The price of trading: 
Fees, rebates and other inducements

Outline

- Background questions
  - How do markets charge for their services?
  - How do these charges affect our trading decisions.
- Examples
  - Maker-taker pricing
  - Taker-maker (inverted) pricing
  - Payment for order flow
  - Soft dollars
The traditional arrangement

- The customer paid a “standard” commission, which covered exchange fees.
- The exchange service fee was usually based on executed shares, no matter how the execution was accomplished.

Maker/taker pricing

- Many exchanges charge a “taker” fee for incoming marketable orders (also called a “liquidity removal fee”)
- Executed limit orders receive a liquidity rebate (a “maker” rebate)
Example

- Jiro sends an order “Sell 100 XYZ, limit 50.00” to BZX.
  - The order goes into the book.
- Kathy sends “Buy 100 XYZ, limit 50.00” to BZX
  - This order executes against Jiro’s order.
- Ignoring the taker fee and maker rebate, Kathy would pay $5,000; Jiro would receive $5,000.
- With the taker fee, Kathy pays $5,000 + 100 × $0.0030 = $5,000.30
- With the maker rebate, Jiro receives $5,000 + 100 × $0.0020 = $5,000.20.
Embedded problem 1

- The market in ABC is $20.10 bid; offered at $20.15; there are no hidden orders.
  - Dana is alone at the offer, for 100 shares.
- Emma: “Buy 100 XYZ, limit 20.15” to BZX
  - What happens?
  - Who are the maker and taker?
  - What are the maker and taker fees/rebates?
  - What are the net amounts paid and received?
- Answers in online version

Embedded problem 2

- The market in ABC is $20.10 bid; offered at $20.15; there are no hidden orders.
  - Brian is alone at the bid, for 200 shares.
- Catherine: “Sell 300 XYZ, limit 20.10” to BZX
  - What happens?
  - Who are the maker and taker?
  - What are the maker and taker fees/rebates?
  - What are the net amounts paid and received?
- Answers in online version
**Price distortion**

- Suppose that exchanges A and B are both posting $10.20, but
  - A’s access fee is zero.
  - B’s access fee is $0.003.
- Someone buying at A pays $10.20; someone buying at B pays $10.203.
- To determine who really has the best bid and offer, you have to net out access fees.

**Payment for order flow**

- Internalization
  - The NBBO in XYZ is 20.20 bid, offered at 20.30.
  - A broker (“E-Trade”) has a customer order (“Buy 100 XYZ at the market.”) The broker sends the customer order to the dealer (“G1 Execution Services”), who sells to the customer at $20.30
  - G1 sends to the E-Trade about (“less than”) $0.0014
The economic forces

- It is profitable to make a market against retail customers.
  - They are numerous, small, and (usually) uninformed.
- It is unprofitable to make a market against sophisticated proprietary traders.
- Payment for order flow encourages brokers to send retail orders to a dealer.
- Brokers don’t usually rebate the payments directly to the customers.
  - They argue that brokerage is a competitive industry, and customers benefit indirectly from lower overall commissions.

Broker’s obligations

- A broker has a *agency* duty to the customer.
  - The broker must act as an agent for the customer, and solely in the customer’s interest.
  - An *agency* duty is legally weaker than a *fiduciary* duty.
- Payment for order flow has been criticized as being inconsistent with this duty.
- At a minimum, brokers monitor their customers’ executions to ensure that their order-routing practices don’t adversely affect the terms of execution.
The SEC position

- Payment for order flow is legal as long as it is disclosed.
- Rule 606
  - Entering brokers must document their order-routing practices (including payments for order flow) on their web sites.
  - How many orders did you get? Where did you send them? What inducements did you receive?

From E*Trade’s Rule 606 Report

1. New York Stock Exchange Listed Securities

<table>
<thead>
<tr>
<th>For quarter ending 3/31/2014</th>
<th>Non-Directed Orders</th>
<th>Market Orders</th>
<th>Limit Orders</th>
<th>Other Orders</th>
</tr>
</thead>
<tbody>
<tr>
<td>Orders Routed to:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>G1 Execution Services, LLC¹</td>
<td>48.08%</td>
<td>69.55%</td>
<td>30.62%</td>
<td>47.30%</td>
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<tr>
<td>EDGX Exchange, Inc.²</td>
<td>19.24%</td>
<td>0.00%</td>
<td>38.21%</td>
<td>0.00%</td>
</tr>
<tr>
<td>Citigroup Global Markets, Inc.³</td>
<td>17.71%</td>
<td>3.24%</td>
<td>25.86%</td>
<td>39.90%</td>
</tr>
<tr>
<td>KCG Americas, LLC⁴</td>
<td>6.81%</td>
<td>11.13%</td>
<td>2.53%</td>
<td>11.21%</td>
</tr>
<tr>
<td>Citadel Securities, LLC⁵</td>
<td>5.79%</td>
<td>11.24%</td>
<td>2.10%</td>
<td>1.12%</td>
</tr>
<tr>
<td>Total E*TRADE Orders</td>
<td>97.4%</td>
<td>41.3%</td>
<td>50.3%</td>
<td>8.4%</td>
</tr>
</tbody>
</table>
“At Senate Hearings, Brokerage Firms Called Out for Conflicts”

- TD Ameritrade, a brokerage firm that handles vast numbers of stock trades for average investors, promises to execute those orders on the best possible terms.
- But in practice, TD Ameritrade routes a large number of the customer orders to the exchanges that pay it the most, Steven Quirk, an executive at the firm, said at a Senate hearing on Tuesday.
- …
- “Your subjective judgment as to which market provided best execution for tens of millions of customer orders a year allowed you to route all of the orders to the market that paid you the most,” [Senator Carl] Levin said. “I find that to be a frankly pretty incredible coincidence.”
- …

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1 G1 Execution Services LLC (G1) was an affiliate of E*TRADE until it was sold in February 2014. In connection with the sale E*TRADE entered into an agreement with G1 for equity order routing and execution services, for which it receives certain payments from G1. Payments received from G1 averaged less than $0.0014 per share. G1 executes on a principal basis and may have profited or lost in connection with such transactions.

2 Payments received from EDGX Exchange, Inc. averaged less than $0.0034 per share.

3 Citigroup Global Markets may utilize its affiliate LavaFlow ECN for the display of limit orders. Payments received from Citigroup Global Markets, Inc. averaged less than $.0032 per share.

4 Payments received from KCG Americas, LLC averaged less than $0.0013 per share.

5 Payments received from Citadel Securities, LLC averaged less than $0.0011 per share.
Exchange retail liquidity programs

- Recall the economic force behind payment for (retail) orders:
  - Retail traders aren’t “informed”; a market maker has less exposure to private information; it is cheaper to make a retail market.
- Traditional payment for order flow allowed dealers a way to monetize that advantage.
- Newer retail liquidity programs allow traders on exchanges to compete for retail order flow.

- NYSE
  - A retail order originates from a natural person. (It is not computer-generated.)
  - An NYSE member can register to become a “Retail Liquidity Provider” (RLP)
  - An RLP can enter limit orders that can be executed only by incoming retail orders.
  - The RLP’s bids and offers aren’t displayed, and they guarantee price improvement.
Soft dollars

- SEC: "Soft dollars are credits or rebates from a brokerage firm on commissions that clients pay for trades executed in an investment adviser’s client accounts. If appropriately disclosed, an investment adviser may use the soft dollar credits to pay for such expenses as brokerage and research services that benefit clients.

SEC Administrative Proceeding File No. 3-15663:
In the Matter of Instinet, LLC (December, 2013)

- On the basis of this Order and Respondent’s Offer, the Commission finds that
- From January 2009 through July 2010, Instinet paid approximately $430,000 in client commission credits called “soft dollars” as requested by its customer, J.S. Oliver Capital Management, L.P. ("JS Oliver"), a San Diego-based investment adviser, for expenses that JS Oliver had not properly disclosed to its clients.
- The improper payments included
  - $329,365 to the ex-wife of JS Oliver’s president, Ian O. Mausner;
  - thirteen months of increased rent payments totaling $65,000 for JS Oliver’s offices at Mausner’s home;
  - and two payments totaling $40,094.54 for upkeep on Mausner’s New York City timeshare.
- Instinet made the payments pursuant to JS Oliver’s requests even though the information JS Oliver had provided to Instinet when requesting approval of the payments presented significant red flags and clear suggestions of irregular conduct that each payment was improper.