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Fight Stirs on Prices Small Investors Get --- Citadel Securities and SEC will face off over payment to brokers for order flow

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One morning in September, Phil Hanson clicked a button on his TD Ameritrade screen and sold 100 shares of Immunovant Inc.

It was among the millions of trades made by individual investors that day. The Houston resident's order didn't go to the New York Stock Exchange or Nasdaq Inc., where buyers and sellers haggle over the company's shares.

Instead, TD Ameritrade sent Mr. Hanson's order to Citadel Securities, an electronic trading firm that deals directly with brokerages to execute their customers' trades.

Within milliseconds, Citadel Securities bought Mr. Hanson's Immunovant stock for $5.0221 a share -- an improvement over the best price quoted on exchanges, where buyers were offering $5.02 for the shares.

The result: Mr. Hanson made an extra 21 cents, earning $502.21. Meanwhile, Citadel Securities paid TD Ameritrade a slice of its profit from handling the order, a practice called payment for order flow. Regulatory filings suggest the broker got about 10 cents.

Did Mr. Hanson get a good deal? Proponents of payment for order flow cite gains like his 21 cents as evidence the market works well for small investors. Critics say the practice has so warped the market that it's impossible to say what Mr. Hanson would have earned in a truly open marketplace.

For years, that debate was largely academic. But it's now at the core of a showdown between powerful trading firms -- Citadel Securities chief among them -- and a Securities and Exchange Commission chair who views them warily.

On Wednesday, the SEC is set to propose the biggest shake-up of U.S. stock market structure in more than a decade. Chair Gary Gensler has said he wants to give investors a better deal on stock trades by forcing greater competition for their orders.

The proposals will likely stir up a hornets' nest of opposition. Brokerages and trading firms say there's little evidence the current system hurts investors. Some firms, including Robinhood Markets Inc., have signaled that they could sue the SEC if Mr. Gensler's changes go too far.

Last year, the 12 largest U.S. brokerages collected $3.8 billion in payment for order flow, according to Bloomberg Intelligence. The largest source was Citadel Securities, which paid just under $1.5 billion.

At Charles Schwab Corp., the parent of TD Ameritrade, Jeff Starr, a managing director, said, "When you see the sort of execution quality that we're getting, it's really hard to say that payment for order flow is a problem."

Citadel Securities, though less known than sister company Citadel, a $59 billion hedge fund, is a behemoth that handles over 20% of the shares that change hands in the U.S. stock market.

Both were founded by billionaire Ken Griffin, known for his art collection and trophy homes, including a $106.9 million waterfront estate in Miami. He is also a Republican power broker. Since 2021 he has given more than $68 million to federal campaigns, according to OpenSecrets.org.

GameStop's January 2021 extraordinary rally and crash thrust Citadel Securities into the spotlight. Citadel was the biggest processor of orders from Robinhood, prompting a conspiracy theory that Citadel used its influence to halt the meme-stock rally. It denies doing this. Still, Mr. Griffin was challenged about his firm's role at a contentious House committee hearing. Since then, his firm has been less outspoken in criticizing the SEC's plans than other industry players such as rival trading firm Virtu Financial Inc.

Citadel Securities instead has pressed its case against the overhaul at industry conferences and in closed-doors meetings with regulators.

Mr. Griffin met with Mr. Gensler in June 2021 and discussed a Citadel Securities white paper on market structure, in which the firm outlined a set of changes less radical than what the SEC is now planning, people familiar with the matter said. In March, a team from Citadel Securities met with staff from the SEC's trading and markets division, said people familiar with the meeting. A presentation, seen by The Wall Street Journal, touted the firm's ability to deliver savings to investors.

In an interview, Mr. Gensler said investors would get better prices if there were more competition between trading firms for their orders. He acknowledged that his plans could hurt the profits of brokers and trading firms.

"Putting folks in competition is better for investors and issuers," he said. "It might have a tendency to lower some of the economic rents in the middle."

Citadel Securities will await details of Mr. Gensler's plan before deciding how hard to fight it said Joseph Mecane, the executive who leads the unit of the firm that processes trades for retail brokerages.

"Anything that, in our opinion, would impact the retail experience in a negative way would be something that we worry about," he said.

For firms such as Citadel Securities, it is more consistently profitable to fill individuals' orders than to trade with large investors encountered on stock exchanges. Citadel Securities, Virtu and similar firms earn money by market-making -- capturing the difference between the buying and selling price of stocks, known as the bid and the ask.

Market-making is risky on exchanges. If a hedge fund is selling millions of dollars of Ford Motor, for instance, it could chop up the transaction into hundreds of sell orders over several days. A market-maker offering to buy Ford could lose money as it buys over and over, while the big seller drives the price lower.

Customers of brokers like TD Ameritrade typically are more balanced between buys and sells. Market-makers can offer better prices when they know they're facing the little guy, giving sellers like Mr. Hanson higher prices for their shares, while giving greater discounts to buyers of shares.

Traders call this "price improvement," and data show individual investors collectively save billions a year as a result. And thanks to payment for order flow, nearly all major brokerages have shifted to zero-commission trading.

Critics of payment for order flow -- a mix of Wall Street veterans and advocacy groups -- ask if brokers get paid to route orders, are they really putting their customers first?

"At the heart of it, you're putting a perverse incentive out for the firm that is supposed to be working the hardest to get you the best possible price that they can," said Doug Atkin, former CEO of brokerage Instinet.

They also say the benefits of the current system are overblown. The reported savings that brokers deliver their customers is based on the difference between the price an investor gets for a stock and its bid and ask price on exchanges. Some analysts say that benchmark is flawed because about 40% of trading volume takes place outside of exchanges.

BestEx Research, a trading-**technology** firm, estimated last year that if all retail orders were sent to exchanges, bid-ask spreads there would narrow by 25%. Since the current system makes those spreads artificially wide, the savings that investors receive are inflated, the firm said.

"Price improvement on retail market orders is akin to getting a 30% discount on an item after the shopkeeper raises the price by 40%," BestEx Research wrote.

Could Mr. Hanson have gotten a better deal? Some analysts who reviewed the data on his trade say it's possible. For instance, some exchanges allow buyers and sellers to do "midpoint" trades in the middle of the spread, in this case between the $5.02 bid and $5.04 ask. By selling his stock at the midpoint, Mr. Hanson would have earned $5.03 a share, or $503 in all, for a gain of $1 instead of 21 cents.

Executives at brokerages and market-makers have questioned the methodology of the BestEx paper. Schwab said it got midpoint executions or better on 52% of its customers' market orders last year.

Payment for order flow emerged in its current form in the 1980s, when it was championed by Bernie Madoff. Decades before his conviction for masterminding a vast Ponzi scheme, Mr. Madoff led a firm that paid retail brokerages for orders and executed them off-exchange.

In 1994, the SEC adopted a rule that required brokers to disclose whether they were receiving such payments. It revisited the practice later but always stopped short of a ban, choosing to step up disclosure requirements instead.

Mr. Griffin founded Citadel Securities in 2002 when the transition from trading floors to electronic marketplaces was creating new opportunities for computerized trading. It was initially called Citadel Derivatives Group and focused on options market-making.

The firm urged the SEC to ban payment for order flow in 2004. "This practice distorts order routing decisions, is anti-competitive, and creates an obvious and substantial conflict of interest between broker-dealers and their customers," Citadel wrote the agency in a letter. Mr. Griffin has said the letter reflected Citadel's concerns about the options market at the time.

Citadel soon began paying for order flow to break into equities market-making. Former employees say Mr. Griffin was determined to win business from big-name brokerages. Citadel positioned itself as a high-tech disruptor, honing its algorithms to give better trade executions than rivals, the ex-employees said. It had a breakthrough in 2005 when TD Ameritrade agreed to start sending it orders.

By the Covid-19 pandemic, Citadel Securities was handling as much as 47% of U.S. individual investors' stock-trading volume. It had grown into a global market-maker in futures, Treasurys and currencies with revenue of $7 billion last year, a person familiar with the matter said.

In January 2021, investors banding together on Reddit ignited a huge run-up in GameStop and other meme stocks -- only to see the rally collapse when Robinhood and other brokers temporarily blocked customers' ability to buy the stocks. Many social-media users embraced the theory that Citadel Securities had spearheaded the decision to remove the buy button.

Both Citadel and Robinhood denied this. Robinhood said it made the unpopular decision after the clearinghouse for U.S. stock trades demanded billions of dollars of collateral amid the mounting volatility. A congressional report in June confirmed that explanation.

Nonetheless, Mr. Griffin was vilified by an online movement of investors calling themselves apes, who trolled him with hashtags such as GBP CitadelScandal, and some paid for truck-mounted digital billboards to drive around with slogans bashing the firm.

Near the peak of the GameStop frenzy, the Biden administration chose Mr. Gensler to head the SEC. Now he is pursuing the most aggressive agenda for an SEC leader in decades.

Mr. Gensler has called payment for order flow potentially detrimental to investors' interests, and last year indicated he was open to the idea of banning it. He has also said the business of processing individual investors' orders is concentrated in too few firms.

Citadel says it wins a lot of retail order flow because it offers the best prices. A recent academic study found that Citadel Securities saved investors more money through price improvement than any other market-maker.

Mr. Griffin has said his firm would be fine even if payment for order flow were banned. "Payment for order flow is a cost to me," he said in a public appearance last year. "So if you're going to tell me that by regulatory fiat one of my major items of expense disappears, I'm OK with that."

Eliminating payment for order flow would be trickier to brokerages, some of which lean heavily on it. Robinhood, which makes the bulk of its revenue from selling order flow for stocks, options and cryptocurrencies, indicated when it went public last year that new restrictions on the practice could hurt its business.

In a June speech, Mr. Gensler appeared to back away from the idea of banning payment for order flow. Instead, he is set to unveil a proposal to funnel investors' orders into auctions, in which market-makers would compete to give the best price on trades.

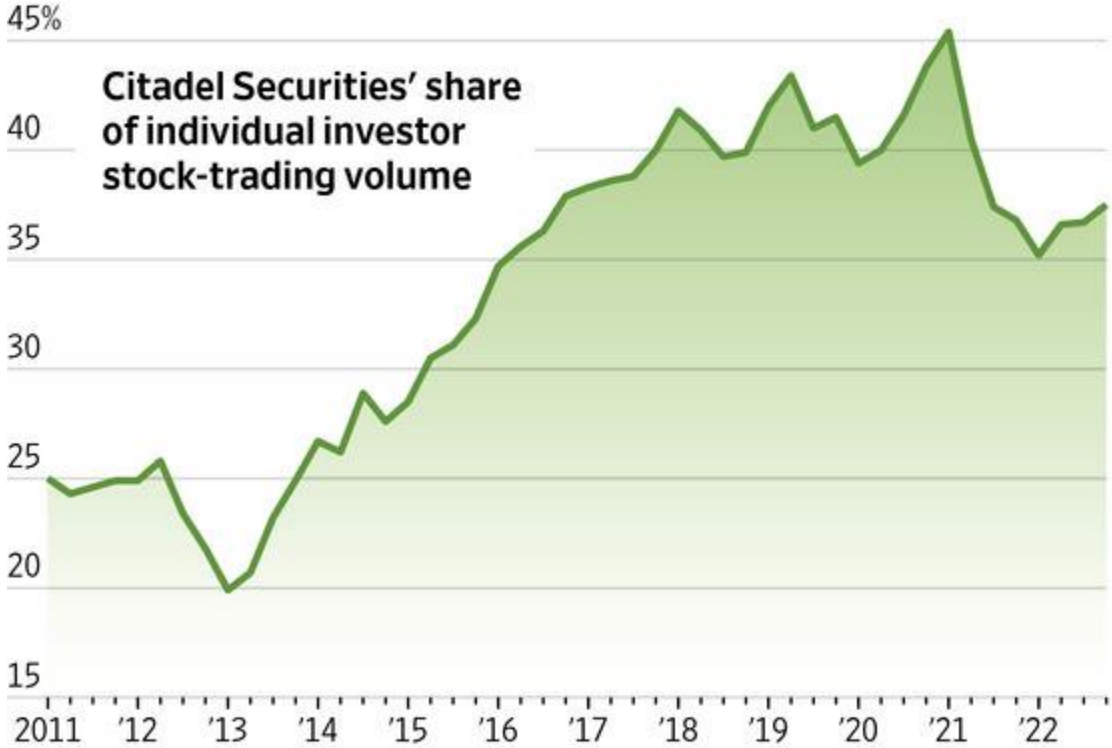
His agenda has brought criticism even from Democrats who might seem like his allies. "There would be no zero-commission trading without payment for order flow," said Rep. Ritchie Torres (D., N.Y.), a member of the Congressional Progressive Caucus. "So my message to the SEC is simple: Don't throw out the baby with the bath water."

Supporters of Mr. Gensler dismiss such concerns as the result of industry scaremongering. "It's your standard terrify-the-regulators approach," said Dave Lauer, founder of market-data startup Urvin Finance. "They'll say, 'You tinker with anything, it's all going to come falling apart.'"

Many SEC watchers expect the industry to challenge Mr. Gensler's proposals in court.

"There has been a secular trend in the last two decades toward an improved retail trading experience," said Jason Clague, a managing director at Schwab. "What we're struggling to understand from Chair Gensler and his staff is why they feel the market is broken, despite a wealth of evidence to the contrary."

Paul Kiernan contributed to this article.



Note: Based on market and marketable limit orders from 100 to 9,999 shares. 4Q 2022 figure shows data from October.
Source: the company

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