive, the size of exchange costs in comparison to other costs borne by firms and investors is vanishingly small,[11] and spreads have shrunk dramatically.[12] Perhaps it is time for the Commission to recognize that "for-profit" is not a dirty word, and that the market forces unleashed in the last decade by allowing vigorous competition between for-profit exchanges and alternative trading systems have enhanced market quality, reduced overall costs, and improved the product offerings of trading venues. The type of

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8 Division of Trading & Markets, SEC, "Staff Guidance on SRO Rule Filings Relating to Fees" (May 21, 2019) (available at https://www.sec.gov/tm/staff-guidance-sro-rule-filings-fees). But see Chairman Jay Clayton, SEC, "Statement on Division of Trading and Markets Staff Fee Guidance" (June 12, 2019) (available at https://www.sec.gov/news/ public-statement/statement-division-trading-and-markets-staff-fee-guidance).

9 84 FR at 41795.

10 IEX's efforts to analyze how its fee will impact different types of customers only serves to demonstrate what a morass this effort would involve. For example, IEX asserts that "[t]he proposed fee will not apply differently based upon the size or type of the market participant, but rather based on the number of Order Entry Ports a User requests…" 84 FR at 41796. One might reasonably enquire whether this is true, however, or whether requesting a large number of ports correlates with being a particular size or type of market participant. Such assessments would become unavoidable if the Commission undertook to make policy judgments about the correct allocation of fees to various customer classes. In addition, if the Commission actually elected to evaluate fees relative to (allocated) costs, it would also need to undertake the daunting task of establishing the permissible rate of return on exchange assets.

11 Mackintosh, "The Big Picture on the Data Debate" (August 1, 2019) (available at https://www.nasdaq.com/article/the-big-picture-on-the-data-debate-cm1188780).

12 Mackintosh, "Reg NMS for Dummies" (May 9, 2019) (available at https://www.nasdaq.com/article/reg-nms-for-dummies-cm1145885).

government intrusion in the market invited by IEX's filing is truly a solution in search of a problem.

Very truly yours,

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