BETTER MARKETS

– FACT SHEET –

Payment for Order Flow: How Wall Street Costs Main Street Investors Billions of Dollars through Kickbacks and Preferential Routing of Customer Orders

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The frenzied trading in GameStop and other so-called "Reddit Rebellion" equities has brought attention to longstanding equity market structure issues. In particular, retail broker-dealer Robinhood Markets Inc.'s ("Robinhood") order routing practices have—again—come under regulatory and public scrutiny. In 2020, Robinhood reportedly received $687 million dollars in so-called "rebates" for essentially selling its customers' orders to six high frequency trading ("HFT") firms that serve as its executing broker-dealers (*i.e.,* the HFTs that execute or facilitate the execution of Robinhood's customer orders). These rebates, called "payment-for-order-flow" ("PFOF"), are used by nearly all of the "commission-free" retail broker-dealers (*e.g.,* Robinhood, E-Trade, Schwab/TD Ameritrade) who receive orders from Main Street investors. PFOF across all retail broker-dealers in 2020 was reportedly $2.6 billion.

Of course, the HFTs were willing to rebate $2.6 billion to retail broker-dealers because execution of retail customer orders generated net trading profits of more than the rebated amount. The key question raised by these practices is whether retail customers end up worse off in a material number of securities transactions routed to the HFTs because of the PFOF. Despite often inaccurate or incomplete HFT-industry claims to the contrary, the answer to this question is "yes."

The essential facts about PFOF are as follows:

- **Conflicts of Interest:** First, PFOF creates conflicts of interest between (1) a retail broker-dealer's duty to seek the "best execution" available for customer orders and (2) its duty to maximize its own profits for shareholders and/or owners through PFOF revenues generated by preferentially routing transactions to select HFTs. The regulatory standards governing "best execution" are multi-factor, malleable, and difficult for regulators to monitor, much less enforce, making them an inadequate mitigant for these conflicts of interest.

- **Harm to Investors:** Second, these conflicts, in practice, have been found to affect order routing decisions and harm Main Street investors. This is evidenced, for example, by a recent Securities and Exchange Commission ("SEC") enforcement action finding that Robinhood executives internally reviewed the firm's order routing practices, determined that limiting order routing to the PFOF executing dealers was harming its customers, and yet, continued to preferentially route orders to those dealers. Robinhood paid a $65 million civil monetary penalty for failing to disclose those practices to its customers—the facts are damning and seem to indicate that the firm intentionally concealed the adverse effects of PFOF from its customers. Robinhood did not admit or deny the SEC's findings in connection with that enforcement action.

- **Harm and Risks to Markets:** Third, PFOF takes retail customer orders and transactions (referred to as "liquidity") away from transparent securities exchanges and redirects that order flow to a very small number of HFTs that execute an almost alarming percentage of overall trading. This lost liquidity (1) affects all investors directly or indirectly using the securities exchanges, (2) potentially disincentivizes the provision of resting liquidity to the exchanges, (3) has serious and potentially systemic risk implications, (4) incentivizes, if not requires, exchanges to design distortive liquidity rebates and programs, order types, and trading protocols to attract and advantage trading originating with these HFTs; (5) results in a needlessly fragmented system of created complexity that lacks sufficient transparency and investor protections; and (6) interferes with the price discovery and capital allocation functions of the securities markets.

A more detailed fact sheet explaining each of these essential facts can be found here.

It is noteworthy that other jurisdictions, including the United Kingdom, Australia, and a few European Union member states, have prohibited payment for order flow without adverse consequences.

Do PFOF and internalization result in "price improvement" for individual investors?

Sometimes, but too often "no."

Citadel Securities ("CS"), like other HFTs, repeatedly cites exaggerated and misleading "price improvement" statistics meant to quantify the supposed value of PFOF and internalization to investors. CS recently stated, for example, that it provided $1.5 billion of "price improvement" on retail equity orders in 2020. This misleading figure leaves out the following inconvenient facts:

- **So-called "price improvement" statistics are not measured against the "best" price available to investors.**

  - "Price improvement" must be measured relative to the market price an investor would receive with reasonable effort under prevailing market conditions. Thus, the key question rarely asked is the only valid one: "Improved compared to what price?"

  - In equity markets, the national best bid or offer ("NBBO")—a national best price across the U.S. exchanges for large orders—is used as an improper proxy for fair market prices and as a benchmark for the claimed price improvement statistics.

  - The claimed benefits of internalization and routing to PFOF executing dealers would be at least dramatically reduced if "price improvement" were based on reasonably available prices rather than the NBBO. Why? Because the NBBO excludes a substantial number of executable orders from its calculation. As a consequence, there often is an "inside" spread in the markets—narrower than the NBBO and perhaps a better reflection of the available fair market price for small retail orders. If executing dealers measured "price improvement" against that inside spread, the statistics would dramatically change and reveal how often retail traders are being harmed relative to a fair market price.

  - Benchmarking trades against the NBBO alone and pretending that this is pro-investor "price improvement" utterly fails to recognize the difference between one available price for investors and the best price reasonably available for investors. Importantly, this difference, taken out of the pockets of retail traders, is, in part, how those HFT firms paid $2.6 billion in PFOF in 2020 and still posted record trading profits.

- **There would be more price improvement in the absence of PFOF.**

  - Retail broker-dealers do not necessarily route to the executing dealers that result in the greatest price improvement to customers. Although there is execution competition for spreads and rebates under PFOF arrangements, the competition is limited to firms willing to enter into PFOF arrangements.

- Robinhood itself was one of the few firms sanctioned for programming its order routing systems to preferentially send order flow to the executing dealers rebating the most in PFOF, even when it knew doing so routinely caused its own customers to get inferior prices. If Robinhood instead had an enforceable legal duty to get its customers the best reasonably available execution on all automated orders, it would have had to program a non-discriminatory order router that considered all reasonably available avenues for trade execution. That, in turn, would have improved its customers' execution quality dramatically according to Robinhood's own internal analysis (as detailed in the SEC's recent enforcement action).

    - This demonstrates all too clearly and embarrassingly that Robinhood was designing its order routing practices to enrich itself and its executing dealers—like Citadel Execution Services, a primary source of revenue—not its customers.

- Retail broker-dealers and executing HFT dealers have perverse incentives to capture as much of the spread in a trade as possible and therefore to fill orders as close to the edges of the NBBO spread as possible. In other words, retail broker-dealers and executing dealers have incentives to provide as little of the claimed benefits of PFOF and internalization to investors and to keep as much of the benefits for themselves as possible.

- This is not just theory. This reality is perhaps best evidenced by the SEC's recent enforcement case against Robinhood's most used executing dealer, Citadel Execution Services, which, among other things, programmed an algorithm, called "FastFill," to route orders to be filled at the outermost acceptable price in the markets—the NBBO—when a better price inside of the NBBO was readily available at the time of execution.

Interestingly, Citadel Securities—now perhaps the single largest PFOF rebate generator—once correctly identified multiple problems with PFOF and urged the SEC to prohibit PFOF. It seems that Citadel Securities has since adopted a "can't beat 'em, join 'em" philosophy, likely motivated by the SEC's multi-decade failure to address uncurable conflicts of interests and protect investors by prohibiting PFOF.

Let's hope the SEC will take a fresh look at the PFOF issues under its new leadership. The incentives are clear—unless there are far more meaningful restrictions and prohibitions on broker-dealers that prioritize their bottom line over their customers' best interests, investors cumulatively will continue to lose billions of dollars a year from inferior execution. That total, one penny at a time, almost certainly exceeds the savings for many investors derived from commission-"free" trading and investing. Put differently, "commission-free trading" is not the same thing as "free trading." The PFOF practices behind "commission-free trading" decidedly disadvantage and harm investors and markets far in excess of any benefit, which should be clear from all the money retail broker dealers and HFT firms are making from retail order flow.

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