Testimony of Robert Battalio before the
Securities and Exchange Commission’s Equity Market Structure Advisory Committee

October 27, 2015

Good morning and thank you for inviting me to participate in the SEC’s Equity Market Structure Advisory Committee’s discussion of make/take fees. It is an honor to have the opportunity to present my views on SEC Rule 610. I am currently a Professor of Finance in the Mendoza College of Business at the University of Notre Dame.

In my recent research with Shane Corwin and Robert Jennings, we identify four national retail brokers that seemingly route orders to maximize order flow payments: selling market orders and sending limit orders to venues paying large liquidity rebates. Angel, Harris, and Spatt (2011) argue that this type of routing may not always be in customers’ best interests. In our work, we document a strong negative relation between liquidity rebates and several measures of limit order execution quality. Based on this evidence, we conclude that the decision of some national brokerages to route all of their nonmarketable limit orders to a single exchange paying the highest rebate is not consistent with the broker’s responsibility to obtain best execution.

We think there are at least three potential approaches to reduce or eliminate this conflict of interest.

The most aggressive approach is to completely eliminate make-take rebates and fees. While this approach might eliminate the conflict we address in our paper, it is quite possible that other (and potentially worse) conflicts could arise as a consequence.

Order flow is a valuable commodity and payment for order flow has a long history. For decades, actors in the U.S. equity markets have been actively seeking to segregate order flow into its most and least valuable components. Make rebates and take fees are tools used by venues to attract different types of orders.

Order flow will not lose its value should make-take rebates and fees be eliminated. It is likely that the market will introduce other inducements to attract the desired order flow. One advantage to the make-take model is that the payments are reasonably transparent. If incentives to attract a particular type of order flow continue after the make-take model is regulated away, then understanding what the replacement system of inducements might look like is important. It
seems reasonable to wonder if the payments might be less transparent than the current system and, thus, harder to study/monitor.

The make-take model is only part of the effort to segregate order flow in today’s equity marketplace. Two other examples are payment for order flow and dark pools. Without a comprehensive effort to address all order flow inducements, eliminating one aspect of them is ill-advised.

If the approach of eliminating make-take fees is taken, it should not be done without a thorough evidence-based review of the potential unintended consequences. This could potentially be done in the form of an SEC pilot program related to make-take fees. However, careful consideration would have to be given to ensure that such a pilot is well-designed and to whether such a pilot could even be used to effectively study the alternative market structures that would develop in the absence of make-take fees.

A second approach is to mandate that rebates and fees flow through to the investor. In theory, this would solve the conflict of interest identified by Angel, Harris and Spatt. If fees and rebates are passed through to the customer, the broker would only be concerned about receiving the commission, which is paid only if the order is filled. Thus, the broker would be motivated to maximize limit order fill rates. But, at what cost?

Our analysis suggests that it is often the case that nonmarketable limit orders execute regardless of the venue on which they are displayed. In these situations, retail investors are better off receiving a rebate rather than paying a fee when their limit orders execute. This suggests that even customers of brokers that pass fees and rebates directly through to their customers can benefit from enlightened order routing.

The least aggressive approach, and the approach that my coauthors and I recommend, is to enforce current best execution requirements on brokers and to improve the Rule 605 and 606 disclosures. The current regulatory structure requires that brokers provide best execution for customers. Requiring that brokers rigorously demonstrate that their routing practices insure best execution for their clients on a regular basis (as laid out in NASD Notice to Members 01-22) would be a good first step before initiating additional regulations. It seems unlikely to us that routing all non-marketable orders to a single high fee venue can be justified as best for the client.
If this approach is taken, it should be combined with additional disclosure by brokers. Some of this disclosure could be accomplished through improvements to the 606 reports. For example, brokers should be required to separately report routing information for marketable and non-marketable limit orders. Finally, Rule 605 reporting should be extended to individual brokers. As noted recently by Joe Ratterman, CEO of BATS, in the current trading environment, investors cannot in any meaningful way tie the Rule 605 and Rule 606 data together to evaluate the execution quality their broker is achieving on their behalf. Requiring brokers to produce monthly Rule 605 reports would allow investors, academics, and the press to make more informed comparisons of execution quality across similar brokers.

Thank you for giving me the opportunity to speak to the Market Structure Advisory Committee.