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S.E.C. Is Said to Examine Stock Pricing by Big Brokers

By JENNY ANDERSON

Lable price for stocks they were trading for their customers

The Securities and Exchange Commission is investigating about a dozen brokerage firms - including [Morgan Stanley](#), [Merrill Lynch](#), [Ameritrade](#), [Charles Schwab](#) and E*Trade Financial - on suspicion that they failed to secure the best available price for stocks they were trading for their customers, according to people who have been briefed on the inquiry.

At issue is the way the companies executed trades of Nasdaq-listed securities when the markets opened in the morning, a period of intense trading activity resulting from the backlog of orders since the market's close the previous day.

After examining trading data from the last four years, the investigation found evidence that trades were often processed in ways that favored the firms over their clients, these people said.

Securing the best price is one of the industry's critical obligations to investors. If the investigators' suspicions are confirmed, these practices are not likely to add up to significant costs for individual investors - the difference would be pennies a share traded - but in total they could represent substantial amounts of money for the brokers.

More important, the investigation opens another possible conflict of interest involving the big firms on Wall Street. In the last few years, the financial industry has been jolted by a series of scandals over practices that rewarded company insiders at the expense of ordinary investors.

Brokers have a "best execution" obligation, defined by common law, fraud provisions of the securities acts and market rules to get the best possible price for investors.

The investigation - the first to look at this aspect of trading - can be expected to put executives and traders on notice that regulators are monitoring best-execution practices and could reignite the debate over how trades should be carried out.

An S.E.C. spokesman declined to comment on the inquiry, as did representatives from Ameritrade, Schwab, Merrill Lynch, Morgan Stanley and E*Trade, all of whom said their firms did not discuss regulatory investigations. Peter Yandle, a spokesman for NASD, the Nasdaq market's parent company, said he was unaware of the S.E.C. inquiry.

According to the people briefed on the investigation, it is examining two common, if arcane, methods of executing trades known in the industry as internalization and payment for order flow. Both are permitted by the S.E.C., and while they have long been controversial as they appear to pit the interests of a brokerage firm against those of its clients, they are illegal only if the customer does not receive the best price available.

With the first method - internalization - the brokerage firm trades an order against its own inventory, either shares it owns, or other buy and sell orders waiting to be executed. For example, if an investor wants to sell 100 shares of Company X at \$20 each, the broker looks to fulfill the order from its own buy orders for Company X or from shares of the company it might own, rather than expose it to another stock exchange or marketplace. That way, the broker makes a small profit on both sides.

Internalization becomes a problem for investors if the broker chooses to trade against its own inventory when there is a better price available elsewhere.

The other practice under investigation involves order flow, where retail brokerage firms send aggregated small orders to market makers - firms that buy and sell particular stocks to maintain orderly trading. As a way to attract orders from brokers, some stock exchanges or market makers will pay for routing the order to them - perhaps a penny or more a share. The S.E.C. is looking into such payments, aware that problems can occur when brokers have a deal with market makers to send them orders. Because the order is not exposed to the larger marketplace, the investor may be missing out on the best price.

"Payment for order flow obviously poses a risk because the broker is getting reimbursed for its customer's order flow," said Richard Repetto, associate director of research at Sandler O'Neill & Partners. "Without strict guidelines and oversight, the customer may not get the best execution."

This investigation is looking only at those firms that deal directly with retail orders, then either internalize or ship the orders out.

To make matters more complicated, some firms play multiple roles. Some retail brokerage houses, like Ameritrade, sell their order flow, focusing on customer service rather than trading itself. Others are both market makers and sell their order flow. Still others, including Merrill Lynch, neither buy nor sell orders, but could internalize trades. While many in the industry say quietly that payment for order flow is on the wane, a recent deal underlined how valuable access to retail order flow can be for brokers.

In August, UBS paid \$265 million for Schwab's fledgling capital market business, including its significant Nasdaq market operation. As part of the agreement, Schwab agreed to route its order flow to

UBS for eight years. While UBS was presumably interested in building its Nasdaq trading capabilities and the deal helps accomplish that, the order flow component of the deal was also significant.

"The most compelling part of the Schwab capital markets sale to UBS was the agreement for Schwab customer order flow," Mr. Repetto said. "Retail order flow is very valuable to institutional market makers because they can attract additional liquidity."

In a 2000 study on payment for order flow in the options industry, the S.E.C.'s Office of Compliance Inspections and Examinations determined that payment for order flow did indeed affect where trades were routed, and that brokerage firms were not passing along any benefits to their retail investors.

"Firms are obligated to seek the best possible executions for their customers' orders, irrespective of payment for order flow or other inducements," an S.E.C. statement related to the study said. "However, payment for order flow and internalization create conflicts of interest for brokers because of the tension between the firms' interests in maximizing payment for order flow or trading profits generated from internalizing their customers' orders, and this fiduciary obligation to route their customers' orders to the best markets."

The Nasdaq stock market recently revamped its system for how stocks trade at the start of the day, establishing a single price. This system could help reduce instances where brokers do not secure the best price for their investors, people briefed on the inquiry said. It does not, however, completely solve the problem, these people said.