Friend or Foe?

In the popular imagination, exchanges and market makers go together like chocolate and peanut butter. The truth though is not so exquisite. With about 25 percent of all flow executed off-board by internalizers and dark pools, the relationship between the two is not always chummy. Market makers may supply liquidity to exchanges, but they also compete against the exchanges for order flow.

According to Joe Mecane at the NYSE, wholesalers and other internalizers scrape the cream of the order flow off the top, leaving the exchanges with the toxic dregs. Many of the easier or more desirable orders are executed before they make their way into the public venues, he said.

One big regulatory difference between the two groups is that exchanges aren't allowed to discriminate among customer types; they must treat every order the same, regardless of whether it is retail or institutional. Wholesalers, on the other hand, can choose with whom they trade.

"At a micro level, it's a positive thing for the retail firm who is getting price-improved," Mecane said. "Or, the internalizer will commit more capital because it knows the source of the order and who it is—there are some benefits to that."

Still, exchanges want that order flow. The stock exchange owned by the Chicago Board Options Exchange for example has introduced pricing meant to partly challenge wholesalers' dominance of retail flow. In an inversion of the traditional maker-taker pricing model, the CBOE Stock Exchange now pays liquidity takers a relatively high rate while charging liquidity suppliers. As most retail customers are liquidity takers, the pricing scheme targets them.

The program is designed to neutralize some of the advantages wholesalers have over exchanges. That is, they can pay for order flow and provide price improvement in hundredths-of-a-cent increments. "We're trying to get people to say, 'Let's go to the displayed markets first,'" said CBSX president David Harris.

—Peter Chapman and James Ramage