"Payment for Order Flow" Is No Deal for Individual Investors

By James B. Cloonan

Over the last several decades, individual investors have gradually been reducing their holdings in the stock market. At least part of the reason, and maybe a major part, is their awareness of inequities in the system.

During the past year, I have discussed some of these inequities—front office fraud, unfair management of public limited partnerships and unnecessary short-term market volatility. Unfortunately, there are other inequities, and over the next several months, I will be discussing some of these.

I start this month with the practice called "payment for order flow" by the industry, but it could also be called the kickback system. Under this system, an over-the-counter dealer pays the stockbroker, with whom you may have placed your stock orders, a fee for making stock trades through the dealer. This fee, usually one cent to three cents a share, increases the costs of the dealer.

Supporters of this arrangement argue that the increase in costs to the dealer is offset by the increased efficiency that results from the higher volume of stock trades for the paying dealer. From the viewpoint of individual investors, this is the best-case scenario—they don't really lose anything from the practice.

The intermediate-case scenario is that the increased costs are offset at least partially by increases in the spread between the prices at which dealers are willing to buy and sell stocks. If this is the case, then in effect individual investors are paying all or part of the fee.

There is also a worst case scenario. Under NASD rules, which govern the over-the-counter markets, if the broker directs an order to a specific dealer with whom there is an arrangement, that dealer must meet the best prices currently available from any dealer. It is, however, very difficult to police such trades because there can be disagreements about how many shares any dealer's prices are good for. In addition, there appear to be some pricing variations of less than 1/8 that won't show up on dealers' screens; these differences, therefore, don't enter into the picture. The bottom line is that under these arrangements, investors can't be absolutely sure they have gotten the best price for their trade.

Another less obvious problem is that the dealer(s) with the best prices are the ones taking the risk associated with being on the hook for a given number of shares. If the market moves quickly, it is their capital that will be sacrificed to stabilize the market. A dealer with an arrangement doesn't have these risks; he has the opportunity to refuse the order or to be good only for an unknown number of shares. Thus, payments for order flow reward dealers for attributes other than risk taking.

In short, it appears that payment for order flow in over-the-counter stocks will, at best, not hurt individual investors, but in many cases will increase costs and reduce investor returns or reduce market efficiency.

All of the above discussion focuses on over-the-counter stocks. The problems become more severe when one considers the over-the-counter trading of exchange-listed stocks. To understand these problems, which are rapidly increasing, let's review the over-the-counter and exchange mechanisms.

The over-the-counter market is a dealer's market: All public orders are executed with dealers. Customer orders cannot "cross"—in other words, one customer who wants to buy at a particular price is not "crossed" with another customer who wants to sell at the same price. Instead, if the best bid price (the highest price at which a dealer is willing to buy shares) is 30 and the best offer price (the lowest price at which a dealer is willing to sell shares) is 30 1/4, then a public customer can only buy at 30 1/4 and sell at 30. If, simultaneously, one public customer puts in a limit order to sell at 30 1/8 and another customer puts in a limit order to buy at 30 1/8, these two orders cannot be matched; instead, they must await execution until a dealer's bid or ask reaches the limit.

There is a built-in profit for the dealer, which is justified by the risks taken and the costs of doing business.

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The spreads—the difference between dealers' bid and offer prices—are wider for thinly traded (risky) stocks, and very tight for the heavily traded stocks such as MCI or Apple.

In exchange-traded stocks, the vast majority of trades are matched either electronically or by the brokerage firm agents at the various posts. A small percentage of trades that have no immediate public match available go through a specialist who functions as a dealer does on the over-the-counter market, but there is only one specialist (dealer) per stock. The specialist gets the difference between the bid/ask spread in return for assuming the risk of taking positions to smooth the market. The specialist, however, is only allowed to function when public orders cannot be crossed with other public orders.

In general, the functioning of both the over-the-counter and exchange markets can be justified, and there are arguments for and against each method, depending on the assumptions. A problem exists, however, when a stock is traded on both markets. Most individuals don't realize that exchange-listed stocks can be and are traded over the counter. About 10% of the trading of New York Stock Exchange stock is carried out in the over-the-counter markets. Institutional transactions generally are not executed in the over-the-counter market, which means that a fair number of the exchange-listed trades of individual investors are done in the over-the-counter market. The figure has been growing steadily.

With payment for order flow by over-the-counter dealers, brokers will direct orders for listed stocks to this market. Since public limit orders cannot be crossed in the over-the-counter market, the execution of such orders may be delayed or sent to the exchange. Market orders, however, can go to the over-the-counter market where the bid/ask spread goes to the dealer, usually without the dealer taking any risk. The problem is that orders that might have been crossed in between the bid/ask spread on the exchange are not. Even when a spread would be taken by the specialist, it is going to the risk-taker who is making a market.

Much of the problem would disappear if there were no payment for order flow. I certainly would like to see payment for order flow prohibited. In the absence of such prohibition, individuals can help alleviate abuses by requesting that orders for over-the-counter stocks be executed on the SOES (Small Order Execution System) and that orders for exchange-listed stocks be traded on an exchange. It doesn't matter which exchange is specified; when a stock is listed on more than one exchange, the best execution will be selected.

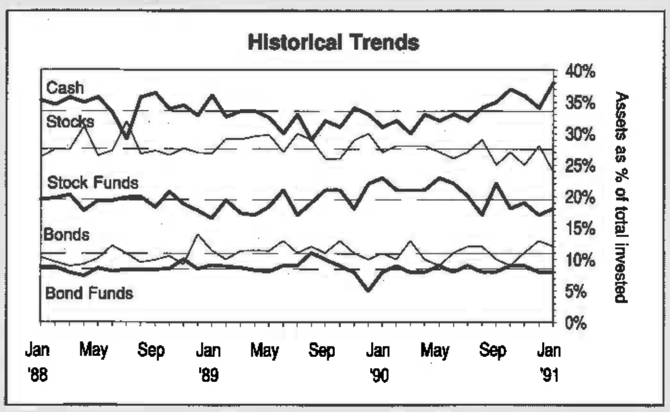
There may be other ways around some of the problems discussed, and I am not suggesting that there are a lot of abuses of regulations. I just have a hard time understanding the practice of payment for order flow or kickbacks. It is a practice that would be unethical, illegal or in restraint of trade in most industries.

I also wonder how many millions (or billions) of dollars a year out of the pockets of individual investors those unnecessary 1/8 points generate. I don't mean the normal spreads, but the 1/8 points or 1/4 points on orders that should have been crossed.

AAII Allocation Survey: Where Individuals Commit their Assets

The percentage of individual investors' portfolios committted to stock funds and cash rose during January. Stock funds are currently 18% of assets, up 1% from December; and cash is 38% of assets, up 4%. During the same period, the portion allocated to stocks and bonds declined. Stocks currently represent 24% of assets, down from 28%; and bonds are 12% of assets, down from 13%. The percentage committed to bond funds remained unchanged during January at 8% of assets.

In a monthly survey, AAII members are asked to calculate the percentage of their portfolio invested in cash, bonds, bond funds, stock and stock funds.



The dashed lines indicate the average allocation of each category over the duration of the survey.

The graph provides an indication of where individuals commit their assets over time. It is, however, an average; individual portfolios should vary according to personal circumstances and risk tolerances.

It is interesting to note that while investor sentiment varies widely over time, individual investors' actual allocation of their assets remains remarkably stable, indicating that investors on average do not tend to make major portfolio changes based on short-term impulses.