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Commentary: Rebate Debate Misses the Mark

Though often criticized, broker rebates provide an incentive for efficient trades, but one model offers investors a better deal. Using discounts in the form of rebates is a well-worn marketing tactic used in myriad industries, from auto dealers to cable providers to retailers like Amazon. The principle is pretty straightforward: If a business offers customers a rebate, they'll be more likely to buy their products or use their services.

Straightforward, that is, except when it comes to U.S. equity exchanges. Critics, notably the IEX Exchange, have demonized the practice of giving rebates to brokers who execute orders on a specific exchange, even going so far as calling the practice a "kickback" in congressional testimony. They and others claim the practice creates a conflict of interest for brokers, and the Securities and Exchange Commission is now actively studying the matter.

Before we suffer regulatory overreach, however, we should take a step back and look at the bigger picture: There is nothing intrinsically wrong with rebates. The problem here is with the brokerage industry's dominant fee model, which results in rebates benefiting the broker-dealers themselves and not investors. Specifically, these include the pension and mutual funds that invest the hard-earned savings of millions of Americans.

Why is that? Under the standard commission model, brokers charge an agreed-upon per-share fee that is inclusive of costs, including the fees charged by exchanges and technology vendors. While brokers all have best execution obligations, those using the traditional "all-in" commission model have an obvious incentive to minimize fees if possible, making exchanges that offer rebates an extremely attractive destination for executing clients' orders.

This has always struck us as a silly way to charge customers. Instead, we have advocated that investors should use a "cost-plus" pricing model. With cost-plus pricing, investors pay a brokerage commission plus the costs noted above. If the costs are negative because there is an exchange rebate, that rebate is passed directly back to the investor. That not only removes the broker's conflict of interest, but also allows investors of all types to be rewarded for price formation, which is extremely important in today's fragmented marketplace where investors have difficulty finding liquidity. This model initially created minor back-office operational challenges for some large investors and asset managers, but in our experience most have happily solved them without too much trouble.

However, a client-aligned pricing model alone is not enough. Investors must be provided full transparency into every order to enable them to see exactly how their brokers made routing decisions. These analytics should consider not only the actions brokers undertook when executing orders, but also the actions not taken, because measuring those theoretical trading costs are necessary for investors to understand and measure the true impact on the market and ultimately the quality of the trades executed on their behalf.

Currently, the SEC is considering a pilot program to measure the impact of changes to the rules regarding exchange "access fees," which in effect will be a test of whether banning rebates – as IEX would like to see – will harm market quality. While we think that any pilot undertaken without also requiring full routing transparency is doomed to fail – how can you measure what you can't see? – we also think it's misguided. To our mind, moving to cost-plus pricing with full order routing transparency solves all the legitimate issues created by rebates, while not injecting the potential for unintended consequences on liquidity provision.

Our hope is that the investment community will vote with their order flows and insist that brokers who wish to service them move to this model, thereby creating a market-level solution that saves us from a costly new regulatory burden, however well-intentioned.

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