BETTER MARKETS

– Key D.C. Circuit Case Challenging SEC Pilot Program Will Determine How Stocks Are Traded on U.S. Exchanges– For the Benefit of Investors, or, for Benefit of Exchanges and High-Frequency Traders –

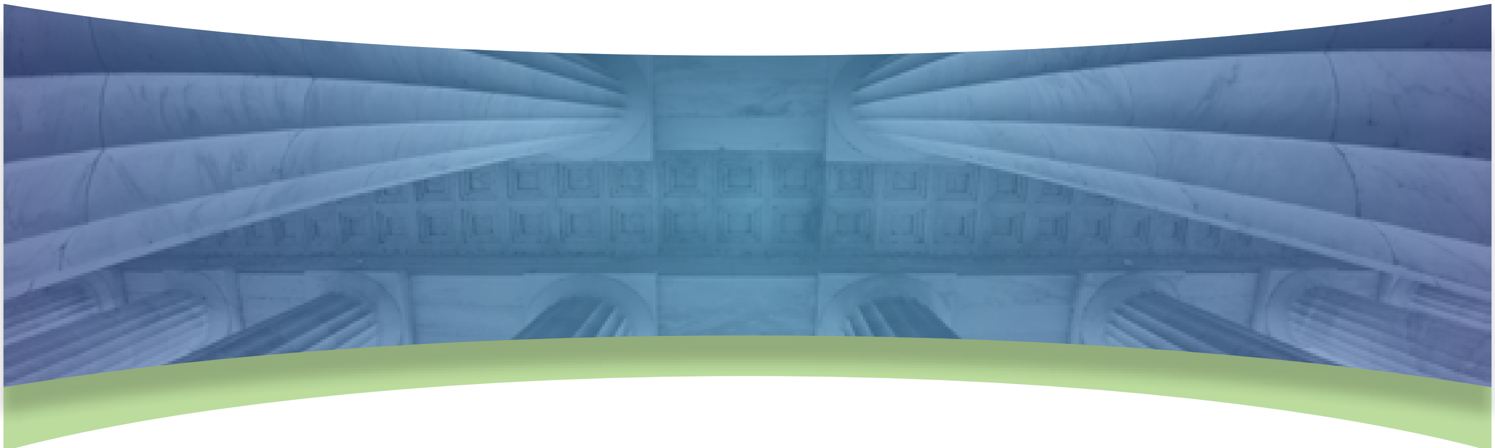
Oral Argument Scheduled this Friday, October 11, 2019
New York Stock Exchange LLC v. SEC, No. 19-1042 (D.C. Cir.)

Summary – A case being heard this Friday, October 11th, before the D.C. Circuit will have a profound and lasting impact on the way virtually all stocks are traded on U.S. exchanges. The law requires brokers to obtain the best execution for their customers' stock transactions, but today, brokers are incentivized instead to send those orders to particular exchanges that pay those brokers for their customers' orders. These are known as "maker-taker" fees and rebates.

The brokers and exchanges claim this practice does not interfere with best execution, but many see it as (1) nothing more than a form of legalized bribery that inevitably results in everyday investors paying more than they otherwise would, and (2) fragmenting the markets and making it easier for predatory high-frequency traders to skim profits off the trades of those investors. To resolve this dispute, the SEC adopted the Transaction Fee Pilot program designed to obtain concrete data and determine more precisely the impact of the maker-taker regime. The data generated by the Pilot will help the SEC develop a lasting solution to the problem. Several stock exchanges have challenged the SEC's authority and basis for adopting the Pilot, and the D.C. Circuit will hear the arguments of the parties on Friday, October 11.

Background – Currently, securities exchanges are allowed to pay brokers to induce them to route and execute customer orders on their exchanges. Many of the most powerful players in the securities markets profit handsomely from these kickbacks, known as "maker-taker" fees and rebates. One prominent broker reported revenue of over $1 billion from order routing payments in the period from 2016 to 2018. It doesn't stop there. Exchanges sell information about the order flow that this legal bribery attracts to high-frequency traders, who then use it to engage in predatory high-speed trading strategies.

The losers are ordinary retail investors, i.e. Main Street Americans who use the equities markets directly or through mutual and pension funds to save for important life goals, such as education for their children and retirement. When brokers violate their duty to seek best execution and instead chase higher rebates, retail investors suffer by receiving inferior execution quality for their orders, therefore paying more than they otherwise would. And when high-frequency traders, using inside information purchased from exchanges, execute their predatory trading strategies, it is often retail investors on the other side of those trades getting soaked for even more losses.



The Pilot – The Securities and Exchange Commission ("SEC") is the federal agency charged with protecting investors and the integrity of the securities markets by ensuring a fair and level playing field. On December 18, 2018, the SEC initiated the Pilot, after extensive public engagement, to study the impact of the maker-taker practice. The Pilot would only apply to 1,460 stocks (out of over 8,000) for up to two years. The Pilot represents an appropriately measured response to patterns of abuse that are largely shrouded in mystery for lack of concrete data. Limited in both scope and duration, the Pilot will enable the SEC to accurately assess the impact of these practices and provide the agency with sufficient information to fashion the most appropriate long-term regulatory response.

The Exchanges' Challenge – If the Pilot, as expected, demonstrates that legalized kickbacks are harmful to the integrity and fairness of the securities markets, then the SEC will have a foundation for a strong rule that clamps down on the practice—posing a threat to the profits of the exchanges. Accordingly, several of the exchanges, including NYSE and Nasdaq, have joined forces to challenge the Pilot in the D.C. Circuit and have it nullified. They argue that the Pilot is a fanciful experiment with no real justification and further that the Pilot is arbitrary and capricious because the SEC has not predicted with certainty the impact it will have on companies, exchanges, and investors.

However, as we point out in our amicus brief, these arguments are baseless. There is already ample evidence of the harmful impact of the current system of legalized kickbacks, certainly enough to justify a study to gather more data. Moreover, the SEC is only required to **consider** the impact of the Pilot before initiating it, not resolve all uncertainty about its impact; indeed the purpose of the Pilot is to eliminate the very uncertainty about which the exchanges complain.

What's at Stake: There is evidence that investors lose **billions** of dollars annually as a result of the legalized kickbacks allowed by the status quo. If the Court invalidates the Pilot, that harm would continue to be inflicted on investors indefinitely. More broadly, the ability of the SEC to regulate in the public interest would be undermined. If the Court accepts the Exchanges' arguments that uncertainty as to the impact of a rule invalidates the rule—a radical departure from current law—then the SEC and other agencies will face huge new challenges as they seek to write rules to protect the public interest, as all regulatory actions involve some degree of uncertainty about future impact. Oral argument in the case is set for October 11, 2019 in the D.C. Circuit.