CARLTON FIELDS

Payment for Order Flow (PFOF): Your Questions Answered

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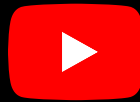

This podcast details why payment for order flow and gamification are in the news, and how regulators and the industry in general are addressing related issues and concerns.

The episode features Brattle Senior Consultant and Broker-Dealers & Financial Services Practice Leader Hollie Mason, MS, JD, who is joined by Carlton Fields Shareholder and former FINRA Senior Director Justin Chretien.

Transcript

Hollie: Hello everyone, welcome to the Brattle Group's podcast where we are discussing Payment for Order Flow today with Justin Chretien from Carlton Fields. My name is Hollie Mason. I am head of Brattle's Broker-Dealer and Financial Service Practice and will be your host today for today's podcast.

Justin, with us today, is a former Senior Director at FINRA, where Justin and I worked together for several years, as well as former SEC Trial Attorney. He's brought his 13 years of regulatory experience recently to Carlton Fields and he works out of their D.C. office - welcome Justin.

Justin: Thank you for having me.

Hollie: Wonderful to have you! So, Justin, we are talking about Payment for Order Flow. What is Payment for Order Flow and why is it in the news so much?

Justin: Well let me take the last question first. Last January, the GameStop trading halt debacle, for lack of a better word, exploded across the headlines and fingers were pointed at Robin Hood, at market-makers, hedge funds and even at retail investors. But after all the smoke cleared, what remained were questions about the trading model used by Robin Hood which relied upon Payment for Order Flow, "P-F-O-F" or PFOF. Now, the Chair of the SEC says that banning PFOF - banning Payment for Order Flow - is on the table. This should be taken as a shot across the bow for wholesale market-makers and retail broker-dealers who rely upon PFOF.

Your first question was, "What is PFOF"? Well, PFOF has been in existence since at least the 1990s and has always been legal, if controversial. It is compensation that broker-dealers receive for directing customer orders to particular trading venues. Typically, this means retail broker-dealers who direct order flow to wholesale market-makers who in turn provide a small payment back to the retail broker-dealer as compensation for that order flow. For example, if a young investor instructs a retail broker-dealer, perhaps through a trading app, to execute a stop trade, the broker-dealer may automatically direct the trade to a wholesale market-maker, who provides a small payment to that broker-dealer, for the order flow. The market-maker then executes the transaction and profits from the spread between the offer and sale price. The narrower the spread, the less profit to the market-maker and the better price for the investor. That's how it's supposed to work. There is, however, a potential conflict of interest. Some wholesale market-makers may provide more PFOF than other market-makers. That provides an incentive for retail broker-dealers to direct the order flow to the market-makers who are providing the most PFOF. At the same time, though, retail broker-dealers have an obligation to provide best execution to their customers. Regulators view this duty as sacred. Broker-dealers cannot sacrifice best execution to their customers in order to obtain more PFOF from market-makers. Thus, there is a potential conflict of interest between best execution and PFOF.

Hollie: All right. So, we want our retail customers to get the best price for the securities that they want to purchase...

Justin: Exactly!

Hollie: ...while at the same time broker-dealers, you know, watching that price and even if they are getting payment for order flow - that makes a lot of sense. I don't think it's any secret that regulators are looking into this issue. So, what are FINRA and the SEC concerned about? What are they looking at and why are they concerned about it?

Justin: Well, FINRA has different concerns than the SEC. FINRA is concerned about the potential conflict of interest and so is focused on reiterating and enforcing the best execution requirements of member firms. FINRA has not proposed any rulemaking regarding PFOF but would certainly entertain any proposal by the SEC to increase disclosure obligations regarding PFOF. The SEC, however, has broader concerns. The most significant of these are those dealing with market structure. There are three subparts to this concern about market structure. The first is that current markets are segmented - that is, the public exchanges comprise 53 percent of trading volume, the ATS or dark pools comprise nine percent of trading volume, and the wholesale market-makers have the other 30 percent of trade volume.

Segmentation means that different rule sets apply to the different segments. For example, exchanges must compete with all the other exchanges on an order-by-order basis to get the best prices for their orders. They are subject to the order protection rules. Market-makers, on the other hand, are able to price simply by reference to the NBBO, which is a much less competitive benchmark. Also, the NBBO used by the exchanges is priced in penny increments while market-makers can transact in sub-penny increments, which provides an advantage. The thinking is that segmentation reduces liquidity across all markets as a whole and creates an uneven playing field.

The second concern dealing with market structure that the SEC has expressed is that trading in the wholesale market-makers segment is concentrated with respect to that particular segment - just seven market-makers handle the vast majority of all trading in that segment. The thinking is that concentration deters healthy competition and innovation and increases systemwide risk in the event that one market participant has some type of failure.

The third concern about market structure expressed by the SEC is that concentration of trading also leads to the aggregation of trading data by certain market-makers. Market-makers see their own proprietary trading data; of course, they also see the trading data from the exchanges because they are public. The thinking is that this may provide certain market-makers with a competitive advantage over other market-makers with less order flow - less trading data - and over the exchanges, you see, you have even less because they see only their own data, not what the market-makers have.

Those are the structural complaints by the SEC.

Gensler has also expressed a broad concern about a lack of transparency that is related to market structure but can be segregated for the purpose of discussion - it's the NBBO. It does not reflect two of the unlit segments of the market - for example, the NBBO does not reflect trading in dark pools. The NBBO does not reflect trading of the wholesale market-makers, and even on the exchanges, it does not represent or reflect odd lot orders or non-displayed orders. As a result, the NBBO according to the SEC is not a complete representation of the market. Gensler believes that this lack of transparency is a barrier to fair, orderly, and efficient markets. Gensler's last concern is pricing - that PFOF may benefit the market-maker more than the investor.

Hollie: Transparency and an even playing field lead us to efficient markets, according to our regulators. What have FINRA and the SEC done? Have they taken any steps to address these concerns?

Justin: Yes. As a matter of fact, FINRA has a long-standing rule (Rule 5310) that requires best execution and they already had a regulatory notice in effect that was issued in 2015 regarding best execution obligations and PFOF, and both FINRA and the SEC have prosecuted firms for best ex-violations when the firms were receiving PFOF. And in March, this is after GameStop, FINRA issued another regulatory notice reminding firms of their order handing and best execution obligations during extreme market conditions. This was a direct response to GameStop. And in May, the CEO of FINRA, Robert Cooke, testified before Congress about PFOF. He first lauded the benefits of innovations in the industry and emphasized the need for regulators to adapt the rules to such innovations, not the other way around - in other words, regulatory regime accommodates technical advances such as PFOF, not the other way around. He then detailed FINRA's response to GameStop, which is essentially an internal working group that is reviewing member firm conduct during GameStop, but also broader review of PFOF practices, generally.

He also stated that PFOF, for FINRA's purposes, is permissible, provided it does not interfere with best execution but that he would support the SEC if it chose to enhance disclosure requirements. And in June, FINRA published yet another regulatory notice again reminding firms of their best execution obligations in the context of PFOF. This is about all that FINRA can do with respect to best execution and PFOF.

As for the SEC, in May, the SEC Chair Gary Gensler also testified before Congress. He also spoke in June before an industry conference and before a conference in London, then he spoke again to Barron's in an interview on August 30, and this is when he first stated that, "Banning payment for order flow was on the table." This is the shot across the bow of which we speak. So, Gensler has asked his staff for recommendations and according to the Barron's interview, any changes to PFOF may take place as part of a larger "reshuffling" of how trades are processed and tracked.

Hollie: So, it sounds like FINRA has proffered guidance, sort of reiterating their prior rules. It sounds like the SEC is on board with making market structure changes, so what has the industry's response been to these announcements and proffers?

Justin: Well, if you survey the literature, you can see that many have criticized PFOF. At the initial reaction of the industry to a possible ban, it's largely negative and many experts don't believe a ban is likely - at least not in the near term. There are several reasons for this. First, there are several policy reasons suggesting a ban is not likely. The issue first is complex and political and the SEC has other priorities right now, including the ESG mandate from the White House that was issued in May. The SEC may also hesitate to take any action that could increase cost for retail investors, especially when PFOF has opened up investing to millions of young people, including women and minorities. Arguably, the SEC would be blowing up a system that allows average people to trade for free. And critically, there is no hard data to support a better alternative. To be sure, there are studies that indicate moving all trading to a public forum would result in better execution quality overall, but such studies rely upon favorable assumptions and estimates about the effects of such a move. Let me give you an example. In one study, the conclusion of better execution quality by moving all order flow to exchanges relies on two assumptions and estimates. Number one, about order flow - the study describes the benign nature of the order flow, presently going to wholesale market-makers, versus the more toxic order flow, presently going to exchanges. In other words, small and largely balanced retail order flow versus institutional, high frequency, equity-taking order flow. The thinking is that the order flow going to the wholesale market-makers reflecting retail investors were relatively uninformed in their investing strategies compared to the high frequency traders, and as a result, their smaller orders are often cancelled out. So, there is not an effect on the NBBO as there is with the high frequency traders. That's why that type of order flow is considered more toxic. But the study estimates that NBBO spreads would narrow if the separate order flows were combined into one stream with less overall toxicity that presently goes to the exchanges. That is, the present system has one stream of less toxic overall flow and another stream of more toxic order flow. If you move all trading to the exchanges, the order flow evens out and the NBBO shrinks, meaning less profit for the exchanges, but better prices for the investors.

The second assumption and estimate is that the NBBO spreads would also narrow if there were less aggregation of data by certain wholesale market-makers. So, while both of these propositions appear reasonable, there is no hard evidence to support a quantification of the effect on NBBO spreads and prices. This is also the SEC's dilemma. They lack hard evidence, not only to define what the problem is with PFOF, but what the solution ought to be.

Third, a ban might not be effective and the possible tradeoffs might be worse. For example, banning PFOF without moving the trading to the exchanges may result simply in wholesale market-makers buying firms like Robin Hood or it might result in broker-dealers working out trade service agreements with market-makers or internalizing the order flow themselves to basically continue

what they are doing today. And even if all trading were moved to exchanges, it is not clear this would provide any tangible price improvement to retail investors for the reasons discussed previously - and just redirecting order flow to multiple exchanges, offering different rebates, may not eliminate conflicts of interest or segmentation or concentration of the markets. It may just move the problems from the wholesale market-makers to the exchanges. It is actually no surprise then that critics of the exchange rebates sound very similar to critics of PFOF from wholesale market-makers. Further, the likely tradeoff of banning PFOF may be a return to commission-based trading.

As former Commissioner Michael Piwowar testified recently before Congress following GameStop, "There are no solutions, there are only tradeoffs. The regulatory framework of the U.S. equity markets is complicated and reflects a complex system of legal and regulatory decisions that have been made over decades. The markets have evolved within this framework into a highly interconnected system. Any change to market structure policy in one area will likely affect other areas. For example, if payment for order flow were restricted or banned, zero commission trades would likely disappear. This is one tradeoff that the Commission will have to weigh when deciding whether to make any changes in existing regulations of payment for order flow. Changes to existing market structure and market infrastructure policy always involves tradeoffs."

Fourth, as a practical matter, any effort to ban PFOF will likely be challenged. A ban poses an existential threat to some market participants and upheaval to many more. The SEC has offered no evidence of PFOF fraud, for example, or any hard data about how executions would be better if PFOF were banned. Under these circumstances, expect Wall Street to lobby Congress aggressively and to challenge the SEC in court if rule making is proposed. Still, some experts believe that a ban could happen. Gensler appears highly knowledgeable about the subject, has shifted his tone quickly to "a negative tenor" according to one expert, and has called for in-depth reviews of best execution requirements. And FINRA's wariness about PFOF makes SEC action more likely.

Hollie: So you and I, Justin, we both know this is a very complex issue and we are talking about it briefly today. I know our broker-dealer clients have very strong opinions about this topic and related topics. It is clear that this is an ongoing issue and it is going to be talked about, whether in the news media or behind closed doors, for a long time to come. What are your thoughts on how the industry should react? What should they be focusing on in terms of next steps?

Justin: Well, much is at stake. Even if a total ban is unlikely in the immediate future, substantial due diligence must be exercised by the industry to address any proposed rulemaking. But here are some possible areas of focus: reducing tick size at the exchanges; reducing the access fee cap at the exchanges to lower exchange fees; reducing or eliminating the volume base thresholds and Reg ATS that trigger fair access and public display requirements that would have improved transparency in the dark pools. Revising disclosure requirements presently in SEC Rules 605 & 606 to improve transparency regarding PFOF and calculations of price improvement. This should include disclosure

of execution data from all off-exchange trading venues lighted or dark. That is not presently the case. Implementing a means for trades to compete on an order-by-order basis rather than by which segment of the market the orders originate. Implementing a means to mitigate or eliminate any information advantage of wholesale market-makers and implementing a means to improve the NBBO as the benchmark for pricing and price improvement.

Given Gensler's statements, the last three are the most important and those also will be likely the most difficult.

Hollie: Well, Justin, it's been a pleasure talking with you today. I think our audience has learned a lot about PFOF and gamification. I look forward to working with you and your firm on this and other issues in our industry in the future.

Justin: I thank you for the opportunity to speak today and I greatly appreciate it.

Presented By

Justin L. Chretien

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