

Will the Trade-At Rule Fix the Subpenny Problem?

Access fees may discourage liquidity providers

BY DENNIS DICK, CFA

Access fees were designed to attract liquidity providers by giving them incentive to display orders. But these access fees may actually discourage liquidity providers because they lead to a predatory practice called subpennying in which a market participant in an undisplayed market center steps ahead of a displayed limit order by a fraction of a cent.

Access fees are charged by the displayed market centers (the public exchanges and ECNs) for “accessing liquidity.” Any market participant taking a displayed offer or hitting a displayed bid is charged this fee. Alternatively, the participant displaying the bid or offer is provided with a rebate. These access fees are capped at 0.3 cents per share by the U.S. Securities and Exchange Commission (SEC).

Many retail brokerage houses charge a flat commission rate to their customers. When their customer takes liquidity by taking the offer or hitting the bid, the brokerage house absorbs this access fee. Thus, these brokerage houses have an incentive to route order flow to venues that do not charge these fees, and brokers can avoid this fee in a number of ways. They can internalize the order by taking the other side of the trade themselves, route the order to an OTC market maker that doesn’t charge this fee (and in some cases, they actually get paid for this service, which is called “payment for order flow”), or route the order to a dark pool.

The problem is that such practices drive volume out of the displayed market centers and actually discourage liquidity providers from displaying orders because many of their displayed orders go unexecuted.

Consider the following example.

A trader places a passive limit order to sell 500 shares of stock XYZ at US\$25. Another trader from a retail



brokerage house decides to buy the 500 shares and places a US\$25 buy order. The brokerage house of the buy-side customer charges a flat fee on its order, so it

will have to absorb the access fee for its customer. Therefore, the brokerage house internalizes the order by taking the other side of the trade.

The order is executed at US\$24.9999, and the brokerage house avoids the access fee. The displayed seller is “subpennied” and left unfilled. If the access fee didn’t exist, the brokerage house may have routed the order to the displayed US\$25 sell order.

Because access fees discourage brokerage houses from routing to the publicly displayed exchanges, liquidity providers are displaying fewer limit orders as more and more of their displayed limit orders go unfilled. This practice reduces displayed liquidity and, over time, will lead to larger bid-ask spreads.

The SEC’s concept release on equity market structure outlines the concept of a “trade at” rule. According to the release, the trade-at rule “would prohibit any trading center from executing a trade at the price of the National Best Bid and Offer (NBBO) unless the trading center was displaying that price at the time it received the incoming contra-side order.”

This rule would help the subpennying problem because it would give priority to the displayed NBBO. It would put the NBBO back to a first-come, first-served basis. If a

market order was placed to buy 2,000 shares and the NBBO was displaying 1,000 shares on the offer, the 1,000 shares offered on the NBBO would get filled. Then, the broker/dealer could fill the remaining 1,000 shares from its inventory. This would be a much more satisfactory result to the liquidity provider displaying the offer.

Unfortunately, access fees are a major hurdle here. It’s not fair to force the broker/dealer to route its customer’s order to the NBBO when it can internalize the entire order and

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avoid the access fee. This situation creates quite the problem for implementing a trade-at rule.

Although the trade-at rule would protect the NBBO and undoubtedly would encourage liquidity providers by routing more order flow to the displayed market centers, the rule is unlikely to be implemented as long as access fees exist. Therefore, these subpennying problems are likely to continue. The displayed market would be much better off without access fees. /

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