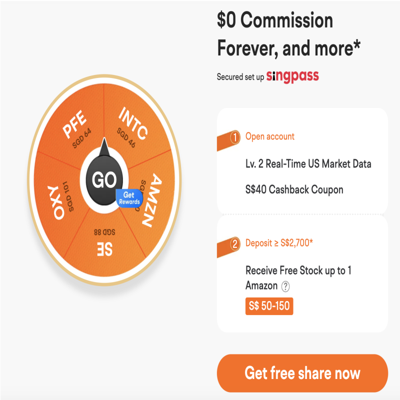


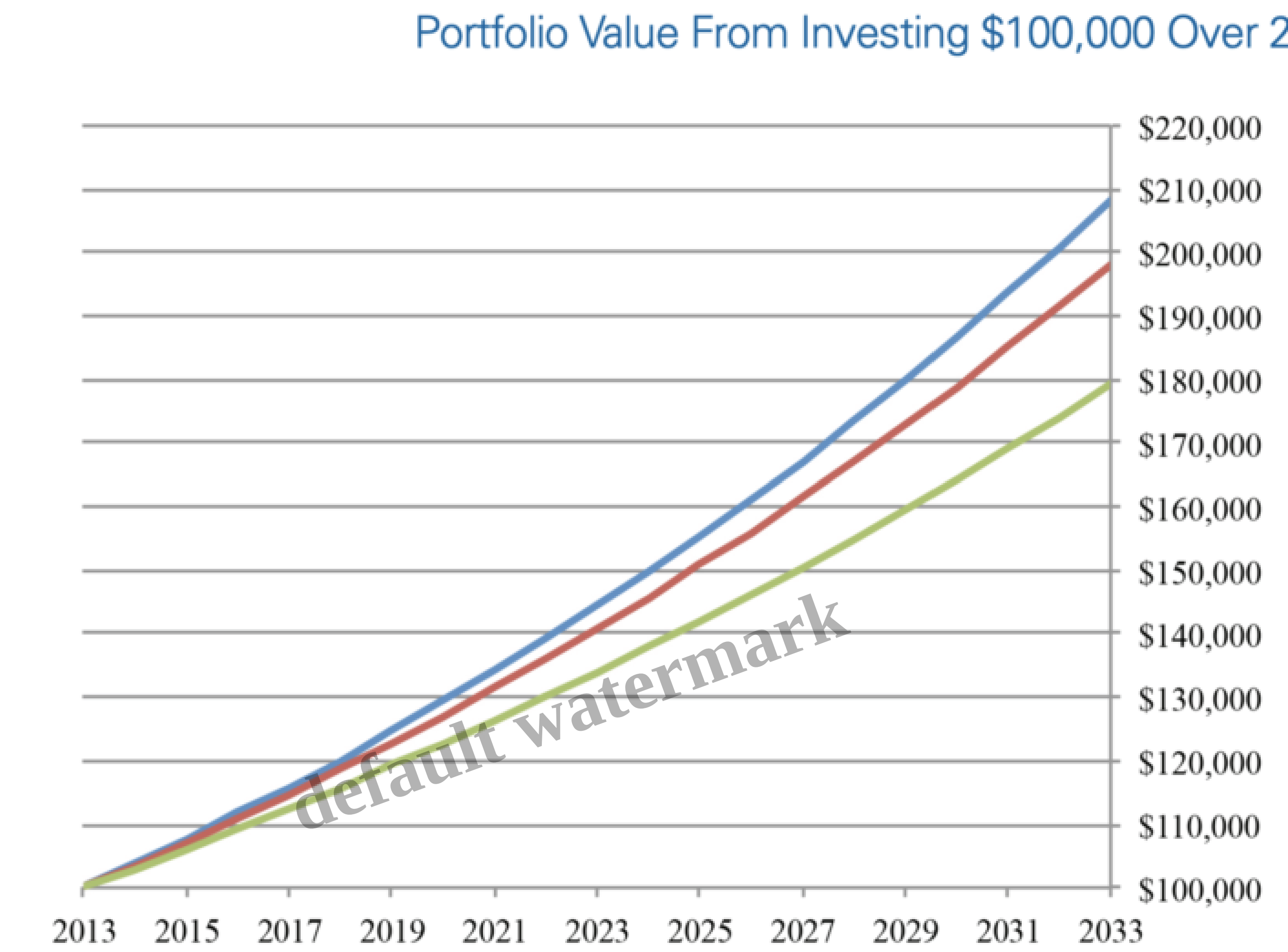
The Truth Behind Zero Commission Trades

Description

Are zero commission trades too good to be true? What is the catch, otherwise, how are such brokerages able to offer their services without charging? If not, then why did it take so long for brokerages to start offering zero commissions a.k.a commissions-free trades?

How many of you started investing a decade ago, and still remember how we had to pay $25* commission fees to a brokerage in order to execute a trade each time?

As a beginner investor who took to heart the traditional financial advice of “keeping your investment costs to under 1%”, those previous thresholds meant that I needed a capital of at least $2,500 for each position, which was a significant limitation to overcome.



Source: [The SEC Investor Bulletin – How fees and expenses affect your investment portfolio]

I'm certainly glad investors today no longer have to pay so much for each trade anymore. Today, with the option to use a digital brokerage that can offer zero commission trades, young investors no longer face the same hurdles and can start investing even with much lower capital. Don't look down on this, because it provides a key advantage – investors can now accumulate experience in the markets from a younger age, which will serve you well as you grow older and your portfolio expands.

But as we all know, **there's no such thing as a free lunch**. Surely brokerages have to earn money somehow. So…what's the catch?

How do digital brokerages like moomoo make money if it does not charge customers for trading with them?

One of the best platforms to buy US stocks in Singapore is moomoo SG, which has approximately 1 in 5 adults in Singapore using its platform to trade and invest. In Singapore, it is also the first digital brokerage till date to receive full memberships from the SGX Group across securities and derivatives markets.

But the headline of zero commissions always begets the question – how do they earn money then? And is it sustainable?

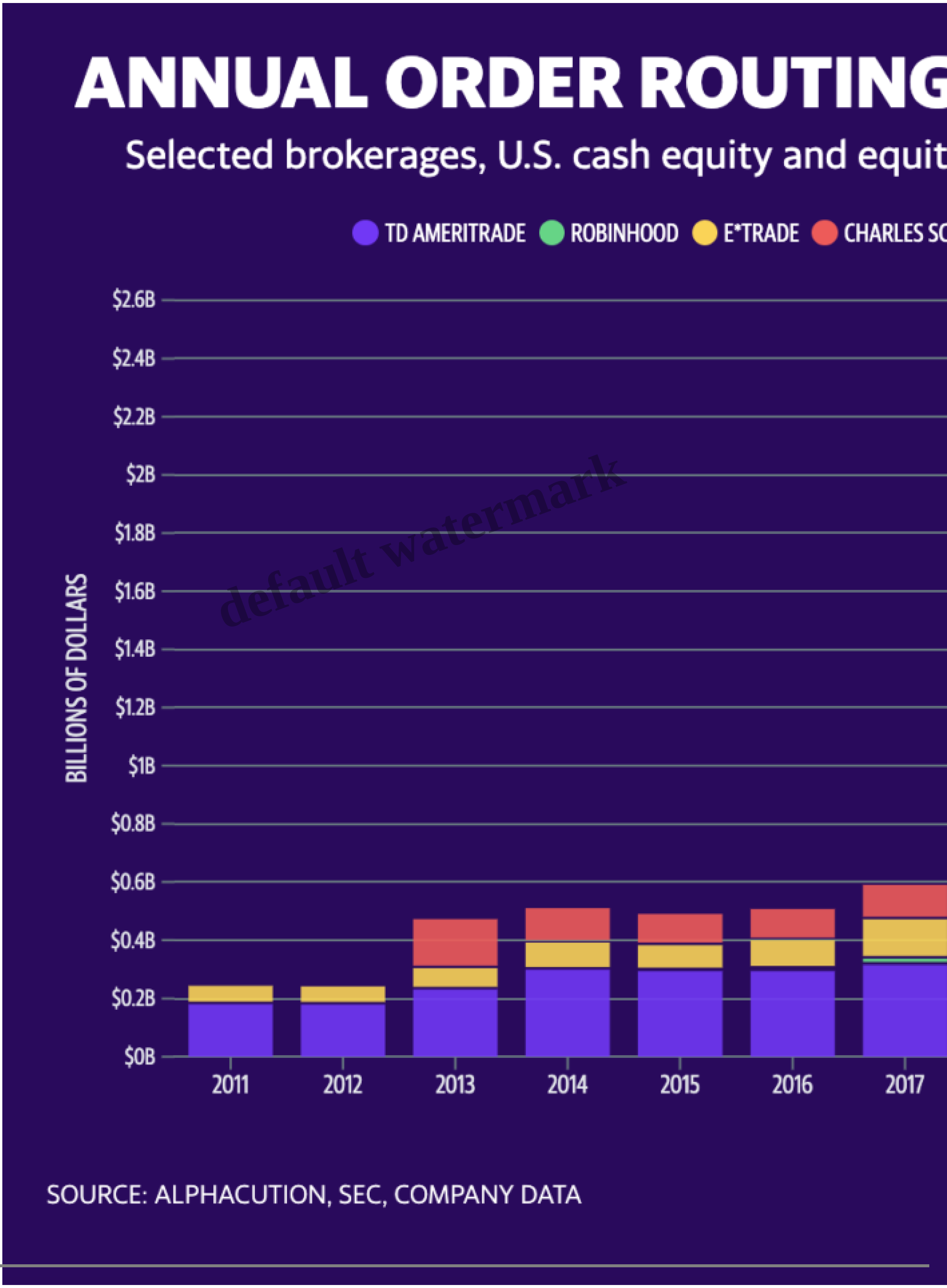
To get to the heart of the matter, we first need to understand how most brokerages typically make money, and what it needs to spend on to run its business operations. I compiled the following list, and while it is non-exhaustive, it should nonetheless give you a good idea of how the money flow works:

Revenue	Expenses
Commissions on each trade	
Custodian fees	
Dividend handling fees	
Forex spread	
Data fees	
Platform fees	
Late fees and interests	Settlement fees
Inactivity fees	Regulatory fees
Net interest income	Clearing fees
Paper statements	Staff wages
Options	Physical outlets and rent
Margin interest and financing	Platform maintenance and upgrades
Fund charges	
Revenue from IPO distribution services	
Employee share option plan (ESOP) management service fees	
Market makers	
Payment for order flow (PFOF)	

From this, the premise becomes clearer – brokerages who are able to earn from other revenue sources can afford to charge no commissions for its services.

But it is still good to be skeptical, given that in recent years, we learned that zero-commission trades from brokerages such as Robinhood and TD Ameritrade were typically possible **because they earn from other revenue sources** – of the most controversial is the payment for order flow (which has become the primary way for brokerages to still make money from commission-free trades).

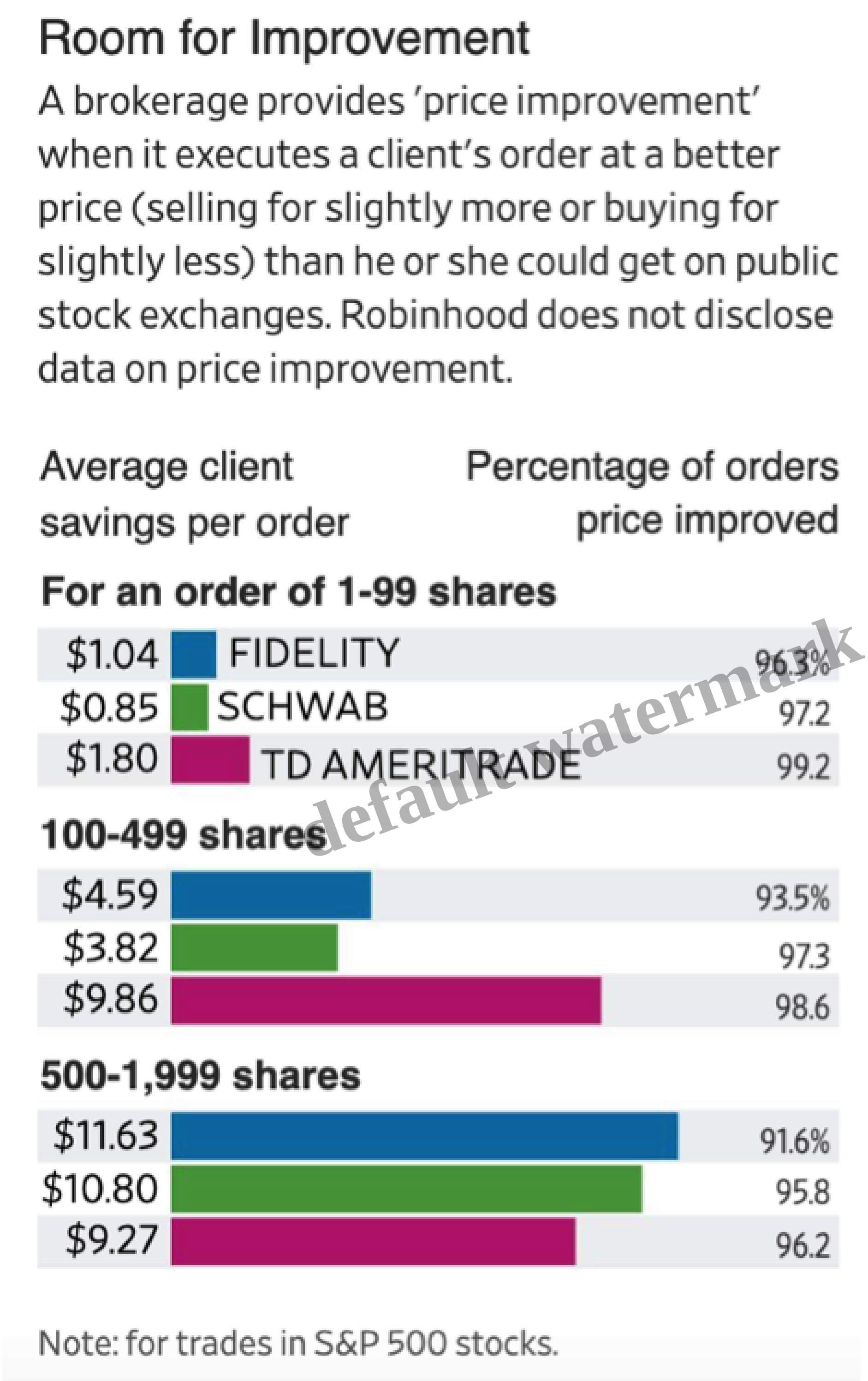
PFOF often leads to lower quality order execution i.e. slightly higher buy prices and lower sell prices each time. The SEC has a detailed document here that outlines how this works. Another key document worth reading is this research paper produced by the London Business School. *In fact, regulatory documents disclosed that US-broker Robinhood received $271 million from payments for order flow during Q2 2020, while TD Ameritrade made the most ($1.15 billion) among the 4 main brokerages in that year.*


ANNUAL ORDER ROUTING
Selected brokerages, U.S. cash equity and equit
TD AMERITRADE
ROBINHOOD
E*TRADE
CHARLES SC
BILLIONS OF DOLLARS
$2.6B
$2.4B
$2.2B
$2B
$1.8B
$1.6B
$1.4B
$1.2B
$1B
$0.8B
$0.6B
$0.4B
$0.2B
$0B
2011
2012
2013
2014
2015
2016
2017
SOURCE: ALPHACUTION, SEC, COMPANY DATA

Source: Yahoo Finance

Making the bulk of its revenue from PFOF in lieu of commissions has become the de facto operating model for many digital brokerages, but the practice is highly controversial – one that the SEC is looking into stemming.

This is hardly surprising, especially considering how in 2020, popular US-brokerage Robinhood had to pay the SEC $65 million to settle charges that they misled consumers by not disclosing that *customers paid the highest possible prices for the shares they purchased*, and *received the lowest price for those sold*. Trading on zero-commission brokerages like Robinhood may have been free, but it was done at the expense of execution, and SEC said that as a result, Robinhood's customers paid over $34 million more than they would have with other brokerages that charged commissions.



Source: [Screenshot from The Wall Street Journal]

While Robinhood doesn't operate here in Singapore, the question remains – do our brokerages here (which offer zero commissions) engage in the same practices?

I didn't get the chance to clarify with all of them, but at least for moomoo SG, the answer is no.

So how are digital brokerages like moomoo able to offer zero commissions?

To offer a free service in business, there's typically 2 main ways to pull it off:

- Incur less expenses
- Earn from other revenue sources

Reducing costs

This is where being a digital brokerage with no physical presence becomes an advantage. Fintech brokerages like moomoo SG can afford to charge lesser (or nothing at all) on trades because they have reduced manual costs to a minimum, which in turn allows them to charge customers less.

For instance, if you invested prior to 2010, you'd be familiar with how each investor had a dedicated broker assigned to our account whom we could call to execute trades; today, this is all DIY through an online platform or app. Technology has made traditional brokers redundant, and since there are no humans involved in each execution, moomoo SG incurs less manpower expenses.

Fixed operating costs are also lower, because unlike many legacy local brokers, moomoo SG does not have an offline presence. There are no physical outlets or customer service centres to operate, and hence no upkeep on rental, electricity fees or phone subscriptions.

This competitive edge grows as the brokerage scales – moomoo SG can serve more customers without having to spend more to set up additional offline outlets. Hence, as the number of clients increases, economies of scale start to kick in and the marginal cost of doing business decreases.

Plus, if you go back to the expenses table above, you'll see that moomoo SG passes on the settlement fees, regulatory fees and clearing fees (i.e. fees charged by other third parties) back to the customer. In turn, its reduced customer-facing staff headcount and minimal fixed operating costs mean that the bulk of its expenses are mainly spent on its platform, technology and staff wages.

Earning from other revenue sources

Rather than earn the bulk of its income from customers by charging commission fees, moomoo SG earns from other revenue sources such as options, interest income from margin, fund charges, securities lending services, futures trading, IPO fees, etc.

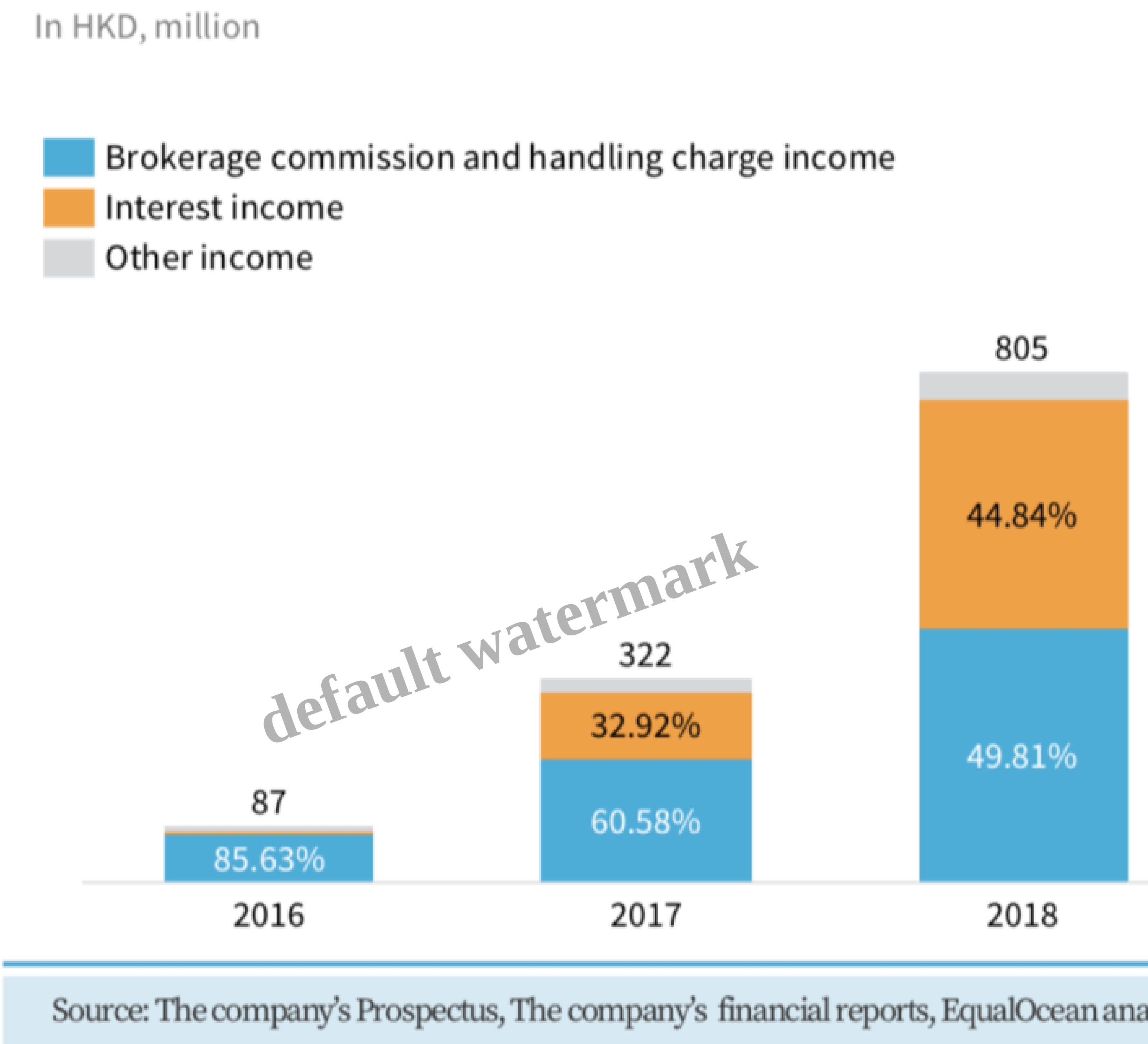
Different brokerages also employ different sources of revenue. For instance, you may have realized that some brokerages charge you for custodian fees on even local Singapore stocks, whereas others don't charge you anything for it.

For context, local brokerages are still charging $2+ a month in custodian fees for EACH position that you hold in an overseas market. This means if you want to buy US stocks in Singapore and you're an investor holding 5 different US positions, investing through a local bank brokerage will incur at least $10 each month in custody fees. Imagine how quickly this adds up for folks who own many different stocks! I know, because I experienced this firsthand since I started my investment journey before the era of digital, online brokerages.

Others, like Robinhood, may sell customer orders to high frequency traders (read the Wall Street Journal article on concerns surrounding Robinhood here). They receive a fee in return for this; you can watch my friend break down the different revenue sources of various local brokers here by diving into their listed financial statements.

I checked, and **moomoo SG states that it does not sell order-flow data to third parties.** So if that's something that would have been a deal-breaker for you, rest assured.

Another blogger has simplified moomoo's multi-fee generating structure, shown below. Given how diversified their revenue sources are, it explains why moomoo SG can afford NOT to charge commissions or custodian fees, but still earn from providing brokerage services.



Source: [EqualOcean]

Having multiple sources of income is always useful. In bull markets, the company tends to generate more revenue from its margin financing business; in bear markets, the assets in investors' accounts can provide interest income; and when markets are volatile, transaction fees add significantly to its revenue.

What are the fees that investors need to know?

Of course, **zero commissions** is just the icing on the cake – it certainly **does not mean you pay zero fees.**

There are still other charges you will incur in each trade, such as settlement fees, regulatory charges and fees that need to be paid to third parties such as the clearing houses.

In the case of moomoo (SG), which charges zero commissions on US stocks, here's the full fee structure disclosed on their website for investors:

Type	**Fees**	**Charged by**
Commission	$0	moomoo
Platform fees	$0 for the first year. $0.99 per order thereafter	
Data fees (Level 2)	$0	
Settlement fees	$0.003 per share, capped at 1 per cent of transaction amount	US Settleme Agency, etc
SEC fees *(sells only)*	0.0000229 of transaction amount. Minimum of $0.01 per order	U.S. Securiti Exchange Co
Trading Activity Fees *(sells only)*	$0.00013 per share. Minimum of $0.01 per order, capped at $6.49 per order	Financial Inc Regulatory A

An important point to note is that while some zero-commission brokerages do not cap their settlement fees, moomoo SG limits this to no more than 1% of the transacted amount by the customer.

Hence, if you're using moomoo SG, **there is no way you will ever find yourself in a position where you have to pay more for transaction fees vs. what you bought or sold**.

If you intend to use a dollar-cost averaging strategy on your investments to hedge against inflation, then using a platform like moomoo SG can help you significantly lower your costs each time.

Sponsor's Message

moomoo SG has decided to implement a permanent commission-free strategy on US

We are in the position to do so thanks to our strong financial holdings (we have net assets of US$2.69 billion last year) and by keeping costs low.

Of course, another way that brokerages can earn is via the bid-ask spread. After all, the stock market functions similarly to an auction house where investors (be it individuals, corporations or governments) buy and trade securities. The buyer states the bid price, where the seller names their ask price. It is then the role of the stock exchanges and the brokerages to facilitate these transaction.

The difference between the bid and ask price is called the "spread", which is kept as a profit by the broker handling the transaction.

If you're in a hurry and simply want your trade executed right away, you can set a market order. *You'll find that when you submit a market sell order, you receive the lowest buying price; when you submit a market buy order, you receive the highest selling price.*

For moomoo SG, they support a 60 bid/ask spread. But there's a way to get around this – simply set limit orders where you only buy/sell at prices that YOU want and are comfortable with.

TLDR: There is no free lunch, but zero commission brokerages can significantly reduce your investment costs

While the headline of ZERO COMMISSIONS always seems attractive, I hope this article has helped you to understand how this is possible, and more importantly, that zero commission does not mean zero cost for consumers.

When you understand this, you will then be in a better position to choose the best zero-commission brokerage to invest with.

Paying attention to the brokerage's financial status, quality of order execution, any charges for inactivity, the bid/ask spread, the type of orders you can set, as well as noting any caps on settlement fees are important.

If not, you may find yourself in a rude shock when you get charged more than what you were prepared to pay for.

With players such as moomoo SG disrupting the scene, I won't be surprised if eventually and in time to come, every broker goes down the zero-commissions path one day.

From now until 23 September 2022, get the following benefits when you open an account with moomoo :

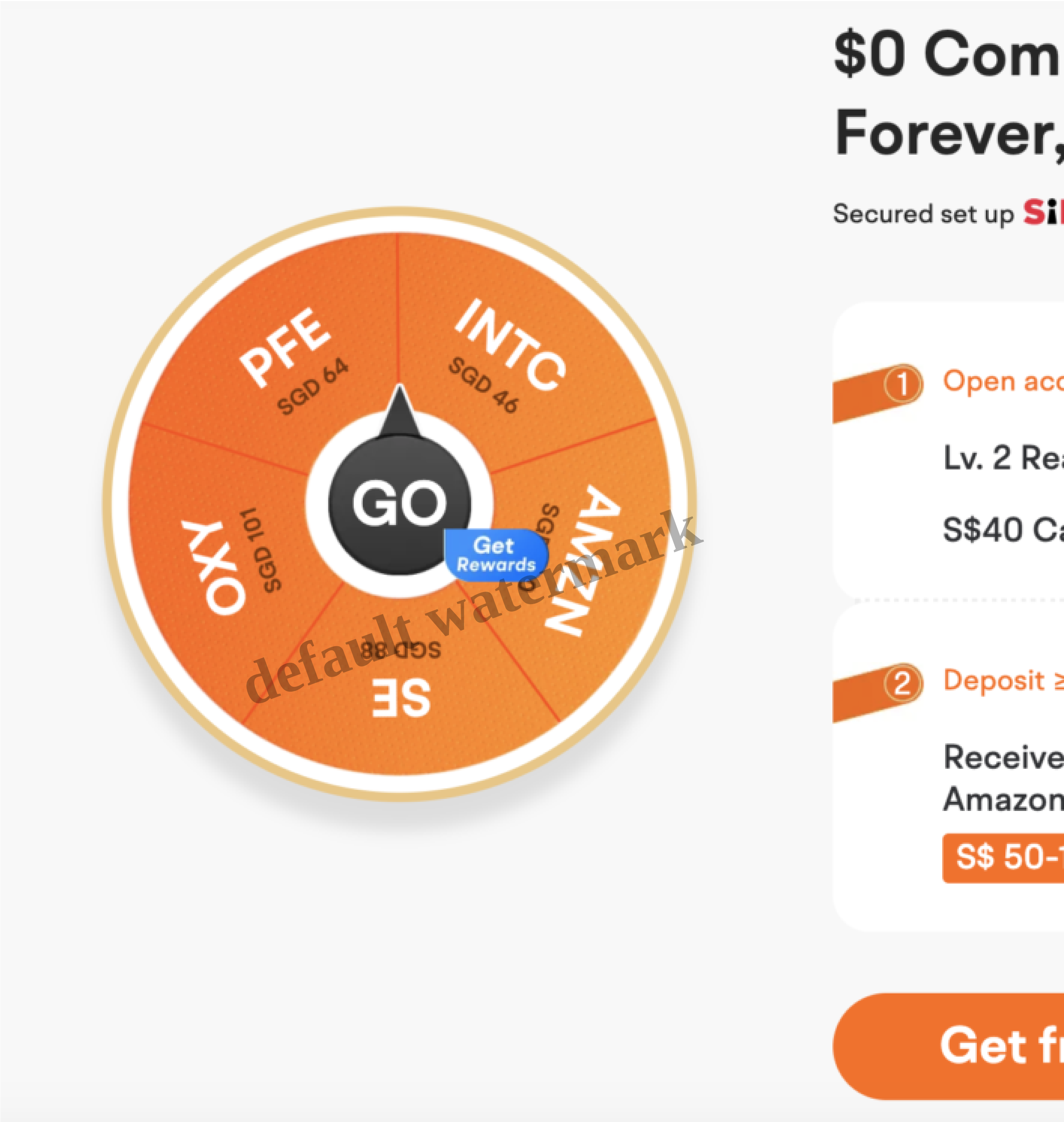
– $0 Commission Lifetime Forever for US Stocks*

– $0 Platform Fee 1-Year for US Stock*

– Lv.2 Real-Time US Market Data

– S$40 Cashback Coupon*

Deposit more than S$2,700 (or ? S$1,000 if you're a student) and receive a free stock worth S$50 – S$150, up to 1 Amazon share!



Disclosure: I embarked on this investigative post out of my own initiative, but approached Moomoo Financial Singapore Pte Ltd to clarify on how they're able to offer such attractive rates to customers. What ensued was a sponsorship agreement in exchange for several sponsored message sections (which you see in the boxes above) on this article. All opinions here (and money deposited in my moomoo SG trading account) are that of my own.

Category

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