Free Trading: If You Didn't Pay For The Execution, You Are The Product

Why Read This?

South of the border, Charles Schwab announced that they are eliminating commissions on equity trades in their self-serve channel. TD Ameritrade followed suit later that same day. We discuss what we believe the implications are for equity market structure.

A Bit of Background

One critical difference between the Canadian and U.S. equity markets is in the manner in which retail flow is executed. In Canada, the UMIR Order Exposure Rule requires that small orders (i.e. most retail orders) are immediately exposed to the market. By contrast, the U.S. market allows retail executing firms to route flow directly to dealers who can take the other side. Those dealers, in turn, generally pay for this order flow to maximize their ability to interact with non-directional ("uninformed") orders. This practice is known, unsurprisingly, as "payment for order flow" ("PFOF").

In Canada, payment for order flow is not permitted – commissions paid by clients must be positive. Instead, interaction of this nature takes place on inverted marketplaces which allow a dealer to pay for flow indirectly, by having the marketplace collect a fee from the passive side and pass most of it to the active. Nevertheless, this mechanism is at least multilateral (which is also a consequence of our Order Exposure rule).

All the dimensions of this discussion are complex. For a good summary of the Canadian situation, we refer you to the recent CSA/IIROC Consultation Paper on the topic of internalization and its comment letters.

In the U.S. market, the practice of payment for order flow has long subsidized the retail experience, not to mention the corporate bottom line of direct investing firms. This has led to a compression of explicit commissions, and more recently has led to business models where firms offer commission-free transactions in the knowledge that the order flow they garner can be monetized. How? If an order is resting in the market, it will typically sit on a venue that pays a large rebate – such as the NYSE. If the order is filled, the dealer is paid. If the order is marketable, it will be routed to a liquidity provider – and again, the firm is paid.

The result has been a steady erosion of explicit trading commissions at the expense of fragmentation in order routing. Quite simply, many orders never make it to the multilateral market at all.

Is This a Problem?

Retail executing firms will argue that what they do is in the best interest of their client. Obviously. It's easy to argue this when executions at the order-by-order level demonstrate some price improvement. Every order is no worse off than had the executing firm routed it to the lit exchange and paid a take fee. The question we ask, however, is whether the market ultimately benefits from this practice. Perhaps the individual order is "better off", but the collective environment is not?

If "best execution" is seen as a process and not an outcome for a particular order, then we believe that any arguments about individual orders' price improvements are fundamentally flawed. The process of best execution should account for the average outcome. By the same token, we think it's appropriate for all stakeholders to consider whether the process of a collection of firms each engaging in "best execution" through PFOF, and therefore fragmentation, is ultimately damaging the overall trading ecosystem.

The Canadian regulators have started examining this with the aforementioned CSA/IIROC Consultation Paper on internalization. The principal question being asked is whether the good of a particular investor is more or less valuable than the "common good." This is a worthwhile debate, particularly in the context of decisions which are made by for-profit entities that are tasked with growing shareholder value therefore their corporate "individual good".

What does this have to do with Schwab? By explicitly moving to a zero-commission fee structure similar to that of Robinhood and more recently IBKR Lite, the firm is further drawing the line that the individual good ("reduced commission") is more important than countervailing forces that might promote a common good ("order routing independent on third party payments"). Additionally, when the largest direct investing brokerage in the U.S. triumphantly announces that the commission cut *"removes the final pricing barrier to investing online"* they simultaneously suggest that the previous $4.95/trade was somehow a barrier, and that transaction costs should be nil.

We disagree. Transaction costs are never zero, and there is a cost to delivering Schwab's service. When retail investors see "free commission", the message that their order flow is being monetized indirectly is hidden away. Since the cost of the service isn't zero, and Schwab is not a charity, the brokerage is clearly being paid on the other side. The principal mechanism today is payment for order flow (although "free trading" in ETFs where the brokerage also owns the fund manager is another common strategy). This arrangement is not transparent, even though conventional wisdom says that transparency benefits clients.

One could argue that the people willing to pay the most should get to buy the item at question. Conceptually, if someone is willing to pay for order flow, they "should" get it. That's reasonable only to the extent that the bidding process is an open process, and enough bidders materialize. Payment-for-order-flow arrangement are anything but open; there is no ability for third parties to insert themselves into the competition. In fact, a certain order flow executive was famously quoted in the book Flash Boys as saying that "the payment for the order flow is as off-the-record as possible" along with some other juicy tidbits.

The underlying issue is that PFOF is a bilateral mechanism for rewarding an order flow aggregator (Schwab, TD Ameritrade, among others) at the expense of the overall market's ability to interact with flow. It also benefits the buyers of the flow by removing potential competition from other participants who might want to compete for flow and interact with it, by giving those buyers a first look. This increases market power for both parties: the value to each is a function of their scale. The bigger the retail brokerage, the more it can claim its order flow has value to be monetized. The bigger the liquidity provider, the more they can shut out competing market makers, because size leads to more opportunities to monetize flow and hence lower aggregate risk.

In a narrowly-constructed market with environment like this, is it reasonable to think that an oligopsony of a few order-flow buying firms would maximize the value to retail investors – either individually or at large?

More philosophically, PFOF is a bilateral arrangement overlaid on top of a market that is designed through regulation to encourage multilateral interaction. In the U.S., Reg NMS protects quotations from trade-through, while the payment of rebates encourages liquidity providers to make the quotes to begin with. The mechanism is there to steer the market towards multilateral interaction (although both order protection and rebates have their nuanced issues). On the other hand, allowing payment for order flow and explicit internalization as a reward for this payment flies in the face of giving the broader market a chance to interact with market-bound orders.

None of this is new-news. Payment for order flow is not suddenly appearing. In fact, prior to these commission cuts, the same firms were already monetizing their flow while simultaneously charging commissions. By dropping the commission line, the pressure will rise to extract more value out monetizing flow. This is a zero sum game: if the net price paid to an investor (including the PFOF component) is fixed, the liquidity provider can tweak the split between what the client gets as price improvement (if any) and what the executing dealer gets as PFOF.

In other words, even if you did pay for the retail brokerage execution, you are still the product.

Institutions Holding the Bag

If the philosophical foundation of a bilateral retail market is somewhat murky, we also point to the health of the players who are on the outside and looking in: the institutional investors.

If the "best" natural order flow is routed to retail internalizers, and typical institutional investors have no means of being on the other side, what remains is of worse quality. There is no need to be particularly precise about defining what is "good" – suffice it to say that the fact that some flow isn't purchased means that it's less valuable (to the buyers) than the flow that is being bought. The buyers are taking the other side of their clients' trade; they will only want to buy profitable flow. In practice, the "bad" flow (which no one wants to buy) is the large, market-moving directional orders of institutional investors that are investing on behalf of their retail beneficiaries. These investors need counterparties. If the multilateral market is thinned out, overall toxicity levels will rise, and the institutional experience will be worse.

Again, none of this is new-news. Institutional investors have been discussing this issue for a long time. The most telling example is the widespread buy-side support for the Transaction Fee Pilot in the U.S. (currently in legal proceedings as the U.S. exchanges sue the SEC in an effort to protect the status quo) and for the Canadian Trading Fee Rebate Pilot Study. Each of these efforts attempt to deal with (or at least study) the consequences of marketplace rebates, which are another form of indirect and bilateral payment. In fact, in Canada, payment for order flow and marketplace rebates are synonymous because retail flow internalization takes the form of trading on inverted venues.

Unfortunately, there is little that can be done in the near term to stem this particular tide. Even a well-intentioned and well-constructed initiative such as the SEC's Transaction Fee Pilot does not attempt to meddle with the practice of PFOF, because anything that touches the retail experience through explicit costs is seen as kryptonite. On the other hand, structures where retail explicitly pays less but is implicitly charged (such as free trading in a related-party investment fund) are seen as a marketing home run.

Finally, we believe that addressing one component of the order handling dynamics is liable to spill the effect into other areas. For example, if payment for order flow is banned, but marketplace rebates persist, inverted trading will rise, resulting in the type of fragmentation we see in Canada. If marketplace rebates are curtailed without addressing systematic internalization with PFOF, the level of payment (or price improvement) may well increase to compensate for the wider quotes. In all these cases, some of the same behaviour may also shift to dark pools where, with a lack of trade-at, it's reasonably easy to operate in parallel to the Reg NMS market structure and achieve the same economics that are achievable in the bilateral PFOF market today.

In short, this is a difficult and messy situation with no clear solution. In the meanwhile, Schwab and TD Ameritrade's decision to cut commissions have just entrenched the status quo.

Word of the Day

Oligopsony (n.): a market situation in which each of a few buyers exerts a disproportionate influence on the market

Please do not hesitate to contact us if you have further questions.

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