United States Senate

COMMITTEE ON
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
WASHINGTON, DC 20510-6250

July 9, 2014

VIA U.S. MAIL & EMAIL (davisjz@sec.gov)

The Honorable Mary Jo White
Chairman
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Chairman White:

Last month, the Senate Permanent Subcommittee on Investigations, which I chair, held a hearing, "Conflicts of Interest, Investor Loss of Confidence, and High Speed Trading in U.S. Stock Markets." At the hearing, the Subcommittee heard witness testimony relating to two conflicts of interest in the U.S. equity markets: the so-called "maker-taker" system and payments for order flow by wholesale brokers to retail brokers. Conflicts of interest erode public confidence in the markets and have the potential to harm investors and I believe the SEC should take prompt action to eliminate these conflicts of interest.

Under the "maker-taker" system, exchanges and other trading venues pay rebates to brokers for certain types of orders and charge fees for other types of orders. The system creates a conflict of interest for stock brokers who have a legal duty to seek best execution of their customer's orders. Maker-taker creates an incentive for brokers to route customer orders to venues that offer brokers the highest rebate, or conversely, away from venues that charge brokers the highest fee, even when those venues may not offer best execution. Academic and market research into order routing decisions suggest that the conflict is resulting in real harm to investors.

For example, a recent study by Professor Robert Battalio at the University of Notre Dame's Mendoza College of Business found that the order routing practices of four prominent retail brokers appeared "consistent with the objective of harvesting liquidity rebates" and "does not appear to be consistent with the [brokers' legal obligation] of obtaining best execution."[1] Professor Battalio, who was a witness at the Subcommittee's hearing, testified that a routing strategy designed to maximize rebate income can result in customer orders being routed to an exchange where they are as much as 25 percent less likely to be executed.

Professor Battalio's findings are consistent with other research. A 2011 report by Goldman Sachs also found that trading based on rebates rather than on best execution would

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[1] Robert H. Battalio, Shane A. Corwin & Robert H. Jennings, *Can Brokers Have It All? On the Relation Between Make Take Fees & Limit Order Execution Quality* (Working Paper, 2014).

leave customers with higher total costs.[2] In addition, a recent report by Sanford C. Bernstein confirmed that certain venues, especially inverted exchanges, where brokers are charged a fee for posting orders and paid a rebate for removing liquidity, offer significantly better order execution. The report pointed out, however, that routing to such venues would require brokers to forego rebates, and instead, require them to pay fees – putting the brokers' self interest in direct conflict with best execution for its customers.[3] These studies highlight the conflicts of interest inherent in the maker-taker system. My concern about the implications of these conflicts on investors and market confidence is shared by many market participants.

For instance, Tom Farley, President of the New York Stock Exchange (NYSE), testified that NYSE and its parent company, Intercontinental Exchange (ICE), support eliminating the maker-taker structure, stating that "broad adoption of this policy [eliminating maker-taker payments] would reduce the conflicts inherent in such pricing schema and further reduce complexity through fewer order types and fewer venues." Joseph Brennan, the Vanguard Group's Head of Global Equity Index Group testified that "the maker-taker pricing model creates an appearance of a conflict of interest" and that "the decision to submit orders to public markets should not be driven by the desire to capture a rebate or avoid a fee." This from a company that manages $2.6 trillion of retirement funds and other savings accounts for more than 20 million customers.

Best execution for customers should always drive broker routing decisions. Unfortunately, that does not appear to be the case in practice. For example, the Subcommittee also heard from Steven Quirk, a Senior Vice President at TD Ameritrade, one of the retail brokers named in Professor Battalio's study as appearing to have a routing strategy designed to maximize rebates. Mr. Quirk confirmed that the size of a rebate offered by a venue influences TD Ameritrade's decision about whether or not to route orders to the venue. Mr. Quirk also confirmed that, for the time periods discussed at the hearing, TD Ameritrade virtually always routed customer orders to venues paying them the highest rebates. While Mr. Quirk testified that best execution of customer orders takes precedence over TD Ameritrade's pursuit of rebates, the fact is that TD Ameritrade's virtually always routed orders to venues offering the highest rebates. (His point was reinforced at the Subcommittee's hearing by the President of the New York Stock Exchange.)

Clearly, eliminating maker-taker pricing would improve confidence in U.S. equity markets. Such action would also reassure investors that they can rely on their brokers to provide best execution of their trades, without having to question whether a broker might instead be seeking to maximize its own profits at the customer's expense.

A similar conflict exists in the practice of wholesale brokers paying retail brokers for order flow. Such payments create another incentive for brokers to maximize their own profits at the expense of best execution of customer orders In addition, while retail brokers must disclose the amount they receive per-share from wholesale brokers for order flow, the aggregate totals of such payments are typically not disclosed. As a result, in most cases, consumers are unaware that the fractions of a cent received by retail brokers per-share add up to a multi-million dollar

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[2] George Sofianos, JuanJuan Xiang & Ali Yousefi, *Smart Routing: All-In Shortfall and Optimal Order Placement*, GOLDMAN SACHS EQUITY EXECUTION STRATS STREET SMARTS, January 14, 2011.
[3] Research Note by Sanford C. Bernstein Electronic Trading (2014).

conflict of interest. Furthermore, the limited disclosures currently required are not filed with the SEC and often disappear from broker web sites at the end of each quarter.

Recently, the United Kingdom Financial Services Authority (FSA) raised concerns about payments for order flow, noting that the practice "create[s] a clear conflict of interest between the clients of the firm and the firm itself."[4]

Among other things, the FSA questioned why, if a wholesaler broker offers the best possible execution for a customer order, there should be a need for payments to retail brokers, stating that "it is difficult to see how a firm could provide any justification that [payment for order flow] benefits the client directly," and that "an argument that the client obtains a benefit because the firm obtains a benefit is tenuous at best." It should be noted that the FSA requires brokers to provide justification "as to why the payment was designed to enhance the quality of service to the client."

U.S. equity markets may be the best in the world, but permitting conflicts of interest to persist undermines investors' confidence that they are getting a fair deal. Evidence, such as that presented at the Subcommittee's hearing, shows one reason why. The SEC has had more than four and a half years to examine the results of the holistic market structure review that it launched in 2010.[5] Further study will not change the fact that conflicts of interest are inherent in the maker-taker system and payments for order flow. The SEC should immediately initiate action to eliminate them.

Thank you for your consideration. If you have questions, please do not hesitate to contact me or have your staff contact Dan Goshorn at the Permanent Subcommittee on Investigations of my staff at (202) 224-9505.

Sincerely,

Carl Levin

Carl Levin
Chairman
Permanent Subcommittee on Investigations

cc: Luis A. Aguilar, Commissioner
Daniel M. Gallagher, Commissioner
Kara M. Stein, Commissioner
Michael S. Piwowar, Commissioner

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[4] Guidance on the practice of 'Payment for Order Flow,' 2012, FSA-FG12-13.

[5] Concept Release on Equity Market Structure, Release No. 34-61358, File No. S7-02-10 (Jan. 14, 2010).