November 20, 2015

VIA Email

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

Re: Investor's Exchange LLC Form 1 Application (Release No. 34-75925; File No. 10-222)

Dear Mr. Fields:

I appreciate the opportunity to comment in connection with the Investors' Exchange LLC ("IEX") Form 1 application. I presently serve as an Assistant Professor of Law at the George Mason University School of Law. I am writing in my individual capacity, and my views are my own. My views are however informed by my work as a tenure track professor of securities law. My views are also informed by my recent experience as 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. Please note, I am not being compensated for this comment letter.

I have sincerely appreciated, both during my time at the House Financial Services Committee and subsequently, Chair White and the Commission Staff's thoughtful, deliberative, and process-oriented approach to the complex issues involved in the market structure debate. I appreciate that at times in this debate it may become difficult to separate the firm-specific interests of individual market participants from the Commission's broader statutory obligation under the Securities Exchange Act to encourage competition in this area. I would personally observe that the Chair, the Commission and the Staff have weighed those concerns thoughtfully in their approach to this issue.

Despite my confidence in the Commission, I feel compelled to speak up at this time. I fear that recent comment letters from a small handful of market participants regarding IEX's exchange application seek to short-circuit the Chair's deliberative approach, and instead suggest a change of course toward firm-specific, one off "regulation by licensing application" that would represent a very different approach to the challenges of market structure reform than the one the Commission has thus far pursued.

I hope the Commission will reject the suggestion in these comment letters that it abandon its measured approach to these issues in favor of an alternative approach that instead would favor incumbents in the industry through firm-specific "regulation by licensing application" that targets new entrants to the exchange business for heightened scrutiny, which by implication incumbent exchanges that have been previously approved would not similarly face.

My primary concern is with the nature and tone of some of the objections seen in industry comment letters that respond to IEX's application. For example, a letter from the NYSE Group observes: "Like the 'non-fat yogurt' shop on Seinfeld, which actually serves tastier, full-fat yogurt to increase its sales, IEX advertises that it is 'A Fair, Simple, Transparent Market,' whereas it proposes rules that would make IEX an unfair, complex and opaque exchange."

Cultural references are a helpful way to crystallize debates, particularly references to the universally respected television sitcom Seinfeld, however I suggest that the tone of the NYSE Group's observations conjures a different Seinfeld reference, as the NYSE Group would have the Commission deny IEX's application with a curt "No Soup for You!" on the basis of scant justification.

These industry objections bear a striking similarity to the objections raised by incumbent taxicab companies to the operation of Uber and by hotel chains to innovation by AirBandB. An extensive prior literature in economics explores how incumbent firms have long sought to utilize regulatory barriers to entry to minimize competition, and it would appear a number of firms are presently using the regulatory comment process regarding IEX's application as a venue to replicate that strategy here.

A Strong Analogy Between Licensing Regulation and the Export-Import Bank Controversy

There has been a sizeable focus in the Congress on the distortive economic effects that trade subsidies provided by the Export-Import Bank of the United States impose on the American economy. That congressional focus resulted in a significant period this year during which the Export-Import Bank's continuing authorization as a government agency was up for debate, and indeed was rendered unauthorized for many months.

The government subsidies that the Export-Import Bank of the United States provides to recipients of government guaranteed loans is directly analogous to the market distortions that regulatory barriers to entry create by favoring incumbent firms, including in this particular policy arena.

Henry Manne, a founding Dean of the George Mason University School of Law, observed that the NYSE has long employed a strategy designed to utilize regulatory barriers to entry to obtain market advantage when we wrote in 2001 that:

> …from its inception, American securities regulation consistently has benefited politically powerful financial interests, and that only competition and newer forms of communications technology — not the SEC — have disrupted those cozy arrangements…. The most famous effort by the SEC to benefit established financial interests at the expense of the investing public was the campaign to help the New York Stock Exchange (NYSE) preserve its now-defunct price-fixing rule for brokerage services. The Big Board's "fixed-commission-rate structure," the very heart of its alleged cartel power, had existed from the exchange's inception in 1792. But, as eventually happens with all cartels, cheating by price cutting, kickbacks, rebates, and special favors of all kinds had become a way of life among NYSE firms by the late 1950s. The problem was exacerbated by the growing demand from financial intermediaries, like mutual funds, for lower commission rates on large-block trades. The situation threatened to overwhelm the SEC, which had concurrent enforcement authority with the NYSE over

> the commission rate structure. As then-chairman Manny Cohen complained, "Almost every regulatory problem we have concerning the securities markets is related in some way to the level or structure of rates prescribed by the minimum commission rules of the New York Stock Exchange." Still, the SEC struggled to preserve this most sacred of Wall Street interests, and its efforts did not fully cease until 1975, when Congress ordered an end to the ancient rule. By then, effective cheating and new forms of competition had rendered the rule nearly meaningless, largely dissolving the available monopoly rents that had kept Congress sympathetic.[1]

When Dean Manne passed away early in 2015, the Wall Street Journal's op-ed page offered a much deserved half-page tribute summarizing his decades of extraordinarily insightful commentary in their pages. His commentary on this particular question is sorely missed.

Chairman Hensarling has also relatedly observed with respect to many financial regulation questions that: "regulation is a huge barrier to entry and solidifies their [incumbent firms] competitive position. It has helped them get a larger share of a shrinking pie."[2] The Chairman is correct that firm subsidies obtained through loans guaranteed by the federal government is directly analogous to the problem of subsidies obtained via regulatory barriers to entry.

Industry commenters would have the Commission determine the propriety of various exchange practices in this individual application, where those questions are more properly reserved to a comprehensive review of market structure. For the Commission to do otherwise would raise serious concerns about the oversight relationship between the Commission's licensing process to bless exchange registrations and the incumbency advantages enjoyed by the incumbent large exchanges. These concerns would properly fall within the "crony capitalism" theme that has been a primary focus in various features of the House Financial Services Committee's oversight of a multitude of regulatory and subsidy issues, including its oversight of the Export-Import Bank.

This "crony capitalism" focus of the House Financial Services Commission is further implicated in the present debate because, as a designated Financial Market Utility, the NYSE further obtains access to the Federal Reserve's discount window. That access to the federal safety net already provides the NYSE with a distinct competitive market advantage, which is effectively backed up by the American taxpayer since Federal Reserve annual surpluses not loaned to FMUs would otherwise be remitted to the Treasury. I hope the Commission will carefully consider the implications of regulatory barriers to entry the NYSE presently enjoys, which are further compounded by the federal safety net advantage that the NYSE in particular presently enjoys as a designated Financial Market Utility.

<u>The NYSE Group's Comment Letter, And Other Industry Comment Letters, Implicate Serious Process Concerns</u>

The evidence offered by the industry commenters that IEX's processes will systematically disadvantage certain groups of retail investors is cursory and hypothetical. If at a later time more substantial evidence of that assertion should arise, and in a way that implicates practices clearly and expressly prohibited by

[1] http://object.cato.org/sites/cato.org/files/serials/files/regulation/2001/12/brieflynoted.pdf
[2] See http://fortune.com/2015/05/18/jeb-hensarling-takes-a-swing-at-corporate-welfare/

the Securities Exchange Act, the Commission will have an opportunity to take action as part of a compliance examination and/or an enforcement action.

All of the challenges raised in the NYSE's comment letter, and many challenges raised in other comments, come in two distinct flavors. They first focus on unsubstantiated concerns that are not clearly prohibited by the Exchange Act and the rules promulgated thereunder, and that, even if later substantiated by concrete econometric evidence, and further determined to violate the Exchange Act, would be better addressed by way of a compliance audit and enforcement action by SEC staff after the exchange application is approved.

Or, alternatively, they speak to a larger debate about equity market structure that has been percolating for over a decade, that implicate controversial practices not presently prohibited by the SEC at many firms, including practices presently employed by firms that have offered critical comment with respect to IEX's application, and that would ultimately be better determined pursuant to a comprehensive reconsideration of market structure regulation and which should ultimately be best judged by the operation of natural market forces.

Misinterpretation of Regulation NMS and the Evolving Concept of Time, circa 2005

The NYSE Group requests that the SEC prohibit the POP "speedbump" utilized by IEX using two arguments. Their first retail investor impact argument has previously been addressed with this letter's observation that no serious empirical, or econometric, evidence has been presented to support that assertion. The next section of this comment letter will further suggest that concerns about enhancing competition will trump fairness concerns in judicial review of an exchange application such as this one under a fair reading of the Exchange Act and in light of *Business Roundtable v. SEC*.

The NYSE Group further argues that the IEX speedbump is prohibited by the SEC's Regulation NMS. That argument rests on an overly formalistic reading of Regulation NMS that fails to account for the rise of high speed trading in the last decade.

The difference between a reference to prohibited time delays promulgated by language adopted by the Commission in 2005, and where we stand now in 2015, is analogous to how the English language's understanding of the concept of time changed before and after Einstein's publication of the theory of relativity. In any setting other than an attempt to halt a competitor's application for registration, it would surprise me if a sophisticated financial market firm like the NYSE, conversant in the evolution in high speed trading seen over the last decade, would suggest the obtuse interpretation of Regulation NMS that they proffer in their comment letter on this particular exchange application.

The Relevance of the Commission's Cost-Benefit Analysis Requirements As Interpreted In *Business Roundtable v. SEC* to this Discussion

The NYSE Group further requests that the SEC prohibit IEX's POP speedbump by arguing that it would have adverse affects on a subset of retail investors. The NYSE Group does not however provide empirical evidence to support that assertion, nor does it demonstrate that the Securities Exchange Act

presently prohibits latency practices designed to further an explicit and credible investor protection purpose and designed to enhance competition in the execution of trades. In the wake of *Business Roundtable v. SEC*, that turns out to have a highly significant implication in this context.

Section 11A of the Exchange Act requires the SEC to weigh a number of factors in this area, including: "(1) economically efficient execution of securities transactions, (2) fair competition among broker-dealers, among exchange markets, and between exchange markets and non-exchange markets; (3) price transparency; (4) best execution of investor orders; and (5) an opportunity, consistent with economic efficiency and best execution, for investor orders to meet without the participation of a dealer."[3] This list of five goals contains items which may at times be in mutual competition.

A fair reading of the Securities Exchange Act, particularly in light of the DC Circuit Court of Appeals opinion in *Business Roundtable v. SEC*, is that the Commission's obligation to consider "efficiency, competition, and capital formation"[4] in addition to investor protection should serve as the Commission's guiding compass in weighing tradeoffs inherent in the five factors enumerated in Section 11A. I would argue that the competition element in those factors is most strongly implicated at this particular stage of the Commission's decision to weigh on the application of a new entrant to the public exchange business, which presently has a fairly small number of operative exchanges.

The SEC's decision to admit a new entrant to the exchange world, or not, will have an outsized impact on competition in the matching of trades on public exchanges. Given the rate of growth in relative trade routing to recently approved exchanges that obtained access to protected order flow, that had similar trade volume to this applicant prior to exchange approval, it is clear that this exchange approval decision will have an outsized impact on the competition element in the three part statutory mandate added to the Exchange Act by the Gramm-Leach-Bliley Act.

Concerns about efficiency or investor protection can be subsequently better addressed via the Commission's regulatory oversight authority over registered exchanges. I would therefore argue that, in the event the Commission failed to approve this particular exchange application, the impact on competition would trump other concerns in the Commission's "economic analysis" or "cost-benefit analysis" mandate reaffirmed by the D.C. Circuit in *Business Roundtable v. SEC* in interpreting that provision in the Securities Exchange Act. In addition, the fact that the POP speedbump is designed to credibly and explicitly further an investor protection purpose would likely further bolster a future legal challenge to an exchange application denial if brought under the economic analysis requirement elaborated by *Business Roundtable v. SEC*.

Conclusion

I hope it does not surprise any readers of this comment letter to learn that my concern is not whether IEX ultimately succeeds. I think Cliff Asness and Michael Mendelson of AQR Capital Management said it best in the pages of the Wall Street Journal:

[3] https://www.sec.gov/spotlight/emsac/memo-rule-611-regulation-nms.pdf.
[4] https://www.sec.gov/about/laws/sea34.pdf

> These big, traditional investment managers represent a business opportunity to anyone who can offer them new market venues, like IEX, that might conceivably avoid the perceived ill effects of high-frequency trading. We wish them well in that effort, and if they succeed these new exchanges and their clients will benefit. But let's allow the issue to be decided by open competition, not by politics, demagoguery and rules born of crony capitalism. Our bet is that high-frequency trading comes out on top as it offers more investors better execution. But we have zero problem being proven wrong by the marketplace.[5]

In summary, my argument is that if the Commission failed to approve IEX's application solely, or principally, on the basis of the arguments that have thus far been raised in the comment process by incumbent firms, that decision:

1) would constitute a complete about-face by the Commission from its current deliberative, market wide approach to market structure regulation reform,
2) should invoke a legitimate inquiry from congressional oversight regarding the Commission's relationship with incumbent exchanges and related crony capitalism concerns, as a logical and necessary extension of the Congress's oversight of government subsidies provided through the Export-Import Bank,
3) may invite a challenge pursuant to the reasoning in *Business Roundtable v. SEC* that the Commission insufficiently considered the impact of disapproving this application on competition in this industry, and insufficiently considered that the POP speedbump was credibly designed to further an investor protection purpose, and
4) would pre-judge relevant questions on the basis of insufficient evidence which the Commission would retain the power to investigate via compliance audits and/or enforcement actions at a later time in the event more substantial evidence of Exchange Act violations were put forward.

I thank you for considering this comment letter.

Sincerely,

J.W. Verret

Assistant Professor of Law

George Mason University School of Law

[5] http://www.wsj.com/articles/SB10001424052702303978304579475102237652362