EFFORTS TO SUE THE SEC OVER BROKER-INDUCEMENT REGULATION UNLIKELY TO SUCCEED

J.W. VERRET*

ABSTRACT

This article considers a rulemaking effort underway at the Securities and Exchange Commission (SEC) to regulate the conflicts of interest that result when brokers send client orders to venues that pay the broker a fee in exchange for routing to them. These payments for order flow or rebates present a distortive conflict to a broker's duty of best execution that has troubled the SEC for over 40 years and which the SEC has tried to regulate through multiple reforms. The SEC's new Chairman has indicated he will more forcefully address broker conflicts. A number of regulated entities have threatened to challenge the rule in court.

Analysis of this rule, and of the likely outcome in subsequent court challenge, shows that the expected challenge is likely to lose. Yet, this analysis is of interest not merely to brokers accepting payment for order flow (PFOF) Along the way the reader is taken on a tour of lesser-known SEC rulemaking objectives that take on surprising significance in the market structure context.

The SEC's competition objective will play a central role in this rule, reminding readers that the SEC is, at least to some extent, an antitrust regulator. The SEC's fairness objective will also feature prominently in this rule. This fairness focus does not easily lend itself to economic analysis and therefore will require that a qualitative conflicts analysis be paired alongside any traditional economic analysis. Since prior SEC rule challenges have focused on economic analysis, it would appear a rulemaking under the fairness objective bolster's the SEC's chances of success.

* J.W. Verret, J.D., C.P.A. is an Associate Professor at the Antonin Scalia Law School at George Mason University, where he teaches securities law, corporate law, banking law and financial accounting.

What begins as an analysis of a specific rule, and a brewing challenge over a specific rule ultimately provides a richer understanding of the SEC's multi-factor mission and of the administrative law constraints governing SEC rulemaking.

TABLE OF CONTENTS

I. BACKGROUND ON BROKER INDUCEMENTS: CONFLICTS OF INTEREST FROM PAYMENT FOR ORDER FLOW AND EXCHANGE REBATES 182

II. ADMINISTRATIVE REVIEW OF THE AGENCY RULE CHANGES: UNIQUE CONSIDERATIONS FOR THE SEC 186

III. THE SEC AS FAIRNESS REGULATOR: A NEW DIMENSION PRESENT HERE, BUT NOT IN PRIOR SUCCESSFUL CHALLENGES TO SEC AUTHORITY AND ECONOMIC ANALYSIS 188

IV. FEE PILOT LITIGATION 194

V. SEC AUTHORITY TO REGULATE FEES AND REBATES 195

VI. THE SEC AS A COMPETITION REGULATOR 197

VII. APPLYING TRADITIONAL ECONOMIC ANALYSIS: SIFTING THROUGH IRRELEVANT ARGUMENTS 201

VIII. EVIDENCE FROM OVERSEAS 207

IX. VERDICT ON LITIGATION THREAT: UNLIKELY 208

I. BACKGROUND ON BROKER INDUCEMENTS: CONFLICTS OF INTEREST FROM PAYMENT FOR ORDER FLOW AND EXCHANGE REBATES

Payment for order flow (PFOF) is not new.[1] The practice, which was popularized by former regulator turned infamous criminal, Bernard Madoff, is a conflict of interest at the heart of today's capital markets.[2] PFOF involves a payment by a market maker or exchange to a broker as an inducement for the broker sending order flow to their venue.[3]

Brokers are legally obligated to seek the best prices for their customers.[4] But by letting brokers keep these inducements, the question becomes, are brokers routing their customers' orders to market makers and exchanges that pay them the most money, or are they routing to the venues that get the customers the best prices?

In recent years, some retail brokers have become increasingly dependent upon PFOF for their business models. Importantly, PFOF isn't solely a retail trading concern. Stock exchanges provide a similar form of broker inducement to pay brokers who send orders to their venues in the form of an exchange rebate. These exchange rebates are paid out on an aggregate monthly basis in rebate "tiers" that price discriminate among brokers. Collectively, exchange rebates and PFOF are often referred to as broker inducements or order routing inducements.

These broker inducements create a conflict of interest, as a broker may choose to execute their client's trades on the venue paying the largest PFOF or highest rebate rather than on the venue that provides superior execution of their client's order.[5] This article demonstrates that inducements are also

---

[1] *See* Stanislav Dolgopolov, *In Madoff's Shadow: Reflecting on the Trajectory of the Regulatory Environment for Off-Exchange Market Makers*, MEDIUM (Aug. 17, 2021), https://medium.com/@s_v_dolgopolov/in-madoffs-shadow-reflecting-on-the-trajectory-of-the-regulatory-environment-for-off-exchange-1eb402591d29 [https://perma.cc/5HJB-VS63].

[2] Kevin Travers, *Payment for Order Flow: Bernie Madoff's Golden Goose*, FINTECH NEXUS NEWS (Oct. 4, 2021), https://news.fintechnexus.com/payment-for-order-flow-bernie-madoffs-golden-goose/ [https://perma.cc/3DKR-AHJT].

[3] Technically, Madoff popularized the practice of PFOF at the retail level, related exchange rebate practices came later.

[4] FINRA, Rule 5310(a)(1) (2014), https://www.finra.org/rules-guidance/rulebooks/finra-rules/5310.

[5] *See Conflicts of Interest, Investor Loss of Confidence, and High-Speed Trading in U.S. Stock Markets: Hearing Before the Permanent Subcomm. On Investigations of the S. Comm. on Homeland Sec. and Gov't Affs.*, 113th Cong. 48 (2014) (statement of Steven Quirk, Senior V.P., TD Ameritrade) (noting that TD Ameritrade always routed its orders to the venue that paid the rebate); *see also* Robert Battalio et al., *Can Brokers Have It All? On the Relation between Make-Take Fees and Limit Order Execution Quality*, SEC (Mar. 31, 2015), https://www.sec.gov/spotlight/emsac/can-brokers-have-it-all.pdf [https://perma.cc/WE5T-5X44]:

associated with trading practices that can exploit information obtained via the order flow to the detriment of the retail trader that originated the purchased order flow.

The SEC is currently considering changes to its enforcement practices and rules to address conflicts of interest posed by order routing inducements. The SEC could ban order routing inducements for brokers acting as agents altogether or may otherwise substantially limit their application. After SEC Chair Gary Gensler expressed his view that major market structure reform would be soon released, the CEO of Virtu Financial (one of the two dominant market makers in the securities market) was quoted saying "[e]veryone would sue . . . it will be like a conga line to the DC Court."[6]

This article considers that threat to challenge a ban on brokerage inducements. There is little doubt that any actions by the SEC to limit brokers' ability to accept conflicted routing inducements from market venues would materially negatively impact some brokers' businesses. It seems likely that these few firms would file a challenge to the rule in *the* DC Circuit, a venue in which the SEC has lost rule challenges before.[7] Given differences however between this contemplated regulatory action and previous SEC actions successfully challenged in court, it appears that this threat is unlikely to succeed.

Of particular importance to this review is that Chair Gensler has already indicated that he has asked the staff to focus particularly on the SEC's objectives of fairness and of competition in designing a new rule to reshape market structure.[8] The focus he has requested for new rules in this area build

---

> We identify retail brokers that seemingly route orders to maximize order flow payments: selling market orders and routing limit orders to venues paying large liquidity rebates. Using a simple model, we demonstrate that this type of routing may not always be in customers' best interests. For both proprietary limit order data and a broad sample of trades from TAQ, we document a negative relation between several measures of limit order execution quality and rebate/fee level.

[6] Declan Harty, *Why Biden's SEC Chief is Enraging Wall Street*, POLITICO (Oct. 12, 2022, 4:31 AM), https://www.politico.com/news/2022/10/12/wall-street-gary-gensler-sec-00061245 [https://perma.cc/2A4L-B6SL].
[7] *See* Business Roundtable v. SEC, *infra* note 26.
[8] *See* Chair Gary Gensler, *Testimony Before the United States House of Representatives Committee on Financial Services*, SEC (Oct. 5, 2021), https://www.sec.gov/news/testimony/gensler-2021-10-05 [https://perma.cc/XPJ9-D6CM]:

> I think it's time we take a broad view about what the market structure should look like today. The Commission started this exercise with regard to market data under former Chairman Jay

on prior work that similarly focused on the SEC's fairness and competition objectives.

The SEC has previously undertaken substantial regulation of the practice of payment for order flow, when in 1994 it adopted rules requiring disclosure of payment for order flow.[9] The SEC's 1994 adopting release observed that "the practice raises concern as to whether the customer is being treated fairly. Specifically, payment for order flow raises concerns about whether a firm is meeting its obligations of best execution to its customer."[10]

The fact that PFOF continues to raise the same concerns twenty-seven years later suggests that the disclosure-based approach taken in that rule is insufficient, and stronger action is warranted to address the conflicts of interest that broker inducements represent and associated distortions of execution quality they create. Indeed, broker-dealer best execution obligations have been described by various courts as having a fiduciary quality that is similar to other principal/agency relationships contained in the common law.[11] Fiduciary duties in other contexts, such as corporate law or

---

> Clayton. I've asked staff for recommendations, particularly around two key questions: First, how do we facilitate greater competition and efficiency on an order-by-order basis—when people send each order into the marketplace? While there is fragmentation amongst trading platforms, past reforms and new technologies may have led to more segmented markets and higher concentration amongst market makers. Nearly half of the volume transacted is executed in "dark pools" or by wholesalers. One firm has publicly stated that it executes nearly half of all retail volume. Further, I wonder whether this means that the consolidated tape—the so-called National Best Bid and Offer—fully reflects the full range of activity on exchanges. Second, how do we address financial conflicts in the market? As I have stated previously, I believe payment for order flow and exchange rebates may present a number of conflicts of interest. Around those two key principles, I've asked staff for recommendations as to how we can ensure a more level playing field, enhance competition, and improve resiliency in our markets.

[9] *See* Cheryl Nichols, *Broker Dealer Regulation: Cases and Analysis*, CAROLINA ACADEMIC PRESS 849 (2017) (citing Rule 11Ac1-3 and amendments to Rule 10b-10).

[10] *See* Payment for Order Flow, SEC Release No. 34-34902, at 4 (April 3, 1995), https://www.sec.gov/rules/final/orderfin.txt [https://perma.cc/AQ9R-8UNP].

[11] Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, 270 (3d Cir. 1998); *see, e.g.,* Hall v. Paine, 224 Mass. 62, 112 N.E. 153, 158 (1916) ("broker's obligation to his principal requires him to secure the highest price obtainable"); Restatement (Second) of Agency § 424 (1958) (agent must "use reasonable care to obtain terms which best satisfy the manifested purposes of the principal"); *see also* Opper v. Hancock Sec. Corp., 250 F. Supp. 668, 676 (S.D.N.Y. 1966) ("[T]he duties of a securities broker are, if anything, more

trust law, do not generally allow conflicts of interest to be addressed by disclosure alone but also require curing the conflict via ratification.[12]

The SEC took another stab at addressing these issues with another effort at a disclosure-based approach with rules adopted in 2000, when it noted "dealer practices such as internalization and payment for order flow have contributed to the isolation of investor limit orders and to less vigorous quote competition."[13] When major changes to market structure were adopted by way of Regulation NMS in 2005, Nichols observes that "[t]he content of Rules 605 through 609 remained essentially the same as their former pre-Reg NMS counterparts."[14]

The 1994 PFOF rules and the changes to order routing practice disclosure adopted in 2000 were adopted pursuant to both the SEC's fairness objective and the SEC's competition objective.[15] The fairness objective carries unique importance when it comes to lawsuits against the SEC, as it turns out the SEC has more regulatory flexibility when adopting rules pursuant to that objective.

This article argues that to the extent SEC rulemaking addresses its fairness objective alone, *it is not subject to economic analysis requirements*. To the extent that SEC rulemaking addresses *both* its fairness objective *and*

---

stringent than those imposed by general agency law."), *aff'd,* 367 F.2d 157 (2d Cir.1966). Moreover, as the district court correctly recognized, the best execution duty "does not dissolve when the broker/dealer acts in its capacity as a principal." In re Merrill Lynch, 911 F. Supp. 754, 760 (D.N.J. 1995). *Accord* E.F. Hutton & Co., Exchange Act Rel. No. 25887, 49 S.E.C. 829, 832 (1988) ("A broker-dealer's determination to execute an order as principal or agent cannot be 'a means by which the broker may elect whether or not the law will impose fiduciary standards upon him in the actual circumstances of any given relationship or transaction.'").

[12] *See e.g.*, Schreiber v. Carney, 447 A.2d 17 (Del. Ch. 1982).

[13] *See* Disclosure of Order Execution and Routing Practices, SEC Release No. 34-43590, n.5 (Jan. 30, 2001), https://www.sec.gov/rules/final/34-43590.htm [https://perma.cc/DK7A-YQ7G]. In footnote 1 of the adopting release the SEC further listed the regulatory objectives it was addressing:

> Section 11A of the Securities Exchange Act of 1934, 15 U.S.C. 78k-1, grants the Commission authority to promulgate rules necessary or appropriate to assure the fairness and usefulness of information on securities transactions and to assure that broker-dealers transmit orders in a manner consistent with the establishment and operation of a national market system. The principal national market system objectives set forth in Section 11A(a)(1) include the efficient execution of securities transactions, fair competition among market participants, the public availability of information on securities transactions, and the best execution of investor orders. The rules adopted today should significantly further these objectives. *Id*. at n.1.

[14] *See* Nichols, *supra* note 9, at 862.

[15] *Id.* at 849.

another objective together, then economic analysis would be required but must be weighed in combination with a qualitative assessment of conflicts of interest and other fairness considerations. In that event, the review becomes more of a multi-factor test, in which economic analysis considerations will be weighed on equal footing with a more qualitative fairness that focuses on conflicts of interest.

In addition to its fairness objective, the SEC will also uniquely be addressing its competition objective in this area. While that objective does fall within the economic analysis requirements, it also implicates aspects of economics that have been traditionally under-analyzed in SEC rulemaking. A renewed focus on competition in speeches by the SEC chair indicates that this rulemaking is likely to consider the economic implications of market concentration, along the lines of traditional antitrust law and economics (or industrial economics) that would help to substantially buttress SEC rulemaking in this context.

Depending upon how the SEC were to propose and implement reforms, it is highly likely that courts would side with the SEC. The extent of economic evidence supporting a ban on broker inducements, the SEC's statutory authority to impose a ban, and the statutory requirements the SEC operates under to consider competition and fairness in this unique regulatory area all buttress a potential ban on brokerage inducements from challenge.

II. ADMINISTRATIVE REVIEW OF THE AGENCY RULE CHANGES: UNIQUE CONSIDERATIONS FOR THE SEC

What the SEC is contemplating with respect to both sides of the broker inducement issue, exchange rebates and payment for order flow, may ultimately be deemed a change in agency regulation. The SEC has previously permitted both practices (albeit subject to best execution requirements) and appears likely to continue to do so.[16] Agencies are however permitted to change course on regulatory approaches. Agency action is governed by the Administrative Procedures Act and through legal precedent in the field of administrative law generally, which includes various interpretations of an agency's empowering statute.[17]

Agencies are permitted under this precedent to change regulatory course.[18] The Supreme Court observed in 2007 that agencies "whittle away

---

[16] Lydia Beyoud & Katherine Doherty, *SEC Set to Let Wall Street Keep Payment-for-Order-Flow Deals*, BLOOMBERG (Sept. 22, 2022, 7:00 AM), https://www.bloomberg.com/news/articles/2022-09-22/sec-poised-to-let-wall-street-keep-payment-for-order-flow-deals [https://perma.cc/9WU9-EEHH].
[17] *See* RICHARD J. PIERCE & KRISTIN HICKMAN, ADMINISTRATIVE LAW TREATISE 1 (6th ed. 2020).
[18] *See generally* Note, *Judicial Review of Agency Change*, 127 HARV. L. REV. 2070, 2070 (2014).

at [problems] over time, refining their preferred approach as circumstances change and as they develop a more nuanced understanding of how best to proceed."[19] The Supreme Court similarly observed in 1967 that "[r]egulatory agencies do not establish rules of conduct to last forever. . . . They are neither required nor supposed to regulate the present and the future within the inflexible limits of yesterday."[20]

Agencies are nevertheless encouraged to maintain consistent regulatory approaches.[21] In the present context, the SEC Chair's suggestion that he will pair both forms of broker inducements together—exchange rebates and PFOF—will bolster this consistency objective of administrative law and ensure that exchanges and wholesale brokerage venues are not treated differently by the regulation.

In *FCC v. Fox Television Stations*,[22] the Supreme Court held that agencies are generally not subject to any heightened review when they change course on a previously adopted regulatory approach than when they initially promulgate new rules.[23] But a more detailed justification may be required when the existing policy being changed has "engendered serious reliance interests."[24]

If the SEC's shift in approach to broker inducements is deemed to be a significant change, then no doubt challenging parties will argue that they have significant reliance interests. This article will proceed to offer a menu of multiple lines of analysis, each of which will prove sufficient for the SEC to successfully defend any change of course in regulatory approach.

Further, the existing best execution obligations that govern broker inducements would suggest a stronger limit or ban on brokerage inducements in a future rule is to some extent consistent with existing rules. If the SEC moves to simply ratchet up existing best execution restrictions on broker inducements, because those restrictions aren't working, the alteration would represent more of an evolving approach along a spectrum of options to address conflicts of interest. If a "ratcheting up" of existing rules is the policy route taken by the SEC, then the SEC may be able to argue that its new approach is not a significant change, and therefore deserving of added deference in court review.[25]

---

[19] *See id.* (citing Massachusetts v. EPA, 549 U.S. 497, 524 (2007)).
[20] *See id.* (citing Am. Trucking Ass'ns v. Atchison, Topeka & Santa Fe Ry. Co., 387 U.S. 397, 416 (1967)).
[21] *See* Yoav Dotan, *Making Consistency Consistent*, 57 ADMIN. L. REV. 995, 996 (2005).
[22] FCC v. Fox Television Stations, 556 U.S. 502, 514–15 (2009).
[23] *Id.*
[24] *Id.* at 515.
[25] *See* Note, *supra* note 18, at 2071–72 n.15 ("[T]he consistency of an agency's position is a factor in assessing the weight that position is due." (citing Good Samaritan Hosp. v. Shalala, 508 U.S. 402, 417 (1993))); ("The weight of such a judgment in a particular case will depend upon . . . its consistency with earlier and

In any event, this article will assume that the SEC's policy choices are deemed to be a significant change in regulation. Those policy choices therefore receive the least scrutiny in subsequent administrative challenges and this article will analyze the SEC's risk of legal challenge under that less deferential standard.

III. THE SEC AS FAIRNESS REGULATOR: A NEW DIMENSION PRESENT HERE, BUT NOT IN PRIOR SUCCESSFUL CHALLENGES TO SEC AUTHORITY AND ECONOMIC ANALYSIS

A challenge to SEC rules alleging the agency acted in an arbitrary and capricious manner, and therefore violating the above referenced administrative law constraints, will be determined against the principles and objectives contained in the agency's governing statute.

For the SEC, that focus typically is on the requirement that the SEC consider, when it acts in the "public interest," the impact of new rules on investor protection as well as "efficiency, competition and capital formation." With a focus on these four principles, the D.C. Circuit has held that the SEC operates under a "statutory obligation to determine as best it can the economic implications of [a proposed] rule."[26] The SEC's statutory requirements to engage in robust economic or benefit-cost analysis stem from interpretations of these four statutory objectives added to the Securities Exchange Act of 1934 by the National Securities Markets Improvement Act of 1996 ("NSMIA")[27] and highlighted in a number of successful challenges to SEC rules in the DC Circuit referenced in this article in the following section.

It is important to consider carefully the statutory language on which cases like *Business Roundtable v. SEC*[28] and *Chamber v. SEC*[29] rest. These cases reference changes made to the Exchange Act, and other acts empowering the SEC, contained in the NSMIA. That law contained the following global changes to rulemaking by the SEC authorized under the Securities Exchange Act of 1934:

> Whenever pursuant to this title the Commission is engaged in rulemaking, or in the review of a rule of a self-regulatory organization and is required to consider or determine

later pronouncements . . . . ") (citing Skidmore v. Swift & Co., 323 U.S. 134, 140 (1944))).

[26] Chamber of Com. v. SEC, 412 F.3d 133, 143 (D.C. Cir. 2005); *see also* Bus. Roundtable v. SEC, 647 F.3d 1144, 1148 (D.C. Cir. 2011); N.Y. Stock Exch. LLC v. SEC, 962 F.3d 541, 553 (D.C. Cir. 2020).

[27] National Securities Markets Improvement Act of 1996, Pub. L. No. 104–290, § 106(b), 110 Stat. 3416, 3424 (1996).

[28] *Bus. Roundtable*, 647 F.3d at 1144.

[29] *Chamber of Com.*, 412 F.3d at 133.

> whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[30]

Notice how the reference to mandatory consideration of "efficiency, competition and capital formation" applies only to rulemaking done "in the public interest." The '33, '34, and '40 Acts all contain numerous references to the SEC's authority to take action "in the public interest."[31] But *not all* sections of the '34 Act authorizing the SEC to take action include references to action "in the public interest."

And some sections of the '34 Act pertaining to exchange or to broker-dealer regulation refer to the SEC's authority to take action with the alternative statutory purpose of maintaining "fair and orderly markets." Some references to the SEC's objective of maintaining "fair and orderly markets" do so without even mentioning the phrase "public interest." Yet, NSMIA does not tie the economic analysis requirements of its prescription to the SEC's statutory "fairness" or "fair and orderly markets." Those requirements apply only to the SEC's "public interest" objective.

As evidence that Congress intended "the public interest" and "the maintenance of fair and orderly markets" to mean distinct and separate objectives of the SEC, those phrases are used separately in the same paragraph in the "Congressional Findings" paragraph of those amendments.[32] Section 11A of the Exchange Act charges the SEC with implementing a national market system and requires the SEC action be consistent with the goals of "having due regard for the public interest, the protection of investors, and the maintenance of fair and orderly markets . . . ."[33] Notice that the dual objectives of the public interest and the maintenance of fair and orderly markets are treated as separate goals in that section. Some other references to the objective of maintaining "fair and orderly markets" in the Exchange Act do not reference the "in the public interest" language at all.

15 USC 78k-1, the section of the code promulgated under the Securities Exchange Act of 1934 that governs the National Market System, contains fourteen references to "fair" or "fairness" in describing the SEC's authority and responsibility with respect to the National Market System. The Securities Exchange Act's provisions governing exchanges and broker-dealers contain numerous references to fairness. For another example, in the Exchange Act's section regarding registration of stock exchanges, the SEC is statutorily

---

[30] National Securities Markets Improvement Act of 1996, Pub. L. No. 104–290, § 106(b), 110 Stat. 3416, 3424 (1996).

[31] The phrase "public interest" appears seven times in a search of a list of the rules promulgated under the Exchange Act, as maintained at https://www.law.cornell.edu/uscode/text/15/78c.

[32] *See* 15 U.S.C. § 78k-1(a)(1)(C).

[33] *See* 15 U.S.C. § 78k-1(a)(2).

authorized to ensure that the rules of the exchange are not "designed to permit unfair discrimination between customers, issuers, brokers or dealers . . . ."[34] Numerous sections of the Exchange Act and the rules promulgated thereunder reference the SEC's authority to ensure "fair and orderly markets" in the regulation of exchanges and in its regulation of registered broker-dealers.[35]

In 15 USC 78f(f), the SEC has extended the application of exchange rules to non-members of exchanges who regularly execute trades on an exchange as well.[36] There are other sections of the Exchange Act relating to broker dealers that directly reference "fairness" or the Commission objective of maintaining "fair and orderly" markets.[37]

The SEC responded to rulings like *Business Roundtable v. SEC* and *Chamber v. SEC,* in which rules it adopted were struck down for insufficient economic analysis, by bolstering its economic analysis function and creating a new Division now called the Division of Economic and Risk Analysis (DERA). The author was one of many who strongly encouraged the SEC to bolster its economic analysis capabilities in the wake of rulings like *Chamber v. SEC* and *Business Roundtable v. SEC*.[38] The SEC also adopted a memorandum to guide its economic analysis in rulemaking in response to a series of successful challenges.[39]

While the SEC will no doubt conduct an economic analysis of the economic impacts of a rulemaking to ban or discourage PFOF and exchange rebates on the market anyway, its analysis should also contain a fairness dimension (and a related requirement to maintain "fair and orderly markets") that was not present in prior successful challenges to SEC rules like *Business Roundtable v. SEC* and *Chamber v. SEC*.

Indeed, it is not entirely clear that the SEC is affirmatively required to conduct an economic analysis of all of its expected rulemaking, provided it makes clear when and where it is taking action exclusively intended to "to maintain fair and orderly markets" and not "in the public interest." That nuance of text may mean the difference in whether or not an economic analysis is ultimately required in whole or in part with respect to pending rule changes.

The SEC will undoubtedly conduct an economic analysis anyway for all or at least most of the new rule, and it will have significant evidence to bolster

---

[34] *See* 15 U.S.C. § 78f(b)(5).

[35] *See* 15 U.S.C. § 78f, 78f(b)(4), & 78f(f).

[36] *See* 15 U.S.C. § 78f(f).

[37] *See* 15 U.S.C. § 78(o).

[38] *See The SEC's Aversion to Cost-Benefit Analysis: Hearing Before the Subcomm. on TARP, Fin. Servs. and Bailouts of Pub. and Priv. Programs of the H. Comm. on Oversight and Gov't Reform*, 112th Cong. 90–91 (2012) (testimony of author).

[39] *See generally* Memorandum from Sec. & Exch. Comm. Div. of Risk, Strategy, and Fin. Innovation & Off. of Gen. Counsel to the Staff of the Sec. & Exch. Comm. Rulewriting Divs. & Offs. (Mar. 16, 2012), https://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf.

such an analysis as seen below. Yet that economic analysis may be found not to be a binding constraint on some or all of the rule it ultimately adopts. And at a minimum, any economic analysis considered will need to be considered alongside an independent qualitative fairness analysis of conflicts of interest.

Agencies are given some deference in administrative law to interpret their own statutes. The Supreme Court has held that courts should give some deference to agency interpretations of their own statutes.[40] The SEC could take a reasonable position in a rule proposal that when it is adopting rules pursuant to a fairness objective, it may solely (or at least principally) rely on a qualitative analysis of the presence of conflicts of interest without being required to rely on a quantitative analysis of the economic impact of its rule.

The SEC might argue that action taken "in the public interest" is constrained by the economic analysis required under NSMIA. Meanwhile, SEC action designed to maintain "fair and orderly" markets relies on a separate statutory objective and therefore is not subject to the same economic analysis constraints. Such an interpretation of the SEC's authority should obtain *Chevron*[41] deference.

While the SEC should conduct the relevant economic analysis of the rule anyway, as a matter of good policymaking and to protect against a contrary legal interpretation, it should still assert that its fairness objective stands separate and apart from related objectives that were constrained by NSMIA.

One may prefer the SEC not act as a fairness regulator and argue as a policy matter that the SEC should instead utilize the same disclosure-based philosophy in exchange and broker regulation that it principally follows in registered issuer disclosure. That argument might have appeal as a policy matter, but it is irrelevant for the present circumstance, as it would require major statutory reform of the Securities Exchange Act. The fact is that the SEC has a statutory mandate to act as a fairness regulator with respect to exchange and broker-dealer regulation as contemplated in 15 U.S.C. 78k-1 and the rules adopted thereunder.[42]

For this aspect of the SEC's statutory mission, the SEC will not be required to estimate all of the indirect costs of these conflicts of interest. While it may represent a good practice to nevertheless account for these costs in an economic analysis, the SEC should assert in its final rule that the fairness goals set forth in the '34 Act are met by merely mapping out the conflicts of interest. In that respect, the SEC's report on the market volatility in early 2021 (or the "GameStop report") already begins to map out these conflicts.

---

[40] Chevron U.S.A. Inc. v. Nat'l Res. Def. Council, Inc., 467 U.S. 837, 844 (1984) ("We have long recognized that considerable weight should be accorded to an executive department's construction of a statutory scheme it is entrusted to administer . . . . ").

[41] *See id.* at 844.

[42] As demonstrated in the extensive discussion in this section.

The GameStop report observes:

> The execution of retail orders by off-exchange market makers raises further questions about whether individual investors may still be subject to other less conspicuous costs and conflicts of interest. While these features are not necessarily the cause of the meme stock volatility, investors should be mindful of how their orders are handled, including the difference between 'free' and 'no' commissions.[43]

The GameStop report notes that in some ways exchange rebates present similar conflicts of interest as PFOF, though exchange rebates are subject to rules of the exchange and are adopted via a public filing.[44]

These observations are not new. In 2010, Angel, Harris and Spatt (three leading economists in the market structure space) wrote about the conflicts of interest that these practices created. They observed in a paper that was presented to the SEC's Equity Market Structure Advisory Committee:

> Make-or-take pricing has significantly distorted trading in the National Market System in which best execution standards and mandated order routing determine execution venues and execution prices . . . . It has distorted order routing decisions, aggravated agency problems among brokers and their clients, unleveled the playing field among dealers and exchange trading systems, produced fraudulent trades, and produced quoted spreads that do not represent actual trading costs . . . . In competitive markets, the actual spread will not depend on how high the access fees and liquidity rebates are, so long as the difference between them is constant. Traders simply adjust their quoted prices so that the net prices that they pay or receive are the same on average. The make-or-take pricing model thus would appear to accomplish nothing besides reducing quoted spreads and thereby obfuscating true economic spreads, which are the net spreads inclusive of the access fees and liquidity rebates . . . . Brokers make most order routing decisions based on the quoted prices that their clients will receive, and not the true net prices of the trades. They typically route customer

---

[43] SEC, STAFF REPORT ON EQUITY AND OPINIONS MARKET STRUCTURE CONDITIONS IN EARLY 2021, 2 (Oct. 14, 2021) [hereinafter *GameStop Report*], https://www.sec.gov/files/staff-report-equity-options-market-struction-conditions-early-2021.pdf [https://perma.cc/F8DQ-R48V].
[44] *See id.* at 13.

> limit orders that they cannot immediately execute to make-or-take exchanges where the broker will receive a rebate—which usually is not passed on to the customer—for the order execution. . . . The SEC could solve these make-or-take problems by requiring that all brokers pass through access fees and liquidity rebates to their clients. Presently, some brokers do this voluntarily or upon request by their clients. However, the practice is complex and therefore confusing to most customers . . . . Alternatively, we recommend that the SEC eliminate access fees. This change would offer a common pricing standard for exchange services and thereby ensure that price quotes are comparable across exchanges.[45]

The SEC can begin to map out how these conflicts of interest manifesting from broker inducements during the comment process over a proposed rule. Many proposed rules appropriately ask questions of market commenters in order to better design a final rule. Some questions the SEC can ask to eventually map out conflicts of interest posed by PFOF and exchange rebates to put together the qualitative fairness analysis that would support a final rule could include questions like:

How can a broker claim to be meeting their best execution obligations if, though required to potentially access better liquidity (such as midpoint execution) price comparison becomes difficult as available wholesale prices remain unlit?

Does the "guarantee of execution" frequently cited as the reason for routing to a wholesaler (who is providing PFOF payments) hold up when those orders are later simply routed by the wholesaler to other venues? If the wholesaler is acting merely as an order routing agent, and utilizing patented trading technologies to avoid "toxic flow," then is the wholesaler really meeting their duty of best execution with respect to those orders?[46]

If a dealer seeks to satisfy their duty of best execution by executing orders against the full displayed size of the NBBO on exchanges, but then routes the remainder to a venue that executes the order at a price inferior to the revised NBBO, how does that constitute best execution?

Consider the common circumstance where a broker routes to a wholesaler paying them PFOF and claims best execution on the basis of speed of execution, potential price improvement, and likelihood that the order will

---

[45] *See* Angel et al., *Equity Trading in the 21st Century*, 43–46 (Marshall Research Paper Series, Working Paper FBE 09-10), https://www.sec.gov/spotlight/emsac/equity-trading-in-the-21st-century.pdf [https://perma.cc/8QKF-YRD4].

[46] For a thorough review of wholesaler's duty of best execution, *see* Stanislav Dolgopolov, *Wholesaling Best Execution: How Entangled are Off-Exchange Market Makers?*, 11 V. L. & BUS. REV. 149 (2016).

ultimately be filled. What if that broker also posts limit orders onto exchanges that pay them high rebates but that might have a long line of orders, longer wait times for execution, diminished likelihood of ultimate execution, and immediate adverse selection? Though best execution obligations are reviewed on a trade-by-trade basis, does this inconsistency across similar trades pose a problem for firms representing that they have fulfilled their best execution obligations? How do order routing inducements contribute to the potential inconsistency in those two approaches?

IV. FEE PILOT LITIGATION

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.[47]

The Court was also concerned that the pilot program would result in disparate regulatory treatment between exchanges and off-exchange venues.[48] The Chair's suggestion that PFOF and exchange rebates be paired together in the pending regulatory proposal would help the Commission's rulemaking withstand scrutiny in that respect, as it would alleviate the issue of disparate treatment that was asserted during the fee pilot litigation.

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.[49] 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.[50]

The SEC also did not assert the argument made in this article that the fee pilot was buttressed by a separate "fair and orderly" statutory objective not bound by economic analysis constraints. Indeed, in that rule the SEC failed to reference an objective of maintaining "fair and orderly" markets at all, and instead simply referenced an objective of acquiring data, a fact which the DC Circuit noted in the opinion overturning the rule that helped lead to the rule's demise.[51]

Judge Pillard's concurring opinion makes clear that the SEC would, with reasonable evidence, have authority to set different rates or to prohibit

---

[47] N.Y. Stock Exch. LLC v. SEC, 962 F.3d 541, 545 (D.C. Cir. 2020).
[48] *Id.* at 551.
[49] *Id.* at 558.
[50] *Id.* at 560 (Pillard, J., concurring).
[51] *Id.* at 555.

rebates.[52] 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.[53]

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.

It would be tempting to assume that because the SEC lost a prior challenge to a rule affecting exchange rebates, a future challenge to an exchange rebate rule (or to a rule affecting analogous PFOF practices) might be successful. 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 broker inducement conflicts and justify that action to withstand scrutiny in the DC Circuit.

V. SEC AUTHORITY TO REGULATE FEES AND REBATES

Unlike prior challenges to SEC legal authority, the SEC has direct authority under the Exchange Act to regulate practices like payment for order flow and exchange rebates.[54] The SEC's defeat with respect to the rebate fee pilot was because of the experimental nature of the pilot, which the SEC justified on the ground of a data gathering mission that illegitimate.

The DC Circuit determined that the SEC did not have direct statutory authority to adopt a pilot. Along the way the court suggested that if the SEC had instead directly regulated in this area and justified its regulatory changes to fees and rebates with an analysis, then its action would have been more defensible.[55]

In one way the SEC and the Financial Industry Regulatory Authority (FINRA) already regulate PFOF and rebates via the best execution obligations of brokers and dealers, an obligation which also applies to wholesale brokers.[56] This will bolster an SEC rule challenge like the one that was successful against the fee pilot.

---

[52] *Id.* at 560 (Pillard, J., concurring).

[53] N.Y. Stock Exch. LLC v. SEC, 962 F.3d 541, 560–61, 566–68 (D.C. Cir. 2020) (Pillard, J., concurring) (the ruling did not have the benefit of the nuanced statutory interpretation argument regarding SEC rulemaking under the fairness objective advanced in this article).

[54] *See* 15 U.S.C. §§ 78f, 78f(b)(4), & 78f(f).

[55] *See* N.Y. Stock Exch. LLC v. SEC, 962 F.3d 541, 553 (D.C. Cir. 2020).

[56] *See* Stanislav Dolgopolov, *Off-Exchange Market Makers and Their Best Execution Obligations: An Evolving Mixture of Market Reform, Regulatory Enforcement, and Litigation*, 17 N.Y.U. J. BUS. L. 477, 482 (2021) ("FINRA rules require *any* broker-dealer, including wholesale market makers . . . to comply with

FINRA has already made it clear that:

> 1. Simply matching or even beating the national best bid or best offer "may not satisfy a firm's best execution obligation, particularly with respect to small orders;"
> 2. Brokers are obligated to "compare the execution quality they receive under their existing order routing and execution arrangements" with "the quality of the executions they could obtain from competing markets;" and
> 3. Brokers "may not negotiate the terms of order routing arrangements for those customer orders in a manner that reduces the price improvement opportunities that otherwise would be available to those customer orders absent payment for order flow."[57]

Oddly, however, some of these banned practices appear to be widespread in the retail brokerage community. The SEC and FINRA's rules with respect to best execution have been described as "the scope of the duty of best execution has evolved over time with changes in technology and transformation of the structure of financial markets."[58] It may be that a stronger approach to best execution, one that includes a ban or substantial restriction on PFOF and rebates, is best viewed as simply the next step in this evolution considering the technological changes that have happened in the high frequency trading (HFT) environment and in light of increased market trades moving to unlit venues.

We should expect some commenters will argue during the comment process that the SEC should abandon new rulemaking in this area, and that the SEC and FINRA should just do a better job of enforcing the existing best execution obligations. Yet it seems that this mechanism is not working. One current FINRA official likened FINRA's difficulty in best execution determinations to "nailing jello to a wall," given the variety of factors that can be included in a best execution determination.[59]

---

best execution and order- protection requirements for customer orders routed there by other broker-dealers . . . .") (emphasis added) (internal quotations and citation omitted).

[57] FIN. INDUS. REGUL. AUTH., REGULATORY NOTICE ON BEST EXECUTION AND PAYMENT FOR ORDER FLOW, 4 (June 23, 2021), https://www.finra.org/sites/default/files/2021-06/Regulatory-Notice-21-23.pdf [https://perma.cc/RB24-BRNB].

[58] Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, 271 (3d Cir. 1998).

[59] *See March 28, 2019, Meeting of the Securities and Exchange Commission Investor Advisory Committee*, SEC. EXCH. COMM.,

Despite a handful of settlements by FINRA and the SEC in discrete instances, the SEC appears to have taken a largely hands off approach to broker inducements and related distortions to a broker's obligation of best execution. The practice of large PFOF payments suggest that a broker may be being "unduly influenced" in a way that runs afoul of FINRA Rule 5310. FINRA also bans broker receipt of gifts of over $100 to limit conflicts of interest, and yet allows the broker to receive in some instances over $1 billion in payment for order flow from execution venues.[60] PFOF is an odd duck when compared to much of the rest of the regulatory architecture of broker-dealer regulation.

Further, the SEC and FINRA do not judge best execution on a trade-by-trade basis, though they arguably should even under current rules. FINRA recently reminded regulated parties that "order-by-order review of execution quality is increasingly possible for a range of orders in equity securities and standardized options, and it is required for any orders that a member firm determines to execute internally."[61]

The SEC may make a reasonable determination that the conflicts of interest posed by PFOF and by exchange rebates pose an insurmountable conflict to those best execution obligations and must be banned. Such a determination would fit squarely within the SEC's delegated authority to regulate exchange practices in light of the "fairness" emphasis placed into the Exchange Act by the '75 Act Amendments as explored throughout this article. The fact that the SEC has already tried to police these issues using its clear statutory authorization to do so, and it is taking steps to more forcefully address them, will only bolster its defense of rulemaking against subsequent challenge.

VI. THE SEC AS A COMPETITION REGULATOR

There has been a renewed focus on the SEC's mission as a competition regulator. The Exchange Act's empowering language charges the SEC with,

https://www.sec.gov/video/webcast-archive-player.shtml?document_id=iac032819 [https://perma.cc/RB24-BRNB].

[60] *See Gifts, Gratuities and Non-Cash Compensation*, FINRA (last visited Jan. 29, 2023), https://www.finra.org/rules-guidance/key-topics/gifts-gratuities-and-non-cash-compensation [https://perma.cc/AFA3-DZJ3]; s*ee also* Aquilina et al., *Quantifying the High-Frequency Trading "Arms Race"* 1 (BIS Working Papers, Working Paper No. 955, 2021), https://www.bis.org/publ/work955.pdf.

[61] FIN. INDUS. REGUL. AUTH., REGULATORY NOTICE ON BEST EXECUTION AND PAYMENT FOR ORDER FLOW, 3 (June 23, 2021), https://www.finra.org/sites/default/files/2021-06/Regulatory-Notice-21-23.pdf [https://perma.cc/RB24-BRNB].

in addition to investor protection, acting to further "efficiency, *competition*, and capital formation."[62]

Despite the frequent references to a "tripartite mission" of investor protection, efficiency and capital formation, the SEC has a four-part mission. Indeed, in the context of exchange regulation and the national market system the SEC has a five-part mission, with the fifth mission being to promote "fair and orderly" markets (though at times efficiency and fairness are often described together in phrases contained in the Exchange Act).

The SEC is not required to become exclusively a competition regulator but should weigh competition against its other objectives.[63] In *Susquehanna v. SEC*,[64] the DC Circuit chided the SEC to do more as a competition regulator in its review of exchange fees.[65] In *Credit Suisse v. Billings*[66] the Supreme Court determined that the SEC is effectively the antitrust regulator in areas where the SEC has substantial authority—such as exchange practices and trading regulation.[67] In *Bradford Nat. Clearing Corp v. SEC*, the Second Circuit determined that the SEC had an important competition role to police monopoly or market power that the SEC weighs against its other statutory objectives.[68]

Former Commissioner Jackson has described the SEC's competition mission as the "forgotten fourth pillar of the SEC's mission."[69] He noted that "from the moment of its birth the framers and founders of the Commission . . . were concerned about ensuring competition in America's capital markets."[70] Commissioner Jackson encouraged the SEC to bulk up its investment in industrial organization economists to further its competition mission.[71]

Practices like PFOF and exchange rebates have a direct link to competition issues. Exchange rebates are provided in highly segmented tiers

---

[62] *See* National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, § 106(a)(2), 110 Stat. 3416, 3424 (1996).
[63] *See* Belenke v. S.E.C., 606 F.2d 193, 200 (7th Cir. 1979) (citing S. Rep. No. 94–75, at 37 (1975)) ("[T]he legislative history to the 1975 Amendments to the Securities Exchange Act makes explicit Congress' intent that competitive impact be one factor among many to be considered in making regulatory decisions and that the goal of enhancing competition should not become paramount to the great purposes of the Exchange Act.").
[64] Susquehanna Int'l Grp., LLP v. SEC, 866 F.3d 442 (D.C. Cir. 2017).
[65] *See id.* at 445.
[66] Credit Suisse Sec. v. Billing, 551 U.S. 264 (2007).
[67] *Id.* at 283–84.
[68] *See* Bradford Nat. Clearing Corp v. SEC*,* 590 F.2d 1085 (1978).
[69] Robert J. Jackson, Jr., Comm'r, SEC, Competition: The Forgotten Fourth Pillar of the SEC's Mission (Oct. 11, 2018) (transcript available at https://www.sec.gov/news/speech/speech-jackson-101118 [https://perma.cc/XVV7-56LG]).
[70] *Id.*
[71] *See* Jackson, *supra* note 69.

which price discriminate among brokers sending in order flow. Those "rebate tiers" are exceptionally top heavy, such that a few brokers receive the lion's share of the net rebate (netted against fees) and middle market brokers are largely left out and thereby suffer a substantial competitive disadvantage.[72] These price discriminatory practices implicate the SEC's competition jurisdiction.[73] These practices further contribute to consolidation in the brokerage industry and consolidation with respect to off-exchange market makers alike, which is a second reason why exchange rebates implicate the SEC's competition jurisdiction.[74]

PFOF has also contributed to the rise of internalization and has contributed to consolidation among internalizing wholesale brokers or non-designated market makers. In the two decades since PFOF was permitted, the number of non-designated market makers has decreased from over forty to only a handful.[75] This follows the general trend in the HHI index for financial services generally which is 7,000 (a 135% increase over a twenty year period), which when compared to HHI indices of market concentration utilized by the DOJ and FTC to determine market consolidation suggest a

---

[72] *See* SEC Inv. Advisory Comm., Recommendation Regarding Exchange Rebate Tier Disclosure (Jan. 24, 2020), https://www.sec.gov/spotlight/investor-advisory-committee-2012/exchange-rebate-tier-disclosure.pdf [https://perma.cc/36DZ-KHDS].

[73] *See* Chester Spatt, *Is Equity Market Exchange Structure Anti-Competitive?*, 18 (2020), https://www.cmu.edu/tepper/faculty-and-research/assets/docs/anti-competitive-rebates.pdf [https://perma.cc/H6M3-UYQW] ("Some observers have suggested that many of the pricing paths are used by relatively few broker-dealers and in some instances may have been customized by a stock exchange for a particular broker-dealer.").

[74] For more on the level of consolidation in the securities industry, *see generally* Edwin Hu & Dermot Murphy, *Competition for Retail Order Flow and Market Quality* 1 (June 8, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4070056 [https://perma.cc/5TVC-4L75].

[75] *See* Alexander Osipovich, *High Frequency Trader Hudson to Execute Retail Stock Trades*, WALL ST. J. (June 30, 2021), https://www.wsj.com/articles/high-frequency-trader-hudson-river-to-execute-retail-stock-trades-11625047200/ [https://perma.cc/TFY6-WWVV]; *see also* John Ramsay, *The Rising Tide of Broker Costs and the Shrinking Pool of Competitors*, MEDIUM (June 8, 2021), https://medium.com/boxes-and-lines/the-rising-tide-of-broker-costs-and-the-shrinking-pool-of-competitors-40d4d389e59a/ [https://perma.cc/H736-KECR]:

> For example, according to a regulatory filing in 2005, at the time of the stock market crash in 1987, there were 55 specialist firms (now known as Designated Market Makers, or DMMs) trading on the floor of the New York Stock Exchange. Merger, consolidation, and attrition reduced that number to 25 in 2000, and cut it again to seven in 2005. Today, there are just three left standing.

highly concentrated market.[76] Studies by Alphacution suggest that HHI Index analysis of market makers like Citadel show an even more consolidated industry.[77]

Nichols observes that one concern with a rise in internalization is that:

> [T]he practice has inherent conflicts of interest. The broker-dealer has a fiduciary duty to obtain best execution, but acting as a dealer trading against its own customers, there is an incentive to execute customer orders at the most favorable price to the broker dealer. This generally results in an execution of the customer's order at the NBBO that is publicly displayed. The publicly displayed NBBO may not be the best bid or offer available in the non-displayed order flow. In addition, research conducted about the impact of internalization has shown an adverse impact on the NBBO, i.e., internalization results in wider spreads, especially for less liquid securities.[78]

No less that Citadel Securities, the leading wholesale internalizer in the US, warned in a comment letter to the SEC in 2004 that: "Internalization is one of the greatest threats to price discovery in the financial markets. Broker-Dealers internalize the orders most advantageous to the broker dealer (usually retail orders) and expose less advantageous orders to the market."[79]

The shift in trading execution toward internalization, which carries these harms previously identified by Citadel, has occurred contemporaneously to a steady consolidation in the number of wholesale brokers, which further exacerbates those problems. Broker inducements have played a central role in those developments and therefore are of necessity a key focus for the SEC in fulfilling its competition mission.

If the SEC's final rule on this question includes an extensive analysis of the competition effects of broker inducements, and how those inducements have led both to consolidation and to anti-competitive practices that are price

---

[76] *See Firm Concentration is Rising, Particularly in Retail and Finance*, THE HAMILTON PROJECT (June 13, 2018), https://www.hamiltonproject.org/charts/firm_concentration_is_rising_particularly_in_retail_and_finance/ [https://perma.cc/QN9U-X7SR] (chart showing that the HHI Index in the Finance Industry is more than three times higher than the DOJ and FTC "Horizonal Merger Threshold").

[77] *See* Paul Rowady, *Want Better Markets? Try a Herfindahl Kiss*, ALPHACUTION (Nov. 28, 2019), https://alphacution.com/want-better-markets-try-a-herfindahl-kiss/ [https://perma.cc/A6Z2-SE53].

[78] *See* Nichols, *supra* note 9, at 952.

[79] Letter from Kenneth Griffin, President and Chief Exec. Off., Citadel Inv. Grp., to Jonathan G. Katz, Secretary, SEC (July 9, 2004) (on file with SEC secretary).

discriminatory, and if it includes a thoughtful economic analysis of these issues that utilizes the tools of industrial organization economics, then the SEC's ability to defend its rule from legal challenge will be substantially bolstered. To the extent the SEC is required to conduct an economic analysis, an analysis rich in competition economics will substantially bolster its rulemaking and will stand alongside the separate qualitative fairness analysis discussed above.

VII. APPLYING TRADITIONAL ECONOMIC ANALYSIS: SIFTING THROUGH IRRELEVANT ARGUMENTS

We have already seen that the SEC (and FINRA) possess significant authority to adopt limits on discriminatory practices like payment for order flow and exchange rebates by way of their statutory authority, including the SEC's authority to maintain "fair and orderly" markets and by way of its authorization as a competition regulator.

The SEC can also address the problems posed by order routing inducements by way of its traditional investor protection mission. Indeed, trading practices governed by FINRA or exchange rules may nevertheless result in 10b-5 fraud liability.[80] For example, trades executed at the NBBO may nevertheless be determined to be both a violation of best execution violation and constitute 10b-5 fraud depending on other factors.[81] Even practices that are "widespread in the industry" can be found fraudulent under 10b-5.[82]

---

[80] *See* City of Providence, Rhode Island v. Bats Glob. Markets, Inc., 878 F.3d 36, 51 (2d Cir. 2017)
(Overturning the district court summary judgment of a case challenging fraudulent trading practices like latency arbitrage facilitated by broker inducement and allowed the case to proceed as in part a 10b-5 violation); SEC v. Pasternak, 561 F. Supp. 2d 459, 498–99 (Dist. N. J. 2008) (not finding liability in the fact pattern at issue but recognized that best execution violations could rise to the level of a 10b-5 violation).

[81] *See* Newton v. Merrill Lynch Peirce Fenner and Smith, Inc., 135 F.3d. 266, 274 (3d Cir. 1998).

[82] *Id.* ("Even a universal industry practice may still be fraudulent"). *See* Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1171–72 (2d Cir. 1970) (saying non-disclosure of widespread industry practice may still be non-disclosure of material fact); Opper v. Hancock Sec. Corp., 250 F.Supp. 668, 676 (S.D.N.Y. 1966) (saying industry custom may be found fraudulent, especially on first occasion it is litigated), *aff'd,* 367 F.2d 157 (2d Cir. 1966); *see also* Vermilye & Co. v. Adams Express Co., 88 U.S. (21 Wall.) 138, 146, 22 L.Ed. 609 (1874); REPORT OF INVESTIGATION PURSUANT TO SECTION 21(A) OF THE SECURITIES EXCHANGE ACT OF 1934 REGARDING THE NASD AND THE NASDAQ MARKET, 1996 SEC LEXIS 2146 (Aug. 8, 1996) (Indeed, the SEC recently completed an investigation in which it found that certain practices by NASDAQ market makers, not at issue here, were fraudulent even though they were widely followed within the industry).

To the extent that the SEC acts under its investor protection objective, it will be bound by economic analysis requirements. It should have more than sufficient evidence to conduct such an analysis. For one thing, the competition economic analysis suggested above will be relevant, and opens up a new and fertile ground for economic analysis in market structure rulemaking for the SEC generally.

For its part, were the SEC to revise its rules or adopt a new rule explicitly prohibiting PFOF and rebates on the basis of its investor protection mission and pursuant to its "in the public interest" authority, it would conduct an economic or benefit-cost analysis of its rulemaking. That analysis will have significant evidence to rely on. The SEC staff interpret their benefit-cost analysis requirements in a 2012 staff memo.[83] There are a wealth of academic studies that demonstrate that PFOF and exchange rebates are inefficient, disruptive, or harm consumers.[84] There are studies of practices facilitated by broker inducements, like the cost of latency arbitrage, that estimate the investor losses that can be directly linked to broker inducements. For example, the UK Financial Conduct Authority has estimated that latency arbitrage practices facilitated by PFOF and exchange rebates cost investors an average of $5 billion per year.[85]

There will be a number of arguments easily anticable during the comment process and during subsequent litigation that will be irrelevant to the requisite economic analysis that this section will proceed to address. The SEC's economic analysis requirements are focused on the market broadly and require consideration of market wide consumer and producer surplus. Prior comment letters regarding, for example, the SEC's transaction fee pilot have looked at the costs to a discrete group of issuers,[86] an argument that was

---

[83] Memorandum from Sec. & Exch. Comm. Div. of Risk, Strategy, and Fin. Innovation & Off. of Gen. Counsel to the Staff of the Sec. & Exch. Comm. Rulewriting Divs. & Offs., *supra* note 39.

[84] *See, e.g.*, Christine A. Parlour & Uday Rajan, *Payment for Order Flow*, 68 J. FIN. ECON. 379, 400 (2003); *see also* Robert H. Battalio & Tim Loughran, *Does Payment for Order Flow to Your Broker Help or Hurt You?,* 80 J. BUS. ETHICS 37, 37–44 (2008); Battalio et al., *Can Brokers Have it All? On the Relation Between Make-Take Fees and Limit Order Execution Quality*, 71 J. OF FIN. 2193 (Oct. 2016); *see also* Liyan Zhang & Haoxiang Zhu, *Back- Running: Seeking and Hiding Fundamental Information in Order Flows*, 33 REV. OF FIN. STUD. 1484 (July 2, 2019); *see also* Markus K. Brunnermeier & Lasse Heje Pedersen, *Predatory Trading*. 60 J. OF FIN. 1825–63 (Aug. 2006); *see also* Eaton et al., *Retail Trader Sophistication and Stock Market Quality: Evidence from Brokerage Outages*, 146 J. OF FIN. ECON. 502 (Nov 2022).

[85] Matteo Aquilina & Peter O'Neill, *Big Bucks from Small Change*, INSIGHT (Jan. 27, 2020), https://www.fca.org.uk/insight/big-bucks-small-change [https://perma.cc/QLQ7-YPK8]; *see also* Matteo Aquilina et al., *Quantifying the High-Frequency Trading "Arms Race"* 3 (U. Chi. Booth S. Bus., Working Paper No. 20-16, 2021).

[86] Many of whose shareholders, incidentally, supported the pilot.

entirely inconsistent with a sound economic analysis.[87] The fact that a single firm or handful of firms' business models will be negatively impacted is not a relevant cost for Commission consideration.

Indeed, to the extent that a firm's business model is heavily dependent on payment for order flow, the profits flowing to this firm arise from the conflicts of interest that the Commission's expected rule targets (as demonstrated by a record of Commission and FINRA actions against the firm for conflicts of interest stemming from PFOF). Driving conflicts out of firms provides the benefit intended by the rule.

Doubtless the argument that zero commissions and PFOF are unavoidably linked, and one can't have one without the other, will appear in any challenge to SEC authority to adopt a PFOF ban. But that argument will ultimately prove unavailing for three reasons. First, it is not clear that banning PFOF will inevitably result in an end to zero commission trading. It appears that many firms sustain zero commissions without the necessity of PFOF.[88]

Second, the cost of changes to zero commission trading for retail investors, if demonstrated, will still only provide part of the picture, as any ultimate measure of consumer wealth changes from a PFOF ban will have to further consider expected improvements in trading execution by removing the distortionary effect of broker inducements on the quality of execution.

Finally, and perhaps most importantly, a broker's duty of best execution is not a duty that can be netted against other benefits. It's a duty to seek the best prices. So, for example, a broker cannot under existing rules disclose that it provided inferior stock prices to its customers, but in return, it provided other services at lower or no cost.

The SEC's economic analysis guidance notes that economic analysis requires the SEC to consider the costs and benefits of new regulations against a baseline.[89] To state the obvious, the baseline for a rule on broker inducements would likely be the current execution environment. It would be a mistake to assume, as some criticisms of an inducement ban appear to assume, that zero commission trading would no longer be available in such an environment.

The presence of conflicts of interest in a broker's decision to accept PFOF or exchange rebates in exchange for routing of that customer's order is also the type of "principal-agent problem (such as economic conflicts of interest),

---

[87] *See, e.g.*, *SEC Transaction Fee Pilot: Understanding the Impact to Investors and Listed Companies*, N.Y. STOCK EXCH., https://www.nyse.com/network/article/sec-transaction-fee-pilot [https://perma.cc/Z2UW-6ZEW].

[88] *See Commitment to Execution Quality*, FIDELITY (last visited Jan. 16, 2023), https://www.fidelity.com/trading/execution-quality/overview [https;//perma.cc/LK53-4SCR].

[89] *See* Memorandum from Sec. & Exch. Comm. Div. of Risk, Strategy, and Fin. Innovation & Off. of Gen. Counsel to the Staff of the Sec. & Exch. Comm. Rulewriting Divs. & Offs., *supra* note 39.

and asymmetric information" the SEC's memorandum on economic analysis lists as typical justifications for rulemaking.[90] This article has thus far considered conflicts of interest as an issue under the SEC's separate fairness objective. A qualitative fairness analysis may similarly be re-used under the rubric of economic analysis given these references to conflicts as instances of the economic concept of information asymmetry.

In essence, the SEC may do well to incorporate a qualitative "fair and orderly markets" section of a rulemaking, then cut and past the same analysis into its "public interest economic analysis" section with appropriate references to the problem of information asymmetry.

There is a persistent information asymmetry with respect to the quality of execution that investors are getting when orders are routed to wholesale unlit venues for execution in exchange for PFOF. Trade reports are masked by a Trade Reporting Facility (TRF) subject to substantial latency. Investors cannot identify where the trade executed; only that it executed off-exchange.[91]

Indeed, wholesale brokers select the marketable orders they route to price formative exchanges and select the marketable orders that trade off-exchange, where the latter is reported latently via the TRF.[92] Through this process, wholesale brokers impact the National Best Bid and Offer (NBBO) as the division of these transactions based on their varying impact influence the setting of the NBBO at the exchanges.[93]

This is a conflict worth considering here given that it contributes to the information asymmetry problem. Few consider the impact of conflicts of interest of market makers that routinely decide whether to route on or off exchange. The SEC has noted the limited utility of the NBBO as a metric against which to measure best execution in the Gamestop Report, noting that "price improvement statistics based on the NBBO may overstate the actual price improvement."[94]

Supporting the impact of the direction of orders to the latent TRF relative to more timely exchange pricing updates, a new study by Ernst, Sokobin and Spatt titled "The Value of Off-Exchange Data" provides:

> Exploiting the structure of geographic latencies, we study the effect of trade reporting of off-exchange equity transactions and contrast that with reporting of exchange trading. Publication of off-exchange transactions by the

---

[90] *See id.*

[91] *See* Robert P. Bartlett, III & Justin McCrary, *How Rigged Are Stock Markets? Evidence from Microsecond Timestamps* 1 (Nat'l Bureau of Econ. Rsch., Working Paper No. 22551, 2016); *see also* Phil Mackintosh, *How the U.S. SIP Really Works*, FOCUS (Apr. 2021), https://focus.world-exchanges.org/articles/nasdaq-market-data [https://perma.cc/P3LB-UP8F].

[92] *Id.*

[93] *Id.*

[94] GameStop Report, *supra* note 43, at 14.

> Securities Information Processor (SIP) leads to a sharp burst in trading and quoting activity, suggesting that market participants learn from those reports, with their unique information content lingering throughout the lengthy reporting process. In contrast, there is no spike in response to SIP publication of exchange trading, but instead an earlier spike that reflects the response to the near-immediate reporting from proprietary feeds. Due to the varied locations of the off-exchange trade reporting facilities (TRFs), SIPs and exchanges, we use distinct geographical latencies to pinpoint the patterns. We document that realized spreads for the TRF- response trades are negative, consistent with these orders being informationally- motivated and contributing to price discovery.[95]

These findings prove the value of trading within the TRF, and the wholesaler's ability to time that impact through a basic routing decision. An investor's order may be part of a coordinated effort to immediately impact the NBBO or impact the NBBO latently through the delayed TRF report.[96] Given their aggregation of the order flow of multiple retail brokers, wholesale venues are positioned to profit from their direct knowledge of the varying price impacts that they can trigger from the orders that they control and direct.[97]

This is not the only information asymmetry present. Also worth noting is that the same wholesalers that interact with retail flow off-exchange are some of the largest on-exchange players, including bearing the responsibility of quoting and contributing to the NBBO. For example, by far the two largest wholesalers are Citadel and Virtu; they are also two of NYSE's three designated market makers or designated market makers DMMs. This creates a significant information asymmetry between these firms and other market-makers and impacts the ability for firms to compete on an even playing field for who can provide the best prices.

---

[95] Thomas Ernst et al., *The Value of Off-Exchange Data* (drafted Apr. 26, 2021), https://people.stern.nyu.edu/jhasbrou/SternMicroMtg/SternMicroMtg2021/Papers/TRF_NYU%20Conference.pdf [https://perma.cc/3T4L-T9XV].

[96] *6380A Transaction Reporting*, FINRA (2021), https://www.finra.org/rules-guidance/rulebooks/finra-rules/6380a [https://perma.cc/HF8G-NK6R] (Current FINRA rules provide a lenient ten second delay, but otherwise make clear that "In no event may a member purposely withhold trade reports, e.g., by programming its systems to delay reporting until the last permissible second.").

[97] The SEC's settlement with Credit Suisse provides an indication of this particular strategy. *See* Credit Suisse Sec., LLC, Securities Act Release No. 10565, Exchange Act Release No. 84314 (Sept. 28, 2018) (order instituting administrative and cease-and-desist proceedings and imposing remedial sanctions and a cease-and-desist order).

Given conflicts impacting the routing of retail orders, and the conflicts within the off-exchange venues themselves, information asymmetry problems will persist even with added disclosure about the impact of PFOF and exchange rebates.

The relevant impact of the information asymmetry in this case will not be limited merely to retail traders. The SEC's economic analysis guidance suggests that SEC rules can seek to create "Positive externalities . . . from network effects of standards (such as accounting standards), or social benefits from information disclosure that are not fully reaped by the disclosing party."[98]

The extent to which the distortionary impacts of PFOF or exchange rebates impact price discovery—or result in behavior that distorts the NBBO—should also factor into the SEC's economic analysis. Existing guidance makes clear that "executing customer orders at the NBBO does not automatically meet the broker-dealer's best execution obligation, but may be used as a factor in determining whether this obligation has been met."[99] The extent to which changing factors like consolidation among off-exchange market intermediaries at the same time as fragmentation to unlit venues distorting the NBBO may mean that an entirely new approach to best execution, on which abolishes or substantially limits PFOF and rebates, may be warranted.

SEC guidance also discusses negative externalities as a justification for regulation,[100] and the link between broker inducements and the "zero-sum" race for technological speed artificially created by the environment that inducements create (as through latency arbitrage practices that counsel for Citadel admitted have occurred in the market)[101] would be a ready example of this problem.

Another requirement of economic analysis is that reasonable alternatives to the rule should be addressed. The SEC will undoubtedly consider, as one alternative to the rule, increased disclosure of pricing and execution quality. To begin with, disclosure is most beneficial when it is well understood—the challenge in this environment, where nanoseconds count, arises from the exceeding complexity of pricing in the high-speed and multi-venue

---

[98] *See* Memorandum from Sec. & Exch. Comm. Div. of Risk, Strategy, and Fin. Innovation & Off. of Gen. Counsel to the Staff of the Sec. & Exch. Comm. Rulewriting Divs. & Offs., *supra* note 39.

[99] *See* Nichols, *supra* note 9, at 972.

[100] *Id.*

[101] During oral argument counsel for Citadel admitted that latency arbitrage practices have occurred in the market, but downplayed concerns about them by arguing that they no longer occur. *See* oral argument at 1:26, Citadel Sec. LLC v. SEC, No. 20-1424 (D.C. Cir. Oct. 25, 2021), https://www.courtlistener.com/audio/78189/citadel-securities- llc-v-sec/ [https://perma.cc/Q6HJ-VVK8].

marketplace.[102] If disclosure were expanded, it is likely that only a limited few participants with high expertise and substantial investment in technological infrastructure will be able to adjust for latencies and gain insight from the disclosures. As such, the SEC might reasonably conclude that such an alternative is insufficient to alleviate information asymmetry, conflicts of interest, price distortions, and zero-sum investments in a technological speed race to which broker inducements collectively contribute.

The SEC is required to consider reasonable alternatives advanced by a party during the comment period.[103] The DC Circuit has previously determined that the SEC must consider reasonable alternatives advanced by a dissenting Commissioner.[104] Parties uniquely affected by this ban, and indeed parties who have already threatened litigation, might be expected to advance an alternative proposal during the comment process that does not impact their business model to bolster subsequent litigation against the rule. The SEC may be required to consider that alternative as well.

The SEC is not required to demonstrate that the approach taken is less costly than a reasonable alternative advanced during the comment process, and if the SEC determines that an advanced alternative does not remedy the problems that the rule seeks to address the SEC simply needs to provide support for that position.[105] To the extent that an advanced alternative is a "disclose more information" or "do a better job with existing best execution enforcement" styled approach, the SEC will have ample evidence to support rejection of such an alternative.

VIII. EVIDENCE FROM OVERSEAS

Broker inducements like PFOF and exchange rebates are strongly discouraged and may even be banned in the future in the European Union, and not permitted in the United Kingdom or Canada.[106] The evidence utilized

---

[102] *See generally* Onnig H. Dombalagian, *Best Execution: An Impossible Dream?* 1 (Tul. Pub. L. Working Paper, Paper No. 21-3, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3857919 [https://perma.cc/Y5VE-C8Z9].

[103] Chamber of Com. v. SEC, 412 F.3d 133, 144–45 (D.C. Cir. 2005).

[104] *See* Memorandum from Sec. & Exch. Comm. Div. of Risk, Strategy, and Fin. Innovation & Off. of Gen. Counsel to the Staff of the Sec. & Exch. Comm. Rulewriting Divs. & Offs., *supra* note 39, at 1 (citing Chamber of Com. v. SEC, 412 F.3d 133, 144 (D.C. Cir. 2005)).

[105] Chamber of Com. v. SEC, 412 F.3d 133, 144 (D.C. Cir. 2005).

[106] *See* Sviatoslav Rosov, *Payment for Order Flow in the United Kingdom*, CFA INSTITUTE (June 2016), https://www.cfainstitute.org/en/advocacy/policy-positions/payment-for-order-flow-in-the-united-kingdom [https://perma.cc/Y9LF-JSTM]; *see also* Laurie McAughtry, *EU Lawmaker Confirms PFOF Ban*,

by these jurisdictions to justify a ban on broker inducements should be cited by the SEC in a final rule.

In the European Union, while there is no outright ban on PFOF, the practice is strongly discouraged. Recent guidance from the ESMA states: "ESMA is of the view that, in most cases, it is unlikely that the receipt of PFOF by firms from third parties would be compatible with MiFID II."[107] The European Commission recently put out a draft that would go a step further than the EMSA's strong discouragement and instead take the formal step of affirmatively prohibiting PFOF.[108]

Further, the fact that those markets continue to operate in an "orderly and efficient" manner despite the lack of broker inducements is evidence that a ban on broker inducements would not be costly to market operation in the US. For example, a paper by Sviastov Rosov at the CFA Institute compares execution quality before and after the UK Financial Services Authority banned PFOF in 2012 and finds that the PFOF ban resulted in an improvement to execution quality.[109] The high execution quality in Canada is further useful evidence to support SEC action in this context.[110]

IX. VERDICT ON LITIGATION THREAT: UNLIKELY

Unlike prior successful challenges to SEC rules, the SEC's expected rule on broker inducements is protected by a belt and suspenders (and armor and force field) of statutory power. The SEC has direct statutory authority to adopt a substantial restriction or even a ban on broker inducements.

The SEC can focus its analysis in adopting such a rule solely on the fairness implications of conflicts of interest posed by the rule in a qualitative analysis. The SEC can focus solely on the competition aspects of broker inducements. The SEC can focus solely on the traditional economic costs of broker inducements on the quality of retail execution as part of a more

---

THETRADE (July 27, 2022, 12:44 PM), https://www.thetradenews.com/eu-lawmaker-confirms-pfof-ban/ [https://perma.cc/W8A4-UA8G].

[107] *ESMA Warns Firms and Investors About Risks Arising from Payment for Order Flow*, EUR. SEC. AND MKTS AUTH. (July 13, 2021), https://www.esma.europa.eu/press-news/esma-news/esma-warns-firms-and-investors-about-risks- arising-payment-order-flow [http://perma.cc/HH6N-584C].

[108] *See Proposal for a Regulation of the European Parliament and of the Council Amending Regulation (EU) No 600/2014 as Regards Enhancing Market Data Transparency, Removing Obstacles to the Emergence of a Consolidated Tape, Optimizing the Trading Obligations and Prohibiting Receiving Payments for Forwarding Client Orders*, COM (2021) 727 final (Nov. 25, 2021).

[109] *See* SVIATOSLAV ROSOV, PAYMENT FOR ORDER FLOW IN THE UNITED KINGDOM: INTERNATIONALISATION, RETAIL TRADING, TRADE-THROUGH PROTECTION, AND IMPLICATIONS FOR MARKET STRUCTURE 21 (2016).

[110] Carole Comerton-Forde et al., *Regulating Dark Trading: Order Flow Segmentation and Market Quality*, 130 J. FIN. ECON. 347, 350 (2018).

quantitative, econometric analysis. If the SEC does all of the above in its final rule (and requests a full airing of the above issues during the comment process), then any threat to sue the SEC will turn out to be an empty bluff.