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Payment for Order Flow: The SEC Proposes Reforms

The past few years saw an unprecedented surge in retail investor securities trading at major discount broker-dealers such as Robinhood, Charles Schwab, TD Ameritrade, and E*Trade. Among the driving factors are the zero trading commissions many now charge for trades. The nonexistent commissions are often subsidized by a controversial rebate paid to the broker-dealers of fractions of a penny per share called payment for order flow (PFOF) by entities known as market makers, internalizers, or wholesalers, such as the market dominant Citadel and Virtu, which execute the orders. The wholesalers can profit by earning the *bid-ask spread* (matching buyers generally willing to pay a slightly higher price to sellers generally willing to take a lower one) and trading against the retail orders. In the latter case, the orders represent profit-making opportunities because as a group, retail investors are perceived to be less informed and less sophisticated vis-à-vis institutional investors whose trades are generally conducted on other trading venues such as stock exchanges. Reports indicate aggregate PFOF revenue for stocks was about $0.9 billion for 2022.

At the center of policy debates over PFOF is the broker-dealer's duty of best execution with respect to customer trades, a duty that is chiefly enforced and historically defined by the Financial Industry Regulatory Authority (FINRA), the frontline regulator of broker-dealers. *Best execution* denotes the broker-dealer's obligation to seek the most favorable terms for a customer's transaction in the context of the prevailing circumstances. PFOF's supporters assert that such trades do conform to best execution and indirectly benefit investors by subsidizing low- or zero-commission rates and other services. Some critics have argued that because broker-dealers do not generally pass the PFOF rebates onto their clients, they may have economic incentives to send retail orders to rebating market makers, creating potential conflicts with the duty of best execution.

The Current Regulation of PFOF

FINRA and the Securities and Exchange Commission (SEC) regulate PFOF through an array of regulations:

FINRA's Rule 5310. Under this rule, brokers must use "reasonable diligence" to determine the best market for a security and execute an order at a price that is "as favorable as possible under prevailing market conditions."

SEC's Regulation National Market System, Rule 606 and 607. Currently, the SEC's regulatory approach to PFOF involves disclosure rules under Regulation National Market System (Regulation NMS). Regulation NMS derives from the Securities Exchange Act of 1934 and was a set of rules adopted in 2005 by the SEC to refine how exchange-listed U.S. stocks trade (known as the National Market System or NMS).

Under Rule 606(a) of Regulation NMS, broker-dealers must provide quarterly, aggregated public disclosure of their practices in the routing and handling of "held orders," which require prompt execution at the best possible price. Generally, upon a customer's request, under this rule, a broker-dealer must provide customer-specific disclosures related to the routing and execution of the customer's exchange-listed securities submitted on a "not held" basis that gives the broker-dealer both time and price discretion during the prior six months.

Under Rule 607 of Regulation NMS, broker-dealers must, upon opening a new customer's account, provide annual descriptions of the terms of any payments received for order flow and any profit-sharing arrangements that may influence a broker-dealer's order routing decision.

The SEC's Proposed December 2022 Reforms

On December 14, 2022, six months after SEC Chair Gary Gensler expressed concerns over the fairness of PFOF and proffered an alternative protocol of order-by-order auctions, the SEC commissioners voted 3-2 to propose a new set of PFOF rules for certain retail equity trades. The proposal would amend Regulation NMS by adding a new rule, Rule 615, designed to help "bring greater competition in the marketplace for retail market orders." The rule was one of four market structure proposals concurrently adopted by the SEC. Among the four proposals is the introduction of an SEC "best execution" standard, which would require brokers to detail policies and procedures for achieving best execution.

The SEC's proposed PFOF reforms would require that certain individual, retail *marketable stock orders* (orders seeking to be immediately executed at the best available prices) initially routed to the wholesalers (called *restricted competition trading centers*) be then routed to an open auction (called *a qualified auction*) at a specified *limit price* (a buy or sell stock price order threshold). Open competition trading centers, including national stock exchanges such as Nasdaq and the New York Stock Exchange (NYSE), and *alternative trading systems* (non-exchange, electronic trading systems regulated as broker-dealers, which includes dark pools) would operate the proposed auction. The proposal could result in more retail stock orders being executed on these venues.

Also under the proposal, when wholesalers receive a *segmented order* they would route it to a qualified auction at specified limit prices. Under the rule, with some exceptions, segmented orders are orders for NMS stocks made for the account of (1) a natural person or a group of related family members (2) where the average daily number

of trades executed in NMS stocks was less than 40 in each of the six preceding calendar months.

After receipt of such an order, a wholesaler would then be required to route it to a qualified auction at a specified limit price. The wholesaler could then participate in the auction. If the segmented order were then not executed in full during the qualified auction, the wholesaler would be permitted to execute the segmented order at or better than the specified limit price. Alternatively, the wholesaler could opt to return the order to its broker client without execution.

Some of the Proposal's Plausible Outcomes According to the SEC

The SEC notes uncertainties about outcomes if the auction proposal is implemented. However, it said that some plausible outcomes include:

- Opening up retail investor orders to the order-by-order auction-based competition could translate into significantly better execution prices for them, remedying a current competitive average annual shortfall of between $1.12 billion and $2.35 billion.
- Members of national securities exchanges, which currently interact with a small portion of retail investor marketable orders, would likely be able to expand their volume of such trades.
- Institutional investors would likely get a heightened opportunity to interact with the retail orders.
- Wholesalers would "most likely" wind up executing a smaller share of retail order flow and see an attendant reduction in profits from their interactions with such orders. (However, Virtu has said that under an auction system where it could more selectively bid on orders, it might save hundreds of millions of dollars annually.)
- There could be a significant or total loss of PFOF. If so, there are several reasons why retail brokers would generally not be likely to return to commissions. Among them is the fact that most brokers reportedly receive relatively little or no PFOF, subsidizing commission-free trading through other revenue-generating lines of business. This can vary significantly from firm to firm: Robinhood is said to be exceptionally PFOF reliant, while some brokers take no PFOF.

Praise and Criticism

The proposed Rule 615 has earned support and criticism from various entities. Proponents include NYSE officials and some retail investor advocates such as Better Markets. Criticism or concerns have come from several Republican Members of Congress, Robinhood, Virtu, Citadel, and the Securities Industry and Financial Markets Association (a trade group for broker-dealers). Supportive arguments for the proposed Rule 615 include:

- The proposal would benefit individual investors by promoting competition and transparency to enhance the opportunity for their orders to receive more favorable execution prices than they currently do. An added competitive dimension would likely come from greater retail order interaction by institutional investors and stock exchanges.
- The reform could mitigate broker conflicts of interest by removing broker discretion on sending orders.
- The reform could also help remove the competitive advantage that wholesalers have over retail orders.

Arguments critical of the proposal include:

- According to some estimates, the amount that retail investors saved in execution price improvement from PFOF beyond the National Best Bid and Offer (NBBO) was in the billions of dollars in 2022. (NBBO denotes the best displayed offers to buy and sell individual stocks on exchanges at given points in time.)
- A robust trading presence by wholesalers improves the trading of less liquid and less traded securities and can reduce market volatility. Even if the proposed auction regime does enhance execution quality for some retail investors, reducing the role of wholesalers could reduce these benefits.
- Marketable retail orders routed to wholesalers appear to provide retail brokers with a high degree of consistency regarding execution quality. Investors are also more likely to receive price improvements from the NBBO when routed to wholesalers compared to securities exchanges.
- The complicated reform would introduce problematic investor trading risks, including execution challenges and operational uncertainties.
- In one study, five professors personally conducted 85,000 separate trades through several zero-commission brokers for 128 stocks. They found significant variations in execution prices away from the best posted executed prices for transactions in identical stocks. This was estimated to be equivalent to tens of billions of dollars in excess aggregate annual costs for all retail investors. PFOF, which not all the subject brokers participated in, however, was not found to be a significant factor in the variations. (The variations were attributed to wholesalers systematically giving different execution prices for identical trades to different brokers, potentially raising other questions about wholesaler-broker relationships.)
- The proposal could wind up costing retail investors more than it benefits them in execution price improvements beyond the NBBO if it results in the disappearance of zero commissions, which is said to have saved investors billions of dollars. (The study described in the previous bullet found that zero-commission brokers can, however, have excess execution costs that are ultimately borne by investors.)

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