

08/31/2021

Just Change the Verbiage: 'Payment for Order flow is really the 'OUTSOURCING of Execution!' and 'At The Market' IS a 'Price!'

'Payment for Order Flow' circa 2021 / SEC File # S7-10-21

What if EVERYONE would just CHANGE this description from 'Payment for Order Flow' TO 'We OUTSOURCE our execution function to OTHERS who can do it MORE efficiently than we do for many types of order flow', and their 'fee' is the 'spread?' Which is also known as the 'NBBO.' Well then there is no more conspiracy theory vs 'who is getting rich at the expense of who' on RobinHood's platform.

The overall idea being that in the current market 'structure', the ever-increasing costs for regulatory compliance filings, accessing fractured markets, IT costs TO trade etc, efficiently accessing the NBBO on behalf of clients has become expensive.

Which is WHY many already do exactly this. They OUTSOURCE THEIR TRADING. And even those BD's (and Buy Side A/C's) that DO maintain extensive trading infrastructure and related personnel, they may (do!) still outsource their algo's / dark pool routes / various direct market access (DMA) touch points etc. (think Credit Suisse's 'in the top 5' AES platform?)

And here's the 'real kicker!' The NBBO quote IS REGULATED BY THE SEC! Meaning, it IS a FAIR representation OF where a stock is trading at ANY given moment in time. The SEC literally GUARANTEES THIS to be 'TRUE' for ALL investors. And the FACT that Citadel ROUTINELY provides execution INSIDE the NBBO for much of their order flow (they can PROVE this btw) means their customers (Robinhood and other BD's) are getting an even 'FAIRER' price! Get it?

AND because RobinHood's speed of execution (via outsourcing this function TO Citadel!) CAN offer to the client an execution literally within seconds of the client SEEING the NBBO quote for THEMSELVES, the NBBO in effect renders a 'market order' placed by the RobinHood investor as an order that DOES IN FACT HAVE A SET and KNOWABLE and FAIR price parameter for the customer to SEE IN ADVANCE.

Again, it's called the REGULATED PUBLICLY DISPLAYED NBBO QUOTE itself! Which means the Market Maker (in this case, Citadel) does NOT 'pick the price.' (As stated btw in *Interactive Brokers current VERY MIS-leading commercials!!*) Instead, it IS the CUSTOMER that does so in effect by FIRST 'seeing' the NBBO quote, and THEN continuing to enter a buy OR sell order if they 'like the price.' Which again, USUALLY gets executed INSIDE the NBBO quote. AKA: 'The PUBLICLY DISPLAYED FAIR PRICE.' (over 94% in RobinHood's case vs their website information in this regard)

Oh, not to mention the fact that a 'timely execution' is ALSO part of the 'best ex' calculation for many. Some would argue btw that given that the spreads are now SO SMALL (sometimes literally 100'ths of a tenth of a penny!), a 'timely' and or even an 'immediate' execution is MORE important to many vs their 'best ex' requirement than increments of improvement of 'less than a penny' within the price itself.

It is THESE 'increments of less than a penny' (even 100'ths!) that Citadel is 'collecting' ('charging' if you must!) TO provide the 'QUALITY PRODUCT' of equity order execution of market orders WITHIN the confines of the SEC REGULATED (!!) NBBO spread.

So, is Citadel making money? Yep. Are they providing a quality product for LITERALLY 'less than fractions of pennies' EVERY TIME you 'use' their product in this particular regard? Yep. Are they making a REAL LOT of money based on their position in the marketplace / daily volume? Yep, for SURE. They are 'killing it!'

BUT, can I MYSELF as a Sell Side Broker (and or my firm) do the same AS efficiently vs 'round lot' and 'fractional share' order flow for our retail clients on a consistent high-volume basis AND still be able to charge ENOUGH on a 'per share commission schedule' basis TO stay in business in the current way our business is now structured vs ever INCREASING electronic and regulatory costs literally TO trade? NO WAY!

In short? If we just think of 'Payment for Order Flow' as the 'OUTSOURCING of Execution' to those that 'do it BETTER FOR LESS' for many types of order flow, AND think of the NBBO quote as an 'actual KNOWN IN ADVANCE Price', suddenly, the whole setup is NOT as nefarious as many (POLITICIANS?!?) currently make it sound.

Or put another way? NO ONE is getting ripped off structurally and on a regular basis on RobinHood's platform regarding the COST and or QUALITY of equity order flow execution. In fact, it may be the BETTER WAY to execute order flow of the retail / partial share type.

And as the FINAL PROOF that Robinhood DID figure out a 'better way' / is NOT 'ripping off' their customers 'just so Citadel can get richer?' Just ASK the Robinhood customers! They can and do use limits when they want to for 'round lot' orders and or market orders when they want. AND, they seem have very few / if ANY real complaints with equity order execution itself in the aggregate either regarding price or timely-ness. (Obviously RobinHood's decision to halt trading in some stocks because of volatility is a separate issue with its 'own set' of regulatory and customer 'complaints.')

And if you DON'T believe RobinHood's customers? Well then ask Schwab's or TD Ameritrade or Fidelity or multiple OTHER Broker Dealers who now use the SAME execution structure as RobinHood to execute either all or some of their customer order flow. (Institutional included btw!)

So the 'Pro Tip' here?:

SIMPLY CHANGE the verbiage FROM 'Payment for Order Flow' TO 'Outsourcing our Execution Function' to those that do it BETTER and CHEAPER than we can for many types of order flow! And CHANGE the verbiage from 'Free Trades' to 'NET Execution Price.' And ADD IN the verbiage (fact?!) that the NBBO is not only a FAIR price, but it's also a 'PUBLICLY DISPLAYED KNOWN PRICE IN ADVANCE' of ANY equity market orders entered by ANY clients.

And Voila!, just like that! No more 'HOOD (or any other BD) is ripping off the little guy!' narrative. Get it?

Also, please note: The SEC's views on the issue of 'Gamification of Online Trading' does not particularly 'interest' this 'observer' at this time / for the purposes of thinking of how to 'better explain' PFOF than a 'Senate Finance Committee' (or even Citadel Founder Ken Griffin !!!) can / did a few months ago.

Full disclosure: The above is PURELY the 'view' of ONLY this 'observer and in no way represents any attempt to influence or suggest a buy or sell order in any related names. Also, this document will be submitted to the WSJ op-ed Editor for 'consideration to publish.'

Respectfully yours,

*Patrick G. Shallis
Gordon Haskett Capital Corp.*

