Nasdaq Dealers, Hit by Rules, Move to Use Commissions

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By many measures, the cost of trading on the Nasdaq Stock Market has fallen since federally imposed rules went into effect last year. But with their trading margins squeezed by the rules, some Nasdaq dealers are beginning to add new fees.

A few dealers have already begun to implement a different way to charge portfolio managers and other investors for buying and selling stocks, and many other dealers are contemplating adding fees. In essence, the fees are negotiated commissions on each Nasdaq trade.

The change to commissions would be a radical shift for Nasdaq dealers, most of whom make their money on the "spread," or the difference between the prices at which dealers are willing to buy and sell a stock. For instance, a dealer might sell a stock at 20 1/4 for which he paid 20, keeping the 25-cents-a-share difference as compensation. The negotiated fee that some dealers are now charging -- say, 10 cents a share for a particular stock -- would replace the spread, so that a buyer would get the stock at 20, the same price the dealer paid for it. The total cost would be the cost of the actual stock and the negotiated fee.

Two Ways to Pay

How a customer's order to buy 1,000 shares of Microsoft can be handled on the Nasdaq Stock Market:

Dealer-Markup System

- Nasdaq dealer buys 1,000 shares of stock from the market at prevailing bid price.
- Resells them to the customer at the higher ask price.
- No commission is charged, but customer effectively pays the markup from the price dealer pays.

Commission System*

- Nasdaq dealer buys 1,000 shares of the stock.
- Resells them to the customer at the same price.
- The customer then pays the Nasdaq dealer a separately negotiated fee of a few cents per share.

*Limited availability

But the fee is creating some controversy among institutional investors who fear commissions will weigh heavily on their cost structure and draw the ire of their individual investor clients. "Institutional investors will be challenged by their customers about why they would pay a commission where there was no commission before," says one Nasdaq trading-desk manager.

The U.S. Securities and Exchange Commission says there isn't any rule to bar Nasdaq dealers from collecting a commission. But the dealers aren't allowed to collect both a commission and a spread on a trade, says a spokesman for the SEC. Officials at the National Association of Securities Dealers, Nasdaq's parent, didn't return calls seeking comment but are known to be considering several proposals that would make it easier for Nasdaq dealers to charge a commission instead of using spreads.

Commission-based trading "is clearly more prevalent now" on Nasdaq than it was in years past, says Thomas Joyce, managing director of U.S. equities at Merrill Lynch. "It didn't exist [on Nasdaq] five years ago." Merrill and several other Nasdaq dealers, including Goldman Sachs, J.P. Morgan Securities and Herzog, Heine, Geduld, have already handled a small percentage of their Nasdaq trades on a commission basis.

"There is a growing recognition that the Nasdaq will eventually move toward an agency-type market," which uses commission payments instead of the traditional Nasdaq dealer markup, says Chuck Soderstrom, co-head of equity trading at J.P. Morgan. In June, the securities-trading arm of the large bank sent a letter to about 40 of its largest clients touting the benefits of commission-style trading.

"We are proposing an alternate method to the way we currently execute your Nasdaq trades," the letter said. "We believe that execution of institutional orders should move toward this commission structure." Response to the letter was mixed, and about five J.P. Morgan clients are now using the commission payment instead of the old payment system for some trades. Mr. Soderstrom declined to comment on which firms were using commissions or how much they were paying.

But some investors are concerned that the commissions might be applied unevenly, hurting individual investors. "It always scares me when someone tells me about negotiated commissions," says Kenneth S. Janke, president of the National Association of Investors Corp. in Madison Heights, Mich. "The institutions get lower commissions, and the individuals' get quadrupled overnight."

Furthermore, some stocks that trade with a small spread of 1/16 of a dollar or less are already cheap for investors. Substituting a commission for a spread in those stocks might increase the cost for investors, says Mr. Janke. "Investors would have to be careful," he says, and compare exactly how competitive a six- or eight-cent commission would be compared with the spread and with other brokers' commissions.

Some buyers, however, think a commission system would help ease volatility in Nasdaq trading and aid investors trying to buy large chunks of stock.

"I can see paying a reasonable commission for big trades in more thinly traded stocks," says Jerry Castellini, a portfolio manager at Loomis Sayles in Chicago. Earlier this year, Mr. Castellini was trying to buy 500,000 shares of Ciena but could get only 100,000 shares at a price he liked. "We want to trade off market impact for commission as long as we see real improvement" in the price of buying the stock, says Mr. Castellini.

Commission supporters say market makers will sell in larger quantities if they are guaranteed a payment to do so. And commissions may give portfolio managers' orders more anonymity, says Holly Stark, head trader at asset-management firm Dalton, Greiner, Hartman, Maher. Ms. Stark, who serves on a Nasdaq trading panel, says the commission system blurs the origin of a market maker's trade, while the dealer system lets other traders discern when a market maker is executing a trade for a customer.

Many Nasdaq dealers say more trading will move to commissions, mainly because order-handling rules introduced by the SEC made the alternative markup system less profitable to dealers. Already, electronic-communications networks that charge commissions make up a significant chunk of Nasdaq trading. And 70% of trading managers surveyed by the Security Traders Association said future institutional business should be done using commissions instead of markups.

Nasdaq traders are "moving to a quasi-auction market," says E.E. Geduld, president of Herzog, Heine, Geduld. A handful of the wholesaler's clients have started using commissions since the summer, says Mr. Geduld.

In the short run, however, competitive pressures and logistical difficulties in switching over to a new trading-pay structure may slow things down. Donaldson, Lufkin & Jenrette and Knight Securities, for example, aren't doing commission-based trading on Nasdaq.

"I'd love to get the commission, but it's a competitive issue," says Bernard Madoff, president of market-making firm Bernard L. Madoff Investment Securities. He says he doesn't plan to offer commission-style trading. "It's a question of who makes the move first," he says. "I won't do it."