Understanding Order Execution

Often investors and traders alike do not fully understand what happens when you click the "enter" button on your online trading account. If you think your order is always filled immediately after you click the button in your account, you are mistaken. In fact, you might be surprised at the variety of possible ways in which an order can be filled and the associated time delays. How and where your order is executed can affect the cost of your transaction and the price you pay for the stock.

A Broker's Options

A common misconception among investors is that an online account connects the investor directly to the securities markets. This is not the case. When an investor places a trade, whether online or over the phone, the order goes to a broker. The broker then looks at the size and availability of the order to decide which path is the best way for it to be executed.

A broker can attempt to fill your order in a number of ways:

1. **Order to the Floor -** For stocks trading on exchanges such as the New York Stock Exchange (NYSE), the broker can direct your order to the floor of the stock exchange, or to a regional exchange. In some instances regional exchanges will pay a fee for the privilege to execute a broker's order, known as payment for order flow. Because your order is going through human hands, it can take some time for the floor broker to get to your order and fill it.
2. **Order to Third Market Maker** - For stocks trading on an exchange like the NYSE, your brokerage can direct your order to what is called a third market maker. A third market maker is likely to receive the order if: A) they entice the broker with an incentive to direct the order to them or B) the broker is not a member firm of the exchange in which the order would otherwise be directed.
3. **Internalization** - Internalization occurs when the broker decides to fill your order from the inventory of stocks your brokerage firm owns. This can make for quick execution. This type of execution is accompanied by your broker's firm making additional money on the spread.
4. **Electronic Communications Network (ECN)** - ECNs automatically match buy and sell orders. These systems are used particularly for limit orders because the ECN can match by price very quickly.
5. **Order to Market Maker** - For over-the-counter markets such as the Nasdaq, your broker can direct your trade to the market maker in charge of the stock you wish to purchase or sell. This is usually timely, and some brokers make additional money by sending orders to certain market makers (payment for order flow). This means your broker may not always be sending your order to the best possible market maker.

As you can see your broker has different motives for directing orders to specific places. Obviously, they may be more inclined to internalize an order to profit on the spread or send an order to a regional exchange or willing third market maker and receive payment for order flow. The choice the broker makes can affect your bottom line. However, as we explore below we will see some of the safeguards in place to limit any unscrupulous broker activity when executing trades. (For more information, check out *The Basics Of Order Entry*.)

Broker's Obligations

By law, brokers are obligated to give each of their investors the best possible order execution. There is, however, debate over whether this happens, or if brokers are routing the orders for other reasons, like the additional revenue streams we outlined above.

Let's say, for example, you want to buy 1,000 shares of the TSJ Sports Conglomerate, which is selling at the current price of $40. You place the market order and it gets filled at $40.10. That means the order cost you an additional $100. Some brokers state that they always "fight for an extra 1/16th", but in reality the opportunity for price improvement is simply an opportunity and not a guarantee. Also, when the broker tries for a better price (for a limit order), the speed and the likelihood of execution also diminishes. However the market itself, and not the broker, may be the culprit of an order not being executed at the quoted price, especially in fast moving markets.

It is somewhat of a high-wire act that brokers walk in trying to execute trades in the best interest of their clients as well as their own. But as we will learn the Securities and Exchange Commission (SEC) has put measures in place to tilt the scale towards the client's best interests.

The SEC Steps In

By invoking a rule made effective April 2001 (SEC Disclosure Rule), the SEC has recently taken steps to ensure that investors get the best execution. This rule forces brokers to report the quality of executions on a stock-by-stock basis, including how market orders are executed and what the execution price is compared to the public quote's effective spreads. In addition, when a broker, while executing an order from an investor using a limit order, provides the execution at a better price than the public quotes, that broker must report the details of these better prices. With these rules in place it is much easier to determine which brokers actually get the best prices and which ones use them only as a marketing pitch. (To learn more, see *What is the difference between a stop and a limit order?*)

Because the rule imposes significant fines and penalties on the brokers failing to provide the best execution service, it is debatable whether this rule will be effective in helping investors because should these fines start occurring, investors will ultimately be the ones to absorb these costs in paying higher commissions. This is something only time will tell.

Additionally, the SEC requires broker/dealers to notify their customers if their orders are not routed for best execution. Typically, this disclosure is on the trade confirmation slip you receive in the mail a week after placing your order. Unfortunately, this disclaimer almost always goes unnoticed.

Is Order Execution Important?

The importance and impact order execution can have really depends on the circumstances, in particular the type of order you submit. For example, if you are placing a limit order, your only risk is the order might not fill. If you are placing a market order, speed and price execution becomes increasingly important.

When considering an investor with a long-term time horizon, an order for $2,000 of stock the difference of 1/16th is less than $20 - a small extra when entering a stock for the long haul. Contrast this to an active trader who attempts to profit from the small ups and downs in day-to-day or intraday stock prices. The same $20 on a $2,000 order eats into a jump of a few percentage points. Therefore, order execution is much more important to active traders who scratch and claw for every percentage they can get.

Conclusion

Remember, the best possible execution is no substitute for a sound investment plan. Fast markets involve substantial risks and can cause execution of orders at prices significantly different than expected. With a long-term horizon, however, these differences are merely a bump on the road to successful investing.

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