CARLTON FIELDS

SEC Targets Payment for Order Flow: What Broker-Dealers and Wholesale Market Makers Should Know

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In January 2021, the GameStop trading halt exploded across the headlines. Consumer advocates and the financial press pointed fingers at a number of industry players, paying particular attention to the model of "payment for order flow" (PFOF) from wholesale market makers to online brokers.

Since January, FINRA has taken steps to address what it describes as potential conflicts of interest arising from PFOF, through the issuance of regulatory notices and continued enforcement of existing rules.

But the SEC has focused instead on broader concerns, including concerns about the structure of our equity markets.

Now, in a surprise move, SEC Chair Gary Gensler has stated that banning PFOF is "on the table."

This statement must be taken as a shot across the bow of broker-dealers and wholesale market makers who rely on PFOF.

This article provides an overview of PFOF and summarizes what the regulators are doing, how the industry has responded, and what the industry should focus on going forward.

What Is PFOF?

PFOF has been in existence since at least the 1990s and has always been legal, if controversial. It is compensation that retail broker-dealers ("firms") receive for directing customers' orders to a particular trading venue. Typically, firms direct order flow to wholesale market makers in return for

payment from the market makers for the order flow. Alternatively, exchanges may provide rebates to firms for liquidity-providing order flow, which is also a form of PFOF.

Some wholesale market makers, however, may provide more compensation for order flow than others. So there may be an incentive for firms to route order flow to those venues. At the same time, firms must provide best execution to their customers. Regulators have generally taken the view that firms may not sacrifice best execution for customers to get more PFOF from market makers. Thus, regulators have focused on the potential conflict of interest between best execution and PFOF.

FINRA has a long-standing rule requiring best execution. In addition, FINRA issued a regulatory notice in 2015 reiterating the requirement for best execution in the face of increasing advances in technology, including PFOF. And both the SEC and FINRA have prosecuted firms for alleged best execution violations where the firm received PFOF.

Firms are also required to disclose PFOF arrangements. Under the Exchange Act, firms must provide written notification to customers at or before completion of a transaction that the firm will receive PFOF and that the firm will furnish the source and nature of the compensation upon request. Under Regulation NMS, firms must make publicly available each quarter a report on the firm's order routing practices to include the aggregate amount of any PFOF received, both as a dollar amount and per share, and a description of any arrangement for PFOF.

This was the landscape until the end of January 2021, when the GameStop trading halt brought PFOF into the spotlight, even though it was not the cause of the trading halt.

What Has FINRA Said and Done About PFOF Since GameStop?

In March 2021, FINRA published a regulatory notice reminding firms of their order handling and best execution obligations during extreme market conditions.

In May, FINRA CEO Robert Cook testified before Congress regarding 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. He then detailed FINRA's response to the GameStop event, which includes an internal working group to review member firm conduct during the event and a review of PFOF practices to assess compliance with order handling and best execution rules both during the market events and more generally. He also stated that PFOF is permissible provided it does not interfere with best execution and that he would support the SEC if it chose to enhance disclosure requirements.

In June, FINRA published another regulatory notice, again reminding firms of their best execution obligations in the context of PFOF. And FINRA's review of member conduct during the GameStop event in January continues.

In sum: Even after GameStop, FINRA has not criticized PFOF. Instead, it has issued regulatory notices to reiterate best execution requirements and continues to enforce those requirements. FINRA has indicated that it would be receptive, however, to the SEC imposing additional disclosure requirements regarding PFOF.

What About the SEC?

SEC Chair Gary Gensler has shared a number of concerns about PFOF, starting in May, when he testified before Congress. He expanded on those remarks in June at an industry conference and again at a conference in London. On August 30, he was interviewed by Barron's and went so far as to state that banning payment for order flow was "on the table."

Let's review all his statements. To start, Gensler, like Cook, has lauded technological innovations that expand access to markets. And, like Cook, he has expressed concern regarding alleged conflicts of interest and best execution, which may fall more neatly in FINRA's wheelhouse than that of the SEC, given that FINRA enforces the best execution rule. But Gensler's focus is on three broader areas:

The first is **market structure**. There are three parts to this concern:

- Current markets are *segmented*. There are the public exchanges, which handle about 53% of trade volume; off-exchange wholesale market makers, which handle about 38%; and alternative trading systems or dark pools, which handle the other 9%. Segmentation means that different rule sets apply. Exchanges, for example, must compete with each other on an order-by-order basis to get the best prices available. Wholesale market makers, on the other hand, can price simply by referencing the national best bid and offer (NBBO), which is a much less competitive benchmark than the order-by-order standard. And dark pools derive their own prices from order flow and the NBBO. In addition, the NBBO used by the exchanges is priced in penny increments, while market makers and dark pools can transact in sub-penny increments. Gensler's view is that segmentation reduces liquidity in the entire market and creates an uneven playing field.

- Trading in the wholesale market maker segment is *concentrated*. Just seven market makers handle the vast majority of all trading in that segment. Gensler's concern is that concentration deters healthy competition and innovation, and increases systemwide risks in the event of a failure by one participant. In addition, the firms with the greatest market share tend to reap the profits from that concentration, he argues. Gensler questions whether both segmentation and concentration promote "fair, orderly, and efficient markets."

- Concentration of trading also leads to the *aggregation of data* by certain market makers, Gensler continues, which may provide those market makers with a competitive advantage over other market makers with less order flow and over the exchanges, who see only their own data.

Gensler's second broad concern is an alleged **lack of transparency** associated with the segmentation of the markets. In particular, the NBBO does not reflect two of the unlit segments of the market, namely the trading that occurs with wholesale market makers that internalize order flow or in dark pools, which is almost half of all trading. Nor does it reflect odd-lot orders or non-displayed orders on the exchanges. As a result, in his view, the NBBO 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 third broad concern is **pricing**, that PFOF may benefit the market maker more than the investor. According to Gensler, when markets are opaque and customer orders are processed differently, prices are affected. And the "best price" in one trading venue may not be the best overall price.

Finally, according to Gensler, any changes to PFOF may take place as part of a larger "reshuffling" of how trades are processed and tracked.

How Has the Industry Responded?

Although many criticize PFOF, the initial reaction of the industry to a possible ban is largely negative and many experts do not believe a ban is likely.

First, there are pragmatic reasons against a ban. The issue is complex and political, and the SEC has other priorities right now, including executing the recent ESG mandate from the White House. Moreover, many believe the SEC will be loath to take any action that could increase costs 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.

In addition, no hard data has been presented to support a better alternative. PFOF critics point to studies that indicate moving all trading to a public forum would result in better execution quality overall, but such studies rely on favorable assumptions or estimates about the anticipated effects of such a change. For example, in one often-cited study, the conclusion of better execution quality in moving to a public forum relies on assumptions about the benign nature of the order flow presently going to wholesale market makers (i.e., small retail orders and largely balanced order flow) versus the more "toxic" order flow presently going to exchanges (i.e., larger, institutional or high-frequency orders and unbalanced order flow). The study estimates that NBBO spreads (and prices to investors) would decrease if the separate order flows were combined into one stream with less overall

“toxicity” than presently goes to the exchanges. It also estimates that NBBO spreads (and prices to investors) would decrease if there were less/no aggregation of data by certain wholesale market makers. While both of these propositions appear reasonable, there is no hard data to support a quantification of their effect on NBBO spreads and prices. The lack of such hard data presents the SEC not only with the challenge of defining the “problem” with PFOF but also with the more difficult challenge of proposing, and testing, a “solution.” Thus, many firms expect that there will be no ban, at least in the near term.

Second, a ban might not be effective at solving the “problem” and the possible trade-offs might be worse. For example, just banning PFOF without moving the trading to the exchanges may result in wholesale market makers simply buying retail broker-dealer firms. Or firms could work out trade-service agreements with market makers or internalize the flow themselves to accomplish the same thing. And even if PFOF were banned and all trading moved to exchanges, it is not clear this would provide any tangible price improvement to retail customers, for the reasons discussed above. Indeed, redirecting all order flow to multiple exchanges offering different rebates as a form of PFOF may not eliminate alleged conflicts of interest, segmentation, and concentration concerns. It may just move them to the exchanges. Thus, critics of exchange rebates sound very similar to critics of PFOF from wholesale market makers. Gensler, for example, has also criticized exchange rebates. And while Gensler advocates for trades to compete on an order-by-order basis, rather than based on which segment it originated from, he has not explained this further.

Further, the likely trade-offs of banning PFOF may include a return to commission-based trading. According to former SEC Commissioner Michael Piwowar in Congressional testimony following the GameStop event:

> There are no solutions; there are only trade-offs. The regulatory framework of the U.S. equity markets is complicated; it 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. As a result, 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 and, if so, how to make any changes in existing regulation of payment for order flow arrangements. Changes to existing market structure and market infrastructure policy always involve tradeoffs.

Third, any efforts to ban PFOF will likely be challenged. A ban poses an existential threat to some market participants and upheaval to many more. Gensler has offered no evidence of PFOF fraud or how executions would be better if PFOF were banned. Under these circumstances, many expect Wall Street to lobby Congress aggressively and challenge the SEC in court if rulemaking is proposed.

Still, some experts believe a ban could happen, noting that Gensler appears highly knowledgeable about the subject, has shifted his tone quickly to "a negative tenor," and has called for in-depth reviews of best execution requirements. And FINRA's wariness about PFOF makes SEC action more likely.

As for the timing of any SEC action, the U.S. House of Representatives is considering the Order Flow Improvement Act (H.R. 4617), directing the SEC to study PFOF and, if necessary, consider banning or prohibiting it. The bill would order the SEC to provide a report within 180 days and commence any rulemaking within 18 months. Notably, the act expressly authorizes the SEC to regulate, limit, or prohibit PFOF before the completion of the study, if necessary.

Areas of Focus

Much is at stake. Even if a total ban were unlikely in the immediate future, given the regulatory focus on PFOF, participants in PFOF arrangements may find it prudent from a compliance perspective to review their practices in light of the public positions taken by FINRA and the potential actions of the SEC. Such a review should focus on (1) current firm practices and procedures to achieve best execution under the PFOF model; (2) regular and rigorous reviews of execution quality under the PFOF model (including an assessment of execution quality at competing markets); and (3) the firm's supervisory system and written procedures to ensure compliance with the firm's best execution obligations. The review also should consider the consequences of likely proposals for future rulemaking regarding PFOF, and affected firms may wish to prepare to present their views should rulemaking commence.

The following are a few topics that may be considered in connection with possible reforms in this area:

- Whether to reduce the NBBO one-cent "tick" size used by the exchanges to improve competitiveness with wholesale market makers, who transact in sub-penny increments.
- Whether to reduce the fee cap at the exchanges to lower exchange costs, thereby increasing competitiveness with wholesale market makers.
- Whether to reduce or eliminate the volume-based thresholds in Reg ATS that trigger fair access and public display requirements, thereby improving transparency in dark pools.
- Whether to revise the disclosure requirements of Exchange Act Rules 605 and 606 to improve transparency regarding PFOF and calculations of price improvement, possibly requiring disclosure of execution quality data from off-exchange trading venues, lighted or dark.
- Whether and how to implement a means for trades to compete on an order-by-order basis rather than by which segment of the market the orders originate.

- Whether and how to implement a means to mitigate or eliminate any information advantage of wholesale market makers.
- Whether and how to implement a means to improve the NBBO as a benchmark for pricing and price improvement.

We look forward to sharing a podcast in the next few weeks that will detail 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 podcast features Carlton Fields shareholder Justin Chretien and Hollie Mason, broker-dealer and financial services practice leader at the Brattle Group.

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