

# Wall Street Journal

## Markets

# Study: Rebates Are Key to Where Brokers Route Orders

Updated Dec. 17, 2013 6:35 p.m. ET

Stockbrokers appear to routinely send client orders to certain markets with the goal of obtaining payments from exchanges, trading that can stick retail investors with subpar buys and sells, according to a new academic study.

At issue are payments that exchanges make to brokers to attract business. The study largely focused on retail-investor trades and whether these fees designed to boost market liquidity skew broker priorities.

The analysis comes amid a growing debate over exchanges' trading incentives and how these deals may create conflicts between brokers and their clients.

Known as rebates, the payments typically run about 20 or 30 cents for each 100 shares traded. Exchanges also charge firms that take those orders several cents for each 100 shares. The fees usually aren't directly passed on to clients and instead are retained by the brokers.

The system of charging fees for taking an order and paying a broker for making an order is designed to boost trading at an exchange or alternative trading venue. Most exchanges use this "maker-taker" system.

One conflict highlighted by the study is that exchanges offering the best fees often provide worse-trade execution for investors compared with exchanges with less lucrative fees. The study concludes that the practice "might be inconsistent with a broker's responsibility to obtain best execution."

The authors of the study—finance professors Robert Battalio and Shane Corwin at the University of Notre Dame and Robert Jennings at Indiana University—have presented their findings to exchange executives and other market participants over the past several weeks, according to people familiar with the matter.

The Securities and Exchange Commission says it frequently reviews academic studies and that it has been looking into whether exchange fees have an impact on brokers' routing decisions. Officials at the Financial Industry Regulatory Authority, which oversees brokers, are reviewing the study. "Best execution of equity limit orders is a topic of considerable interest and will be a priority for Finra in 2014," a Finra spokeswoman said.

The professors analyzed trading reports from [TD Ameritrade Inc.](#), [E\\*TRADE Financial Corp.](#) ScotTrade Inc. and Fidelity Investments and found that the brokers consistently route limit orders "with the objective of maximizing order-flow rebates."

A limit order is an order to buy or sell shares at a specific price or better. Brokers are required by SEC rules to seek the best execution reasonably available for customer orders.

Mr. Battalio and Mr. Corwin said in an interview that they supported the idea of requiring brokers to pass rebate payments onto customers. "That way a broker would have no conflict of interest when routing an order," Mr. Battalio said. "It would be a better way to align a broker's incentives."

Three of the brokers mentioned in the study said they disagreed with the findings, while a fourth declined to comment.

"We disagree with the paper's suggestions and believe it misrepresents our order-routing strategy," a TD Ameritrade spokeswoman said in an email.

"We do not direct orders to certain destinations because of any payments received," a ScotTrade spokeswoman said in an email.

"We work hard to ensure that our customers get the highest execution quality and lowest execution costs available," a Fidelity spokesman said. "We employ a team of financial engineers to constantly evaluate the many trading venues we use."

A spokeswoman for E\*Trade declined to comment.

Some academics also disagreed with the conclusion of the study.

Bernard Donefer, a Baruch College and New York University professor who studies capital markets, said that exchange payments to brokers keep trading fees low.

"As a retail customer, I get fast, price-improved executions for \$7.95 a trade, a great software platform and other benefits," he said, referring to the brokerage offering at Fidelity. "For me, that's a great deal."

The study was published on the Social Science Research Network last week.

### **Corrections & Amplifications**

An earlier version of this article incorrectly said that rebate payments typically run about two or three cents for each 100 shares traded. They run about 20 to 30 cents for each 100 shares.

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