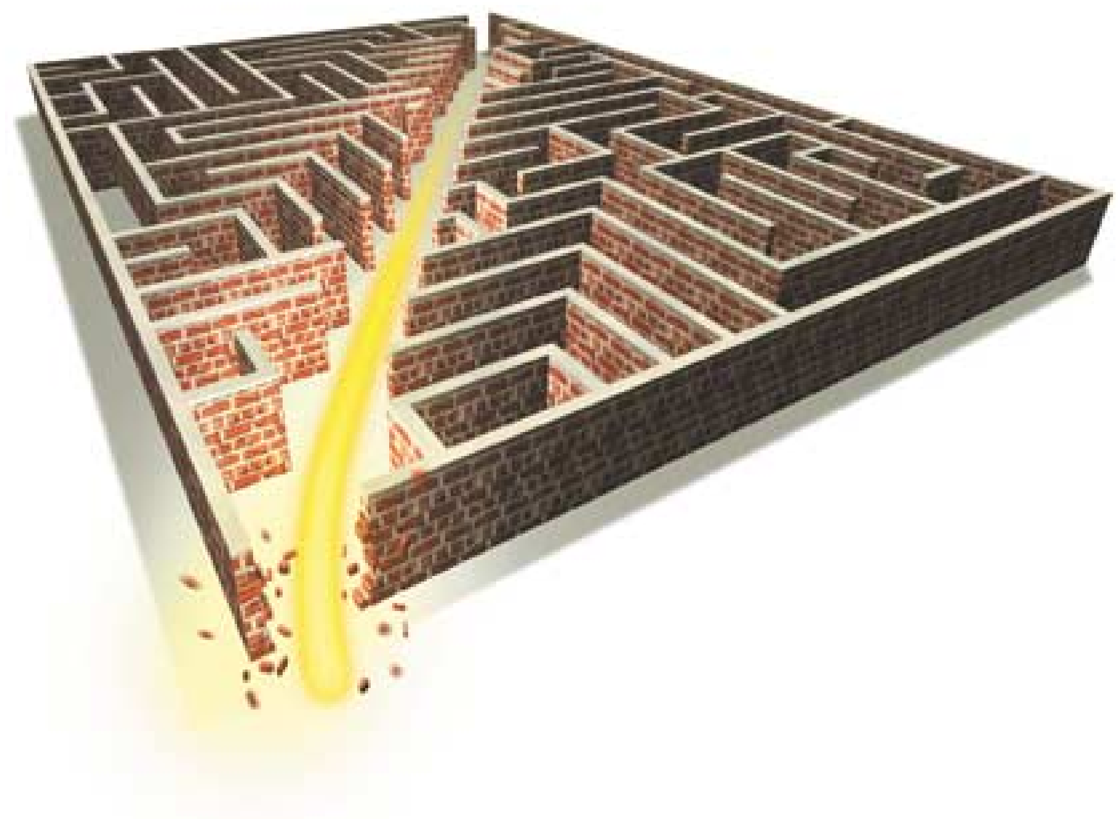

Best Execution

SEC rules shed light on the real costs of trading.

ILLUSTRATION BY PAUL JOHNSON

Too often investors focus simply on price and commission rates and don't consider the true costs of trading. SEC rules instituted earlier this year are expected to change that by highlighting the performance of U.S. market centers and brokerages and by creating new sources of information to help investors make more informed decisions.

"Increasingly, but still not enough, investors are empowered to decide where their orders are executed," says Dick Grasso, NYSE chairman and CEO. "The prevalence of information about the quality of order executions will help these decisions be informed choices."

Under the Execution-Quality Disclosure Rules, each month all market centers that trade national-market-system securities must disclose on a public Website execution-quality data for each stock they trade. For example, the NYSE must categorize each stock's orders by type and for each category report such factors as execution speed, fill rates and price improvement (or "disimprovement"). The data is further broken down by order size. Researchers are expected to compile and analyze all the data for the general public's consumption.

The rules also require brokers to disclose each quarter the market centers that handle a significant percentage of their orders and any financial arrangements related to order routing. Some brokers get paid—perhaps a penny or more per share—by markets or market makers for routing orders their way, a practice known as "payment for order flow," which the SEC had questioned. Brokers who fill orders from a firm's own inventory (or "internalize" them), rather than route them to a market for execution, make money on the spread. Studies show that such order-routing choices can raise transaction costs. One report by Hendrik Bessembinder, Blaine Huntsman presidential chair in Finance at the University of Utah, confirms that trades in listed stocks executed off the NYSE are more costly.

The NYSE has long championed the idea of market participants developing uniform "best-execution" measurements. Monthly best-execution summary reports have been published on nyse.com since August 2000.

What is Best Execution?

Best execution constitutes "a bundle of goods," such as price improvement, speed and certainty of execution, and liquidity, says Edward Kwalwasser, NYSE group executive vice president, Regulation. "An investor deserves to get the best price available at the time the order is entered, and to get that price in a timely manner," he says.

For brokers making order-routing decisions, best execution requires an assessment of relative execution quality among markets, says Robert McSweeney, NYSE senior vice president, Market Structure and New Market Initiatives. "That decision can have a significant impact on execution costs, such as the ability to execute at prices better than the published bid or offer, as well as the likelihood that the order will be filled in its entirety at the anticipated price when it reaches the marketplace," he explains.

Best practices are, in fact, every broker's fiduciary responsibility. Merely filling a customer's order at the national best bid or offer (NBBO) does not meet best-execution responsibilities. Brokers must seek to fill orders at prices better than the NBBO. On the NYSE, such "price improvement" occurs more than half the time and is much less likely in markets with payment for order flow and internalization, Kwalwasser says.

"If all markets were executing orders at the NBBO, then trading costs would be no different across markets," Bessembinder says. "For example, if every dealership sold cars at the suggested retail price, it wouldn't make a difference where you bought one. But if one can get you a better deal, wouldn't it be the place you would make your purchase?"

The NYSE requires each member firm to have a process for assessing order-routing decisions. The SEC must make sure those decisions are in the best interests of customers. This is a complex area of government regulation, says McSweeney, because objectives vary among customers. "While speed might be important to a trader executing simultaneous orders in a derivative or program-trading strategy, I believe that most individual investors wouldn't mind a 15-second delay in receiving an execution report in return for an opportunity to obtain a better price," he says. "The Exchange offers both alternatives so investors can choose how they access the NYSE." (The NYSE has developed a suite of products and services, such as NYSE Direct+™, that offers investors execution choices.)

Low-Cost Auction

On the NYSE, a true agency-auction market, customers' orders meet directly, without the intervention of a dealer, in trades representing about 70% of its volume. The Exchange believes the new rules will reaffirm what independent studies have repeatedly shown—that the NYSE is inherently a cheaper place to trade:

- The SEC's Office of Economic Analysis' January 2001 report confirmed that investors overwhelmingly incur lower costs and get better prices on the NYSE than on Nasdaq.
- An analysis by research firm Plexus Group showed institutional trading costs are lower on the NYSE than on Nasdaq.
- Research firm Elkins McSherry ranked the NYSE as the lowest-execution-cost market in the world for 1998 and 1999.

"These reports show not only that customers get the best price on the NYSE but that the Exchange is the cheapest market to operate in when you look at all costs involved," Kwalwasser says. "This speaks to one of the reasons companies list here—to provide the optimal environment for their shareholders," McSweeney adds.

Although it is unclear whether investors, brokers and market centers ultimately will change, at minimum the new rules should raise investor awareness. "Shareholders will be able to compare execution quality at different market centers, putting them in a better position to evaluate the effectiveness of how their orders are being handled," McSweeney says. "If an investor is paying comparatively low commissions but finds that all of the orders are being sold to a Nasdaq market maker who is trading against those orders, forgoing the price-improvement opportunities of the auction market, then he or she might now ask, 'What am I really saving?'" □

WHAT ISSUERS AND SHAREHOLDERS SHOULD KNOW ABOUT TRADE EXECUTION

- Where and how orders are executed affect the overall cost of each transaction.
- Brokers have options for executing customer trades:
  - For a listed stock, a broker may direct the order to the NYSE, to another exchange or to a third market maker.
  - For a stock that trades over the counter (OTC), a broker may send the order to a Nasdaq market maker, many of which pay brokers for order flow, or to an electronic communications network (ECN) that automatically matches buy and sell orders at specific prices.
  - For a listed or OTC stock, a broker may send the order to another division of a broker's firm to be filled out of the firm's own inventory, a process known as "internalization."
- Brokers have a duty to seek the best execution that is reasonably available for their customers' orders, and to consider "price improvement," the opportunity for an order to be executed at a better price than what is quoted publicly, in carrying out customer orders.
- Investors do have a say in where their orders are executed.
- New SEC rules require all market centers to make monthly electronic disclosures of basic information about the quality of executions on a stock-by-stock basis. SEC rules also require brokers to disclose on a quarterly basis market centers to which they route a significant percentage of their orders.
- SEC regulations do not require a trade to be executed within a set period of time.

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