INVESTING WISDOM

Transaction Quality Can Vary at Your Online Broker

(NAPSA)—Brokerage firms often talk about the services they offer without providing many details about their most important product—the trade. That's because many firms believe that investors cannot compare the quality of the execution they provide. However, there can be significant differences in the way stock transactions are conducted. In fact, these distinctions often determine if brokers are adding value to a transaction or seeking to gain additional profits at the expense of their customers.

Firms that add value to the equity transaction take full responsibility for executing their customers' transactions. To add value to the transaction, a broker should be able to quickly scan the market and route an order to the market participant that is expected to provide the best execution. Most investors are surprised to learn that not all firms do so.

Many brokers—both online and offline—send orders to a middleman for execution. These third parties can be thought of as wholesale brokers who pay retail brokerage firms for the privilege of executing their orders. This process is called "payment for order flow." These middlemen, called market makers, profit by trading against this very same order flow. It is the prospect of making handsome trading profits that prompts market makers to offer payments to retail brokerage firms.

Typical payments for order flow range from $3 to $10 for a 500-share order, adding to the firm's revenue beyond posted commission rate.

Such arrangements can place brokers in a conflicted position: brokers are required to seek the best execution for customers' transactions, yet receive payments from firms that trade against their customers. If the wholesale firms are able to make such a profit, was the best execution for the customer actually obtained?

Researching a broker's order-routing policy can help investors ensure their best interests are served.

It is unusual to find a major broker that does not seek order flow payments or trade against its customers' orders. Dave Whitmore, senior vice president, customer development, Datek Online Brokerage Services LLC, said, "Our computers are programmed to seek the best execution for each order, regardless of order flow considerations. If we do happen to be paid for our order flow, we rebate that money back to our customers. These rebates, which amounted to $2.4 million last year, demonstrate that we have no conflicts."

A variation on order flow payments is the practice of internalization. Some brokers relay orders to their own trading departments, which once again profit by trading against the order flow generated by individual investors. Internal trading departments can earn even greater profits because they don't have to pay for the orders.

While market makers play a valuable role in our capital markets, certain practices stack the deck against smaller investors. For example, a market maker has up to three minutes to respond to an order. This gives the market maker an opportunity to spot a change in the direction of the market, gaining a distinct information advantage over less knowledgeable investors. This could result in a market order that is executed at a price that is different than the one that had been displayed. A limit order may not be executed.

In contrast, alternative trading systems, commonly referred to as ECNs (electronic communications networks), do not have profit-seeking market makers acting as middlemen. ECNs are computer systems that post orders to buy and sell from many different market participants, and quickly match orders electronically.

ECNs typically do not pay brokerage firms for directing orders. In fact, most charge firms a fraction of a cent per share to execute an order. For this reason, many brokers prefer to have arrangements with middlemen that pay them for order flow.

Mr. Whitmore said that the vast majority of Datek's orders are executed on ECNs, and the average speed for a marketable online equity order in March 2001 was less than seven seconds.

The U.S. Securities and Exchange Commission has become more concerned with the quality of execution and will require brokers to publicly disclose the way they route their orders.

These disclosures will help investors evaluate the way brokers execute their orders, and seek out those brokers that work on their behalf, both in the front office and behind the scenes.