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Trading Stocks in America: Key Policy Issues
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The "Good" Old Days

- Manual Trading
- Order Delivery by Phone
- Conditional Quotes
- Eighth Ticks

Crash of 1987 – First Step Forward

- Small Order Execution System
  - NASDAQ quotes could be hit or lifted electronically
  - First wide usage of automatic execution
  - Harvey Houtkin – First SOES Bandit
    - Forbearer of today’s High Frequency Traders

Pre 1996

- NASDAQ viewed itself as a pure dealer market
  - Public limit orders were largely ignored
    - BBO was only NASDAQ (dealer) quotes
  - The only electronic communication network was INSTINET
  - Most order flow was subject to preferencing agreements between brokers and dealers
    - Cash Payment for order flow or soft dollar

Pre 1996

- NYSE Liquidity had inertia
  - Dealers and Regional Exchanges could pay brokers to send orders to them
  - Payments could be substantial
    - Minimum needed spreads were much less than quoted spreads
      - Rounding due to 1/8 tick
      - By only buying small retail orders could avoid losing to informed traders

Order Handling Rules

- Limit orders were able to directly compete with dealer quotes
- Led to creation of a large number of ATSs (e.g., Island, Arca, etc.)
  - Automatic execution
  - Charged traders to access quotes (taker model)
  - Did not pay rebates for orders at first

Decimalization

- Larger tick sizes led to spreads being larger than what they could be
- These excess profits were used to pay for order flow
- Critics felt that PFOF led brokers to route orders to venues that paid the most
- Ticks were reduced to 1/16 then 1 cent
- PFOF was reduced but not eliminated
  - Venues could continue to earn money to pay for order flow by only buying small retail orders

Today

- The ATSs have adopted the maker/taker model
- Exchanges followed suit to compete
- Brokers have learned to earn the spread
  - Internalizing orders
  - Create dark pools where customers can pay brokers to interact with client order flow

Does it matter?

- YES
- Battalio, Corwin, and Jennings
  - routing to highest rebate results in lower market quality
- My paper on internalization
  - Higher internalization rates lead to wider spreads

What could help?

- Trade-at rule?
- Toronto Stock Exchange adopted similar rule
  - A significant reduction in spreads
- Critics say not necessary since spreads are lower than they have ever been
  - Don’t look at what spreads are
  - Rather – what they could be
- Critics say we should allow venues to compete for order flow
  - But they compete for order flow from brokers not natural buyers and sellers

Wider Ticks and IPOs

- Proposal to adopt wider ticks for IPOs to attract liquidity
  - Recall wider ticks = Higher payment for order flow (rebates)
- Fragmented trading of IPOs leads to more under pricing

- Alternative proposal to attract order flow
  1. Have IPOs trade exclusively on a single exchange for a significant period
  2. Allow IPO firms to pay for a liquidity provider as they do in Europe.
  3. Leave tick size alone