Financial Trading

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Lecture 4
Brokers

Relevant article

Article 4-A: Robinhood Financial to Pay $65 Million to Settle SEC Probe

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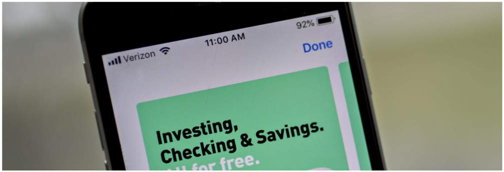
Robinhood Financial to Pay $65 Million to Settle SEC Probe

The brokerage firm settles investigation over early failure to highlight deals with high-speed trading firms



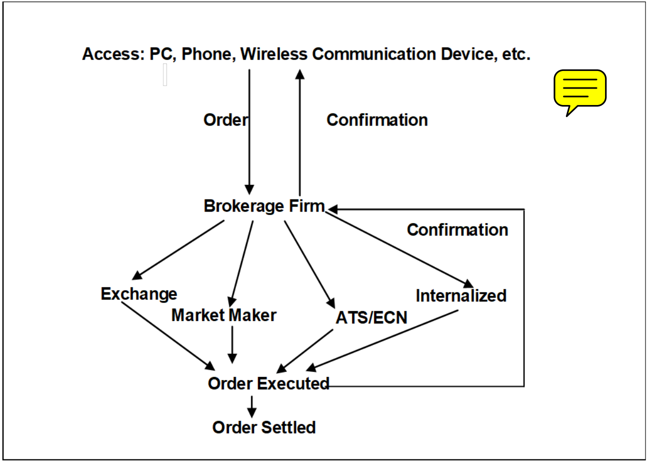
Agenda and objectives of the lecture

- Agenda
  1. What do brokers do?
  2. Potential brokerage problems.
  3. Commissions and payments for order flow.
- Objectives
  1. Be able to describe how the principal-agency problem affects your trading.
  2. Be able to describe how you can be defrauded by dishonest brokers.
  3. Be able to explain how payments for order flow affect retail commissions.

Motivation: If you trade, you will use a broker. You must understand what brokers do to effectively manage your trading and how brokers can defraud you, especially if you trade in less regulated jurisdictions.

Securities order routing process

- Suppose you want to buy 100 shares of JPM. How do you go about it?



What is a broker and what do brokers do?

- Exchanges require a substantial relationship, one that verifies our identity, capability, and authority to trade.
- Most customers establish this relationship indirectly, by setting up an account with a broker.
- A broker is an agent working on behalf of a buyer or a seller.
- "Agent" or "agency" is a legal term that implies certain responsibilities toward the principal.
- Brokers are usually paid a commission for arranging trades for their clients.
- Some brokers also provide investment advice and information.

What is a broker and what do brokers do? (cont.)

- The Financial Industry Regulatory Authority, a self-regulatory organization, regulates investment professionals in the United States.
- Exams that individuals may take for accreditation include the Series 7 exam, the Uniform Securities Agent State Law Exam (Series 63), the Uniform Combined State Law Exam (Series 66), and the Uniform Investment Adviser Law Exam (Series 65).
- Retail brokers service individuals.
  - Discount brokers (Scott Trade, Interactive Brokers) provide services related to trading.
  - Full service brokers (Charles Schwab, Merrill Lynch) also provide research and advice.
- Prime brokers service institutions such as mutual funds and hedge funds (Cowen, Credit Suisse, Goldman Sachs).
  - Larger trades, more securities, more markets.
  - Specialized services (for margin trading and short selling).

What do brokers really do?

- Brokers provide access
  - Provide access to markets with the ability to buy and sell securities on their clients' behalf.
  - (Prime) brokers may provide forums for hedge funds to present before investors (capital introduction)
- Brokers are experts
  - Brokers may know much more than their clients about how to best execute a trade.
  - They may also know
    - Who wants to trade.
    - Who might want to trade.

What do brokers really do? (cont.)

- Brokers are negotiators
  - Negotiations are often more successful when conducted by agents instead of principals.
  - Agents are less likely to get emotionally involved.
  - The trader's true position and intentions can be hidden by controlling the information given to the broker.
  - Agents may simply be better negotiators.
- Trustworthy and creditworthy
  - Two traders who are unknown to each other must determine that their counterparts are trustworthy and creditworthy.
  - A trustworthy trader will faithfully try to do what she promises.
  - A creditworthy trader can do what she promises.
    - These issues are important in all markets.
    - They are especially important when traders arrange future settlement or delivery.

What do brokers really do? (cont.)

- Brokers know their clients
  - Determining whether a trader is trustworthy and creditworthy is costly.
  - Enforcing contracts when traders fail to perform is also costly.
  - Brokers often can solve these problems more cheaply than individual traders.
  - They are organized to solve these problems.
  - They know their clients and in many cases control their assets.
- Brokers are clearing and settlement agents
  - Brokers often guarantee their clients performance.
  - Such guarantees are common in securities markets where a broker will represent a trader repeatedly.
  - They are uncommon in real estate markets were a broker rarely handles more than one trade for an agent.

Brokerage commissions

- Brokers have traditionally charged customers commissions on each trade.
- For many years, commissions were fixed by the NYSE. In 1972, for example, a customer buying 100 shares of a \$50 stock would pay \$22 $+ 0.9\%(100 \times 50) = \$67$.
- In 1975 commissions were deregulated.
- In 2012, one discount broker (Scottrade) was advertising 100-share trades for \$7.
- In 2015 a startup named Robinhood began to offer commission-free trades.
- In October 2019, Charles Schwab, an established full-service broker, adopted zero-commission trading.
- "Zero commissions does not mean zero costs." Customers pay for trading services in many ways.

Brokerage commissions: Soft dollars

- Large institutional clients often pay their brokers large commissions for trading.
- The commissions cover the costs of their trades and the costs of providing investment research and other related services.
- The broker and client account for the commissions using a negotiated formula that allocates part of the commission to the trade and part to the other services.
- The money allocated to other services is called soft dollars.
- Clients buy various services with soft dollars.
- Soft dollar practices are common in the institutional brokerage market.

Brokerage commissions: Soft dollars (cont.)

- Soft dollars are a way for mutual funds to get services without having to pay for them directly.
- A hard dollar payment would require a check to be issued and recorded on a fund's books, and the corresponding cash expense to be passed onto investors via the fund's annual fee.
- With soft dollars, the expenses are hidden in the trading costs.
- A fund's trading activity, the buying, and selling of portfolio securities is not included in the calculation of the expense ratio.
- While the practice is not illegal, and the end result is the same (the investors pay), it does not help investors analyze the costs of using one mutual fund versus another.

Brokerage commissions: Soft dollars (cont.)

- Suppose that an institutional investor pays a brokerage firm six cents per share in commissions. However, it might only cost three cents per share to perform the trade.
- The other three cents are soft dollars used to pay for other non-trading services provided by the brokerage.
- In exchange for paying these higher fees, the institutional investor might receive access to research.
- Although soft-dollar transactions are widely used but there is a growing movement to eliminate them.

A real-world example of soft dollars

Article 4-B

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Press Release

SEC Charges New York-Based Brokerage Firm for Ignoring Red Flags in Soft Dollar Scheme

FOR IMMEDIATE RELEASE
2013-273

Washington D.C., Dec. 26, 2013 — The Securities and Exchange Commission today announced sanctions against a New York-based brokerage firm for ignoring red flags and paying more than $400,000 in soft dollars for expenses that an investment adviser had not properly disclosed to clients.

The principal-agent problem

- Stock brokers earn a living through commissions; therefore, there is a risk for conflict between a stock broker's interest and the interests of his clients.
- The broker, however, has a fiduciary duty to put the needs of his clients above his own.
- A stock broker is also subject to the rules created by regulatory agencies, such as the Financial Industry Regulatory Authority.
- These regulatory agencies require all stock brokers to be honest, trade fair and only make trades that meet the needs of the client- not themselves.
- In practice, brokers often do what they want to do.
  - Brokers may be lazy.
  - Brokers may cut corners.
  - Brokers may defraud their clients.

Internalization

- Internalization occurs when brokers execute their own client buy orders against their own client sell orders, representing both sides of a trade and without routing them to central markets.
- Internalization allows brokers to easily execute transactions at a lower cost.
- Internalization may inhibit the broker's ability to properly represent the client as the client's agent.

Internalization

- Internalization results in fewer transactions being executed in the central market, which increases market fragmentation and reduces transparency and potential price competition.
- Can lead to reduced liquidity and increased price volatility in the central market.
- Can lead to violations of price and time priority.
- The transaction might be more susceptible to manipulation or may not be executed at the best possible prices.

Some illegal brokerage activities: Trade assignment

- A client orders a trade.
- Two or more trades are done at different prices.
- The broker assigns the worst priced trade to the client and keeps the best priced trade for himself or for a favored client.
- The problem is greatest when dual trading is permitted and when audit trails are weak. (Dual trading is when a broker places trades for both their client's and their own accounts at the same time).

Some illegal brokerage activities: Front-running

- A large client orders a trade.
- The broker trades for his own account in front of his client.
- The client's trade has market impact.
- The broker profits.
- Alternatively, the broker tips-off a colleague who does the front-running.
- Front-running based on proprietary brokerage information is illegal.
- Front-running by observant traders is legal.
- Front-running usually damages front-ran.
- Front-running increases purchase price.
- Unwinding front-running position decreases price right after purchase is completed.

Some illegal brokerage activities: Churning

Churning

- When a broker engages in excessive buying and selling of securities in a customer's account without considering the customer's investment goals.
- The main goal is to generate commissions that benefit the broker.
- For churning to take place, the broker must exercise actual or effective command over investment decisions of a client.
- Churning is illegal because it breaks the fiduciary duty a broker must maintain with a client.
- As the SEC explains, a red flag that churning is taking place is when a broker buys and sells securities frequently and the transactions do not seem to fulfill the investment goals of the client.

Relevant article

Article 4-C

CNBC

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FINANCE

Merrill to pay $26 million to New Hampshire, former NH Governor to settle churning allegations

PUBLISHED MON, DEC 7 2020•12:14 PM EST | UPDATED MON, DEC 7 2020•8:33 PM EST

Dawn Giel @DAWNGIEL | Scott Cohn @SCOTTCOHNTV | Scott Zamost @SCOTTZAMOST

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KEY POINTS

- New Hampshire is ordering Merrill Lynch to pay $26.25 million in fines and restitution to settle allegations including unauthorized and excessive trading to the state and to an investor, the former Governor of New Hampshire, who claimed he suffered losses at the hands of a former Boston based broker.

Some illegal brokerage activities: Kickbacks

- A kickback is an illegal payment intended as compensation for preferential treatment or any other type of improper services received.
- The kickback may be paid in cash or by non-monetary considerations.
- While kickbacks can take many different forms, they all feature some sort of collusion between two parties.
- Receiving kickbacks for giving clients preferential access to of initial and secondary public offerings or sending a trade to a dealer with the understanding that the trade will be done at a poor price as examples of illegal kickbacks.

Relevant article

Article 4-D

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Press Release

Broker Charged With Giving Special Access to IPOs for Cash Kickbacks

FOR IMMEDIATE RELEASE
2017-234

Washington D.C., Dec. 19, 2017 — The Securities and Exchange Commission today charged a Wall Street stockbroker with illegally accepting more than $1 million in undisclosed kickbacks for giving certain customers preferential access to lucrative IPOs, enabling them to reap major trading profits in the secondary markets.

The SEC alleges that Brian Hirsch subverted allocation policies and procedures at two brokerage firms where he worked on the wealth syndicate desk, making long-running arrangements with certain customers to give them larger allocations of coveted public offerings being marketed by the firms. In most instances, the customers sold their stock into the market as soon as possible to turn a substantial profit at the expense of the firms' other brokerage customers and the issuers' interests

https://www.sec.gov/news/press-release/2017-234

Relevant article

Article 4-E: At 93, She Waged War on JPMorgan and Her Own Grandsons

Bloomberg Wealth

Wealth

At 93, She Waged War on JPMorgan—and Her Own Grandsons

Beverley Schottenstein said two grandsons who managed her money at JPMorgan forged documents, ran up commissions with inappropriate trading and made her miss tens of millions of dollars in gains. So she decided to teach them all a lesson.

By Tom Schoenberg

February 17, 2021, 4:00 AM EST

Payments for order flow

- Payment for order flow refers to the compensation that a broker receives, not from its clients, but from a third party that wants to influence how the broker routes client orders for fulfillment.
- Many retail stock brokers commonly route their order flow to dealers who pay them for each market order sent.
- The dealers then execute the orders at prices equal to the best available quote, or better.
- The payment can be in the form of a direct cash incentive, a non-monetary service, or a reciprocal arrangement between broker-dealers to route particular order classes to each other.
- Payment for order flow was pioneered by Bernard Madoff.

Payments for order flow (cont.)

- A boom in payment for order flow was a key factor in the retail brokerage industry's move toward a zero-commission model in 2019, with startup Robinhood seeing an estimated threefold year-over-year increase in its routing revenue.
- The New York Stock Exchange opposed its use for years, but in February 2009 it sought permission from the U.S. Securities and Exchange Commission (SEC) to adopt the practice on its electronic exchange(s).
- In the United States, accepting payment for order flow is only allowed if no other trading venue is quoting a better price on the National Market System.

Payments for order flow (cont.)

- In the United States, the broker must inform its client in writing that it accepts payment for order flow:
  - Upon the opening of the brokerage account,
  - On an ongoing annual basis,
  - On trade confirmations.
- Brokers who own a dealer subsidiary often route orders to their dealer for execution.
- If the subsidiary does not trade the stock, the order will be routed to a broker who owns a dealer subsidiary that does.
- The other broker will reciprocate by sending orders that the first broker's dealer trades.

Payments for order flow (cont.)

CNBC

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WALL STREET

Massachusetts investigating whether top U.S. brokers have a kickback conflict

PUBLISHED TUE, AUG 15 2017•3:08 PM EDT | UPDATED TUE, AUG 15 2017•3:08 PM EDT

Liz Moyer

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KEY POINTS

- The state's securities regulator is asking seven big brokerages about how they handle customer orders.
- Letters were sent to Schwab, Scottrade, TD Ameritrade, Fidelity, E-Trade, Edward D. Jones and Morgan Stanley.

Solutions to the principal-agent problem

- Measure execution quality and manage it.
- Compensate your brokers based on their execution quality.
- Give your business only to brokers who have valuable reputations.
- Subject brokers to supervision.
  - Government supervision.
  - Private supervision.

The regulatory problem

- Are order flow inducements kickbacks?
- Brokers argue that their responsibility to their clients is to obtain best execution.
- They claim that the best execution standard is met by filling orders at the best quoted price.
  - What is best execution?
  - Is a quote-based standard appropriate if quotes are not competitive?
  - Price improvement is common?
  - Can a retail customer measure best execution?
  - Who should measure it?

The regulatory problem (cont.)

- Dealers quote wide spreads when they have little incentive to narrow them.
- Narrow spreads expose dealers to informed traders.
- Dealers have little incentive to narrow their spreads when brokers route most orders to them without regard to their quotes.
- Wide spreads make market orders very profitable.
- Especially retail orders which tend not to be well informed.
- Dealers buy market orders.

The regulatory problem (cont.)

- Market orders are profitable to brokers because they receive payments for them.
- Brokers lower their commissions to attract retail order flow.
- Brokers compete away their payments for order flow.
- Customers receive poor execution but pay low commissions.
- They may be better off because they can easily audit their commissions but they cannot easily audit their executions.

Questions for class discussion

- Do brokers work for their clients or for themselves?
- Are payments for order flow kickbacks?
- What is best execution?
- Why should a client value a broker's reputation?
- Do you think that Robinhood is a good broker?