Subcommittee on Investigations to examine conflicts of interest, investor loss of confidence, and high speed trading in U.S. stock markets

Monday, June 16, 2014

WASHINGTON – Conflicts of interest that threaten to undermine investor confidence in U.S. stock markets will be the focus of a Tuesday hearing of the Senate Permanent Subcommittee on Investigations.

The hearing, "Conflicts of Interest, Investor Loss of Confidence, and High Speed Trading in U.S. Stock Markets," is prompted in part by the growing presence of high-speed trading and increasingly complex market technologies and structures that may allow some market participants to profit at the expense of investors. Those same market structures create conflicts of interest that can put broker profits ahead of the interests of their investor clients.

"Innovation cannot be allowed to undermine enduring values," said Sen. Carl Levin, D-Mich., the Subcommittee's chairman. "The conflicts of interest we have examined threaten to damage investors and to erode the trust and confidence on which our free markets depend."

"Even after Congress examined conflicts of interest in the equity markets as far back as 2001, Wall Street continues to have a trust and confidence problem with the American people," said Senator John McCain, ranking member of the Subcommittee. "How well industry addresses the conflicts of interest and suspect high-frequency trading practices that are the subject of the Subcommittee's hearing will help determine whether Wall Street can finally overcome that problem."

The hearing will focus on two specific conflicts of interest: payments by wholesale broker-dealers to retail brokers for their customer orders, known as "payment for order flow;" and "maker-taker" rebates or fees that, depending on the circumstances, exchanges either pay or charge to brokers for executing trades on their platforms.

Roughly two-thirds of Americans believe the stock market unfairly benefits some at the expense of others. Just over half of Americans now own stock or mutual funds, down from two-thirds in 2002. And a recent survey of industry professionals found that 70 percent said they did not believe the stock markets were fair for all participants. Addressing the conflicts of interest identified in the Subcommittee's work could increase market confidence and prevent some

identified in the Subcommittee's work could increase market confidence and prevent some market participants, including some high-frequency traders, from benefitting at the expense of ordinary investors.

The first conflict of interest is payments for order flow. When a retail investor places a stock order with a broker, the broker often does not execute that order directly on an exchange. Rather, the broker may direct the order to a wholesale broker in exchange for payment, and the wholesale broker will then typically execute the order using its own inventory.

The conflict arises because using the wholesale broker who offers the highest payment – and therefore the most profit for the retail broker – may not offer best execution of the investor's order. Payment for order flow is not typically passed on to customers, though supporters of the practice argue it may contribute to lower transaction costs. But there is reason to believe that other factors, including competition among brokers and technology improvements, account for lower transaction costs.

The second conflict of interest relates to rebates paid to brokers by stock exchanges and other trading venues. There are currently eleven public stock exchanges plus over 200 alternative trading systems, including a large number of "dark pools." These trading venues offer various rebate structures in order to attract brokers, and orders, to their platforms. Trading venues pay brokers to place some kinds of orders, earning brokers what are known as "maker" rebates. Other kinds of orders incur a charge from the exchange, known as a "taker" fee. Some brokers place orders that automatically prevent a trade from completing if the trade would cost the broker a "taker" fee.

The trading venue offering the biggest "maker" rebate or smallest "taker" fee may not necessarily offer best execution for a trade. The hearing will examine academic research that suggests that some retail brokers may routinely send some kinds of orders to venues offering the most profitable arrangement for the broker. This research suggests that such a strategy comes at the expense of best execution for customers.

Tuesday's hearing is at 9:30 a.m. in Room 216 of the Hart Senate Office Building. Witnesses are:

- Professor Robert Battalio of the Mendoza College of Business at the University of Notre Dame;
- Brad Katsuyama, president and chief executive officer of IEX;
- Thomas Farley, president of NYSE Group;
- Joe Ratterman, chief executive officer of BATS Global Markets;
- Joseph Brennan, head of Vanguard's Global Equity Index Group;
- Stephen Quirk, a senior vice president at TD Ameritrade.

Prof. Battalio and Mr. Katsuyama will appear on the first panel, while the remaining witnesses will appear on a second panel. The hearing will be webcast on the subcommittee's website.

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