Professional Perspective

Payment For Order Flow & Market Implications

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Like its legendary namesake, the start-up retail brokerage firm Robinhood Markets Inc. has become a cultural phenomenon, and not just a force in financial markets. Robinhood took the lead in offering zero-commission trading, and other more established retail brokerage firms followed suit in various ways. The widespread adoption of zero or low-commission trading has made securities trading accessible to more individuals.

Robinhood's rapid growth has drawn attention to an important financial question, highlighted by its recent initial public offering: How does the company make money if it does not charge commissions? The answer: Robinhood receives substantial "payments for order flow," or PFOF—a long-time market practice under which market makers, or wholesalers, pay retail broker-dealers for the opportunity to fulfill retail customers' orders.

In 2020, for example, about 75% of Robinhood's $958.8 million in revenue came from PFOF. Market participants and regulators are quite familiar with the practice, but until recently PFOF received little public attention. Now it is in the spotlight and being discussed in the press and the halls of Congress.

This article describes PFOF and the obligation of best execution and summarizes relevant Securities & Exchange Commission and Financial Industry Regulatory Authority regulations. It then analyzes Robinhood's 2020 SEC settlement and a 2019 settlement with FINRA that was also related to PFOF, and then concludes by discussing how PFOF may be studied and addressed in coming months.

Overview

Regulatory authorities have scrutinized Robinhood's practices closely numerous times over the years. Most significantly, in a December 2020 order, the SEC found that Robinhood's disclosures and internal oversight of PFOF violated the securities laws and contributed to a failure to give customers best execution of their orders.

Yet, a critical aspect of Robinhood's settlement with the SEC could easily be overlooked: The SEC did not conclude that PFOF violated the law; instead, the settlement rested on the premise that PFOF is entirely lawful under current securities law and regulation. The deficiencies found by the SEC concerned the way PFOF had been disclosed and monitored internally.

PFOF critics are now pressing a more aggressive claim—that PFOF gives rise to an inherent conflict of interest and necessarily deprives retail investors of best execution of their orders—that is, that the very existence of PFOF automatically leads brokers to send orders to certain preferred market makers to maximize their own revenue at the expense of retail customers.

In a late August 2021 interview with Barron's, SEC Chairman Gary Gensler asserted that PFOF poses an "inherent conflict of interest" because, in his view, market makers not only receive a small spread on each trade but also "get the data, they get the first look, they get to match off buyers and sellers out of that order flow," which "may not be the most efficient markets for the 2020s."

Consistent with this view, Gensler said that a full ban of PFOF was "on the table." These comments followed a June 2021 speech in which Gensler announced that the SEC staff would study whether PFOF conflicts with the obligation of best execution.

Lawmakers have also been taking notice. Both the Senate and the House held hearings in May and June 2021 concerning the trading of meme stocks. In early August, the House of Representatives Financial Services Committee reported a bill (H.R. 4617) that would direct the SEC to study PFOF.

PFOF

In the past, when a retail investor told a broker to buy or sell stock, the order was generally sent to an exchange for execution. That is no longer typically true. Now, the retail broker typically sends the order to the market center where it can obtain the best execution for its customer—often to a wholesale broker, or market maker, which looks for the other side of the trade and earns a profit when it successfully captures the spread between the bid price and offer price for the shares.

A market maker has been described as a "risk transfer agent": It bridges the time between when one party sells and another party buys a share of stock by buying from the seller (or selling to the buyer) and holding the risk on its balance sheet until it finds someone looking for that risk.

Retail orders are valuable because they tend to be more balanced, representing a more even mix of buy and sell orders, which increases the chance that the market maker will be able to offset the orders in the course of a day without taking a loss. Retail orders are a source of profit for market makers, which are willing to pay retail brokerage firms for sending such orders to them for execution.

PFOF has been an established feature of the market since the 1980s, regularly studied and discussed by the SEC and FINRA, most notably in 2016 by the SEC's Equity Market Strategic Advisory Committee, and by FINRA in guidance published in June 2021. Though payment for each share is only fractions of a penny, total payments to retail brokers for order flow are substantial.

In 2020, $2.6 billion in PFOF was paid to the seven leading retail brokerages, and those payments amounted to $1.82 billion in the first half of 2021. The largest recipient of PFOF in 2020 was TD Ameritrade, whose PFOF revenue topped $1.4 billion, with Robinhood coming in next with over $680 million. In its recent S-1 filing, Robinhood disclosed that in the first quarter of 2021, it received over $331 million in PFOF—about 81% of its revenue.

Best Execution

Retail brokers have a duty of "best execution," which requires them to endeavor to execute customer orders on the most favorable terms reasonably available in the market. FINRA Rule 5310(a)(1) requires broker-dealers to "use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions." FINRA Rule 5310.

Best execution is determined in relation to the National Best Bid and Offer (NBBO), which is calculated and disseminated as part of the National Market System Plan and shows the best bid and ask prices available for securities listed on the NYSE and Nasdaq. "Price improvement" is achieved when a broker secures a price for an investor that is more favorable than the NBBO. See Regulation NMS Rule 600(b)(42). Broker-dealers must have effective internal systems to monitor and maintain the quality of customer order executions.

FINRA permits brokers to accept PFOF, but such arrangements may not interfere with the duty to obtain best execution for customers. See FINRA Rule 5310; Marc N. Geman, Securities Exchange Act Release No. 43963 (Feb. 14, 2001) (Commission opinion). In June 2021 guidance, FINRA stated that a broker-dealer that receives PFOF must engage in a heightened analysis of execution quality to ensure that the PFOF arrangement is not interfering with its duty of best execution. FINRA further cautioned that compliance with SEC disclosure obligations does not relieve broker-dealers of their duty of best execution. See FINRA Reg. Notice 21-23.

SEC Disclosure Requirements

The SEC has imposed specific and detailed disclosure requirements on retail brokers relating to both PFOF and best execution. In 2005, pursuant to the Securities Exchange Act of 1934, the SEC issued a set of rules known as Regulation National Market System (Regulation NMS) which increased transparency by modernizing and strengthening the regulatory structure of equity markets in the U.S.

Under Rule 605 of Regulation NMS, market centers, including market makers, must disclose monthly data about the quality of their trade executions based on the previous month's trading activity. Rule 606(a) of Regulation NMS requires that broker-dealers provide quarterly reports that provide an overview of their routing practices, and Rule 606(b) requires that a broker-dealer provide a customer, upon request, a general overview of its routing practices, as well as the nature of any relationship the broker-dealer has with the venues to which the orders are routed. 17 C.F.R. § 242.606(b).

Under Rule 607 of Regulation NMS, a broker-dealer must, upon opening an account for a new customer, provide annual descriptions of the terms of any PFOF or other profit-sharing arrangement that might influence the broker-dealer's order routing decisions, as well as a description of the extent to which orders can be executed at prices superior to the NBBO. 17 C.F.R. § 242.607.

Finally, Rule 10b-10 of the Exchange Act requires that, for any NMS stock, a broker-dealer note on a customer's confirmation statement when PFOF has been received for a given transaction, as well as indicate that the source and nature of the compensation received in connection with the transaction will be disclosed upon the customer's written request. 17 C.F.R. § 240.10b-10.

As a result of these requirements, the market gets substantial information about the market makers to which retail brokers route their customers' orders, the amount of money the brokers are paid for doing so, and the quality of the executions given by the market makers to those orders. This information helps market participants decide whether PFOF actually reduces the quality of execution of customer orders.

Robinhood Settlements

Robinhood's business model has hit regulatory snags since the company's founding in 2013. The most significant of these was the December 2020 settlement with the SEC. A close reading of the settlement reveals that it was grounded in SEC findings of discrete failures at Robinhood to comply with SEC and FINRA rules—not a finding that an inherent or unavoidable conflict exists between receiving PFOF and providing best execution.

In December 2020, the SEC issued an Order Instituting Administrative and Cease-and-Desist Proceedings against Robinhood Financial, LLC, which found that Robinhood misrepresented its reliance on PFOF as a source of revenue, and the quality of the executions of its customers' orders; and did not fulfill its duty of best execution.

Regarding the receipt of PFOF, the SEC found that between 2015 and 2018, Robinhood omitted material information about the relative importance of PFOF to its total revenue and income.

Regarding the quality of order executions, the SEC found that between approximately October 2018 and June 2019, Robinhood claimed on its website that its order execution quality matched or beat that of its competitors when, in fact, an internal analysis conducted in March 2019 found that the percentage of its orders receiving price improvement lagged behind other retail brokerages.

Lastly, the SEC found that between approximately September 2016 and June 2019, Robinhood violated its duty of best execution by failing to conduct regular and rigorous reviews of execution quality, including failing to assess whether its receipt of PFOF was adversely affecting order executions. According to the order, Robinhood negotiated a split of the value between price improvement and PFOF, accepting less price improvement for its customers in exchange for higher payments to Robinhood.

Beyond the disclosure and operational shortcomings described in the order, the SEC also described a conflict at Robinhood between the receipt of PFOF and the duty of best execution. According to the order, "Robinhood explicitly offered to accept less price improvement for its customers than what the principal trading firms were offering, in exchange for receiving a higher rate of payment for order flow for itself." The SEC's press release put the matter of cause and effect more starkly: "Due in large part to its unusually high payment for order flow rates, Robinhood customers' orders were executed at prices that were inferior to other brokers' prices."

In the SEC's view, the losses due to inferior execution exceeded the benefits from zero commission trading. According to the order, in the relevant period (October 2016 to June 2019), Robinhood customers lost over $34 million in price improvement compared to what they would have received had the orders been placed at competing broker-dealers, even accounting for the competitors' commission.

Without admitting or denying the SEC's findings, Robinhood agreed to a cease-and-desist order and to retain an independent consultant to promote compliance with its best execution obligation, and to pay a civil penalty of $65 million.

The SEC order followed a December 2019 settlement with FINRA, in which Robinhood submitted a Letter of Acceptance, Waiver, and Consent (2019 AWC) regarding best execution violations. FINRA found that, for over one year—Oct. 1, 2016, through Nov. 9, 2017—a period covered by the later SEC order—Robinhood routed customer trades to broker-dealers that paid Robinhood for that order flow without reasonably considering the Rule 5310 execution quality factors, including price improvement, that might be available from alternative markets.

In other words, FINRA found that Robinhood's best execution committee focused only on the execution quality of its existing routing destinations, with which Robinhood had PFOF arrangements, and did not compare that quality against market makers with which it did not have such arrangements. These findings resulted in a $1.25 million fine.

Current Legal Landscape

The SEC 2020 order and 2019 AWC, along with the July 2021 guidance regarding FINRA Rule 5310, all rest on the premise that PFOF is lawful, but that it must be appropriately disclosed and internally monitored to ensure that it does not interfere with a broker-dealer's duty of best execution. To make sure that a possible conflict between PFOF and best execution does not become an actual one, the broker-dealer must regularly analyze and maintain the execution quality of its customer orders.

The present regulatory framework, therefore, implicitly rejects the notion of an inherent and insurmountable conflict between PFOF and execution quality; if such a conflict existed, then either PFOF would have to be outlawed to save execution quality, or execution quality would have to be sacrificed to preserve PFOF as a viable market practice. But that is not the approach taken by either the SEC or FINRA, and it is not the position that underlies the 2020 SEC order or 2019 AWC.

Critics of PFOF approach the matter very differently. They argue that it poses an inherent conflict with execution quality and necessarily harms customers—even when customers are not charged commissions. In support of this view, the critics can cite the facts found by the SEC in the case of Robinhood, which describe PFOF payments made at the expense of price improvement for clients.

The critics' argument is likely at the heart of the SEC staff inquiry announced by Gensler, as reflected in his recent comments to Barron's. The implications of this inquiry are enormous for investors, and certainly for shareholders of Robinhood. The outcome could lead to rule changes around PFOF that jeopardize commission-free trading.

Strategic & Empirical Questions

Two overarching questions lie at the heart of the relationship between PFOF and best execution.

The strategic question concerns the efficacy of different types of regulation. One approach seeks to use disclosure and market forces to minimize any adverse effects of PFOF; the other approach champions detailed rule-making and restrictions or prohibitions on PFOF to prevent perceived conflicts of interest. Securities regulators thus far have clearly favored the former approach to PFOF, which calls for robust disclosure.

This is understandable since disclosure, permitting informed investment decisions, is the bedrock principle that underlies our securities laws. For instance, the Exchange Act and regulators permit—but require disclosure of—"soft dollar" arrangements between broker-dealers and their institutional clients.

The present scrutiny of PFOF might result in a reaffirmation of the current regulatory approach, perhaps with enhanced disclosure requirements, including requirements for brokers to provide additional data or reports, to ensure that PFOF is not negotiated in a way that impedes price improvement. Pressure may be very great to take a more activist approach that restricts current market practices.

The empirical question, also very important, concerns the ultimate cost to investors under different trading rules, including the cost of commissions, reduced or no price improvement, and other variables. To date, the critics of PFOF have relied not on analysis of industry-wide data but to a large extent on a distrust of financial institutions to be able to avoid the potential conflicts posed by PFOF and the lack of faith in regulators to adequately police the rules.

H.R. 4617, a bill voted out of the U.S. House of Representatives, Financial Services Committee on July 22, 2021, would require the SEC to conduct "a study on payment for order flow received by brokerage firms for routing customer orders to market centers," including among other specific topics "the impact of payment for order flow arrangements on customer trade execution quality." The sort of studies set out in H.R. 4617 would establish a foundation on which to consider the impact of PFOF, assuming the studies are undertaken pursuant to statutory and SEC rule-making authority.

In addition, a study of the costs of trading in Canada and the U.K., where PFOF is prohibited, the European Union, where PFOF is permitted but where regulators have recently raised questions about the practice, and the U.S. might also shed light on the impact on investors of different regulatory frameworks and execution quality.

Conclusion

For many years, regulators have sought market reforms to reduce the commissions paid by retail customers. Separately, technological changes have led to automated trading that relies mostly on electronic communication, not human interactions, to execute trades at lightning speed. These trends came together in Robinhood and other brokers that enable ever more people to trade stocks and with zero or low commissions. Behind this new world of trading lie the market mechanisms that make it possible, and PFOF is a central feature.

All participants in the market will be keeping close watch on how PFOF fares in the Biden administration; its fate may significantly impact the way we all trade stocks and the accessibility of our capital markets for the next generation of investors.