Recommendation of the SEC Investor Advisory Committee
Regarding Exchange Rebate Tier Disclosure

(January 24, 2020)

Exchange regulation by the SEC encompasses an extended set of interrelated regulations, including best execution obligations, the trade-through obligations imposed by Regulation NMS to reroute many trades to venues with the best price, and other related statutory and regulatory requirements administered both by the SEC and FINRA. While that regulatory tapestry is long overdue for a comprehensive review, this proposal considers a particular aspect of fees and related rebates of those fees which could benefit from more targeted disclosure to help the SEC assess exchanges' compliance with the Exchange Act's obligations (e.g., that fees be reasonable, equitably allocated, not discriminatory, and not unduly burdensome on competition) and to help market participants better negotiate their trading relationships with regulated exchanges. The SEC has cited estimates showing as much as $2.5 billion in annual rebate and related fees in a given year.[1]

Competition regulation by other market competition regulators like the Federal Trade Commission and the U.S. Department of Justice is a helpful guide to the SEC's fulfillment of its statutory competition mandate.[2] In that context customer rebates have at times been deemed a legitimate market practice by those analogous regulators and at times been deemed an anti-competitive monopolistic practice by those regulators and in cases brought by them.[3]

Most stock exchanges utilize a "maker-taker" fee model whereby the exchanges pay a provider of liquidity a rebate fee and charge a fee to a taker of liquidity.[4] Other exchanges utilize an inverted "taker-maker" model in which the rebate flows in the opposite direction. Only two exchanges utilize a flat fee model. These rebate practices are set against the backdrop of an exchange fee cap of $.0030 per share for execution of orders coming against a protected quotation.[5]

Under the Securities Exchange Act of 1934, the SEC is charged with reviewing rules by registered exchanges to ensure that those rules, including fee practices, "are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers;"[6] do provide for an equitable allocation of reasonable dues, fees, and other charges;[7] and do

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[1] https://www.sec.gov/rules/proposed/2018/34-82873.pdf

[2] See 15 U.S.C. 78.; 15 U.S.C. 77b(b); 15 U.S.C. 78c(f).

[3] See, e.g., discussion contained in Greenlee, Reitman and Sibley, An Antitrust Analysis of Bundled Loyalty Discounts, available at https://www.justice.gov/atr/antitrust-analysis-bundled-loyalty-discounts

[4] See Transaction Fee Pilot for NMS Stocks, page 5, at https://www.sec.gov/rules/final/2018/34-84875.pdf.

[5] See Transaction Fee Pilot for NMS Stocks, page 9, at https://www.sec.gov/rules/final/2018/34-84875.pdf..

[6] 15 U.S. Code § 78f (b)(5).

[7] 15 U.S.C. § 78f(b)(4).

"not impose any burden on competition not necessary or appropriate in furtherance of the purposes of" the Act.[8]

In the SEC's transaction fee pilot, the SEC referenced a number of comment letters suggesting problems with current rebate practices, including that the rebates exacerbate conflicts of interest between brokers executing trades and retail clients and institutional clients.[9] The lack of public disclosure concerning the structure of rebates for executing brokers makes it difficult for the end client to see the rebates which those brokers obtain for their liquidity, exacerbating a principle-agency conflict in the receipt of rebates for orders executed on behalf of clients but not shared with clients. The reporting and disclosure recommendations provided herein will shed light on how firms are navigating this potential conflict of interest and whether firms have opted to share those rebate windfalls with retail clients whose order flow generates the rebates.

During a session of the Investor Advisory Committee meeting on March 28, 2019, the Investor Advisory Committee heard from a number of market participants regarding fee and rebate practices of registered exchanges. During that meeting Professor Chester Spatt, former Chief Economist for the SEC and Visiting Professor of Finance at MIT, noted that

> "there are three dominant affiliate families that own most of the exchanges and control most of the stock exchange pricing decisions. The maker-taker platforms offer volume discounts or higher rebates to those brokers sending relatively larger amounts of orders that provide liquidity. In effect, this is a mechanism to price discriminate given the oligopolistic ownership and reward larger brokers."[10]

Spatt further noted that the present design of rebate tiers appears to be a mechanism by which exchanges are engaging in price discrimination. If true, then this practice implicates the SEC's statutory responsibility to prevent unfair price discrimination.[11] A reasonable first step to addressing this issue would be to enhance disclosure about the practice to allow market participants to make better informed decisions and help the SEC fulfill its statutory responsibilities.

Other participants during the panel discussion similarly asserted that registered exchanges enjoy oligopoly power and engage in various price discriminatory practices.[12] During that meeting the Investor Advisory Committee heard a competing view from Tal Cohen,

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[8] 15 U.S.C. § 78f(b)(8).

[9] See Transaction Fee Pilot for NMS Stocks, page 10, at https://www.sec.gov/rules/final/2018/34-84875.pdf.

[10] See Opening Statement of Professor Chester Spatt, Meeting of the SEC Investor Advisory Committee, March 28, 2019, webcast available at https://www.sec.gov/video/webcast-archive-player.shtml?document_id=iac032819

[11] See 15 U.S.C. 78.; 15 U.S.C. 77b(b); 15 U.S.C. 78c(f).

[12] including Ken Bertsch, Executive Director of the Council of Institutional Investors; Tyler Gellasch, Executive Director of the Healthy Markets Association; Mehmet Kinak, Vice President at T. Rowe Price; and Brad Katsuyama, CEO and founder of Investors Exchange LLC

Vice President of Nasdaq. The Investor Advisory Committee heard a similar perspective during a subsequent teleconference call with Angelo Evangelou from CBOE.

In order to better weigh the relative benefits of rebate tiering in providing liquidity to the market against the possibility that rebate tiering practices are facilitating prohibited price discrimination or may otherwise be inconsistent with the requirements of the Exchange Act, the Investor Advisory Committee offers two recommendations below to enhance transparency about rebate tier practices at exchanges through reasonable disclosure enhancements in both confidential SEC reporting and in reports released to the public. While these recommendations could be accomplished via formal rulemaking, they do not require the SEC to engage in formal rulemaking to accomplish the objectives set forward in the proposal. The SEC could develop these recommendations via authority the SEC already possesses to obtain information from registered exchanges.

A. Proposal for Enhanced Exchange Disclosure to the SEC Division of Trading and Markets

On a monthly basis, the SEC should receive regular disclosures regarding rebate tiers utilizing relevant market identifiers that can permit the SEC to review the volume of trades that receive a rebate and a disclosure of rebate amounts broken down by volume ranges. The SEC should also be able to readily see the volume of trading that gets charged a fee and the average fee for that volume of trading.

For each Member of a registered exchange, the Division of Trading and Markets should receive a list of specific rebate tiers and any other information used by the exchanges' internal accounting departments in order to compute amounts owed. Reporting to the SEC on rebate tiers should be consistent with internal client accounting records. Exchanges should report the number of Members who qualified for each specific fee tier per month and the Members who qualified for each relevant fee tier in the prior month.

In the event the number of customers is one or two for a particular tier, the Division of Trading and Markets should request comment from the relevant exchange regarding policies and procedures put in place to ensure rebate tiering practices comply with the Exchange Act's requirement that they are "not designed to permit unfair discrimination between customers."[13]

In order to ensure that monthly disclosures are comparable between exchanges, the Division of Trading and Markets should coordinate adoption of uniform monthly

[13] This information will appropriately inform the SEC's regular examination of Exchanges to ensure compliance with the statutory limit on unfair price discriminations. The SEC may also consider formal recordkeeping and reporting requirements pursuant to its authority under Exchange Act Sections 17(a) [15 U.S.C. 78q(a)] (requiring each exchange to make and keep" for prescribed periods such records, furnish such copies thereof, and make and disseminate such reports as the Commission, by rule, "prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of [the Act]"),

exchange invoices (or internal records appropriately reconciled according to a uniform methodology) to ensure consistency among exchanges in how tiers are reported.[14]

B. Proposal for Enhanced Public Disclosure of Rebate Tiers By Exchanges

The SEC should take steps to require monthly public disclosure by exchanges of rebate practices broken down by tiers using the information collected in Proposal A.

Some commenters at the IAC market structure panel warned that public disclosure of rebate tiering practices might risk revealing proprietary commercial information. Others argue that pricing tiers confer benefits and burdens that are inconsistent with the Exchange Act. They have noted, moreover, that some market participants that have negotiated relatively high rebates and lower fees circulate their rates to other market participants in the form of "rate cards" or other marketing related materials, in an effort to attract additional order flow.[15] With these factors in mind, the SEC should consider the extent to which public disclosure of rebate tiering would raise legitimate proprietary information concerns, and the extent to which those concerns may be negated by prior disclosures or be mitigated by the potential beneficial impact of such transparency on competition.

Public disclosure could aggregate numbers in buckets describing items such as rebates, fees and net payments subdivided into appropriate ranges.[16] For each bucket, public disclosure should, at a minimum, include the number of firms in that bucket, the total rebate volume in that bucket, and the firms' total volume in that bucket.

Public disclosure could foster competition among exchanges as broker-dealers can then more readily ascertain how many other Members hit their same rebate tier, the volume required to reach the next tier, and the number of Members that hit the next higher tier.

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[14] See id.
[15] Letter from Healthy Markets Association to SEC, Nov. 13, 2018, at 6-7, at https://www.sec.gov/comments/sr-nyse-2018-49/srnyse201849-4640899-176435.pdf.
[16] For example, aggregated public disclosure could proceed as follows:
Average rebate between 0.31 and 0.35: X # firms, X millions shares traded.
Average rebate between 0.26 and 0.30: X # firms, X millions shares traded.