

I thank you for this opportunity to offer comments and suggestions regarding the Proposed Rule under file no. S7-32-22: Regulation Best Execution.

I strongly support the Commission's proposed Rule 1101(b) to incorporate and set forth the definition of "payment for order flow" ("PFOF") under the existing Rule 10b-10(d)(8) definition from the Exchange Act for purposes of proposed Regulation Best Execution, as it would include any payments from a wholesaler to a retail broker-dealer in return for order flow, and any exchange rebates paid to a broker-dealer in return for sending orders to the exchange.

I commend the Commission for its comprehensive analyses of the Consolidated Audit Trail ("CAT") data provided. However, the results are incredibly concerning.

According to the Commission's analysis, more than 90% of marketable orders from individual investors were routed to wholesalers by retail broker-dealers.<sup>1</sup> This order routing practice has become pervasive even for non-PFOF retail brokers in the NMS stock market.<sup>2</sup> Furthermore, the data indicates that wholesalers internalize the overwhelming majority of orders they receive.<sup>3</sup> Notwithstanding the price improvements that wholesalers were able to achieve for 46% of the shares that they internalized, as shown in Table 7 of the Proposal, it is usually the case that the prices at which individual investors' shares are executed by wholesalers are worse than the National Best Bid and Offer ("NBBO") midpoint.<sup>4</sup> This exemplifies that the duty of best execution for retail broker-dealers was often not fulfilled due to order routing inducements. Bearing in mind that wholesalers dominate the market

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- 1 In the NMS stock market, for example, broker-dealers that primarily service the accounts of individual investors ("retail broker-dealers") route more than 90% of their customers' marketable orders to a small group of off-exchange dealers, known as wholesalers. See Securities Exchange Act Release No. [96496](#) (Dec. 14, 2022) ("Regulation Best Execution Proposing Release").
  - 2 However, regardless of whether the retail broker accepts PFOF, the order type, or the S&P500 index inclusion of the stock, Table 3 shows that retail brokers route over 87% of their customer orders to wholesalers. See id.
  - 3 Wholesalers execute the vast majority of orders that they receive against their own capital, i.e., they internalize the vast majority of orders they receive. See id. Commission analysis shows that wholesalers internalize over 90% of the executed dollar value in NMS stocks from the marketable order flow routed to them by retail brokers, which amounts to more than 80% of share volume. See id.
  - 4 The results indicate that, on average, 51% of the shares internalized by wholesalers are executed at prices less favorable than the NBBO midpoint (Wholesaler Pct Exec Shares Worse Than Midpoint). Out of these individual investors shares that were executed at prices less favorable than the midpoint, on average, 75% of these shares could have hypothetically executed at a better price against the non-displayed liquidity resting at the NBBO midpoint on exchanges and NMS Stock ATs. See id. The total amount of additional price improvement that all of these individual investor orders would have received was about 51% of the total dollar price improvement provided by wholesalers to all of the individual investor marketable orders that they internalized [...]. See id.

access services for retail brokers, including both PFOF and non-PFOF brokers<sup>5</sup>, notably for marketable orders, incentives and inducements have overshadowed retail customers' interests. The interests of retail brokers have taken precedence at the expense of order exposure opportunities to different types of venues such as lit exchanges, price improvements opportunities, order execution quality, and competitive markets.

“The Commission believes [...] that a broker-dealer must not allow a payment or an inducement for order flow to interfere with its efforts to obtain best execution.”<sup>6</sup>

“The Commission believes that the possibility for price improvement, while not the exclusive factor, bears on the question of whether a broker-dealer is fulfilling its duty to seek best execution, especially when payment is received by the broker-dealer in return for guaranteeing order flow.”<sup>7</sup>

FINRA stated that “firms that provide payment for order flow for the opportunity to internalize customer orders cannot allow such payments to interfere with their best execution obligations.”<sup>8</sup>

“In connection with the Adopting Release, six commenters indicated that the internalization of order flow by broker-dealers presents issues similar to those commonly associated with payment for order flow [...] the opportunity to capture the spread through internalized/affiliate practices encourages broker-dealers to execute orders in house or to send orders to an affiliated broker-dealer or exchange specialist. [...] under each practice the broker-dealer is influenced with respect to where it will route customer orders.”<sup>9</sup>

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5 Table 3 confirms that wholesalers dominate the business of providing market access for retail brokers and that PFOF is a factor in retail broker routing decisions. See id. Data from Table 4 indicates that, while retail brokers who accept PFOF from wholesalers tend to send more of their orders to those wholesalers, wholesalers even dominate the market access services for non-PFOF brokers, though non-PFOF brokers route a significantly lower fraction (i.e., 75.2% to 76%) of their market orders to wholesalers, compared to 99.7% to 99.8% of market orders for PFOF brokers. See id.

6 See Securities Exchange Act Release No. [34902](#) (Oct. 27, 1994), [59 FR 55009](#) (Nov. 2, 1994) (“Payment for Order Flow Release”).

7 See id. at 55009.

8 See Regulatory Notice 21-23, Best Execution and Payment for Order Flow (June 23, 2021) (“FINRA Regulatory Notice 21-23”), available at <https://www.finra.org/sites/default/files/2021-06/Regulatory-Notice-21-23.pdf>.

9 See Internalized/Affiliate Practices, Payment for Order Flow and Order Routing Practices, Securities Exchange Act Release No. 34903 (Oct. 27, 1994), [59 FR 55014](#) (Nov. 2, 1994).

It is evident that these conflicted transactions have adversely impacted the order execution quality of individual investors, particularly in terms of price improvement.<sup>10</sup> Therefore, I believe it is appropriate to incorporate the relevant conflicts of interest of broker-dealers identified by the Commission in the proposed Rule 1101(b).

While the Proposal is certainly a step in the right direction to reduce conflicted transactions and help mitigate the potential for incentives and inducements to interfere with broker-dealers' best execution obligations, it's important to note that heightened standards for conflicted transactions would not be enough to completely eliminate PFOF.<sup>11</sup> Thus, I firmly believe that further improvements should be made, which will be addressed subsequently.

## **I. Proposed Rules 1101(b)(1) and (2)**

In the pursuit of alleviating potential conflicts of interest that may arise for broker-dealers when engaging in conflicted transactions, the proposed Rules 1101(b)(1) and (2) serve to pave the way for improving best execution determinations and promoting transparency. By mandating that broker-dealers establish more rigorous policies and procedures that account for various factors pertaining to conflicted transactions, such as the need to obtain and assess additional information beyond what is required for non-conflicted transactions as stipulated under proposed Rule 1101(a)(1)(i), as well as to evaluate a broader range of markets to identify the most favorable prices for customer orders, this represents an appropriate approach in my view.

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<sup>10</sup> In or around May 2016, Robinhood began negotiations with a number of principal trading firms about potentially routing Robinhood customer orders to those entities. See In the Matter of Robinhood Financial, LLC, Securities Exchange Act Release No. 90694 (Dec. 17, 2020) (settled action) (“Robinhood SEC”), the Commission’s Order: Release No. [10906](#). At least one principal trading firm communicated to Robinhood that large retail broker-dealers that receive payment for order flow typically receive four times as much price improvement for customers than they do payment for order flow for themselves—an 80/20 split of the value between price improvement and payment for order flow. See id. Robinhood negotiated a payment for order flow rate that was substantially higher than the rate the principal trading firms paid to other retail broker-dealers—which resulted in approximately a 20/80 split of the value between price improvement and payment for order flow. 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. See id.

<sup>11</sup> Proposed Rule 1101(b) is not designed to eliminate order handling conflicts of interest, and does not ban conflicted transactions. See Regulation Best Execution Proposing Release, supra note 1. In the case of larger broker-dealers that derive significant revenue from PFOF, the Commission preliminarily believes that they will continue to do so and incur the additional compliance costs discussed previously in Table 23. See id.

In light of the potential adoption of the Order Competition Rule (“OCR”) Proposal<sup>12</sup>, which introduces qualified auctions, I wholeheartedly support the specific requirements outlined in proposed Rules 1101(b)(1) and (2) regarding broker-dealer policies and procedures. It is imperative for broker-dealers to conduct thorough evaluations across a broader range of markets in order to competently ascertain the best market for the subject security and acquire the most favorable prices possible for customer orders under prevailing market conditions, regardless of whether they are conflicted or non-conflicted transactions. Exposing orders to a broader array of liquidity sources would not only benefit retail customers but also promote market competition on an order-by-order basis. These requirements complement the OCR Proposal and establish heightened standards for broker-dealers, ensuring that they have robust policies and procedures in place to effectively fulfill their best execution obligations, all while taking into account the contextual circumstances of their customer orders.

## **II. Proposed Rule 1101(b)(3)**

### **A. Documentation for Conflicted Transactions**

The proposed documentation requirement would aid broker-dealers in adhering to the proposed Regulation Best Execution, while also facilitating regulators' oversight of broker-dealers' compliance. By mandating that broker-dealers document all endeavors taken to enforce their policies and procedures for conflicted transactions, as well as the rationale and information relied upon for their determination that such transactions adhere to the best execution standard, proposed Rule 1101(b)(3) will furnish critical information that may further enable broker-dealers to evaluate the effectiveness of their best execution policies and procedures, including their order handling practices.

Moreover, by requiring that the documentation be performed pursuant to written procedures, the proposed Rule would ensure that any broker-dealer that engages in conflicted transactions documents its compliance with the best execution standard in a consistent and rigorous manner. Additionally, it would facilitate regulators' access to comprehensive and effective details about broker-dealers' payment for order flow arrangements. This would provide additional context concerning broker-dealers' operations, business models, and order handling and execution practices, thereby assisting the Commission in the oversight of broker-dealers' compliance.

I believe that broker-dealers should be required to comprehensively document any payment for order flow arrangement, irrespective of whether it is in oral or written form, and unreservedly endorse the prescribed stipulations proffered in proposed Rule 1101(b)(3). Furthermore, the documentation requirements should be expanded beyond the proposed guidelines to encompass additional aspects of the payment for order flow arrangements, such as the nature and scope of any services rendered by the

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<sup>12</sup> See Securities Exchange Act Release No. [96495](#) (Dec. 14, 2022) (“Order Competition Rule Proposing Release”).

broker-dealer in connection with the agreement, any conflicts of interest that may arise from the arrangement, and the arrangement's impact on the execution quality and pricing of customer orders.

By mandating broker-dealers to provide such extensive documentation, the Commission will attain a more thorough understanding of broker-dealers' payment for order flow arrangements, leading to more effective oversight of broker-dealers' compliance. This approach will promote transparency in business practices and provide a more accurate depiction of broker-dealers' operations.

## **B. Require Order-by-Order Documentation for Conflicted or All Transactions**

The Commission should require broker-dealers to document on an order-by-order basis, at the very least for conflicted transactions, the data that they considered for order handling. Ideally, all broker-dealers should be required to document all transactions on an order-by-order basis.

My wholehearted agreement is with the Commission's preliminary assessment that “this is likely to reduce the share of retail customer order flow that is internalized because some broker-dealers that currently receive PFOF are likely to stop receiving it to become deconflicted, and some broker-dealers that pay PFOF will internalize fewer of the orders they receive to comply with the proposal”.<sup>13</sup>

Additionally, it is expected that “under the proposal, retail broker-dealers are likely to reduce their use of PFOF agreements for both NMS stocks and listed options because engaging in such agreements would cause the broker dealer to incur heightened best execution obligations under the proposal and satisfying those obligations may cause broker-dealers to incur costs in excess of their PFOF revenue”.<sup>14</sup>

Taking into account that “smaller broker-dealers in particular may consider curtailing this practice to avoid incurring the additional compliance costs”<sup>15</sup>, it would be reasonable to mandate that broker-dealers engaged in conflicted transactions produce order-by-order documentation, as this requirement would have a relatively insignificant impact on smaller broker-dealers. As the Proposal itself would already serve to mitigate the prevalence of conflicted transactions through compliance costs, any additional documentation requirements would simply act as an additional disincentive that would further encourage smaller broker-dealers to reduce or eliminate their reliance on PFOF as a revenue source. Consequently, this may prompt a transformation in their business model.

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<sup>13</sup> See Regulation Best Execution Proposing Release, supra note 1 at 345.

<sup>14</sup> See id. at 344-345.

<sup>15</sup> See id. at 345.

Although the Commission has expressed apprehension over the prospective costs associated with the requirement, it is worth noting that the largest broker-dealers are unlikely to be significantly affected, as they are “likely to continue to engage in conflicted transactions if the proposed rules are adopted, already maintain this type of documentation for both internal review and operational purposes”.<sup>16</sup> In addition, these broker-dealers will likely incur the additional compliance costs since PFOF represents a substantial revenue stream for them.<sup>17</sup>

As posited by the Commission, mandating order-by-order documentation for broker-dealers engaging in conflicted transactions would yield several benefits. Firstly, it would enhance regulators' capacity to supervise the broker-dealer's endeavors to provide best execution to its customers, as such records would be at regulators' disposal during examinations of the broker-dealer or upon request. Secondly, this requirement would serve to achieve the goal of mitigating the potential for incentives and inducements associated with conflicted transactions to adversely impact broker-dealers' best execution determinations. Furthermore, “any resulting reduction in conflicted transactions could improve the prices retail customers realize for their transactions”.<sup>18</sup> I also share the Commission's belief that this requirement would primarily benefit investors serviced by larger broker-dealers, as expressed: “[...] while the aggregate benefits to investors of such a requirement for smaller broker-dealers is likely to be smaller than for larger broker-dealers that handle more customer orders.”<sup>19</sup>

Considering the aforementioned reasons, coupled with FINRA's stance on the matter<sup>20</sup>, I firmly advocate for the Commission to require order-by-order documentation for broker-dealers engaged in conflicted transactions, as a minimum requirement.

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16 See id. at 369.

17 See supra note 11.

18 See Regulation Best Execution Proposing Release, supra note 1 at 311.

19 See id. at 370.

20 Under FINRA Rule 5310.09, a broker-dealer must have procedures in place to ensure it periodically conducts regular and rigorous reviews of the quality of the executions of its customers' orders if it does not conduct an order-by-order review. FINRA has stated in a regulatory notice that broker-dealers must conduct order-by-order best execution reviews rather than relying on regular and rigorous reviews in certain circumstances. In particular, FINRA has stated that a “regular and rigorous review alone (as opposed to an order-by-order review) may not satisfy best execution requirements, given that the execution of larger-size orders ‘often requires more judgment in terms of market timing and capital commitment.’” FINRA has also stated that “[o]rders that a firm determines to execute internally are subject to an order-by-order best execution analysis.” Finally, FINRA has recognized that advances in order routing technology make order-by-order reviews of execution quality for a range of orders in all equity and standardized options increasingly possible. See id. at 135. See also Regulatory Notice 15-46, Best Execution (Nov. 2015) (“FINRA Regulatory Notice 15-46”), at 3-4, available at [https://www.finra.org/sites/default/files/notice\\_doc\\_file\\_ref/Notice\\_Regulatory\\_15-46.pdf](https://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_15-46.pdf).

### **III. Proposed Rule 1101(c)**

For broker-dealers who currently rely on their executing brokers to conduct execution quality reviews and would otherwise not qualify as introducing brokers under the proposed definition in proposed Rule 1101(d), I believe that proposed Rule 1101(c) should be applicable. Although some of these broker-dealers may lack the necessary resources and expertise to conduct regular execution quality reviews independently, the Commission has stated that, among execution brokers, “some use third party transaction cost analysis (“TCA”) services exclusively while others supplement and verify their own analysis with third party TCA statistics”.<sup>21</sup> Therefore, it would be reasonable for these broker-dealers to adopt a similar approach by providing information on their orders to third party TCA services to produce independent order execution quality statistics for their execution quality evaluation or incorporate third-party analysis in their execution quality reviews.

### **IV. Proposed Rule 1101(d)**

#### **A. Proposed Exemptions for Introducing Brokers**

It is particularly disconcerting when broker-dealers merely recite regulatory requirements in their purportedly “regular and rigorous” reviews, and provide inaccurate written supervisory procedures proclaiming dependence on the broker-dealers to whom they routed orders to conduct such reviews.<sup>22</sup> While the Commission proffered an exemption for introducing brokers from certain provisions of proposed Rule 1101, such as (a), (b), and (c), it is still worrisome that without regular external oversight from unaffiliated third parties, compliance with regulatory policies, procedures, and execution quality pursuant to Regulation Best Execution may not be satisfactorily met.

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<sup>21</sup> See Regulation Best Execution Proposing Release, *supra* note 1.

<sup>22</sup> Robinhood’s written supervisory procedures concerning best execution and its “regular and rigorous” reviews merely recited the regulatory requirements. They provided no description of the Firm’s supervisory system or guidance as to how the Firm should supervise to achieve compliance with those requirements. The written supervisory procedures also were inaccurate in that they indicated that Robinhood relied on the “regular and rigorous” reviews that were being conducted by the broker-dealers to which the Firm routed orders, when, in fact, the Firm had discontinued this practice prior to the Review Period. See *Robinhood Financial, LLC*, Letter of Acceptance, Waiver and Consent (FINRA Case No. [2017056224001](#)) (Dec. 2019) (“Robinhood FINRA”).

## B. Introducing Brokers and Executing Brokers

I strongly support the adoption of Proposed Rule 1101(d), which would prohibit any affiliation between an introducing broker and broker-dealer, as well as PFOF between an introducing broker and its executing broker for the introducing broker to meet the proposed definition. The importance of an introducing broker's fiduciary duty cannot be overstated, as it requires the broker to obtain the best possible execution for its customers' orders. In order to achieve this goal, the introducing broker must conduct regular evaluations of executing brokers' order execution quality and make unprejudiced determinations. However, any agreement with an affiliated broker-dealer could unduly influence the introducing broker's order routing decisions<sup>23</sup>, thereby compromising its duty to seek the best execution for its customers. Additionally, order routing inducements can create conflicts of interest that may interfere with the broker's best execution order routing determinations<sup>24</sup>, underscoring the necessity of the proposed prohibitions and requirements.

## V. Conflicts of Interest and Best Execution Committees

I maintain the belief that the Proposal would effectively promote robust order handling practices by mandating the establishment of a comprehensive framework by each broker-dealer to achieve best execution, and would improve best market determinations, routing, and execution decisions. Nevertheless, the current rigor of broker-dealers' reviews of execution quality remains inconsistent<sup>25</sup> and may continue to be so in the future, due to the potential existence of conflicts of interest within best execution committees ("BEC").<sup>26</sup> As the current regulatory framework permits BEC to evaluate their execution quality, in addition to developing their best execution policies and procedures<sup>27</sup>, these firms and appointed BEC may jointly fail to fulfill their duty of best execution appropriately.<sup>28</sup>

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23 See *supra* note 9 and accompanying text.

24 See *supra* note 5.

25 See 2022 Report on FINRA's Examination and Risk Monitoring Program (Feb. 2022), available at <https://www.finra.org/sites/default/files/2022-02/2022-report-finras-examination-risk-monitoring-program.pdf#page=45> (describing FINRA exam findings relating to execution quality reviews).

26 See *infra* note 29.

27 Some broker-dealers use best execution committees (BECs) to evaluate their execution quality and establish their best execution policies and procedures. See Regulation Best Execution Proposing Release, *supra* note 1. BEC members may consist of senior trading representatives along with members of the broker-dealer's compliance, legal, and operational risk departments. See *id.*

28 The firm's Best Execution Committee (the "BEC") was responsible for reviewing the execution quality received by the firm. The BEC reviewed, among other things, the execution quality measurements of the market centers to which it routed orders and compared its execution quality with certain industry and custom averages. In addition, the BEC included a compliance



## VI. Proposed Rule 1102 – Annual Report and Unaffiliated Third Parties Audits

To effectively mitigate or eliminate conflicts of interest in the annual review of broker-dealers' policies and procedures under proposed Rule 1102, I strongly recommend that the Commission require broker-dealers to have their policies and procedures periodically audited by an unaffiliated third party to assess their design and effectiveness. It is not advisable to allow any personnel, group, or individual affiliated with a broker-dealer responsible for designing or implementing the policies and procedures to conduct the annual reviews as this may result in an inadequate enforcement of their best execution policies and procedures.

I highly recommend introducing a rule that prescribes the requisite experience and expertise for these unaffiliated third parties. Implementing mandatory minimum requirements for this service will ensure that qualification standards are established, bring sufficient consistency to all broker-dealers' auditing

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representative that was dually registered with the firm and its affiliated market maker GI Execution Services ("GLX"). During the Review Period, the BEC lacked sufficient accurate information to reasonably assess the execution quality it provided its customers. Specifically, the BEC: (i) did not take into account the internalization model employed by the firm; (ii) relied on execution-quality statistics based on flawed data in assessing the execution quality of the market centers to which it routed its customers' orders; and (iii) was overly reliant on comparisons of the firm's overall execution quality with industry and custom averages, rather than focusing on comparisons to the actual execution quality provided by the market centers to which the firm routed orders. As a result, the firm failed to conduct adequate regular and rigorous reviews of execution quality. See E\*Trade Securities LLC, Letter of Acceptance, Waiver and Consent (FINRA Case No. [20130368815-01](#)) (June 2016). TradeStation conducted quarterly reviews of execution quality through its Best Execution Committee (BEC). In July 2016, the Firm's Product Management Team (PMT), whose members were also part of the BEC, also began meeting monthly to review execution quality and to modify routing practices. As described below, the Firm failed to meet the reasonable diligence standard required by FINRA's best execution rule for both its customers' equity and option order flow. See also TradeStation Securities, Inc., Letter of Acceptance, Waiver and Consent (FINRA Case No. [2014041812501](#)) (March 2021). During the relevant period, execution quality reports reviewed by the firm's best execution committee showed that fill rates in SuperX for orders routed by the SOR ranged from approximately 12 percent to 32 percent. The same reports showed that orders routed to exchanges, by contrast, had fill rates above 90 percent. In addition, in approximately March 2016, the firm's best execution committee received a memorandum indicating orders subject to the SuperX ping had lower fill rates compared to orders that were not subject to the SuperX ping due to potential latency. Despite this information, DBSI did not modify its routing arrangements. DBSI also failed to reasonably consider how price improvement on orders subject to the SuperX ping compared to price improvement opportunities for orders routed directly to exchanges, as required under Rule 5310.09(b). Although DBSI reviewed price improvement, the firm's reviews did not differentiate between orders subject to the SuperX ping and orders routed directly to exchanges. Thus, the firm could not determine whether the SuperX ping adversely affected price improvement due to information leakage or delays associated with pinging the ATS first. See also Deutsche Bank Securities Inc., Letter of Acceptance, Waiver and Consent (FINRA Case No. [2014041813501](#)) (March 2022).

processes, provide independent oversight of broker-dealers' compliance, and uphold values of fairness, transparency, and integrity.

Furthermore, as part of the annual review, I suggest that the Commission not only require an overall review of the policies and procedures as proposed but also any documentation produced regarding conflicted transactions pursuant to proposed Rule 1101(b)(1) and (2). This documentation will provide valuable insight into the reasoning behind the creation or revision of the policies and procedures and the manner in which they will address the specified requirements. For an unaffiliated third party conducting an audit, this may reveal whether broker-dealers took the appropriate actions in producing their current or revised best execution policies and procedures.

In order to uphold the highest standard of integrity and accountability, it is essential that broker-dealers are not granted the ability to perform their own annual holistic review of best execution policies, procedures, and execution quality without external scrutiny. This is particularly apparent in a prominent case where one of the largest brokerage firms of 2021 undertook an internal best execution review using its BEC. Despite being aware of a significant discrepancy in execution quality and price improvement metrics compared to other retail broker-dealers, the firm failed to address the issue, leading to a breach of its best execution duty.<sup>29</sup> This lapse could be attributed to the firm's incompetence or carelessness in achieving compliance, notwithstanding its awareness of the findings of its internal analysis. Alternatively, potential conflicts of interest stemming from the firm's affiliation with the BEC

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<sup>29</sup> In September 2016, Robinhood began routing customer orders directly and solely to principal trading firms. Around the same time, Robinhood formed a "Best Execution Committee" to monitor the speed and the prices at which the principal trading firms were executing Robinhood customer orders. The Committee met at least once per month and included Robinhood's General Counsel. From October 2016 through at least June 2019, the Committee observed that Robinhood was not obtaining much price improvement on its customer orders in equity securities, particularly on orders of 100 shares or more. See Robinhood SEC, supra note 10. Although Robinhood was on notice that its high payment for order flow rates could lead to less price improvement, the Best Execution Committee did not conduct adequate regular and rigorous reviews to ensure that Robinhood was satisfying its best execution obligations. The Committee took no steps to determine whether Robinhood's payment for order flow rates were having a negative impact on the execution prices that Robinhood's customers received. Until October 2018, the Committee did not consider how Robinhood's price improvement statistics compared to those of other retail broker-dealers, or to the retail order execution market generally. See id. By March 2019, Robinhood had conducted a more extensive internal analysis, which showed that its execution quality and price improvement metrics were substantially worse than other retail broker-dealers in many respects, including the percentage of orders that received price improvement and the amount of price improvement, measured on a per order, per share, and per dollar traded basis. Senior Robinhood personnel were aware of this analysis. See id. However, Robinhood's Best Execution Committee did not take appropriate steps to assess whether, in light of this information, Robinhood was complying with its duty to seek best execution of customer orders. Robinhood's failure from October 2016 through June 2019 to conduct adequate regular and rigorous reviews that involved benchmarking its execution quality against competitor broker-dealers to determine whether it was obtaining the best terms reasonably available for customer orders, violated the firm's duty of best execution. See id.

may have influenced their decision to overlook its findings. Given this, it is imperative that the Commission mandate broker-dealers to prepare a written report detailing the results of its review, which should include a plan to rectify any identified shortcomings, as proposed.

This case and the aforementioned concern<sup>30</sup> serves as a poignant reminder of the crucial role that impartial oversight and audits play in protecting individual investors from the covert risks and consequences that can befall when broker-dealers are permitted to engage in self-review without proper independent supervision. The stakes are exceptionally high, as broker-dealers may find themselves under investigation years later, having potentially derived profit from private negotiations involving price improvement and order routing inducements designed to exploit unsuspecting customers. Hence, it is undoubtedly appropriate and vital to have unprejudiced audits conducted by eligible, unaffiliated third parties to ensure a robust compliance process pursuant to proposed Regulation Best Execution.

## **VII. Ban Payment for Order Flow**

Routing inducements, such as payment for order flow, have brought conflicts of interest to the forefront of the U.S. securities market. Many countries have recognized the issues surrounding PFOF and have concluded that a ban is the appropriate course of action.

In this Proposal, the Commission acknowledged the inherent conflicts of interest that arise with broker-dealers' order handling, which can significantly hinder their ability to make best execution determinations and negatively impact the execution quality for their customers' orders.

PFOF has been known to have a pernicious effect on routing decisions, as it provides financial incentives that are to the detriment of individual investors, reduces order exposure opportunities, and concentrates order flow among a small group of off-exchange dealers, namely wholesalers, who internalize the vast majority of received orders.

Although the Commission has proposed to prohibit PFOF between introducing brokers and executing brokers, and any affiliation between introducing brokers and broker-dealers, with good reason<sup>31</sup>, and has proposed additional requirements that would heighten the best execution standard and thereby mitigate the degree of conflicted transactions, it is likely that such transactions will continue to persist among the largest broker-dealers. Therefore, I strongly urge the Commission to take a further step and

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<sup>30</sup> See supra Section IV.A.

<sup>31</sup> The introducing broker should not be permitted to be subject to a conflict of interest by selecting an affiliated executing broker. Such conflict of interest could impede the introducing broker's efforts to achieve best execution by providing the introducing broker an incentive to act in manner that benefits its own or its affiliate's interests. See Regulation Best Execution Proposing Release, supra note 1 at 147.

join other countries by completely banning PFOF to ensure unbiased and transparent practices in the securities market.

## **A. Singapore**

In a recent regulatory move, Singapore has taken the decision to ban PFOF, which will come into effect on April 1st, 2023.

“PFOF introduces conflicts of interests and is likely to cause harm to customers as the CMS Broker may be incentivized to pursue commission or other form of payment from another broker or counterparty in return for routing customers’ orders to that broker or counterparty for its own benefit. This is inconsistent with the CMS Broker’s duty to provide Best Execution to customers. For instance, PFOF may lead to poorer outcomes for customers as additional costs may be passed to the CMS Broker’s customers, such as through wider bid-ask spreads from the other broker or counterparty who agrees to pay PFOF in return for obtaining customers’ order flow from the CMS Broker.”<sup>32</sup>

## **B. Canada**

PFOF is prohibited for securities trading on marketplaces in Canada that are subject to Universal Market Integrity Rules (UMIR) through UMIR 7.5 - Recorded Prices requirement.

“UMIR 7.5 has the effect of prohibiting payment for order flow by a Dealer Member that is a Participant under UMIR. Like the payment of rebates by marketplaces, the payment for order flow by intermediaries can distort behaviour and trading incentives. Similar conflicts also arise for Dealer Members when receiving payment for order flow directed to an intermediary.”<sup>33</sup>

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32 See Monetary Authority of Singapore (MAS), SECURITIES AND FUTURES ACT (CAP. 289), (Nov. 4, 2022), available at <https://www.mas.gov.sg/regulation/guidelines/guidelines-to-notice-sfa04-n16>.

33 See Investment Industry Regulatory Organization of Canada (IIROC), Guidance on Best Execution (July 6, 2017), available at <https://www.iroc.ca/news-and-publications/notices-and-guidance/guidance-best-execution>.

## C. United Kingdom

The Financial Services Authority's updated guidance banning PFOF arrangements in May 2012.

“PFOF creates a conflict of interest between the broker and its client, as the broker has an incentive to direct order flow to market makers offering PFOF arrangements over the interests of its clients. Where brokers are routing orders to only those market makers willing to pay for order flow, then the duty of brokers to act in the best interests of clients may be compromised. The client also faces another potential detriment because market makers engaging in PFOF may recover these payments by incorporating them into the spreads they offer.”<sup>34</sup>

“An argument might be made that restricting order flow through a particular market maker brings benefits in the form of economies of scale. Since the market maker receives a guaranteed flow of orders [...] If there are economies of scale advantages to be derived from increased order flow, then these could be just as easily achieved by offering the best price, all other things being equal, rather than by paying brokers for order flow. A market maker should not need to make payments to guarantee flow in order to grow scale. If this argument about scale were valid, then the largest market makers which already enjoy a scale advantage would be able to offer narrower spreads and so attract more business and squeeze out smaller competitors without the need to pay for order flow. But this is not observed in practice.”<sup>35</sup>

“[...] the receipt of the payment may encourage the broker to get the highest payment from a market maker rather than the best outcome for its client”.<sup>36</sup>

A recent case precisely depicted an instance wherein a broker-dealer has, in a blatant disregard for their fiduciary obligations, opted to prioritize their own self-interest above that of their customers, culminating in detrimental ramifications for the latter.<sup>37</sup>

“The risk of PFOF is that it undermines the transparency and efficiency of the price formation process, which in turn damages market integrity, inhibits competition and causes detriment to consumers.”<sup>38</sup>

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34 See Financial Services Authority (FSA), Guidance on the practice of ‘Payment for Order Flow’ (May 2012), available at <https://www.fca.org.uk/publication/finalised-guidance/fg12-13.pdf>.

35 See *id.*

36 See *id.*

37 See *supra* note 10 and accompanying text.

38 See Financial Conduct Authority (FCA), Best execution and payment for order flow (July 2014), available at <https://www.fca.org.uk/publication/thematic-reviews/tr14-13.pdf>.

“These payments create a conflict of interest between the firm and its clients. This is because they incentivise the firm to execute its clients’ orders with counterparties based on their willingness to pay commissions. A broker can make a financial gain at the expense of its clients and have an interest in a transaction that is contrary to its clients’ interests, which risks inferior execution outcomes and other potential consumer harms [...] They can also distort competition by forcing liquidity providers to use a ‘pay-to-play’ model. Brokers may concentrate order flow to specific liquidity providers, while avoiding others, which may lead to poorer outcomes for clients and reduce market integrity.”<sup>39</sup>

This is conspicuously evident when considering that wholesalers hold a predominant position in providing market access services to retail brokers, particularly with regard to marketable orders.<sup>40</sup>

In a 2016 study, the CFA Institute conveyed the following statements.

“Because the PFOF/internalisation paradigm does result in some price improvement, the conflicts of interest inherent in PFOF arrangements do not (and should not) typically manifest in execution prices that are “worse” than retail investors could get elsewhere. Instead, conflicts of interest arise from the nontransparent way in which these arrangements are made and the question of whether brokers pass on the full value received for selling their clients’ order flow.”<sup>41</sup>

“Finally, it is interesting to note that the move in the United Kingdom toward execution at the best price has been at the expense of trades executing with price improvement (or at the midpoint). We argue that this is a positive change for market integrity overall because it implies that displayed liquidity providers are being rewarded with executions at the price they quote, something that may not be happening in markets with PFOF where internalisers are able to step ahead of the quoted price on the order book. This reward mechanism upholds market integrity because it supports the incentive to post displayed limit orders, on which price discovery is based.”<sup>42</sup>

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39 See Financial Conduct Authority (FCA), Payment for Order Flow (PFOF) (April 2019), available at <https://www.fca.org.uk/publication/multi-firm-reviews/payment-for-order-flow-pfof.pdf>.

40 See *supra* note 5.

41 See Sviatoslav Rosov, Payment for Order Flow in the United Kingdom: Internalisation, Retail Trading, Trade-Through Protection, and Implications for Market Structure, CFA Institute (2016), available at <https://www.cfainstitute.org/en/advocacy/policy-positions/payment-for-order-flow-in-the-united-kingdom>.

42 See *id.*

## D. Australia

In Australia, it is impermissible for a market participant to offer monetary compensation to another individual in exchange for their orders if such payment would result in a 'negative commission'.

“Retail order flow is viewed as less informed than institutional order flow. It has lower adverse selection risk and is likely to be more profitable for a wholesale market intermediary to trade against. It also gives the purchaser a preview of order flow data before sending it to market. This can give them an informational advantage.”<sup>43</sup>

“Payment for order flow arrangements create conflicts of interest because they can result in the payment recipient directing a client order to the market intermediary that provides the best incentive rather than the best execution outcome for their client. The client may receive a worse overall outcome as they typically do not receive the payment for order flow and the execution price does not capture sufficient price improvement.”<sup>44</sup>

“A study in the United States showed that narrower spreads could be obtained if more retail order flow was transacted on exchange markets rather than being diverted to off-market execution. It estimated that NBBO spreads in the US equity market would decrease by 25% if retail marketable orders were submitted to exchanges rather than internalised.”<sup>45</sup>

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43 See Australian Securities & Investments Commission (ASIC), Consultation Paper 347: Proposed amendments to the prohibition on order incentives in the ASIC market integrity rules (August 2021), available at <https://asic.gov.au/about-asic/news-centre/find-a-media-release/2021-releases/21-224mr-asic-consults-on-payment-for-order-flow-rule-amendments/>.

44 See *id.*

45 See *id.* See also H. Mittal & K. Berkow, The good, the bad and the ugly of payment for order flow, BestEx Research (May 3, 2021), available at <https://f.hubspotusercontent10.net/hubfs/4982966/BestEx%20Research%20PFOF%2020210503.pdf?hsmi=140073413>.

## E. Citadel

“The practice of payment for order flow creates serious conflicts of interest and should be banned.”<sup>46</sup>

“Because payment for order flow creates fundamental conflicts of interest that cannot be cured by disclosure, the Commission should ban payment for order flow altogether. It is crucial that this ban include not only exchange-sponsored programs, but also payment for order flow arrangements entered into privately between order flow providers and market centers.”<sup>47</sup>

## F. Amex

“The Amex stated that internalization impedes price discovery and makes best execution less likely, and because internalized order flow provides the executing market maker with a dealer spread on every internalized trade, there is little incentive for the dealer to narrow the quoted spread.”<sup>48</sup>

## G. State Street

“[...] the failure to regulate internalization creates a competitive advantage for large integrated firms.”<sup>49</sup>

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46 See Citadel Investment Group, L.L.C., Comments on Concept Release: Competitive Developments in the Options Markets (April 13, 2004), Release No. 49175, available at <https://www.sec.gov/rules/concept/s70704.shtml>.

47 See id.

48 See Payment for Order Flow Release, supra note 6, 59 FR at 55016 (Nov. 2, 1994).

49 See id. at 55016.



In its commitment to promoting transparency and fairness in the financial markets, the Commission's initiative to institute an SEC best execution standard is a positive development that enhances the regulatory framework. As such, I am thoroughly pleased with this endeavor. Nevertheless, in anticipation of any underlying concerns, it is my fervent hope that the Final Rule effectively addresses these issues while giving due consideration to the recommendations previously deliberated.

Finally, I want to express my support for this Proposal.

Sincerely,

J. T.