

# DECEIVING THE YOUNG TO GIVE TO THEMSELVES: ELIMINATING PAYMENT FOR ORDER FLOW TO ENSURE LOYAL AGENTS

**Abstract:** When the popular retail brokerage firm Robinhood decided to restrict trades in certain securities in late January 2021, politicians, regulators, and the general public called for increased regulation on brokerage firms. The business model of online brokerage firms like Robinhood came under intense scrutiny. Specifically, regulators and politicians raised questions about Robinhood's zero-commission fee model predicated on payment for order flow. In a report, the Securities and Exchange Commission (SEC) raised questions about payment for order flow—the kick-back received by brokerage firms for a customer's order—and the conflicts of interest such payments pose for brokerage firms when carrying out their duty of best execution. As the SEC considers implementing new regulations on payment for order flow, including increased disclosure requirements and an outright ban, debate exists over the practicality of these regulatory changes. Brokerage firms like Robinhood argue that prohibiting payment for order flow altogether would stymie the democratization of American stock markets. In contrast, critics of the practice argue that the conflicts of interest that arise from payment for order flow necessitate enhanced regulation or an outright ban. This Note argues that banning payment for order flow is a necessary regulatory change for two principal reasons. First, a ban is necessary because it is impossible to eliminate the conflicts of interest that stem from the practice. Second, consent received by broker-dealers from retail investors to receive payment for order flow is inadequate under the common law of agency.

## INTRODUCTION

On January 28, 2021, the popular retail investment firm Robinhood, along with other online brokerage firms, made headlines when they froze trades in certain stocks on their platform, most notably stocks in the company GameStop.<sup>1</sup> Robinhood's decision to halt trades in "meme stocks" was a re-

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<sup>1</sup> Maggie Fitzgerald, *Robinhood Restricts Trading in GameStop, Other Names Involved in Frenzy*, CNBC, <https://www.cnbc.com/2021/01/28/robinhood-interactive-brokers-restrict-trading-in-gamestop-s.html> [<https://perma.cc/6ST4-2MBQ>] (Jan. 28, 2021); Kate Kelly, Matt Phillips & Gillian Friedman, *Trading Curbs Reverse GameStop Rally, Angering Upstart Traders*, N.Y. TIMES, <https://www.nytimes.com/2021/01/28/business/gamestop-robinhood.html> [<https://perma.cc/WWT9-9W8E>] (Jan. 30, 2021); Rob Davies, *GameStop Shares Plunge After Ban by Robinhood App*, THE GUARDIAN, (Jan. 28, 2021), <https://www.theguardian.com/business/2021/jan/28/gamestop-shares-robinhood-app-ban-blackberry-amc-nokia-reddit> [<https://perma.cc/L2S2-4KLH>]. Along with GameStop, Robinhood also froze trades in companies like AMC Entertainment, BlackBerry and Koss. Fitzgerald, *supra*.

sponse to extremely volatile equity markets in January 2021.<sup>2</sup> In particular, Robinhood's decision to stop trades in certain companies on its platform was a response to significant increases in meme stock trade frequency and rapid price movements of those stocks.<sup>3</sup>

Significant public outcry met Robinhood's decision to freeze trades in certain stocks.<sup>4</sup> Politicians on both sides of the political aisle decried the action and called for reforms to the American financial system.<sup>5</sup> The House of Representatives Financial Services Committee required Robinhood's Chief Executive Officer, Vlad Tenev, to publicly answer questions about his firm's decision to bar trading in certain stocks.<sup>6</sup> Moreover, retail investors prevented from

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<sup>2</sup> Adam Hayes, *What Are Meme Stocks, and Are They Real Investments?*, INVESTOPEDIA, <https://www.investopedia.com/meme-stock-5206762> [<https://perma.cc/MYS3-3HX4>] (Sept. 12, 2022); see *Keeping Customers Informed Through Market Volatility*, ROBINHOOD, <https://blog.robinhood.com/news/2021/1/28/keeping-customers-informed-through-market-volatility> [<https://perma.cc/R48T-K3K3>] (Jan. 28, 2021) (providing Robinhood's justification for freezing stock trades). The term "meme stock" refers to stocks whose value and trading frequencies fluctuate based on discussion platforms like Reddit and Twitter. Hayes, *supra*. In October 2021, the Securities and Exchange Commission (SEC) identified several companies whose securities it considered meme stocks, including GameStop, Dillard's, Koss Corp., AMC Entertainment, and Naked Brand Group. U.S. SEC. & EXCH. COMM'N, STAFF REPORT ON EQUITY AND OPTIONS MARKET STRUCTURE CONDITIONS IN EARLY 2021, at 21 (2021). The SEC noted that stock prices of meme stock companies rose drastically in January 2021. *Id.* at 2.

<sup>3</sup> See U.S. SEC. & EXCH. COMM'N, *supra* note 2, at 16 (noting that in January 2021 over one hundred stocks saw significant increases in their trading volume as well as outsized price shifts when compared to the larger market). Although the SEC did not identify a particular cause for the increase in trades in these stocks, many commentators believe that retail investors increased trading in targeted meme stocks for trading to harm institutional investors that engage in short selling. See Roger Cheng, *Reddit's AMC, GameStop Surge Happened Because of Anger Over Wall Street*, CNET (Feb. 1, 2021), <https://www.cnet.com/news/reddits-amc-gamestop-surge-happened-because-of-anger-over-wall-street/> [<https://perma.cc/UMD7-4MXF>] (stating that a desire to devastate short sellers and financial institutions that engage in short selling drove purchases in GameStop stock); Alicia Adamczyk, *'I Thought I Realistically Could Make \$25,000 Off of This': Why Redditors Are Holding GameStop*, CNBC, <https://www.cnbc.com/2021/02/01/why-redditors-are-holding-gamestop-stock.html> [<https://perma.cc/8RUE-PERP>] (Feb. 1, 2021) (noting that members of a popular online forum called "r/WallStreetBets" were more focused on damaging short selling hedge funds than on making trading profits); U.S. SEC. & EXCH. COMM'N, *supra* note 2, at 15 (stating that the causes behind the increase in meme stock trading exceeded the scope of their January 2021 report). Short selling occurs when an investor borrows a stock from a third party that is expected to decline in value, sells that stock at a premium, and later repurchases the stock at a lower price to return to the lender. U.S. SEC. & EXCH. COMM'N, *supra* note 2, at 24 n.74.

<sup>4</sup> See Kelly Anne Smith, *Robinhood Halts GameStop Trading, Angering Lawmakers and Investors*, FORBES ADVISOR, <https://www.forbes.com/advisor/investing/robinhood-gamestop-trading/> [<https://perma.cc/DG7J-R875>] (Jan. 28, 2021) (noting that Robinhood's users expressed frustration online in response to Robinhood's actions).

<sup>5</sup> See Tucker Higgins, *Lawmakers from AOC to Ted Cruz Are Bashing Robinhood Over Its GameStop Freeze*, CNBC, <https://www.cnbc.com/2021/01/28/gamestop-cruz-ocasio-cortez-blast-robinhood-over-trade-freeze.html> [<https://perma.cc/K4L4-G2VW>] (Jan. 28, 2021) (detailing politicians' statements criticizing Robinhood's decision to halt trades in GameStop).

<sup>6</sup> Higgins, *supra* note 5; see Nathaniel Popper, *GameStop Hearing Centers Around Robinhood*, N.Y. TIMES, <https://www.nytimes.com/live/2021/02/18/business/stock-market-today> [<https://perma.cc/5CJ7-3UZQ>] (Mar. 5, 2021) (outlining questions asked of Robinhood's Chief Executive Officer

buying stock on Robinhood's platform during the trading halt brought a class action suit against Robinhood and associated market makers.<sup>7</sup>

The Securities and Exchange Commission (SEC) analyzed the January 2021 stock trading halt and published a report of its findings in October.<sup>8</sup> The report concluded that when brokerage firms stop trading for a period of time, retail investors may experience financial loss because of broad market participation.<sup>9</sup> The report went on to identify four areas for future regulatory consideration but stopped short of proposing any actual regulatory changes.<sup>10</sup> Of particular note, the report identified payment for order flow—the process through which zero-commission broker-dealers like Robinhood generate profits—as one area for future study.<sup>11</sup> SEC Chairman Gary Gensler later released a statement that the SEC was considering reforms to the practice, including an out-

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(CEO) at a hearing). For example, Representative Hines inquired as to why investing with Robinhood was more beneficial to customers than simply investing in a diversified index fund. Popper, *supra*.

<sup>7</sup> See *In re January 2021 Short Squeeze Trading Litig.*, No. 21-2989, 2021 WL 5359731, at \*3 (S.D. Fla. Nov. 17, 2021) (stating that the named plaintiffs in the class action suit were investors barred from making trades in certain securities from January 28, 2021 to February 4, 2021 on Robinhood and other brokerage firms' platforms). The class action suit also accused the brokerage firms E\*Trade and Interactive Brokers LLC of illegally freezing stock trades on their platform. *Id.* at \*2, \*13. Collusion and market manipulation made up the bulk of allegations brought against the defendants. *Id.* at \*13. The district court dismissed an antitrust claim brought against Robinhood and other firms in the class action lawsuit. *Id.* at \*27.

<sup>8</sup> U.S. SEC. & EXCH. COMM'N, *supra* note 2, at 2. In particular, the SEC examined the decision of retail broker-dealers to halt purchases in certain stocks and options. *Id.* The SEC also attempted to identify the incentives of brokerage firms that place orders for stock purchases on behalf of customers. *Id.*

<sup>9</sup> *Id.* at 43. The report also notes that, in addition to the SEC, the Financial Industry Regulatory Authority (FINRA) and public exchanges, such as the New York Stock Exchange (NYSE) and United States National Association of Securities Dealers Automated Quotation System (NASDAQ), also have regulatory control over brokerage firms. *Id.* at 5.

<sup>10</sup> See *id.* at 43–44 (providing four areas for continued study related to the January 2021 stock trading freeze but not providing regulatory proposals); Yun Li, *SEC Says Brokers Enticed by Payment for Order Flow Are Making Trading into a Game to Lure Investors*, CNBC, <https://www.cnbc.com/2021/10/18/sec-says-brokers-enticed-by-payment-for-order-flow-are-making-trading-into-a-game-to-lure-investors.html> [<https://perma.cc/H9BP-2VP5>] (Oct. 18, 2021) (noting that the SEC's report did not make clear suggestions to change stock trading practices). The four areas for potential future study were: (1) clearinghouse participation and the role clearing plays in equity trading; (2) gamification of trading and payments to broker-dealers; (3) off-exchange execution of trades; and (4) the overlap between short selling and price movement. U.S. SEC. & EXCH. COMM'N, *supra* note 2, at 43–44. Although the SEC indicates that all four of these areas contributed to Robinhood and other firms halting trades, this Note focuses on the second area, the use of payment for order flow. See *id.* (providing the four areas for future study); *infra* notes 23–221 and accompanying text (discussing payment for order flow and potential regulatory changes).

<sup>11</sup> U.S. SEC. & EXCH. COMM'N, *supra* note 2, at 44. A regulatory definition for payment for order flow is payment to a broker from another party in return for routing an investor's order to that third party. 17 C.F.R. § 240.10b-10(d)(8) (2023). The SEC notes that payment for order flow encourages brokerage-dealers to create new ways to entice consumers to increase their trading frequency. U.S. SEC. & EXCH. COMM'N, *supra* note 2, at 44. Furthermore, the SEC explains that payment for order flow arrangements may potentially create conflicts of interest for broker-dealers. *Id.* at 12.

right prohibition of the practice, further clouding payment for order flow's future.<sup>12</sup> Nevertheless, in September 2022, the SEC indicated that it would not ban payment for order flow.<sup>13</sup>

Payment for order flow is effectively a kick-back to broker-dealers for routing retail investors' orders to designated execution locations.<sup>14</sup> Broker-dealers who receive payments for sending investor orders to their contractual partners through payment for order flow arrangements often face a conflict of interest between an investor's best execution and their compensation.<sup>15</sup> These conflicts incentivize a brokerage firm acting as an investor's agent to potentially violate their fiduciary duty by routing orders to market makers offering the highest payment and not to those offering the best price available to investors.<sup>16</sup> As such, the payment raises serious ethical questions, especially whether

<sup>12</sup> Thomas Franck, *SEC Chief Gensler Says Regulator Assessing Future of Payment for Order Flow*, CNBC, <https://www.cnbc.com/2021/10/19/sec-chief-gensler-says-regulator-assessing-payment-for-order-flow.html> [<https://perma.cc/4WGN-EB67>] (Oct. 19, 2021).

<sup>13</sup> Lydia Beyoud & Katherine Doherty, *SEC Set to Let Wall Street Keep Payment-for-Order-Flow-Deals*, BLOOMBERG, <https://www.bloomberg.com/news/articles/2022-09-22/sec-poised-to-let-wall-street-keep-payment-for-order-flow-deals> [<https://perma.cc/NUN8-WYQ4>] (Sept. 22, 2022).

<sup>14</sup> See Note, *The Perils of Payment for Order Flow*, 107 HARV. L. REV. 1675, 1675 (1994) (noting critics' characterization of payment for order flow as kickbacks from dealers to brokerage firms). A "broker-dealer" is a person or entity who buys and sells securities either for themselves or for the benefit of others. See Adam Hayes, *What Is a Broker-Dealer (B-D), and How Does It Work?*, INVESTOPEDIA, <https://www.investopedia.com/terms/b/broker-dealer.asp> [<https://perma.cc/2FGW-S6ZH>] (May 29, 2021) (defining broker-dealer). The SEC defines "retail investor" as "a natural person . . . who seeks to receive or receives services primarily for personal, family or household purposes." See *Form CRS Relationship Summary; Amendments to Form ADV*, U.S. SEC. & EXCH. COMM'N, <https://www.sec.gov/info/smallbus/secg/form-crs-relationship-summary> [<https://perma.cc/V7RH-RHQA>] (Sept. 19, 2019).

<sup>15</sup> See U.S. SEC. & EXCH. COMM'N, *supra* note 2, at 2 (stating that execution by off-exchange market makers as part of payment for order flow raises questions about investors' costs and brokers' conflicts of interest); John McCrank & Katanga Johnson, *U.S. SEC Chair Signals Sweeping Review of Exchange, Broker Rules*, REUTERS (June 10, 2021), <https://www.reuters.com/legal/litigation/us-sec-chair-gensler-staff-recommend-rules-ensure-fair-competition-between-2021-06-09/> [<https://perma.cc/4Q2Z-YNEW>] (noting that SEC Chairman Gensler said that payment for order flow presents concerns about conflicts of interests); Jacob Gremillion, *Diamond Hands and Regulatory Demands: GameStop and the Shortcoming of Current Securities Regulation*, 33 LOY. CONSUMER L. REV. 406, 417 (2021) (stating that payment for order flow potentially presents conflicts of interest for dealers who want to increase profits but who must also act as a fiduciary for their customers).

<sup>16</sup> See Allen Ferrell, *A Proposal for Solving the "Payment for Order Flow" Problem*, 74 S. CAL. L. REV. 1027, 1032–33 (using an analogy to real estate prices to demonstrate that dealers who use payment for order flow will often fill orders at the National Best Bid and Offer price (NBBO) established by quotation services as required by law, regardless of other options available in the market-place); Note, *supra* note 14, at 1679 (noting that because the market maker's payment for the order does not flow to the investor, the investor does not get the best price available in the market, and explaining that broker-dealers owe a fiduciary duty to their clients); Stanislav Dolgoplov, *Off-Exchange Market Makers and Their Best Execution Obligations: An Evolving Mixture of Market Reform, Regulatory Enforcement, and Litigation*, 17 N.Y.U. J.L. & BUS. 477, 479 (2021) (stating that Robinhood's commission-free business model predicated on payment for order flow had the potential to result in subpar prices for their customers). A fiduciary duty is the legal responsibility to "act with the highest

it actually helps individual investors receive the best value or instead allows brokerage firms to inaccurately market their services as free to the investor.<sup>17</sup> This perverse incentive for disloyal broker-dealers increases when payment for order flow arrangements generate a large portion of a firm's profits.<sup>18</sup> This Note argues that because payment for order flow incentivizes and causes broker-dealers to violate their fiduciary duty to individual investors, banning the practice entirely is the best regulatory course of action under the common law of agency.<sup>19</sup>

Part I of this Note discusses how payment for order flow operates, its current regulatory framework, and broker-dealer's fiduciary duty to individual investors in the context of principal-agency law.<sup>20</sup> Part II discusses potential regulatory reforms to payment for order flow and the principal arguments for maintaining, revising, or banning the practice.<sup>21</sup> Part III argues that because payment for order flow incentivizes brokerage firms to breach their fiduciary duty to investors, the current disclosure-based regulatory structure is insufficient and investor protection concerns necessitate a complete ban of the practice.<sup>22</sup>

## I. PAYMENT FOR ORDER FLOW AND THE CURRENT LEGAL REGIME

Companies like Robinhood operate as brokers subject to regulation when they buy and sell stocks on customer orders.<sup>23</sup> Brokers first used payment for

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degree of honesty and loyalty" when working on behalf of another party and to act in such other party's best interest. *Duty*, BLACK'S LAW DICTIONARY (11th ed. 2019).

<sup>17</sup> See Ferrell, *supra* note 16, at 1029 (noting that in payment for order flow actions, the market pays the broker an extra one to three cents for the order); Note, *supra* note 14, at 1678 (stating that payment for order flow is problematic because a lack of customer information skews incentives); Siqi Wang, Note, *Consumers Beware: How Are Your Favorite "Free" Investment Apps Regulated?*, 19 DUKE L. & TECH REV. 43, 44 (2021) (referencing the low to zero-cost marketing of Robinhood's services); *Trading Fees on Robinhood*, ROBINHOOD, <https://robinhood.com/us/en/support/articles/trading-fees-on-robinhood/> [<https://perma.cc/9AYA-QX5E>] (advertising on its website that the service is commission-free).

<sup>18</sup> See Alexis Keenan, *Why It Could Be Tough for the SEC to Ban Payment for Order Flow*, YAHOO! FIN. (Oct. 26, 2021), <https://news.yahoo.com/sec-chair-banning-payment-for-order-flow-is-on-the-table-140624328.html> [<https://perma.cc/M3MJ-V8WA>] (noting that in 2020, payment for order flow revenue for four large brokerage firms tripled).

<sup>19</sup> See *infra* notes 195–221 and accompanying text.

<sup>20</sup> See *infra* notes 23–116 and accompanying text.

<sup>21</sup> See *infra* notes 117–194 and accompanying text.

<sup>22</sup> See *infra* notes 195–221 and accompanying text.

<sup>23</sup> See Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(4)(A) (defining "broker" as "any person engaged in the business of effecting transactions in securities for the account of others"). The definition of "security" includes any "note, stock . . . [or] bond." See *id.* § 77b(a)(1) (providing what qualifies as a security). A broker is not the same as a dealer. See *id.* § 78c(a)(5)(A) (providing a different definition for "dealer"). A dealer is one who buys and sells securities for their own account. *Id.* According to the SEC, organizations that operate securities trading interfaces are brokers. *Guide to Broker-Dealer Registration*, U.S. SEC. & EXCH. COMM'N, <https://www.sec.gov/reportspubs/investor-publications/divisionsmarketregbdguidehtm.html> [<https://perma.cc/M3GA-M8UV>] (Dec. 12, 2016). A

order flow as compensation for their services in the 1980s.<sup>24</sup> In the 2010s, brokerage firms rapidly increased their use of payment for order flow, following the lead of Robinhood, whose business model relied almost exclusively on payment for order flow revenue.<sup>25</sup> Section A of this Part discusses how payment for order flow operates.<sup>26</sup> Section B of this Part discusses the current regulatory framework under which brokerage firms that engage in payment for order flow operate.<sup>27</sup> Section C of this Part then discusses the duty owed by brokerage firms to individual investors who place orders with them.<sup>28</sup> Finally, Section D of this Part discusses Robinhood's use of payment for order flow and the January 2021 trading halt to illustrate the conflicts of interest inherent in payment for order flow.<sup>29</sup>

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dealer typically provides buy and sell prices for a marketed security, indicating their interest in constantly trading that security. *Staff Compliance Guide to Banks on Dealer Statutory Exceptions and Rules*, U.S. SEC. & EXCH. COMM'N, <https://www.sec.gov/divisions/marketreg/bankdealerguide.htm> [<https://perma.cc/VF7C-PESX>] (Nov. 7, 2007). A dealer may also be the original issuer of a particular security. *Id.* A dealer who constantly stands ready to buy and sell a designated security serves as a market maker for that security. See *Executing an Order*, U.S. SEC. & EXCH. COMM'N, <https://www.investor.gov/introduction-investing/investing-basics/how-stock-markets-work/executing-order> [<https://perma.cc/8TB7-H67P>] (providing a definition for market maker). Brokers are subject to several regulatory requirements. See, e.g., 15 U.S.C. § 78o(a)(1) (requiring all brokers to register with the SEC prior to purchasing or selling securities for customers); *id.* § 78h (limiting the borrowing and lending capabilities of brokers); *id.* § 78r(a) (imposing liability on brokers who make misleading statements in any filing with the SEC).

<sup>24</sup> See Richard Y. Roberts, Comm'r, U.S. Sec. & Exch. Comm'n, Address to the Ray Garrett Jr. Corporate and Securities Law Institute: Payment for Order Flow, at 2 (Apr. 29, 1993), <https://www.sec.gov/news/speech/1993/042993roberts.pdf> [<https://perma.cc/9PPU-MJEU>] (stating that the SEC first took notice of payment for order flow in 1984 and that the practice gained serious attention from regulators in 1989). Prior to the 1980s, compensation for brokers came in the form of commission fees. See Brian Cheung, *How Do Brokerage Firms Make Money*, YAHOO! FIN. (Feb. 19, 2021), <https://www.yahoo.com/video/yahoo-u-how-brokerage-firms-make-money-105234987.html> [<https://perma.cc/SZ4M-4EYK>] (stating that commissions made on trading securities were historically a linchpin of the brokerage industry).

<sup>25</sup> See Wang, *supra* note 17, at 44–45 (noting that after Robinhood introduced a zero-commission fee model to customers, other major firms, including TD Ameritrade and Charles Schwab, did as well); Kate Rooney & Maggie Fitzgerald, *Here's How Robinhood Is Raking in Record Cash on Customer Trades—Despite Making It Free*, CNBC, <https://www.cnbc.com/2020/08/13/how-robinhood-makes-money-on-customer-trades-despite-making-it-free.html> [<https://perma.cc/SJ6M-CLJ6>] (Aug. 14, 2020) (stating that online brokerage firms depend on payment for order flow as a result of not taking commissions). In 2020, payment for order flow made up nearly 75% of Robinhood's total revenue. Trefis Team, *How Does Robinhood Markets Make Money?*, FORBES (July 23, 2021), <https://www.forbes.com/sites/greatspeculations/2021/07/23/how-does-robinhood-markets-make-money> [<https://perma.cc/68M7-RM25>]. In 2020, total revenue generated by payment for order flow for TD Ameritrade, Robinhood, E\*Trade, and Charles Schwab nearly tripled from its 2019 total. Brian Cheung, *Payments for Order Flow Almost Tripled in 2020 at Robinhood, Other Brokerages*, YAHOO! FIN. (Feb. 18, 2021), <https://www.yahoo.com/now/payments-for-order-flow-exploded-in-2020-215034948.html> [<https://perma.cc/GUW9-7B45>].

<sup>26</sup> See *infra* notes 30–45 and accompanying text.

<sup>27</sup> See *infra* notes 46–71 and accompanying text.

<sup>28</sup> See *infra* notes 72–88 and accompanying text.

<sup>29</sup> See *infra* notes 89–116 and accompanying text.

### A. How Payment for Order Flow Works

In the United States, stock trading is divided into two general markets: a dealer market and an auction market.<sup>30</sup> Dealer markets involve dealers, known as “market makers,” who trade directly with the public by selling securities from a set portfolio.<sup>31</sup> On the other hand, auction markets involve brokers, who act as intermediaries between a customer and the market makers or public exchanges.<sup>32</sup> In an auction market, instead of dealing directly with the dealer selling from their portfolio, the customer relies on a broker to secure a trade.<sup>33</sup>

In between dealer and auction markets is a third, less distinct market made up of off-exchange market makers who trade securities listed on public exchanges to customers via a broker.<sup>34</sup> Because of this third market, brokers have a choice when completing a customer order for a publicly traded stock: they can either go to the public exchange and complete the order or they can order from the market makers on this third market.<sup>35</sup> The path in which an or-

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<sup>30</sup> David M. Schizer, *Benign Restraint: The SEC’s Regulation of Execution Systems*, 101 YALE L.J. 1551, 1554 (1992).

<sup>31</sup> *Id.* Dealer markets may also be referred to as over-the-counter (OTC) markets. Note, *supra* note 14, at 1675. One example of a dealer market is the NASDAQ. Schizer, *supra* note 30, at 1554. Dealers use a published price index, the “bid-ask spread,” indicating the prices at which they will buy or sell a security. *Id.* To generate revenue, the dealer must purchase the security at a price lower than their selling price. *Id.*

<sup>32</sup> Schizer, *supra* note 30, at 1554. The New York Stock Exchange (NYSE) is an example of an auction market in the United States. *Id.* In a traditional auction market, a broker with a customer’s sell order will seek another broker with a buy order for the same security to match together and execute a trade. *Id.* When an investor gives an order to buy or sell a security to their broker, the broker has no time requirement in which they must route the order to market makers or public exchanges. *Executing an Order*, *supra* note 23.

<sup>33</sup> Schizer, *supra* note 30, at 1554. A stark contrast exists between dealer markets and auction markets in automation capabilities. *Id.* at 1555. Dealer markets are significantly simpler to fully automate because dealers merely need to state a price and investors can choose either to pay that price or not. *Id.* On the other hand, auction markets are more difficult to automate because a competitive bidding process takes place. *Id.* Auction markets and dealer markets constantly compete among themselves for investor orders, with auction markets traditionally receiving the majority of investor orders. Ferrell, *supra* note 16, at 1042.

<sup>34</sup> See Note, *supra* note 14, at 1675 (noting that a “third market” lies between the traditional two types of security markets).

<sup>35</sup> *Id.* Market makers in this third market are known as “off-exchange” market makers or “wholesalers.” Stanislav Dolgoplov, *Wholesaling Best Execution: How Entangled Are Off-Exchange Market Makers?*, 11 VA. L. & BUS. REV. 149, 150 (2016). Whereas market makers in a typical dealer market—on-exchange market makers—engage in OTC trades directly on the listed exchange, off-exchange market makers purchase the securities and hold them “off-exchange” for purchase in an auction market. See *id.* (noting that off-exchange market makers engage in both OTC transactions and exchange-listed security transactions); Schizer, *supra* note 30, at 1554 (noting that market makers in dealer markets deal directly with the public through set portfolios). Certain market makers will engage in both on-exchange trading and off-exchange trading, thereby working in both auction and dealer markets. Dolgoplov, *supra*, at 151; see Schizer, *supra* note 30, at 1554 (discussing the differences between dealer and auction markets). A broker completing a trade for a highly traded security has several options at any one time for where to complete a trade for a customer including the NYSE,

der to buy or sell a security travels from the investor to the broker, and then to either a public exchange or the market maker is called “order flow.”<sup>36</sup> To make a profit in this third market, market makers must establish a spread between their purchase price and the price offered to a customer to purchase.<sup>37</sup>

The broker has considerable discretion when deciding with whom to execute trades.<sup>38</sup> Because brokers often have many options for finding a seller or buyer to complete a trade, market makers constantly compete with one another for a brokers’ order flow.<sup>39</sup> Market makers engage in a practice wherein they send compensation back to the broker who routes them customer orders.<sup>40</sup> The purpose of this so-called “payment for order flow” is to ensure that investor orders from brokers are directed to the market maker for execution in the future.<sup>41</sup> This compensation is usually relatively low, only constituting one to two cents per share exchanged in the trade.<sup>42</sup>

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regional exchanges, or a dealer. Ferrell, *supra* note 16, at 1037. In 2018, the SEC noted that in the United States stocks can be traded at thirteen different public exchanges, two hundred OTC market makers, and forty “alternative trading systems.” Disclosure of Order Handling Information, 83 Fed. Reg. 58338, 58392 (Nov. 19, 2018).

<sup>36</sup> Note, *supra* note 14, at 1675–76.

<sup>37</sup> *Id.* at 1676. The spread is the range between the buying price of the market maker for a given security and the selling price. Adam Hayes, *What Is the Market-Maker Spread?*, INVESTOPEDIA, <https://www.investopedia.com/terms/m/marketmakerspread.asp> [<https://perma.cc/6DA4-HEF5>] (Apr. 29, 2022). For example, a hypothetical market maker could have a bid price of \$10 for a security at which he will buy that security from market participants. *Id.* That same market maker could then have an ask price of \$10.05 at which he is willing to sell that security into the market. *Id.* This five-cent difference between the bid and ask prices constitutes the market maker’s spread and his profit for that trade. *Id.* Trading a security at high levels or holding an illiquid security lengthens the market maker’s spread. *Id.*

<sup>38</sup> See Ferrell, *supra* note 16, at 1041 (noting that a broker may consider a number of factors in deciding where to send a trade for execution). These factors include trade execution speed, the size of the order, as well as the offering price at different locations. *Id.*

<sup>39</sup> *Id.* at 1047.

<sup>40</sup> Dolgoplov, *supra* note 35, at 151. Certain brokers use automated execution systems that offer instantaneous execution of trades at a set dealer price. Ferrell, *supra* note 16, at 1038–39. The use of such systems potentially led to increased competition among firms for order flow, in turn leading to a rise in payment for order flow. See Dolgoplov, *supra* note 35, at 154 (stating that payment for order flow appeared to increase as firms adopted automatic execution systems). Brokers often bundle together multiple customer orders for a given security and route the combined orders to a market maker for execution. See Note, *supra* note 14, at 1686 (referring to brokerage firms that receive payment for order flow as “aggregator[s] of customer orders”). These combined orders make market makers’ execution costs far lower as execution of multiple orders becomes more efficient. See *id.* at 1677–78 (discussing how bundling investor orders leads to smaller execution costs). As one scholar notes, payment for order flow arrangements depend on a constant flow of orders and the combining of small orders into larger units for execution. Dolgoplov, *supra* note 35, at 155.

<sup>41</sup> Note, *supra* note 14, at 1676; see Ferrell, *supra* note 16, at 1044 (noting that dealer markets rely on payments to receive order flow). The notorious Ponzi scheme leader Bernie Madoff helped foster payment for order flow use in securities markets. Annie Massa, *Payment for Order Flow*, BLOOMBERG, <https://www.bloomberg.com/quicktake/payment-for-order-flow> [<https://perma.cc/Q4QK-4UTZ>] (Mar. 9, 2017). In the early 1980s, Madoff operated one of the first market makers that sent

Generally, market makers execute orders at a price better than the National Best Bid and Offer (NBBO) for the stock in addition to the payment for order flow, resulting in what is commonly referred to as price improvement.<sup>43</sup> Written contracts between market makers and brokerage firms often establish a formalized agreement to route order flows to the market maker for execution.<sup>44</sup> Payment for order flow results in a significant amount of order flows traveling from retail brokers to market makers in the third market rather than to public exchanges.<sup>45</sup>

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payment for order flow to retail brokerage firms. *Id.* Changes to price quotations and electronic trading resulted in the practice's adoption by other market makers and brokers. *Id.*

<sup>42</sup> Note, *supra* note 14, at 1676; see also Theresa W. Carey, *Payment for Order Flow (PFOF)*, INVESTOPEDIA, <https://www.investopedia.com/terms/p/paymentoforderflow.asp> [<https://perma.cc/FTC4-TCYD>] (July 4, 2022) (noting that payments received by brokers are typically less than a penny per share).

<sup>43</sup> Memorandum from the U.S. Sec. & Exch. Comm'n, Div. of Trading & Mkts. to the Equity Mkt. Structure Advisory Comm. 6 (Jan. 26, 2016), <https://www.sec.gov/spotlight/equity-market-structure/issues-affecting-customers-emsac-012616.pdf> [<https://perma.cc/C5CW-JQ7Z>]; see *Price Improvement*, CHARLES SCHWAB, <https://www.schwab.com/execution-quality/price-improvement> [<https://perma.cc/47RM-27ZP>] (defining price improvement). The NBBO is a securities price that is continuously updated over the course of a trading day by securities information processors. Adam Hayes, *What Is the National Best Bid and Offer (NBBO)?*, INVESTOPEDIA, <https://www.investopedia.com/terms/n/nbbo.asp> [<https://perma.cc/RAG4-NFYA>] (Apr. 23, 2022). The NBBO indicates the highest and lowest posted offers among exchanges and market makers for a particular security. *Id.* A securities information processor is anyone who collects, processes, or publishes price quotations for a security. 15 U.S.C. § 78c(a)(22). An excellent analogy for the NBBO is the listing price for real estate. See Ferrell, *supra* note 16, at 1031–32 (comparing the NBBO to a condominium's listing price). Although the seller of real estate may list their price at a certain amount, they may be willing to sell at lower than the listed value and buyers may be willing to buy at higher than the listed amount. *Id.* Much like in the real estate analogy, the NBBO is merely a statement to the market indicating at any given time what price a buyer might pay for a security. See Ferrell, *supra* note 16, at 1032 (comparing the NBBO to real estate listing price). Market makers are often willing to pay more than their listed price for a stock and thus will engage in price improvement to entice a broker to send orders to them for execution at this better price. *Id.* at 1033. Price improvement against the NBBO is often measured in fractions of a penny. Dolgoplov, *supra* note 35, at 158.

<sup>44</sup> Memorandum, U.S. Sec. & Exch. Comm'n, *supra* note 43, at 6. These contracts typically come in two forms: flat fee and fee per contract arrangements. *Payment for Order Flow and Internalization in the Options Markets*, U.S. SEC. & EXCH. COMM'N, <https://www.sec.gov/news/studies/ordpay.htm> [<https://perma.cc/S47U-X2HQ>] (Dec. 19, 2000). Flat fee arrangements result in a market maker paying the broker-dealer a designated amount each month for the broker's entire order flow. *Id.* By contrast, in fee per contract arrangements, the market maker pays the broker-dealer an amount per order routed to them for execution. *Id.*

<sup>45</sup> Dolgoplov, *supra* note 35, at 156. Retail brokers are brokers that purchase and sell securities for personal accounts as opposed to brokers who work for larger organizations. Kristina Zucchi, *Institutional Traders vs. Retail Traders: What's the Difference?*, INVESTOPEDIA, <https://www.investopedia.com/articles/active-trading/030515/what-difference-between-institutional-traders-and-retail-traders.asp> [<https://perma.cc/J3TZ-W9AZ>] (Aug. 18, 2021).

## B. Regulatory Framework of Payment for Order Flow

This Section outlines the current regulation of payment for order flow.<sup>46</sup> Subsection 1 examines the primary regulatory constraint on payment for order flow: disclosure.<sup>47</sup> Subsection 2 discusses a secondary constraint on payment for order flow: SEC requirements that brokers obtain the best execution possible for customer orders.<sup>48</sup>

### 1. Disclosure Requirements

The SEC's current regulatory approach for payment for order flow focuses on enhanced broker disclosure requirements.<sup>49</sup> In particular the SEC enforces several rules that require disclosure not only to brokerage firm customers, but also to the public at large.<sup>50</sup> Regulation NMS Rule 606 (Rule 606) comprises the bulk of disclosure requirements for brokerage firms that engage in payment for order flow.<sup>51</sup> The SEC argues that such disclosure requirements provide sufficient information to customers as to where and how brokers process their orders in the market.<sup>52</sup>

Under Rule 606, a brokerage firm every quarter must disclose information to the public regarding the routing of customer orders in NMS stocks, as well as the routing of other securities, including option contracts.<sup>53</sup> NMS stocks are those listed on public exchanges.<sup>54</sup> Disclosure reports are required

<sup>46</sup> See *infra* notes 47–71 and accompanying text.

<sup>47</sup> See *infra* notes 49–61 and accompanying text.

<sup>48</sup> See *infra* notes 62–71 and accompanying text.

<sup>49</sup> See Payment for Order Flow, 59 Fed. Reg. 55006, 55006 (Nov. 2, 1994) (stating that the SEC believes enhanced disclosure requirements for brokers serves as part of a larger SEC philosophy that “sunlight is the best disinfectant” (quoting LOUIS D. BRANDEIS, *OTHER PEOPLE’S MONEY AND HOW THE BANKERS USE IT* 92 (10th prtg. 1932)); Dolgoplov, *supra* note 35, at 164 (noting that in 1994 the SEC made the choice to “emphasize disclosure over substantive regulation”). The SEC’s focus on regulating payment for order flow through disclosure requirements may contribute to the current public debate surrounding the practice. Dolgoplov, *supra* note 35, at 164.

<sup>50</sup> See, e.g., 17 C.F.R. § 240.10b-10(a)(2)(i)(C) (2023) (requiring disclosures to customers at the time of an order); *id.* § 242.606(a)(1) (requiring quarterly public reporting).

<sup>51</sup> See GARY SHORTER, CONG. RSCH. SERV., IF11800, *BROKER-DEALERS AND PAYMENT FOR ORDER FLOW 2* (2021) (stating that the SEC’s regulatory approach to payment for order flow is primarily disclosure based and that Rule 606 governs this disclosure). Rule 606 serves to ensure investors are able to analyze how well their brokers handle the orders they receive. *Regulatory Notice 21-35: Order Routing Disclosures for OTC Equity Securities*, FIN. INDUS. REGUL. AUTH. 2–3 (Oct. 6, 2021), <https://www.finra.org/sites/default/files/2021-10/Regulatory-Notice-21-35.pdf> [<https://perma.cc/7Y83-USE8>]. Furthermore, the SEC believes that Rule 606 provides transparency that encourages firms to compete with one another for investor orders, which may result in better prices for investors. *Id.*

<sup>52</sup> Payment for Order Flow, 59 Fed. Reg. at 55007.

<sup>53</sup> 17 C.F.R. § 242.606(a)(1) (2023).

<sup>54</sup> *Responses to Frequently Asked Questions Concerning Large Trader Reporting*, U.S. SEC. & EXCH. COMM’N, <https://www.sec.gov/divisions/marketreg/large-trader-faqs.htm> [<https://perma.cc/D6KZ-JWA2>] (Feb. 22, 2016).

for all orders in which a customer does not specify a particular market in which to complete the trade, so called non-directed orders.<sup>55</sup> These reports must include the percentage of customer orders that were non-directed, the ten market makers that constituted the greatest number of orders routed from the firm to that market maker, and the amount received as payment for order flow from those market makers.<sup>56</sup> Rule 606 reports must also contain a description of each market maker's relationship with the brokerage firm, including any agreement for payment for order flow.<sup>57</sup> Rule 606 requires disclosures be made available on a public website and remain available there for three years.<sup>58</sup>

A brokerage firm's disclosure requirements for payment for order flow are not solely limited to these publicly available reports.<sup>59</sup> In 2018, the SEC amended Rule 606 to require brokerage firms to send individualized, private disclosures to investors who request reports on how the firm routes their orders.<sup>60</sup> Rule 606 now requires brokers, upon customer request, to disclose

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<sup>55</sup> See 17 C.F.R. § 242.606(a)(1) (2023) (requiring disclosure of “non-directed orders”). Non-directed orders are investor orders given to a broker but not directed to a specific market location for execution. See James Chen, *Directed Order*, INVESTOPEDIA, <https://www.investopedia.com/terms/d/directedorder.asp> [<https://perma.cc/G2J7-QXFT>] (Jan. 21, 2022) (defining “non-directed orders” as customer orders that do not designate a specific location for order completion).

<sup>56</sup> 17 C.F.R. § 242.606(a)(1)(i–iii) (2023). According to its quarterly disclosures for the first quarter of 2021, Robinhood had non-directed orders constituting 100% of its total orders, listed five venues as recipients of its order flows, and received over \$1 million from those five venues just for the orders for S&P 500 stocks in January 2021. Robinhood Securities, LLC, Held NMS Stocks and Options Order Routing Public Report 1 (2021), <https://cdn.robinhood.com/assets/robinhood/legal/RHS%20SEC%20Rule%20606%20and%20607%20Disclosure%20Q1%202021.pdf> [<https://perma.cc/YDC6-G35P>]. Payment for order flow for non-S&P 500 stocks in that same month from the same five market makers resulted in Robinhood generating over \$15 million in revenue. *Id.* The five market makers included in the report for January included Virtu Americas, LLC, to whom Robinhood routed 47% of its non-directed orders, and Citadel Securities LLC, who received 19% of such orders. *Id.* Robinhood discusses that such orders and payments are made through “fully-disclosed clearing agreement[s]” made between it and those two firms. *Id.*

<sup>57</sup> 17 C.F.R. § 242.606(a)(1)(iv) (2023). The contents of this disclosure must include any agreement with the potential to influence a broker's decision to route an order to a venue. *Id.* Potential influences are incentive agreements such as bonus payments for reaching or exceeding a certain order flow volume or disincentives like lower payments for failing to meet quotas. *Id.* For example, Robinhood, in its 2021 First Quarter 606 Report, defines its arrangement with Citadel Securities as “receiv[ing] payment . . . for directing equity order[s]” to Citadel. Robinhood Securities, LLC, *supra* note 56. Such payments, according to Robinhood, fluctuate based on the NBBO at execution. *Id.*

<sup>58</sup> 17 C.F.R. § 242.606(a)(1) (2023).

<sup>59</sup> See *id.* § 242.606(b) (requiring certain individualized reports if requested by a customer).

<sup>60</sup> *Id.*; see also Disclosure of Order Handling Information, 83 Fed. Reg. at 58419 (describing the amendments to Rule 606). Even with the changes, market participants note that Rule 606 disclosures do not contain adequate information for investors' execution quality. *Disclosure of Order Routing Information*, GOLDMAN SACHS, <https://www.goldmansachs.com/compliance/Rule606/> [<https://perma.cc/FSD6-L92Z>]. Furthermore, brokerage firms may also release unaudited information on their Rule 606 disclosures, which, in turn, can make their reports inaccurate. *Id.*

within seven days how it handled “not-held” orders that the individual customer placed.<sup>61</sup>

## 2. The Duty of Best Execution

Under SEC rules, brokers have an obligation to secure the best execution for investor orders.<sup>62</sup> A broker’s duty of best execution requires securing the best terms available for the situation at the time an order is made.<sup>63</sup> Determining whether a broker has complied with their duty of best execution requires consideration of elements such as price, the size of the order, availability of information, and execution costs.<sup>64</sup> Although price is not the sole consideration, it is the most important element.<sup>65</sup> Furthermore, the Financial Industry

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<sup>61</sup> 17 C.F.R. § 242.606(b)(3) (2023). A “not-held” order is an order with a set price and allowable time discretion for the broker-dealer. Disclosure of Order Handling Information, 83 Fed. Reg. 58338, 58340 n.19. The report received by the customer upon request pursuant to Rule 606(b)(3) discloses to which venues such orders were sent in both the aggregate and the average order size routed. 17 C.F.R. § 242.606(b)(3) (2023). The new changes to Rule 606 are significantly more complicated than their original form. *SEC Rule Reporting*, ABEL NOSER, <https://www.abelnoser.com/sec-rule-606-reporting.html> [<https://perma.cc/A8TL-667R>]. The individualized reports under amended Rule 606 must include six months of historical data related to execution, routing location, handling practices, and execution speed. *Id.* FINRA is also considering similar regulation to the SEC’s amended Rule 606. *Regulatory Notice 21-35: Order Routing Disclosures for OTC Equity Securities*, *supra* note 51, at 3. FINRA’s proposed required disclosures are almost a verbatim match to Rule 606. *Id.* Outside of Rule 606, Rule 10b-10 of the Securities Exchange Act requires brokers to disclose to customers when they receive payment for order flow in conjunction with a transaction. 17 C.F.R. § 240.10b-10(a)(2)(i)(B) (2023). Such disclosures must come with the customer confirmation statement and include the source of the compensation received. *Regulatory Notice 21-23: Best Execution and Payment for Order Flow*, FIN. INDUS. REGUL. AUTH. 4 (June 23, 2021), <https://www.finra.org/sites/default/files/2021-06/Regulatory-Notice-21-23.pdf> [<https://perma.cc/47ML-XSX3>]. Furthermore, the SEC also requires brokers to disclose payment for order flow receipts to customers when they open an account and on an annual basis. Payment for Order Flow, 59 Fed. Reg. at 55008. Annual disclosures must contain notice that the broker receives payment for order flow, a detailed description of the payment received, as well as information regarding the availability of prices better than the NBBO when the broker receives an order. *Id.*

<sup>62</sup> DIV. MKT. REGUL., U.S. SEC. & EXCH. COMM’N, MARKET 2000: AN EXAMINATION OF CURRENT EQUITY MARKET DEVELOPMENTS 21 (1994). The market maker executing investor orders may also be subject to this duty of best execution. Dologopolov, *supra* note 16, at 481. A market maker may be subject to best execution requirements if: (1) they voluntarily take on that duty through contract, (2) the broker’s duty extends to them by virtue of their order handling agreement, or (3) best execution requirements under FINRA Rule 5310 apply. *Id.*; see *Rule 5310. Best Execution and Interpositioning*, FIN. INDUS. REGUL. AUTH. (May 9, 2014), <https://www.finra.org/rules-guidance/rulebooks/finra-rules/5310> [<https://perma.cc/8C99-FN3A>] (stating that all parties who have orders routed to them are subject to best execution requirements). For example, a market maker who receives an investor order and in turn reroutes that order to another location for execution must comply with FINRA’s best execution requirements. Dologopolov, *supra* note 16, at 481. The market maker may not avoid the imposition of best execution duties through agreements with the broker-dealer. *Id.* at 481–82.

<sup>63</sup> DIV. MKT. REGUL., U.S. SEC. & EXCH. COMM’N, *supra* note 62, at 21.

<sup>64</sup> *Id.* at V-2 to V-3.

<sup>65</sup> *Id.* at V-2. An investor may dictate instructions to their broker that states actions consistent with their duty of best execution. *Id.* at V-3. For instance, if a customer tells their broker that expedi-

Regulatory Authority (FINRA) imposes a duty of reasonable diligence on brokers as part of their best execution duty.<sup>66</sup> To aid investors' ability to ensure they receive best execution, Rule 605 requires market makers to disclose uniform monthly reports regarding execution of customer orders.<sup>67</sup>

Under current federal regulatory standards, a compliant broker must at least secure the NBBO to fulfill their duty of best execution.<sup>68</sup> The NBBO, however, serves only as a floor for best execution, such that executing a trade at the NBBO does not necessarily ensure broker compliance with their duty of best execution.<sup>69</sup> For example, a broker who routes an order from an investor to a market maker without price improvement, even though price improvement opportunities are available at other market makers, may be in violation of their duty of best execution depending on the other best execution factors.<sup>70</sup> Engaging in payment for order flow does not constitute a per se violation of a broker's duty of best execution, but a broker engaging in payment for order flow

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ency and certainty of completing a trade are their most important considerations for a trade, the broker secures best execution by finding the fastest market to complete a trade. *Id.* Nevertheless, the SEC made it clear in their guidelines that if a broker determines that expediency is the most significant factor for best execution for a given trade, the broker must still determine that such expediency is preferable to a slower trade in a market with a potentially better price. *Id.*

<sup>66</sup> Rule 5310. *Best Execution and Interpositioning*, *supra* note 62. Under Rule 5310, the best execution factors are the nature of the market, transaction size and category, how many markets the broker checks, quotation availability, and the customers instructions pertaining to the order. *Id.* FINRA is a nongovernmental organization entrusted by the SEC to impose and enforce ethical obligations on registered brokerage firms. Lauren Perez, *FINRA: The Organization That Regulates Broker-Dealers and Protects Investors*, BUS. INSIDER, <https://www.businessinsider.com/finra> [<https://perma.cc/HUZ6-UJST>] (Sept. 13, 2022). As an SEC-approved self-regulatory agency, FINRA enforces its own regulations upon registered brokerage firms. *Id.*

<sup>67</sup> Disclosure of Order Execution Information, 17 C.F.R. § 242.605 (2023). Rule 605 applies to "market centers." *Id.* A market center is a location where orders are executed, including market makers. See *Market Centers: Buying and Selling Stock*, U.S. SEC. & EXCH. COMM'N (Oct. 15, 2012), <https://www.sec.gov/fast-answers/answersmarkethtm.html> [<https://perma.cc/9777-EWGT>] (listing all venues that qualify as a market center).

<sup>68</sup> See Regulation NMS, 70 Fed. Reg. 37496, 37508 (June 29, 2005) (to be codified at 17 C.F.R. pts. 200, 201, 230, 240, 242, 249, 270) (explaining that the SEC's Order Protection Rule requires order execution at least at the NBBO). See generally Order Protection Rule, 17 C.F.R. § 242.611 (2023) (establishing standards for best execution).

<sup>69</sup> See Regulation NMS, 70 Fed. Reg. at 37508 (stating that the Order Protection Rule requiring a broker to trade at least at the NBBO serves as "a backstop" for the duty of best execution).

<sup>70</sup> Payment for Order Flow, 59 Fed. Reg. at 55008. As a practical matter, because the market for securities often has a lower bid price than individuals would actually pay for a certain security, an investor selling a security will often have the potential to receive a higher price than that offered at the NBBO. Ferrell, *supra* note 16, at 1032–33. Nonetheless, dealers who receive orders consistent with a payment for order flow agreement with a broker will automatically fulfill the order at the NBBO, even if there is a better opportunity available in the market. *Id.* Some scholars propose a solution to payment for order flow at the intersection between the NBBO and the duty of best execution. See, e.g., *id.* at 1034 (proposing a change to best execution requirements to allow a broker-dealer to credit an investor's account at the NBBO when an order is received).

must consider the availability of price improvement to be compliant with their duty of best execution alongside all other relevant factors.<sup>71</sup>

### *C. The Customer-Broker Relationship in the Context of Principal-Agency Law*

The existence of a fiduciary relationship between broker and investor also imposes common law duties on broker-dealers in addition to their statutory requirements.<sup>72</sup> Because an investment customer asks a brokerage firm to act on their behalf in buying and selling securities, the brokerage firm is an agent of the customer.<sup>73</sup> The establishment of a principal-agency relationship has two important consequences in this context: (1) imposition of duties on the agent when acting on their principal's behalf, and (2) limitation of the scope of an agent's actions to those authorized or ratified by their principal.<sup>74</sup>

First, the common law imposes specific duties on the agent because the principal is liable for the acts of their agent done within the scope of agency.<sup>75</sup> One of these duties is the duty of loyalty, which requires an agent, in all circumstances pertaining to the relationship, to act in the best interests of the princi-

<sup>71</sup> Payment for Order Flow, 59 Fed. Reg. at 55009 & n.28; Francis J. Facciolo & Richard L. Stone, *Avoiding the Inevitable: The Continuing Viability of State Law Claims in the Face of Primary Jurisdiction and Preemption Challenges Under the Securities Exchange Act of 1934*, 1995 COLUM. BUS. L. REV. 525, 671. Although the SEC notes the benefits and convenience to regulation of establishing a uniform test of execution, the SEC deemed it unnecessary to establish a singular test for best execution and as such refuses to pass a rule requiring best execution determination predicated exclusively on price. DIV. MKT. REGUL., U.S. SEC. & EXCH. COMM'N, *supra* note 62, at V-3. FINRA Rule 5310 also requires brokerage firms to analyze on a regular basis the availability of superior prices to ensure proper customer orders execution at the best possible price. Rule 5310. *Best Execution and Interpositioning*, *supra* note 62.

<sup>72</sup> See *Robinson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 337 F. Supp. 107, 110 (N.D. Ala. 1971) (stating that brokers are subject to agency duties when acting on behalf of a customer); *Guide to Broker-Dealer Registration*, U.S. SEC. & EXCH. COMM'N, <https://www.sec.gov/reportspubs/investor-publications/divisionsmarketregbdguidehtm.html> [<https://perma.cc/LYD2-AN24>] (Dec. 12, 2016) (noting that the standards of legal fiduciaries apply to broker-dealers).

<sup>73</sup> Ferrell, *supra* note 16, at 1032. An agency relationship is formed when one party asks another party to act on their behalf under their control and the second party agrees to act for that first party. RESTATEMENT (THIRD) OF THE L. OF AGENCY § 1.01 (AM. L. INST. 2006). The first party who asks that another act on their behalf is the principal and the party who agrees to act on their behalf is the principal's agent. *Id.* In the context of brokers and investors, the principal-agency relationship arises when the investor places an order with the broker. *Robinson*, 337 F. Supp. at 111.

<sup>74</sup> See RESTATEMENT (THIRD) OF THE L. OF AGENCY § 8.01 (establishing the duty of loyalty for agents); *id.* § 8.07 (imposing on the agent a duty to abide by terms of the contract with the principal); *id.* § 8.08 (stating an agent's duties of care, competence, and diligence); *id.* § 7.04 (imposing liability on the principal for the agent's actions only when done with actual authority or with the principal's ratification).

<sup>75</sup> See, e.g., *id.* § 7.04 (establishing liability of a plaintiff for actions of an agent done within the scope of the agency relationship); *id.* § 8.01 (imposing the duty of loyalty).

pal.<sup>76</sup> As such, an agent's interests, whether monetary or otherwise, are at all times in the agency relationship subordinate to the interests of the principal.<sup>77</sup>

In addition to acting in the best interests of the principal, the duty of loyalty requires an agent to refrain from acting adversely to their principal.<sup>78</sup> In the broker-dealer context, the duty of best execution stems from this component of the duty of loyalty.<sup>79</sup> Thus, a broker who receives an order from a customer must maximize the economic benefit stemming from that order to comply with the duty of loyalty.<sup>80</sup> A broker is also required to act with a level of care, competence, and diligence equivalent to that of other agents in similar circumstances.<sup>81</sup> Where brokers receive payment for order flow, a conflict be-

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<sup>76</sup> *Id.* § 8.01; see also Leo E. Strine, Jr., Lawrence A. Hamermesh, R. Franklin Balotti & Jeffrey M. Gorriss, *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629, 666 (2010) (stating that the duty of loyalty mandates that the agent act to advance the interests of the principal). An agent's duty of loyalty arising out of their relationship with the principal constitutes the fiduciary principle. See RESTATEMENT (THIRD) OF THE L. OF AGENCY § 8.01 cmt. b.

<sup>77</sup> RESTATEMENT (THIRD) OF THE L. OF AGENCY § 8.01 cmt. b. Consistent with this fiduciary duty, the SEC emphasizes that brokers must always act in the best interests of investors. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33318, 33318 (July 12, 2019) (codified in 17 C.F.R. § 240 (2023)).

<sup>78</sup> Strine, Jr. et al., *supra* note 76, at 666.

<sup>79</sup> See *Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 270 (3d Cir. 1998) (stating that the duty of best execution arises from the duty of loyalty owed by an agent to its principal). Although enshrined in federal law, the duty of best execution existed prior to SEC regulation and flows from common law agency principles related to loyalty and care. *Id.* In *Newton v. Merrill, Lynch, Pierce, Fenner & Smith*, in 1998, the U.S. Court of Appeals for the Third Circuit held that acceptance of investor orders by brokers required the market maker not to execute the order at the NBBO when better prices were available elsewhere. *Id.* at 271. The investor plaintiffs in *Newton* sued NASDAQ market makers for violation of their duty of best execution when they executed orders automatically at the NBBO, rather than at better prices readily available from online quotation services. *Id.* at 269. The court in *Newton* stated that investors establish an agency relationship with a broker to maximize their own economic benefit. *Id.* at 270. As such, the appellate court held that acceptance of the investor orders by the market makers required the market maker not to execute the order at the NBBO when better prices were available elsewhere. *Id.* at 271.

<sup>80</sup> *Id.* at 270.

<sup>81</sup> RESTATEMENT (THIRD) OF THE L. OF AGENCY § 8.08. These three duties, generally referred to as duties of performance, are not independent from the duty of loyalty, rather the duty of loyalty necessitates these other duties. See *id.* § 8.01 cmt. b (stating that the duty of loyalty "complements and facilitates" the other duties owed to a principal). Whether an agent has acted with the requisite care, competence, and diligence required may be determined by an agreement between the principal and the agent. *Id.* § 8.08. The comment to section 8.08 of the *Restatement of the Law of Agency* states that a contract between the two parties is permitted to establish what actions will be consistent with their duties of care, competence, and diligence. *Id.* cmt. b. This rule is far broader than section 8.06 because an agreement for what is consistent with the duty of care, competence, and diligence is always enforceable whereas consent permitted by section 8.06 is not necessarily enforceable. Compare *id.* (allowing a contract to stipulate permitted actions at all times), with *id.* § 8.06 cmt. b (stating that consent is only allowed if it is consistent with the principal's intent of forming an agency relationship). The ability to alter the fiduciary duties of care, competence, and diligence more freely than the duty of loyalty is most prominently displayed in state corporate law. See, e.g., *Malpiede v. Townson*, 780 A.2d 1075, 1094 (Del. 2001) (stating that Delaware's General Corporate Law section 102(b)(7) bars violation of the duty of care claims); DEL. CODE ANN. tit. 8, § 102(b)(7) (2023) (prohibiting a corpo-

tween a broker's interest and their customer's economic interest may arise because of the broker's incentive to deliver orders to specific market makers based on the payment they received from these market makers, regardless of price improvement opportunities at other execution locations.<sup>82</sup>

Second, an agency relationship limits an agent's actions by blocking receipt of material benefits from another party as part of a transaction done on behalf of the principal.<sup>83</sup> A principal may, nonetheless, consent to an agent's receipt of a material benefit.<sup>84</sup> This consent is valid only if the agent acted in good faith, disclosed the facts necessary to the principal that would impact their decision to consent to the receipt, and acted fairly to the principal at the time of receipt.<sup>85</sup> A crucial aspect then in determining whether a customer properly provided consent for a broker's receipt of payment for order flow is contingent on the quality of the broker's disclosure to the customer at the time of consent.<sup>86</sup> If an agent breaches a duty owed to their principal, the agent becomes liable to the principal for that breach, regardless of financial harm to the

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ration from eliminating personal liability of directors for breaching their duty of loyalty). Furthermore, a principal may consent to actions otherwise disallowable under an established agency contract under section 8.08 of the *Restatement*. Deborah A. DeMott, *Defining Agency and Its Scope (II)*, in *COMPARATIVE CONTRACT LAW: BRITISH AND AMERICAN PERSPECTIVES* 396, 396 (Martin Hogg & Larry DiMatteo eds., 2016).

<sup>82</sup> See U.S. SEC. & EXCH. COMM'N, *supra* note 2, at 12 (detailing the potential for conflicts of interest of broker-dealers); D. Bruce Johnsen, *The SEC's 2006 Soft Dollar Guidance: Law and Economics*, 30 CARDOZO L. REV. 1545, 1549 (2009) (noting that the existence of a conflict of interest presents the potential for an agent to breach their fiduciary duty through self-dealing). A conflict of interest presents itself whenever an agent's interests are in competition with the principal's interests. Johnsen, *supra*, at 1549 n.16. Although such conflicts have the potential to result in breaches of the duty of loyalty, a breach of the duty of loyalty only exists if the agent chooses to act on the conflict adverse to the principal's interests. *Id.* Conflicts of interest resulting from payments to brokers from third parties are not limited to payment for order flow arrangements. See *id.* at 1549 (discussing the conflicts inherent in soft dollar payments between brokers and third parties). For example, the existence of soft dollar payments to brokers also creates a conflict of interest for brokers. *Id.* Soft dollar payments are payments from investment advisors to brokerage firms for services other than execution. *Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds*, U.S. SEC. & EXCH. COMM'N (Sept. 22, 1998), <https://www.sec.gov/news/studies/softdolar.htm> [<https://perma.cc/HS9B-6U5E>].

<sup>83</sup> RESTATEMENT (THIRD) OF THE L. OF AGENCY § 8.02. Some courts go as far as requiring an agent to turn over to their principal any profit made by that agent in a transaction done on behalf of their principal. See, e.g., *Sylvester v. Beck*, 178 A.2d 755, 757 (Pa. 1962) (stating that an agent has a duty to give profits received in a transaction to their principal). The duty of loyalty does not allow an agent to use personal interests as a valid motivation for taking actions on a principal's behalf. RESTATEMENT (THIRD) OF THE L. OF AGENCY § 8.01 cmt. b.

<sup>84</sup> RESTATEMENT (THIRD) OF THE L. OF AGENCY § 8.06.

<sup>85</sup> *Id.* The comment to section 8.06 of the *Restatement* goes on to say that consent makes an otherwise disloyal act loyal. *Id.* § 8.06 cmt. b. Not all consent, however, absolves an agent's disloyal act because the law of agency provides specifically designed protections for the principal's intent in forming the relationship in the first place. *Id.*

<sup>86</sup> See Facciolo & Stone, *supra* note 71, at 656–57 (noting that the quality of disclosures is a necessary element to determine the validity of consent granted by the principal).

principal.<sup>87</sup> Typically, a breach of a fiduciary duty results in forfeiture of any received benefits by the agent, including compensation received as a result of that disloyalty.<sup>88</sup>

### *D. Robinhood: A Case Study in Payment for Order Flow*

This Section presents a case study of Robinhood, the brokerage firm driving the payment for order flow phenomenon.<sup>89</sup> Subsection 1 discusses the firm's business model.<sup>90</sup> Subsection 2 presents details on Robinhood's decision in January 2021 to halt trading on its platform of certain stocks.<sup>91</sup>

#### 1. Robinhood's Business Model

The online trading company Robinhood launched in 2013 in response to the Occupy Wall Street movement.<sup>92</sup> Marketed as an investment service de-

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<sup>87</sup> See RESTATEMENT (THIRD) OF THE L. OF AGENCY § 8.01 cmt. d(1) (AM. L. INST. 2006) (containing no mention of financial harm to establish liability). The source of this liability flows not only from principal-agency law, but also from the law of torts, restitution, and unjust enrichment. *Id.*; see also RESTATEMENT OF THE L. (SECOND) OF TORTS § 874 (AM. L. INST. 2012) (establishing liability of a fiduciary who breaches a duty to their principal); RESTATEMENT OF THE L. (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT §§ 1, 3 cmt. a (AM. L. INST. 2011) (establishing restitution liability for one who is unjustly enriched and stating that fiduciaries may be liable for profits received as a result of a breach of duty). Because liability for breaches of an agent's duty is not found solely in tort law, liability is not contingent on the existence of some harm occurring to the principal from that breach. See RESTATEMENT OF THE L. (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 43 cmt. d (establishing liability in restitution for a breach of a fiduciary duty "without regard to economic injury"). The text of the *Restatement of Restitution and Unjust Enrichment* is devoid of any mention of a necessary harm to a principal to establish liability. *Id.* § 43. Rather, an agent is liable in restitution to their principal for any breach of a fiduciary duty, regardless of actual harm to the principal. *Id.* cmt. d. The comment to section 43 of the *Restatement of Restitution and Unjust Enrichment* specifically states that in cases where a fiduciary engages in a self-interested transaction when working on behalf of another party, the receipt of "secret commission," regardless of economic injury, is not allowed because of the potential conflicts of interest. *Id.* The law of agency also arrives at the same conclusion. See RESTATEMENT (THIRD) OF THE L. OF AGENCY § 8.01 cmt. d(1) (stating that if an agent realizes a benefit as a result of a breach, the agent is liable for giving the value of that benefit to the principal even if a loss to the principal is not established). This is to prevent incentivizing an agent to act disloyally even if the agent believes that the principal would not suffer economic harm from their action. *Id.* § 8.01 cmt. d(2). The lack of an economic harm element for liability for breaches of the duty of loyalty is important when faced with arguments from payment for order flow proponents who argue that the cost to investors is negligible. See *infra* note 212 and accompanying text (discussing arguments to maintain payment for order flow because the economic harm to investors is negligible).

<sup>88</sup> RESTATEMENT (THIRD) OF THE L. OF AGENCY § 8.01 cmt. d(2).

<sup>89</sup> See Paul J. Ingrassia, *How Robinhood Has Revolutionized Online Trading and Dramatically Upended the Traditional Model for Payment for Order Flow (PFOF)*, 16 VA. L. & BUS. REV. 183, 190 (2021) (describing Robinhood as the leading firm in the online trading industry); *infra* notes 90–115 and accompanying text.

<sup>90</sup> See *infra* notes 92–104 and accompanying text.

<sup>91</sup> See *infra* notes 105–115 and accompanying text.

<sup>92</sup> Jeff Kauflin & Antoine Gara, *The Inside Story of Robinhood's Billionaire Founders, Option Kid Cowboys and the Wall Street Sharks That Feed on Them*, FORBES (Aug. 19, 2020), <https://www.>

signed to make investing in the stock market accessible to all Americans, the organization quickly revolutionized the brokerage market by offering zero-commission trading on an attractive, easy-to-use app.<sup>93</sup> To make up for the lack of commission-based revenue, Robinhood employs a business model dependent on payment for order flow.<sup>94</sup> The promise of zero-commission fees as well as an easy-to-use app created a new market of younger, less informed investors who began to use Robinhood's platform at extraordinary rates.<sup>95</sup> Robinhood's business model, based largely on payment for order flow, drove other competitor brokerage firms to adopt similar models.<sup>96</sup>

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forbes.com/sites/jeffkauffman/2020/08/19/the-inside-story-of-robinhoods-billionaire-founders-option-kid-cowboys-and-the-wall-street-sharks-that-feed-on-them/?sh=2d629a7e268d [https://perma.cc/E8CF-P2EB]. Occupy Wall Street was a series of protests in major U.S. cities during the Great Recession focused on income inequality. Michael Levitin, *Occupy Wall Street Did More Than You Think*, THE ATLANTIC (Sept. 14, 2021), https://www.theatlantic.com/ideas/archive/2021/09/how-occupy-wall-street-resaped-america/620064/ [https://perma.cc/76XP-3FEA]. Robinhood is the representative example in this Note because of their significant influence on the increase in the use of payment for order flow by major brokerage firms. See Ingrassia, *supra* note 89, at 186 (discussing how Robinhood forced other brokerage firms to adopt its zero-commission business model).

<sup>93</sup> Ingrassia, *supra* note 89, at 186; John R. Fallon, *Equal Access to Investments: At Whose Expense?*, 21 WAKE FOREST J. BUS. & INTELL. PROP. L. 431, 435 (2021); *Our Story*, ROBINHOOD, https://robinhood.com/us/en/support/articles/our-story/ [https://perma.cc/4D23-EW97]. Although not relevant to this Note, how Robinhood designs its platform to entice trades from users, a process known as gamification, is also the subject of recent scholarship. See generally Fallon, *supra*, at 444–60 (discussing Robinhood's use of gamification).

<sup>94</sup> Robinhood Fin., LLC, Securities Act Release No. 10906, Exchange Act Release No. 90694, at 2 (Dec. 17, 2020), https://www.sec.gov/litigation/admin/2020/33-10906.pdf [https://perma.cc/V7XH-TE33]; see also Fallon, *supra* note 93, at 456 (stating that Robinhood generates most of its profits from payment for order flow); *Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide: Hearing Before the H. Comm. on Fin. Servs.*, 117th Cong. 4 (2021) (testimony of Vlad Tenev) [hereinafter *Hearing Before Committee on Financial Services*] (stating that Robinhood's ability to have no commission fees on its platform is because of payment for order flow). Robinhood's profitability is also connected with its relatively low level of costs due to it using only a digital platform and self-directed accounts. Wang, *supra* note 17, at 49; Fallon, *supra* note 93, at 435.

<sup>95</sup> See Ingrassia, *supra* note 89, at 186–87 (discussing how Robinhood caused a seismic increase in young investors entering the market for the first time); Wang, *supra* note 17, at 44 (stating that investment apps are targeted toward “less sophisticated investors”). In 2021, Robinhood had eighteen million users. Maggie Fitzgerald, *Robinhood Has 18 Million Accounts with \$80 Billion in Assets After Rapid Growth, IPO Filing Shows*, CNBC, https://www.cnbc.com/2021/07/01/robinhood-has-18-million-accounts-managing-80-billion-after-rapid-one-year-growth-ipo-filing-shows.html [https://perma.cc/B6RY-ECHZ] (July 2, 2021). In 2021, the average age of Robinhood investors was thirty-one and the value of their accounts was at least twenty times lower than the value of accounts held by their major competitors. Fallon, *supra* note 93, at 435. In addition to the absence of commission fees, Robinhood further encouraged younger investors to use the platform by not requiring an account minimum to engage in trading. Ingrassia, *supra* note 89, at 190.

<sup>96</sup> Ingrassia, *supra* note 89, at 186. Although payment for order flow results in marginally small payments per order to brokerage firms, it results in large amounts of revenue. SHORTER, *supra* note 51, at 1. In the first half of 2020, Robinhood generated over \$270 million from payment for order flow. *Id.* Competitors Charles Schwab and E\*Trade generated slightly less revenue during that time, with roughly \$120 million and \$190 million in revenue, respectively. *Id.* Ameritrade generated over \$500 million from payment for order flow in the first half of 2020. *Id.* Those numbers rose drastically

When it first began taking customer orders, Robinhood depended on other trading firms to complete execution.<sup>97</sup> Robinhood would route customer orders to other brokerage firms for executing customer orders, and those brokerage firms in turn received payment for order flow from market makers.<sup>98</sup> In return for the orders, the executing brokerage firm would send a portion of their received payment for order flow to Robinhood.<sup>99</sup> In 2016, however, Robinhood decided to cut out the intermediary execution firm and negotiated with market makers to directly route orders to them in exchange for payment for order flow that was substantially higher than what other brokerage firms received.<sup>100</sup> Because Robinhood's payment for order flow was so high, several of its customers lost out on price improvement opportunities from market makers unwilling to pay such a high rate.<sup>101</sup> As a result, Robinhood's execution quality was worse than its competitors over the course of three years, with customers losing out on \$34 million in price improvement opportunities.<sup>102</sup> In December 2020, Robinhood agreed to a \$65 million civil penalty with the SEC for its use of payment for order flow to the detriment of customers.<sup>103</sup> Nevertheless, Robinhood continues to generate large swaths of revenue from payment for order flow.<sup>104</sup>

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in 2021 with Charles Schwab generating \$1.7 billion in revenue from payment for order flow and Robinhood generating \$974 million. Alexander Osipovich, *Payments to U.S. Brokers Surged Amid Meme-Stock and Options Boom*, WALL ST. J. (Feb. 1, 2022), <https://www.wsj.com/articles/payments-to-u-s-brokers-surged-amid-meme-stock-and-options-boom-11643745771> [<https://perma.cc/U3Z7-AUBV>]. On the market maker side of payment for order flow, Citadel Securities paid nearly \$1.5 billion to a dozen brokerage firms. *Id.*

<sup>97</sup> *Robinhood Fin., LLC*, Release Nos. 10694, 10906, at 5.

<sup>98</sup> *Id.*

<sup>99</sup> *Id.* The executing brokerage firm in turn would route the orders to what the SEC referred to as "principal trading firms," or market makers. *Id.*

<sup>100</sup> *Id.* at 5–6. Some have suggested that Robinhood's higher payment for order flow is a consequence of its dependence on a commission-free business model. Ingrassia, *supra* note 89, at 198.

<sup>101</sup> *Robinhood Fin., LLC*, Release Nos. 10694, 10906, at 2. (Market makers explicitly informed Robinhood that their requested high levels of payment for order flow would result in less available money for price improvement for investors. *Id.* at 6. One market maker went as far as telling Robinhood that the typical retail broker price improvement and payment for order flow ratio was 80/20 with 80% of the money going to the investor as price improvement and 20% going to the broker-dealer as payment for order flow. *Id.* Robinhood's negotiated agreements with market makers flipped that ratio, giving 20% of the available money as price improvement to customers and 80% to Robinhood as payment for order flow. *Id.*

<sup>102</sup> *Id.* at 7, 10. According to their own statistical models and analyses, Robinhood's staff knew their customers received poorer execution quality as early as 2016. *Id.* at 6. To improve execution quality, Robinhood implemented a new algorithm into the system to route orders to the principal trading firm that provided the most price improvement for the ordered security over the last thirty days. *Id.* The algorithm failed to substantially improve execution quality because it did not control for Robinhood's high payment for order flow rates, nor did it seek out execution at market makers who refused to pay that high rate. *Id.* When one market maker told Robinhood it would not pay the higher payment for order flow rate, Robinhood stopped routing customer orders to that venue. *Id.* at 7.

<sup>103</sup> *Id.* at 1, 15.

<sup>104</sup> See *supra* note 56 and accompanying text (discussing how much revenue Robinhood generated from payment for order flow in the first quarter of 2021).

## 2. January 2021 and Calls to End Payment for Order Flow

Although controversy surrounding payment for order flow dates back decades, it only recently entered the regulatory crosshairs in early 2021 following Robinhood's decision to freeze trades in certain volatile stocks.<sup>105</sup> In January 2021, retail investors engaged in a short squeeze of numerous stocks, most notably GameStop.<sup>106</sup> Robinhood, responding to the rapid increase in GameStop trading, placed a temporary freeze on GameStop orders.<sup>107</sup>

According to Robinhood, the temporary freeze in trading resulted from an inability to meet deposit requirements at its clearinghouse.<sup>108</sup> Market observers, however, suggested that the decision resulted from pressure imposed on Robinhood from its market maker business partners.<sup>109</sup> Both Robinhood and Citadel Securities, a market maker associated with Robinhood, refuted these nefarious allegations.<sup>110</sup> Despite the denials, Robinhood's business model became the subject of intense scrutiny from Congress, the SEC, and their customers.<sup>111</sup> For ex-

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<sup>105</sup> See Note, *supra* note 14, at 1675 (discussing calls to regulate payment for order flow in 1994); Franck, *supra* note 12 (highlighting the SEC Chairman's discussion of increasing regulation of payment for order flow or barring the practice).

<sup>106</sup> See U.S. SEC. & EXCH. COMM'N, *supra* note 2, at 18 (discussing the short squeeze of GameStop stock); Samuel Barder, Note, *Market Manipulation or Just Dumb Money? The GameStop Stock Spike and What Happens Next*, 26 ILL. BUS. L.J. 9, 11 (2021) (discussing the causes of the January 2021 short squeeze of GameStop stock). For a more detailed analysis of the causes and technical aspects of the January 2021 short squeeze, see Barder, *supra*, at 11–13. Ultimately, the short squeeze tactics employed resulted in an extreme spike in GameStop trades. See U.S. SEC. & EXCH. COMM'N, *supra* note 2, at 19–21 (providing graphs showing the increase in GameStop stock value and trades from January 25 to January 29, 2021).

<sup>107</sup> *Keeping Customers Informed Through Market Volatility*, *supra* note 2.

<sup>108</sup> Emma Newburger, *Robinhood Says Restrictions on GameStop Due to Tenfold Increase in Clearinghouse Deposit Requirements*, CNBC, <https://www.cnbc.com/2021/01/30/robinhood-says-restrictions-on-gamestop-due-to-tenfold-increase-in-deposit-requirements.html> [<https://perma.cc/6ZQ5-5S82>] (Jan. 30, 2021). A clearinghouse is an intermediary between the buyer and seller in a trade. Akhilesh Ganti, *Clearinghouse: An Essential Intermediary in the Financial Markets*, INVESTOPEDIA, <https://www.investopedia.com/terms/c/clearinghouse.asp> [<https://perma.cc/6JPW-XNQW>] (Feb. 7, 2023). The clearinghouse essentially ensures that a trade will be completed and gets involved in a trade after the buyer and seller begin execution. *Id.* Changes to the settlement and clearing process were also suggested in the SEC's report on January 2021. See U.S. SEC. & EXCH. COMM'N, *supra* note 2, at 43–44 (suggesting a shortened period for settling trades).

<sup>109</sup> U.S. SEC. & EXCH. COMM'N, *supra* note 2, at 32–33.

<sup>110</sup> See Melanie Waddell, *Robinhood CEO Testifies: 'We Don't Answer to Hedge Funds'*, THINKADVISOR (Feb. 18, 2021), <https://www.thinkadvisor.com/2021/02/18/robinhood-ceo-testifies-we-do-not-answer-to-hedge-funds/> [<https://perma.cc/3LE9-S6R9>] (quoting Robinhood and Citadel Securities CEOs as denying allegations of collusion in January 2021).

<sup>111</sup> See Chris Matthews, *Senate Probes Robinhood Business Model at GameStop Hearing*, MARKETWATCH, <https://www.marketwatch.com/story/senate-probes-robinhood-business-model-at-game-stop-hearing-11615305505> [<https://perma.cc/KF8R-7YMX>] (Mar. 9, 2021) (discussing the U.S. Senate hearing on the GameStop short squeeze). See generally *GameStop Hearing, Part 1*, C-SPAN (Feb. 18, 2021), <https://www.c-span.org/video/?508545-1/gamestop-hearing-part-1> [<https://perma.cc/E9GV-C8NB>] (presenting the U.S. House of Representatives hearing on the GameStop trading freeze); *GameStop Hearing, Part 2*, C-SPAN (Feb. 18, 2021), <https://www.c-span.org/video/?508545-2/>

ample, potential collusion between Robinhood and market makers like Citadel Securities in January 2021 formed the basis of a class action law suit.<sup>112</sup> In Congress, Senator Sherrod Brown, Chairman of the Senate Banking Committee, decried Robinhood's business model, stating that it "exploits small investors" by "sell[ing] their trades to big market players."<sup>113</sup> The SEC, meanwhile, suggested that market maker execution raised conflict of interest concerns about the execution agreements between brokerage firms and off-exchange market makers.<sup>114</sup> SEC Chairman Gensler suggested increased regulation or an outright ban of payment for order flow.<sup>115</sup> Ultimately, in September of 2022, the SEC indicated that it would not ban payment for order flow outright and instead, in December, proposed changes to the current payment for order flow regulatory framework, specifically as it relates to best execution.<sup>116</sup>

## II. PROPOSED CHANGES TO PAYMENT FOR ORDER FLOW'S REGULATORY FRAMEWORK

With the SEC indicating imminent changes to payment for order flow's regulatory framework, several regulatory options with varying strengths and weaknesses remain.<sup>117</sup> Section A of this Part discusses arguments from brokerage firms like Robinhood and market observers to maintain the current regula-

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gamestop-hearing-part-2 [<https://perma.cc/97NB-RQUR>] (same); *In re January 2021 Short Squeeze Trading Litig.*, No. 21-2989, 2021 WL 5359731, at \*3 (S.D. Fla. Nov. 17, 2021) (identifying plaintiffs as Robinhood investors prevented from trading stock in January 2021 and accusing Robinhood of collusion with its payment for order flow partners).

<sup>112</sup> See, e.g., *In re January 2021 Short Squeeze Trading Litig.*, 2021 WL 5359731, at \*9 (stating plaintiffs' allegations against Robinhood and its associated market makers for colluding to restrict trading). According to the plaintiffs' allegations, Robinhood restricted trading in GameStop and other meme stocks to insulate Citadel from taking losses after taking short positions in those stocks. *Id.* The plaintiffs argued that Citadel was able to pressure Robinhood into freezing trades because of its position as the largest purchaser of Robinhood's order flow. *Id.* By taking a short position in meme stocks Citadel expected the price of the security to decrease in value. See Matthew Frankel, *How to Short a Stock*, MOTLEY FOOL, <https://www.fool.com/investing/how-to-invest/stocks/how-to-short-stock/> [<https://perma.cc/F23L-X9VM>] (Feb. 13, 2023) (discussing the short selling process).

<sup>113</sup> Matthews, *supra* note 111.

<sup>114</sup> U.S. SEC. & EXCH. COMM'N, *supra* note 2, at 2.

<sup>115</sup> Franck, *supra* note 12.

<sup>116</sup> See Beyoud & Doherty, *supra* note 13 (stating that the SEC would refrain from banning payment for order flow). See generally Order Competition Rule, 88 Fed. Reg. 128 (proposed Jan. 3, 2023) (to be codified at 17 C.F.R. pts. 240, 242) (providing the SEC's proposed Rule 615, which would require certain orders to be exposed to the market at large under the duty of best execution). Note that Rule 615 has merely been proposed by the SEC and comments were required to have been received by March 31, 2023. *Id.*

<sup>117</sup> See Dmytro Spilka, *Exploring the SEC's Bid to Ban Payment for Order Flow: What Could Replace PFOF?*, NASDAQ (Oct. 21, 2021), <https://www.nasdaq.com/articles/exploring-the-secs-bid-to-ban-payment-for-order-flow%3A-what-could-replace-pfof-2021-10-21> [<https://perma.cc/9VX6-F9KW>] (discussing potential regulatory changes that the SEC could implement for payment for order flow).

tory framework.<sup>118</sup> Section B discusses proposals to change the SEC's current best execution and disclosure regulations.<sup>119</sup> Section C discusses proposals to ban payment for order flow entirely.<sup>120</sup>

### *A. Maintaining the Regulatory Status Quo*

Unsurprisingly, brokerage firms, like Robinhood, that utilize payment for order flow argue that the benefits of maintaining the current regulatory framework outweigh the potential costs to investors.<sup>121</sup> Some neutral market observers also argue that calls for increased regulation are unnecessary.<sup>122</sup> Proponents of the regulatory status quo argue that the regulatory tools already available are sufficient to protect investors and that regulatory changes would hinder or eliminate the benefits of payment for order flow.<sup>123</sup> Subsection 1 of this Section discusses arguments from Robinhood and other market observers that payment for order flow's economic benefits outweigh their perceived costs.<sup>124</sup>

<sup>118</sup> See *infra* notes 121–140 and accompanying text.

<sup>119</sup> See *infra* notes 141–170 and accompanying text.

<sup>120</sup> See *infra* notes 171–194 and accompanying text.

<sup>121</sup> See *Hearing Before Committee on Financial Services*, *supra* note 94, at 5 (stating that payment for order flow significantly benefits investors). Robinhood also argues that routing investor trades to market makers in general is beneficial to investors because market makers generally offer superior prices than public exchanges. *Id.* Nevertheless, the price differences between market makers and exchanges are often only fractions of a penny per share. John McCranck, *U.S. Online Brokers Still Profiting from 'Dumb Money'*, REUTERS, <https://www.reuters.com/article/us-usa-brokers-fees/u-s-online-brokers-still-profiting-from-dumb-money-idUSKBN1WN1UD> [<https://perma.cc/R58D-R8HW>] (Oct. 8, 2019). Robinhood's CEO further argues that payment for order flow results in increased price improvement. *Hearing Before Committee on Financial Services*, *supra* note 94, at 5. He notes that in the first six months of 2020, Robinhood investors received over \$1 billion in price improvement. *Id.*

<sup>122</sup> See Nir Kaissar, *Banning Payment for Order Flow Would Be a Huge Mistake*, BLOOMBERG (Sept. 13, 2021), <https://www.bloomberg.com/opinion/articles/2021-09-13/personal-finance-banning-payment-for-order-flow-would-be-a-mistake> [<https://perma.cc/2D87-KX7J>] (arguing that banning payment for order flow would cause more harm to investors than maintaining the practice); Larry Tabb, *Why Payment for Order Flow Is a Good Deal for Investors*, FIN. TIMES (Oct. 17, 2019), <https://www.ft.com/content/b745ba00-ef1d-11e9-bfa4-b25f11f42901> [<https://perma.cc/D3ZU-S4RQ>] (arguing against a payment for order flow ban because it results in better prices for investors and lower costs for market makers). Proponents of maintaining payment for order flow acknowledge that, on the surface, payment for order flow appears flawed. See Tabb, *supra* (noting that payment for order flow “just sounds bad” because of the conflicts that emerge from paying for an investor's order). Nevertheless, these proponents argue that once you look deeper into the system, you realize that the benefits it provides outweigh its perceived costs. *Id.* They also argue that changes to the payment for order flow system may interfere with the ability of market makers to provide liquidity in the market. See *id.* (noting that banning payment for order flow would require brokers to increase time and monetary costs to search for liquidity).

<sup>123</sup> See *Hearing Before Committee on Financial Services*, *supra* note 94, at 5 (discussing the economic benefits of payment for order flow); Kaissar, *supra* note 122 (arguing against a ban of payment for order flow on the basis of investor benefits); *GameStop Hearing, Part 1*, *supra* note 111, at 1:02:51 (giving one representative's opinion that the best legislative course of action is increased enforcement of current payment for order flow regulations).

<sup>124</sup> See *infra* notes 126–134 and accompanying text.

Subsection 2 discusses arguments supporting the current regulatory framework as sufficiently protective of investors.<sup>125</sup>

## 1. The Benefits of Payment for Order Flow

Proponents of maintaining payment for order flow argue that the practice allows broader retail investor participation in capital markets that otherwise would not be available if the practice was banned.<sup>126</sup> This argument hinges on the premise that payment for order flow eliminated brokerage commissions and increased participation in the U.S. stock market, especially among lower income and younger investors.<sup>127</sup> In addition, advocates claim that payment for order flow helps correct inequities between large investors and small investors by replacing the fixed-price trading costs of commission models with percentage-per-trade costs in payment for order flow.<sup>128</sup> This equity argument posits that fixed commission fees harmed smaller investors more than larger investors

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<sup>125</sup> See *infra* notes 135–140 and accompanying text.

<sup>126</sup> *Hearing Before Committee on Financial Services*, *supra* note 94, at 4; Kaissar, *supra* note 122. Commentators refer to the widespread participation of new investors in the U.S. securities market as the “democratization of markets.” See Kaissar, *supra* note 122 (stating that payment for order flow was “an indispensable tool in the democratization of markets”). Robinhood even advertises its company’s mission as “democratiz[ing] finance for all.” *Our Mission*, ROBINHOOD, <https://robinhood.com/us/en/support/articles/our-mission/> [<https://perma.cc/G6SP-ULKP>]. Although an arguably noble idea, widespread market participation led to some tragic results. See Fallon, *supra* note 93, at 432 (discussing the suicide of a college student who mistakenly believed he had endured a financial loss of over \$700,000 based on representations on his Robinhood account); Nathaniel Popper, *Robinhood Has Lured Young Traders, Sometimes with Devastating Results*, N.Y. TIMES, <https://www.nytimes.com/2020/07/08/technology/robinhood-risky-trading.html> [<https://perma.cc/PR7S-RRKT>] (Sept. 25, 2021) (noting that one trader had to take out multiple home equity loans to pay off debts incurred from trading on Robinhood’s platform). Evidence also suggests that higher participation on online brokerage platforms results in worse returns for retail investors. Popper, *supra*. This is especially problematic because Robinhood gets higher revenue the more its investors trade and because Robinhood’s investors trade riskier products compared to other brokerage firms’ investors. *Id.* These structural dynamics further incentivize Robinhood to get its investors to trade more frequently. *Id.* Furthermore, in the wake of one student killing himself because of a flaw in Robinhood’s software, several Robinhood employees stated that the company does not have sufficient technology protections and support for its retail investors. *Id.*

<sup>127</sup> See *GameStop Hearing, Part I*, *supra* note 111, at 1:25:33 (stating that payment for order flow drove the financial industry to zero commission trading and, in doing so, benefited investors); Fallon, *supra* note 93, at 435 (noting that Robinhood’s customers are significantly younger and have smaller investment portfolios compared to other brokerage firms). The SEC, however, noted that Robinhood’s commission-free advertisement can mislead customers, especially when the result of no commissions is poorer execution quality. Press Release, U.S. Sec. & Exch. Comm’n, SEC Charges Robinhood Financial with Misleading Customers About Revenue Sources and Failing to Satisfy Duty of Best Execution (Dec. 17, 2020), <https://www.sec.gov/news/press-release/2020-321> [<https://perma.cc/BLS8-HJQF>]. Such advertising, therefore, misleads Robinhood customers as to the actual costs of trading with their brokerage firm. *Id.*

<sup>128</sup> Kaissar, *supra* note 122.

because of the respective size of their portfolios.<sup>129</sup> Fixed commission fees therefore imposed disproportionate costs on smaller investors when the commission fees applied equally to small and large investors, a problem eliminated when costs are switched to a per trade percentage fee.<sup>130</sup> Defenders of payment for order flow also note that the payment only costs retail investors pennies per trade, a significantly lower amount than the alternative commission fee model.<sup>131</sup>

Furthermore, proponents of payment for order flow argue that the practice benefits investors by providing price improvement opportunities not otherwise available to investors in public exchanges.<sup>132</sup> The argument claims that by bundling orders together for market makers, the practice allows economies of scale to develop, lowering transactional costs between investors and market makers.<sup>133</sup> Accordingly, investors benefit from these lower market maker costs through increased price improvement opportunities as market makers compete among themselves for increasingly larger order bundles.<sup>134</sup>

## 2. The Sufficiency of Current Payment for Order Flow Regulations

In addition to economic arguments about payment for order flow, proponents argue that the current disclosure requirements and the duty of best execution ensure that investors are getting the best value for their trades, regardless

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<sup>129</sup> *Id.* Prior to eliminating commission fees in 2017, Charles Schwab charged a base fee of \$4.95 for trading U.S. stocks. Richard Henderson, *Schwab Opens New Front in Trading War by Slashing Rates to Zero*, FIN. TIMES (Oct. 1, 2019), <https://www.ft.com/content/cf644610-e45a-11e9-9743-db5a370481bc> [<https://perma.cc/3HA4-66JP>].

<sup>130</sup> Kaissar, *supra* note 122. Under this argument, payment for order flow is a more equitable system because the percentage paid by large investors and small investors is relatively the same. *Id.* Under a fixed commission fee model, the cost of the fee as a percentage of an investor's portfolio has an increasingly disproportionate impact the smaller the size of the portfolio. Cory Mitchell, *May Day*, INVESTOPEDIA, <https://www.investopedia.com/terms/m/mayday.asp> [<https://perma.cc/Q972-F6YY>] (Apr. 25, 2022).

<sup>131</sup> See Matt Levine, *Does Robinhood Need Payment for Order Flow?*, BLOOMBERG (Aug. 31, 2021), <https://www.bloomberg.com/news/newsletters/2021-08-31/what-happens-to-robinhood-if-the-sec-bans-payment-for-order-flow-kt0a5kjg> [<https://perma.cc/D4JX-DFXQ>] (noting that payment for order flow only costs pennies to investors); Henderson, *supra* note 129 (providing Charles Schwab's commission fee of \$4.95 prior to moving to a payment for order flow based model). For options trading, however, payment for order flow can cost investors as much as \$0.50 per contract. Carey, *supra* note 42.

<sup>132</sup> *Hearing Before Committee on Financial Services*, *supra* note 94, at 5.

<sup>133</sup> Ferrell, *supra* note 16, at 1085. This argument is largely predicated on the contractual agreements between the broker and market maker that require sending a minimum number of orders before the market maker issues payment to the broker. *Id.* As more orders get executed by the market maker at once, fewer execution costs exist as they get diffused over a larger number of orders. *Id.* Simply put, market makers reduce costs as small orders are bundled together, resulting in narrower spreads between the buying and selling prices. Tabb, *supra* note 122. With fewer operating costs, market makers have more money to use for price improvement to entice investors and brokers to send their orders to them for execution. *Id.*

<sup>134</sup> Carey, *supra* note 42.

of whether the broker receives payment for order flow.<sup>135</sup> Market observers and some members of Congress suggest that rather than changing regulations or banning payment for order flow, increased enforcement under existing regulations is the best course of action.<sup>136</sup> This could come in the form of initiating more investigations of and proceedings against firms who violate their disclosure and best execution duties, similar to the action brought against Robinhood in December 2020.<sup>137</sup>

Finally, Robinhood argues that its business practices eliminate conflicts of interest because its contracts to designated market makers, consistent with current regulatory requirements, require order flow to go only to one partner, regardless of higher payment for order flow offers from other market makers.<sup>138</sup> Furthermore, according to Robinhood, its contracts with each market maker contain identical payment for order flow percentages.<sup>139</sup> As such, Robinhood argues that any conflicts of interest that would exist in sending orders to spe-

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<sup>135</sup> See Kaissar, *supra* note 122 (stating that brokers are already subject to disclosure and best execution requirements).

<sup>136</sup> See *GameStop Hearing, Part 1*, *supra* note 111, at 1:02:51 (arguing that ensuring existing regulations are operational is the best regulatory solution); Zoe Sagalow, *SEC Unlikely to Ban Payment for Order Flow*, S&P GLOBAL (Dec. 29, 2021), <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/sec-unlikely-to-ban-payment-for-order-flow-68191998> [<https://perma.cc/6JPS-VAMZ>] (noting that one institutional investor believes a sufficient change to payment for order flow regulation would be increased enforcement of existing best execution rules). One member of Congress raised concerns that increased regulation of payment for order flow, including a ban, could result in barring the investing public from stock market participation. *GameStop Hearing, Part 1*, *supra* note 111, at 0:04:58; *GameStop Hearing, Part 2*, *supra* note 111, at 1:33:49. One market observer notes that the entire U.S. financial regulatory system's design seeks not to impose substantial change to permissible market participant activities. Matt Levine, Opinion, *What Does Payment for Order Flow Buy?*, BLOOMBERG (Dec. 8, 2021), <https://www.bloomberg.com/opinion/articles/2021-12-08/what-does-payment-for-order-flow-buy> [<https://perma.cc/P8GV-45KU>]. As such, it would be politically challenging to depart from the current disclosure-heavy system. *Id.*

<sup>137</sup> See generally Robinhood Fin., LLC, Securities Act Release No. 10906, Exchange Act Release No. 90694 (Dec. 17, 2020) (bringing an enforcement action against Robinhood for violating best execution and disclosure requirements). The SEC's enforcement action against Robinhood for duty of best execution breaches may signal an increased SEC focus on payment for order flow relationships. See *id.* at 15 (imposing a fine against Robinhood for violation of its current best execution requirements because of payment for order flow relationships). As the SEC noted, high amounts of payment for order flow caused inferior prices and violations of Robinhood's duty of best execution. *Id.* at 2.

<sup>138</sup> *GameStop Hearing, Part 2*, *supra* note 111, at 1:49:36. In particular, the House committee asked Robinhood's CEO how Robinhood could ensure best execution when eliminating other potential locations to execute a trade. *Id.* at 1:49:25. In response, Robinhood's CEO stated that the contracts between market makers and Robinhood eliminate conflicts of interest by removing decision-making for where to send an order. *Id.* at 4:10:26. To put it another way, Robinhood argues that the uniformity of payment agreements among its market makers eliminates conflicts of interest because they will receive the same payment regardless of where the order is executed. *GameStop Hearing, Part 1*, *supra* note 111, at 1:49:36. The exclusivity of long-term agreements between brokerage firms and executing partners results in what some scholars call "captive order flow" arrangements between brokers and market makers. Dolgoplov, *supra* note 35, at 156.

<sup>139</sup> *GameStop Hearing, Part 1*, *supra* note 111, at 1:49:36.

cific market makers are eliminated because each of its associated market makers pay the same amount of payment for order flow.<sup>140</sup>

### *B. Changes to Current Payment for Order Flow Regulations*

In between maintaining current payment for order flow regulation and banning the practice are proposed reforms to current broker best execution and disclosure requirements.<sup>141</sup> Subsection 1 of this Section discusses proposed changes to current best execution requirements.<sup>142</sup> Subsection 2 discusses proposed changes to current disclosure requirements.<sup>143</sup>

#### 1. Altering Best Execution Requirements

Some scholars believe changes to the duty of best execution's definition and measurement would resolve problems with payment for order flow.<sup>144</sup> For example, one scholar suggests granting brokers an option to credit a customer's account with the NBBO at the time of execution, and then locate a market participant to execute the order.<sup>145</sup> Under this proposal, crediting at the NBBO would fulfill a broker's best execution duty.<sup>146</sup> Brokerage firms would be in-

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<sup>140</sup> Tomio Geron, *Payment for Order Flow Made Robinhood Huge. Now Everyone's Arguing About It*, PROTOCOL (Apr. 27, 2021), <https://www.protocol.com/fintech/payment-for-order-flow-explained> [<https://perma.cc/4GJG-V93J>]. Robinhood, however, does not disclose what the fixed rate market makers pay it for order flow, nor does it compare the amount received in payment for order flow against the amount received by the investor in price improvement for the same order. *Id.* See generally Robinhood Securities, LLC, *supra* note 56 (discussing Robinhood's contractual relationship with market makers in broad terms with no mention of the fixed payment for order flow percentage).

<sup>141</sup> See Sagalow, *supra* note 136 (discussing the unlikelihood of an outright ban of payment for order flow and possible regulatory changes); Spilka, *supra* note 117 (noting widespread belief that the SEC would not ban payment for order flow and offering proposed regulatory changes).

<sup>142</sup> See *infra* notes 144–155 and accompanying text.

<sup>143</sup> See *infra* notes 156–170 and accompanying text.

<sup>144</sup> See Ferrell, *supra* note 16, at 1073 (discussing a proposed change to the SEC's definition of best execution while refusing to ban payment for order flow); Dolgoplov, *supra* note 16, at 529 (stating that although price improvement may indicate adherence to the duty of best execution, the receipt of price improvement must be measured against other opportunities to receive price improvement in the market at large to determine whether the duty of best execution has been fulfilled).

<sup>145</sup> Ferrell, *supra* note 16, at 1073.

<sup>146</sup> *Id.* Currently, execution at the NBBO may constitute best execution, after consideration of the various factors and circumstances. See *supra* notes 68–71 and accompanying text (discussing how the NBBO correlates to best execution requirements). Compliance with the duty of best execution, however, is not guaranteed by a broker simply fulfilling an investor's order at the NBBO. See *id.* (discussing why execution at the NBBO does not necessarily satisfy the duty of best execution). According to Robinhood, 94.5% of its orders are satisfied at the NBBO or better. Geron, *supra* note 140. In comparison, Charles Schwab fulfills 98.8% of its orders at the NBBO or better. *Id.* The requirement that brokers meet at least the NBBO only applies to retail orders of one hundred shares or greater. See Robert P. Bartlett, III, *Modernizing Odd Lot Trading*, 2021 COLUM. BUS. L. REV. 520, 530 (noting that "odd lot orders" are exempt from NBBO requirements under Regulation NMS). Odd lot orders are orders below the one hundred share threshold. James Chen, *What Is an Odd Lot?*, INVESTOPEDIA, <https://www.investopedia.com/terms/o/oddlot.asp> [<https://perma.cc/Z46Y-25B5>] (June 30, 2021). As

centivized to locate the best available price in the market to complete an order because they alone would bear the costs of doing so, thus eliminating conflicts between the investor's and broker's interests.<sup>147</sup> Competition among brokerage firms for investor orders would incentivize firms to grant rebates to customers after securing a better price than the NBBO.<sup>148</sup> This would encourage brokers to provide transparent disclosures about the rebates given to their customers as a way of enticing more investors to use their services.<sup>149</sup>

Other commentators state that the touchstone for best execution compliance measurement should be the availability of price improvement opportunities in the entire market, as opposed to the mere receipt of price improvement from individual market makers.<sup>150</sup> This approach is consistent with prior SEC action altering the substantive requirements of a broker's duty of best execution to control for changes to broker payment models and technology.<sup>151</sup> Spe-

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a result, many orders placed through retail brokerage firms likely do not get NBBO because their orders fall below the one hundred share threshold. Geron, *supra* note 140. As one scholar notes, the investor remains protected under the duty of best execution, even when the order constitutes an odd lot. Bartlett, *supra*, at 530. Monitoring best execution, however, is difficult because the odd lot is exempt from NBBO's definition. *Id.*

<sup>147</sup> Ferrell, *supra* note 16, at 1073. The broker alone would bear the costs in this regulatory model because the price for the investor would already be locked in at the NBBO. *Id.* It does not matter for the investor whether the broker decides to execute the trade with a certain market maker, internally, or on a public exchange. *Id.* The investor receives the same price regardless. *Id.* Thus, the broker has the incentive to find the best price above the NBBO for execution because that increases the profit they will receive. *Id.* at 1073–74. The broker would face further incentive to find the best location for execution because the broker would need sufficient profit to send to the Investor in a rebate to compete against other firm's rebates. *Id.*

<sup>148</sup> *Id.* at 1074. The primary benefit of this proposal, according to the author, is that it allows small investors the ability to compare the benefits of utilizing one firm over another without increased monitoring costs. *Id.* The ability to quickly analyze rebate returns at various firms would further push brokers in an already competitive market to seek the best rebate possible to maintain customers. *Id.*

<sup>149</sup> *Id.*

<sup>150</sup> See Dolgoplov, *supra* note 16, at 529 (arguing that best execution “should be measured against reasonable opportunities for obtaining price improvement elsewhere” and not only on the receipt of price improvement from market makers (emphasis omitted)). Typically, most market makers execute orders based on the NBBO with price improvement added to confirm adherence to best execution requirements. Dolgoplov, *supra* note 35, at 158. An increased focus on price improvement as a measurement of best execution is significant because, as one commentator notes, price improvement is one of the most significant investor benefits of payment for order flow. Geron, *supra* note 140. Even the SEC notes that reliance on the NBBO as a measurement of best execution is often misleading. U.S. SEC. & EXCH. COMM'N, *supra* note 2, at 14. Because a large number of trades take place within the NBBO, price improvement statistics based on the NBBO have the potential to overstate the price improvement received. *Id.*

<sup>151</sup> See *Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 271 (3d Cir. 1998) (discussing changes to the SEC's definition of best execution). The court in *Newton* gives one example of the SEC altering best execution requirements based on technological evolution. *Id.* It notes that prior to NASDAQ's formation, a broker complied with best execution requirements by reaching out to three market makers before executing a trade. *Id.* Following NASDAQ's formation and the adoption of a computerized NBBO, the SEC changed its rules and required a firm to consult the NBBO before executing a trade. *Id.*

cifically, the SEC states that changes to a broker's duty of best execution must occur when the market evolves to improve customer execution, including when better price opportunities become available.<sup>152</sup> Thus, advocates for an adjustment to best execution measurement would argue that the SEC's stated position necessitates a focus on price improvement opportunities available in the wider market as opposed to the simple receipt of price improvement.<sup>153</sup> This is especially true considering that price improvement measurement offered by market makers may be distorted by a number of factors, including reference to the NBBO, other reference transactions, and the time that a trade is executed.<sup>154</sup> Furthermore, the fact that many market makers have exclusive access to brokerage firms' order flow through captive arrangements, as well as the negotiated nature of the price improvement/payment for order flow split of the payment received by brokerage firms for their order flow, suggests that receipt of price improvement in excess of the NBBO is not necessarily a valid measurement of best execution.<sup>155</sup>

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<sup>152</sup> Order Execution Obligations, 61 Fed. Reg. 48290, 48322–23 (1996).

<sup>153</sup> See Dolgoplov, *supra* note 16, at 529–30 (noting that receipt of price improvement by itself is not enough in determining whether best execution has been met if not compared to other price improvement opportunities available in the wider market). Scholars note that the failure to disclose missed price improvement opportunities in the market have a greater impact on retail investors whose orders get misrouted at a higher rate compared to institutional investors. Ferrell, *supra* note 16, at 1058. Criticisms over best execution measurements also focus on firms' permissible periodic evaluation of best execution practices in the aggregate. BETTER MKTS., PAYMENT FOR ORDER FLOW: HOW WALL STREET COSTS MAIN STREET INVESTORS BILLIONS OF DOLLARS THROUGH KICKBACKS AND PREFERENTIAL ROUTING OF CUSTOMER ORDERS 7 (2021), [https://bettermarkets.org/sites/default/files/documents/Better\\_Markets\\_Payment\\_for\\_Order\\_Flow\\_Long\\_02-21-2021.pdf](https://bettermarkets.org/sites/default/files/documents/Better_Markets_Payment_for_Order_Flow_Long_02-21-2021.pdf) [<https://perma.cc/M7BQ-6FYG>]. Such critics suggest changing evaluation of best execution practices on a trade-by-trade basis using modern technology, which allows a broker to see in real time price improvement offered from a variety of market makers for a given security. *Id.* Furthermore, such critics believe the current best execution standard is too difficult to enforce because of its flexibility and that the NBBO is an improper benchmark for measuring price improvement. *Id.* at 8. They argue that price improvement should consider the price available to an investor under all market conditions present at the time of order receipt, including internal offers from other market makers. *Id.* at 9. Furthermore, other critics suggest that the NBBO is not representative of the true best bid and offer available for a stock because certain orders, specifically those placed with instructions not to make their prices public and those below 100 shares, are placed within the NBBO but not calculated into its formula. HITESH MITTAL & KATHRYN BERKOW, BESTEX RESEARCH, THE GOOD, THE BAD, & THE UGLY OF PAYMENT FOR ORDER FLOW 8 (2021), <https://f.hubspotusercontent10.net/hubfs/4982966/BestEx%20Research%20PFOF%2020210503.pdf> [<https://perma.cc/NJX9-UWVF>].

<sup>154</sup> See Dolgoplov, *supra* note 16, at 530 (describing how price improvement measurement may be “gamed or distorted” by market makers).

<sup>155</sup> See *id.* (questioning whether the negotiated split of payment for order flow and price improvement in captive arrangements results in best execution). The SEC, perhaps recognizing the issues with current best execution measurement in payment for order flow arrangements, proposed Rule 615, which would require that brokerage firms expose certain market orders to auctions in the open market for execution. Order Competition Rule, 88 Fed. Reg. at 146. According to the SEC, this so called “order competition requirement” would expose these orders to competition in the market and help ensure the best price for order execution. *Id.* at 147. This requirement, in short, would address

## 2. Changing Disclosure Requirements

Outside of proposed changes to best execution regulation, a number of critics focus on enhancing payment for order flow disclosure requirements.<sup>156</sup> Critics of payment for order flow argue that current disclosure requirements are insufficient for providing customers comparisons of firms' execution quality.<sup>157</sup> Furthermore, critics argue that the current disclosure regime lacks necessary information for investors to determine how well their broker executes their order compared to the NBBO at the time of receipt.<sup>158</sup>

In December 2021, FINRA requested comments on a proposal to change disclosure requirements related to order routing that would require brokers to file their Rule 606 reports on a centralized website.<sup>159</sup> The SEC previously stated that centralized data keeping could facilitate easier access for customers to assess brokerage firms' order handling practices.<sup>160</sup> One commentator stated that centralized reporting would benefit both the public and brokerage firms.<sup>161</sup>

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some of the issues identified by commentators relating to the captive and negotiated nature of payment for order flow arrangements by forcing certain market orders be exposed to other potential execution venues, including national securities exchanges, instead of flowing strictly to one execution partner who has paid for the order flow. *Id.* The SEC, in its release proposing Rule 615, noted that currently when a wholesaler (market maker) receives an order from a brokerage firm for execution, that order generally is executed by that market maker, without regard to other opportunities for execution in the larger market. *Id.* at 130.

<sup>156</sup> See Geron, *supra* note 140 (stating that inadequate disclosure of the practice "casts a pall over the business"); Sagalow, *supra* note 136 (stating that current disclosure requirements lack the desired information and accessibility desired). The viability of proposed changes to disclosure rules is likely higher than other regulatory proposals because of the SEC's stated position preferring disclosure over other regulatory solutions. See *Payment for Order Flow*, 59 Fed. Reg. at 55007 (stating the SEC's position that disclosure for payment for order flow is the best regulatory course of action).

<sup>157</sup> See *GameStop Hearing, Part 2*, *supra* note 111, at 0:21:25–0:24:31 (stating that price improvement disclosures by Robinhood do not allow for informative comparisons with competitors).

<sup>158</sup> *Retail Execution Quality-Overview*, FIN. INFO. F., <https://fif.com/index.php/retail-execution-quality/retail-execution-quality-overview> [<https://perma.cc/LSU8-3L2Q>].

<sup>159</sup> *Regulatory Notice 21-35: Order Routing Disclosures for OTC Equity Securities*, *supra* note 51, at 5. Currently, FINRA requires brokers to file information related to order execution and handling practices on their own publicly available websites. *Id.* FINRA believes that switching to a centralized website will increase transparency for investors, allowing them to better compare their broker's services with others. *Id.* at 5–6.

<sup>160</sup> *Disclosure of Order Handling Information*, 83 Fed. Reg. at 58377–78. Nevertheless, the SEC went on to state that, because of costs and time delays associated with the development of a centralized website, it believes such a requirement would impair customers' ability to assess execution performance. *Id.* at 58378.

<sup>161</sup> Howard Meyerson, Managing Director, Fin. Info. F., Comment Letter on FINRA Regulatory Notice 21-35 (Dec. 2, 2021), [https://www.finra.org/sites/default/files/NoticeComment/Howard%20Meyerson\\_Financial%20Information%20Forum\\_21-35\\_12.2.2021%20-%20FIF%20comment%20ltr%20on%20606%20for%20OTC%20submitted%202dec2021.pdf](https://www.finra.org/sites/default/files/NoticeComment/Howard%20Meyerson_Financial%20Information%20Forum_21-35_12.2.2021%20-%20FIF%20comment%20ltr%20on%20606%20for%20OTC%20submitted%202dec2021.pdf) [<https://perma.cc/MZ3W-Q6UF>]. According to the commentator, FINRA and the SEC could leverage brokerage firm participation in centralized reporting to relieve other reporting obligations. *Id.* Specifically, compliance with the centralized reporting mechanism would alleviate the requirement that firms report the same data under current weekly FINRA reporting rules. *Id.*

Proponents of centralizing 606 reports argue that the current regime makes it nearly impossible for investors to locate the data because the information is spread across multiple brokerage firm websites and are often difficult to locate at those sites.<sup>162</sup> They argue that by centralizing all relevant information among brokers in one location, investors with less resources and time will be better able to review execution practices.<sup>163</sup>

Another proposal for enhanced disclosure is to require firms to disclose a comparison of their execution with the NBBO.<sup>164</sup> The Financial Information Forum (FIF) currently facilitates a working group made up of brokerage firms and market makers that voluntarily disclose more detailed information related to order execution than required under Rule 606.<sup>165</sup> The FIF's reports are markedly different from current Rule 606 disclosures.<sup>166</sup> Unlike Rule 606 Reports, the FIF reports include a breakdown of the average order sizes within a designated order size range.<sup>167</sup> The FIF reports also include the percent of shares in market orders executed at the current market quote or better at the time of order receipt, the percentage of shares in market orders that received price improvement, and av-

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<sup>162</sup> Tyler Gellasch, Executive Director, Healthy Mkts. Ass'n, Comment Letter on Proposed Rule for Disclosure of Order Handling Information (Sept. 26, 2016), <https://www.sec.gov/comments/s7-14-16/s71416-19.pdf> [<https://perma.cc/LPH4-2LZD>].

<sup>163</sup> See *id.* (arguing that the current regulatory regime allowing disclosure on individual websites makes it nearly impossible for retail investors to access Rule 606 disclosures).

<sup>164</sup> See *Retail Execution Quality-Overview*, *supra* note 158 (discussing a working group of market participants committed to publishing enhanced disclosure reports than currently required by law).

<sup>165</sup> *Id.* The Financial Information Forum (FIF) established the working group of brokerage firms and market makers with the goal of providing investors better measurements of order execution quality. *Retail Execution Quality Statistics*, FIN. INFO. F., <https://fif.com/tools/retail-execution-quality-statistics> [<https://perma.cc/MS95-5QG9>]. Only the brokerage firm Fidelity Investments and the market maker Two Sigma Securities are currently members of the working group. *Id.* Market maker Virtu Financial and brokerage firm Charles Schwab previously participated in the working group. *Rule 605 and 606 Reporting*, VIRTU FIN., <https://www.virtu.com/about/transparency/rule-605-and-606-reporting/> [<https://perma.cc/9MZT-VNTQ>]; *Schwab Order Execution Advantage*, CHARLES SCHWAB, <https://www.schwab.com/execution-quality> [<https://perma.cc/XU9T-TLDC>]. Fidelity currently markets itself as the only brokerage firm that implements the FIF reporting standards. *Commitment to Execution Quality*, FIDELITY, <https://www.fidelity.com/trading/execution-quality/overview> [<https://perma.cc/X9PY-QDGG>]. Nevertheless, at least one other firm—Charles Schwab—continues to disclose similar reports, although not a current member of the working group. See Charles Schwab, *Retail Execution Quality Statistics (Q4 2022)*, <https://www.schwab.com/execution-quality/quality-statistics> [<https://perma.cc/2QDZ-4AHL>] (providing a report similar to FIF's recommended disclosures).

<sup>166</sup> Compare Fidelity Brokerage Services LLC, *Retail Execution Quality Statistics (Q4 2022)*, [https://www.fidelity.com/bin-public/060\\_www\\_fidelity\\_com/documents/FIF-FBS-retail-execution-quality-stats.pdf](https://www.fidelity.com/bin-public/060_www_fidelity_com/documents/FIF-FBS-retail-execution-quality-stats.pdf) [<https://perma.cc/6QLD-H5X5>] (providing a breakdown of information by order range, price improvement received, and shares executed at or greater than current market prices), with Robinhood Securities, LLC, *supra* note 56 (failing to provide equivalent information).

<sup>167</sup> *Retail Execution Quality-Overview*, *supra* note 158. For example, Fidelity, in its FIF report, broke down order size ranges into five categories: 1–99 shares, 100–499 shares, 500–1,999 shares, 2,000–4,999 shares, and 5,000–9,999 shares. Fidelity Brokerage Services LLC, *supra* note 166. The report also gives the average order size in shares for orders within that range. *Id.* For instance, in the 1–99 range, Fidelity reported an average order size of 17 shares. *Id.*

erage execution speed between the order routing and the trade execution.<sup>168</sup> Finally, the FIF reports include disclosures on the amount of savings received on an average order resulting from price improvement.<sup>169</sup> FIF reports could serve as an example for enhanced Rule 606 requirements.<sup>170</sup>

### C. Banning Payment for Order Flow

Although SEC Chairman Gensler previously suggested that the SEC could ban payment for order flow, many doubt the viability of doing so.<sup>171</sup> Skeptics of an outright ban argue the elimination of payment for order flow would stymie the stock market democratization that followed the emergence of

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<sup>168</sup> *Retail Execution Quality-Overview*, *supra* note 158. Fidelity reported that 99.45% of shares in the range from 1–99 were executed at the current market quote or better, 91.62% received price improvement, and all shares in that range had an average execution speed of 0.0265 seconds. Fidelity Brokerage Services LLC, *supra* note 166.

<sup>169</sup> *Retail Execution Quality-Overview*, *supra* note 158.

<sup>170</sup> *See id.* (stating that the purpose of enhanced Rule 606 disclosures is to ensure investor receipt of necessary best execution information). The fact that a number of large brokers voluntarily disclose FIF and similar reports enhances the feasibility of the proposed disclosure changes because it demonstrates brokers' ability to disclose that information with negligible costs. *See* Fidelity Brokerage Services LLC, *supra* note 166 (giving Fidelity's FIF report for 2022's fourth quarter); Charles Schwab, *supra* note 165 (giving Charles Schwab's report containing similar information). To assist customer comprehension of the information provided, FIF's reports also include definitions of the terms and explanations of the relevance of the measurements. *Retail Execution Quality-Overview*, *supra* note 158. For example, Fidelity's FIF report defines price improvement as receipt of execution at a price better than the NBBO, which is a positive result for investors. Fidelity Brokerage Services LLC, *supra* note 166. The information included in the definitions and explanation sections of the FIF reports uniformly applies to all participants. *See id.* (providing the definitions and explanations); Wholesaler Virtu Americas LLC, *2019-Q3 Supplemental Retail Execution Quality Statistics* (2019), <https://virtu-www.s3.amazonaws.com/uploads/documents/2019Q3-Virtu-Americas-Supplemental-Retail-Execution-Quality-Statistics.pdf> [<https://perma.cc/NP3L-NSE5>] (same).

<sup>171</sup> *See* Franck, *supra* note 12 (providing Chairman Gensler's statements regarding a payment for order flow ban); Spilka, *supra* note 117 (noting widespread belief that the SEC would not ban payment for order flow). Such skeptics apparently were correct, as the SEC has since backed away from banning payment for order flow. Beyoud & Doherty, *supra* note 13. Outside of regulatory and congressional scrutiny of payment for order flow, investors Warren Buffet and Charlie Munger also oppose brokerage firms like Robinhood that rely heavily on its use. Mark Kolakowski, *SEC Considers Banning Payment for Order Flow*, INVESTOPEDIA (Oct. 22, 2021), <https://www.investopedia.com/sec-considers-banning-payment-for-order-flow-5199447> [<https://perma.cc/TH7T-M93K>]. The gamified system employed by Robinhood concerns both Buffet and Munger who believe it turns investing into gambling. *Id.* For more information regarding the gamification of brokerage apps, see generally Fallon, *supra* note 93 (discussing Robinhood's push to keep investors trading through gamification). Disagreement exists among legal scholars as to whether the SEC has authority to implement an outright ban of payment for order flow. *See* Keenan, *supra* note 18 (detailing arguments of whether the SEC has the power to ban payment for order flow). A former SEC attorney argues that the SEC lacks the statutory authority to implement a ban under antifraud or disclosure statutes. *Id.* On the other hand, another legal scholar believes that the SEC could use common law agency principles to implement a ban. *Id.* Other market participants note that the SEC can ban payment for order flow. Sagalow, *supra* note 136.

payment for order flow business models.<sup>172</sup> Alternative business systems and regulatory structures that successfully ban payment for order flow exist, however, both within the United States and globally.<sup>173</sup>

Proponents of prohibition point to Europe as an example of eliminating payment for order flow, noting that national regulators in European countries are skeptical of the practice.<sup>174</sup> In 2012, the United Kingdom's securities' regulatory body posted guidance that essentially banned brokerage firms' use of payment for order flow.<sup>175</sup> For U.K. regulators, disclosure of payment for order flow was an inadequate regulatory mechanism to manage the "self-created conflict of interest" that arises from the market maker payments to the broker.<sup>176</sup> Rather, U.K. regulators believed that such conflicts of interest were best addressed by simply eliminating the payment and charging a commission fee.<sup>177</sup>

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<sup>172</sup> See Keenan, *supra* note 18 (noting opposition to a proposed payment for order flow ban because it would reverse the democratization of the stock market); Kaissar, *supra* note 122 (arguing against a payment for order flow ban because the practice contributed positively to the increased accessibility of investing for a larger group of people).

<sup>173</sup> See Verena Ritter-Doring et al., *Payment for Order Flow Ban: EU Regulators Set to Follow the UK's Approach*, TAYLOR WESSING (Dec. 14, 2021), <https://www.taylorwessing.com/en/insights-and-events/insights/2021/12/payment-for-order-flow-ban> [<https://perma.cc/2J68-94D6>] (discussing the United Kingdom's effective ban of payment for order flow receipt by brokerage firms); Benjamin Pimentel, *Here's How GameStop Turned Public into the Anti-Robinhood*, PROTOCOL (July 22, 2021), <https://www.protocol.com/fintech/public-payment-for-order-flow> [<https://perma.cc/R6A9-ZGYX>] (discussing one brokerage firm's switch away from accepting payment for order flow).

<sup>174</sup> Dologoplov, *supra* note 35, at 165.

<sup>175</sup> FIN. SERVS. AUTH., GUIDANCE ON THE PRACTICE OF 'PAYMENT FOR ORDER FLOW' 4 (2012), <https://www.fca.org.uk/publication/finalised-guidance/fg12-13.pdf> [<https://perma.cc/LH3D-5ZLN>] ("The receipt of [payment for order flow] gives rise to a conflict of interest between the firm's interest and the interests of its brokering clients which may damage the interests of the clients."); see Ritter-Doring et al., *supra* note 173 (stating that guidance from the Financial Services Association (FSA) essentially outlawed broker receipt of payment for order flow). Although guidance from the FSA did not explicitly ban payment for order flow, the regulator imposed three strict tests that in effect made it nearly impossible for investors to accept such payments. See FIN. SERVS. AUTH., *supra*, at 5–6 (identifying the three tests and outlining how firms could comply). The three tests are: (1) the payments cannot impair a firm's compliance with their duty to act in a client's best interest; (2) the details of the inducement must be disclosed prior to rendering service; and (3) such payments must be designed to enhance the quality of service provided to the client. *Id.* To receive payment for order flow, a brokerage firm must prove that all three tests are met. *Id.* at 5. Although brokerage firms could meet tests one and two, albeit by jumping through difficult regulatory hoops, the third test presents the most pronounced obstacle to payment for order flow receipt. See *id.* at 6 (noting why it is difficult for firms to pass the third test). According to the FSA, it is nearly impossible for a firm to show that payment for order flow provides clear benefit to the client. *Id.* The FSA entertained that the brokerage firm's added remuneration was the only clear benefit. *Id.* Nevertheless, the FSA found it unreasonable to suggest that a broker receiving monetary benefit is actually beneficial to the client. *Id.*

<sup>176</sup> *Observations from Market Maker Review*, MARKET WATCH (Fin. Conduct Auth., London, U.K.), Sept. 2016, at 8, <https://www.fca.org.uk/publication/newsletters/marketwatch-51.pdf> [<https://perma.cc/TR7U-F2P6>].

<sup>177</sup> *Id.* According to the Financial Conduct Authority (FCA), the best way to deal with the conflicts of interest arising from payment for order flow relationships is to prevent them from ever arising.

In the 2014 Markets in Financial Instruments Directive II (MiFID II), the European Union joined the United Kingdom in making it unlawful for a brokerage firm to receive payments or other non-monetary benefits for the routing of investor orders to execution venues if such payments would result in a conflict of interest.<sup>178</sup> The European Union, like the United Kingdom, essentially extinguished the receipt of payment for order flow.<sup>179</sup> Similar to the United Kingdom, the European Union justifies heavy regulation on brokers by citing the misalignment of incentives between the broker agent, the investor principal, and the third-party market maker.<sup>180</sup> Outside of Europe, both Canada and Australia also prohibit payment for order flow.<sup>181</sup> Similar to their European

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ing. *Id.* at 9. As such, refusing to enter into payment for order flow arrangements is the easiest way to comply with regulatory requirements. *Id.*

<sup>178</sup> Directive 2014/65, of the European Parliament and of the Council of 15 May 2014 on Markets in Financial Instruments and Amending Directive 2002/92/EC and Directive 2011/61/EU, art. 27(2), 2014 O.J. (L 173) 349, 412; FIN. SERVS. AUTH., *supra* note 175, at 6.

<sup>179</sup> See Press Release, European Sec. & Mkts. Auth., ESMA Warns Firms and Investors About Risks Arising from Payment for Order Flow and from Certain Practices by “Zero-Commission Brokers” (July 13, 2021), [https://www.esma.europa.eu/sites/default/files/library/esma35-43-2749\\_esma\\_public\\_statement\\_pfof\\_and\\_zero-commission\\_brokers.pdf](https://www.esma.europa.eu/sites/default/files/library/esma35-43-2749_esma_public_statement_pfof_and_zero-commission_brokers.pdf) [<https://perma.cc/27VW-EY7L>] (stating brokerage firms’ regulatory requirements in the European Union to receive payment for order flow); Ritter-Doring et al., *supra* note 173 (noting that firms that want to receive payment for order flow must comply with several regulatory requirements in both the United Kingdom and the European Union). The European Union did not implement an outright ban but, under their guidelines, a brokerage firm may only receive payment for order flow if the payment design enhances the quality of brokerage services and it does not limit the firm’s ability to act in its clients’ best interests. Press Release, European Sec. & Mkts. Auth., *supra*. Furthermore, to comply with the Markets in Financial Instruments Directive II (MiFID II) a brokerage firm must disclose to the client both the nature and amount of payment for order flow received before and after receipt of payment. *Id.* A 2021 proposal from the European Commission would explicitly bar brokerage firms from receiving payment for order flow for the same reasons it implemented the current regulatory structure. *Commission Proposal for a Regulation of the European Parliament and of the Council Amending Regulation (EU) No 600/2014*, at 39, COM (2021) 727 final (Nov. 25, 2021). The proposed amendment would make it illegal for a brokerage firm to “receive any fee” from a third party for “forwarding client orders to such third party for their execution.” *Id.*

<sup>180</sup> See Press Release, European Sec. & Mkts. Auth., *supra* note 179 (noting that a conflict exists for brokers in payment for order flow arrangements because of an improper incentive structure to route orders to third parties offering the highest payment to the broker, rather than those providing the best price to investors). The European Securities and Markets Authority (ESMA) notes in its report that firms attempt to skirt their best execution requirements by providing investors a list of execution venues for the customer to choose from at the time of order placement. *Id.* ESMA argued that such a practice harms investors by improperly enticing investors to select venues that offer payment for order flow. *Id.*

<sup>181</sup> See MKT. REGUL. POL’Y DEP’T, INV. INDUS. REGUL. ORG. OF CAN., ANNOTATED UNIVERSAL MARKET INTEGRITY RULES 7.5-1 (2018), <https://www.iiroc.ca/media/1021/download?inline> [<https://perma.cc/CB23-JR7R>] (preventing a Canadian broker from executing a trade at a price different than the market price on the exchange); *Guidance on Best Execution*, INV. INDUS. REG. ORG. OF CAN. (Oct. 14, 2021), [https://www.iiroc.ca/news-and-publications/notices-and-guidance/guidance-best-execution-0#footnoteref14\\_hlbib40](https://www.iiroc.ca/news-and-publications/notices-and-guidance/guidance-best-execution-0#footnoteref14_hlbib40) [<https://perma.cc/ZZ5W-BC43>] (explaining that Universal Market Integrity Rule (UMIR) 7.5 bans payment for order flow); *ASIC Market Integrity Rules (Securities Markets) 2017* (Cth) pt 5.4B (Austl.), <https://www.legislation.gov.au/Details/F2018C00334/Html/> [<https://perma.cc/>

counterparts, both nations' regulators point to perverse incentive structures, conflicts of interest, and questions surrounding best execution necessitating such bans.<sup>182</sup>

While foreign regulators drive the push to end payment for order flow abroad, some brokerage firms in the United States already operate without payment for order flow.<sup>183</sup> Fidelity Investments is perhaps the most prominent U.S. firm that does not accept payment for order flow for equity trades.<sup>184</sup> Notably, Fidelity maintains a zero-commission brokerage service without using the practice for equity orders, contradicting the argument that prohibiting pay-

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37DC-KXCL] (banning payments from one party to a market participant for the opportunity to execute an order). Under Canadian law, all trades must be executed on public exchanges, eliminating off exchange market makers. Nichola Saminather, *Canada Stock Market Rules Curb Platforms Linked to Churning U.S. Stocks*, REUTERS, <https://www.reuters.com/article/us-retail-trading-canada/canada-stock-market-rules-curb-platforms-linked-to-churning-u-s-stocks-idUSKBN2A92NC> [<https://perma.cc/338R-SXGM>] (Feb. 9, 2021).

<sup>182</sup> See *Guidance on Best Execution*, *supra* note 181 (stating that UMIR 7.5 prohibits payment for order flow because the practice can alter behavior and trade incentives); Press Release, Austl. Sec. & Invs. Comm'n, ASIC Consults on Payment for Order Flow Rule Amendments (Aug. 25, 2021), <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/> [<https://perma.cc/QKQ5-X5HP>] (stating that payment for order flow creates conflicts of interests and negatively impacts liquidity and pricing in the market-place). Critics of the payment for order flow ban in Canada argue that the prohibition causes the direction of retail equity orders into the United States. Anna Nicolaou, *Toronto Stock Exchange Warns on Trade Flow to US Markets*, FIN. TIMES (Feb. 16, 2015), <https://www.ft.com/content/d8ae480c-b39e-11e4-a6c1-00144feab7de> [<https://perma.cc/REV4-TDNE>]. Australian regulators are currently considering enhancing their payment for order flow ban in response to the GameStop stock ordering freeze. Rick Steves, *Australia Wants to Ban PFOF as Practice Comes Under Greater Scrutiny*, FIN. FEEDS (Aug. 25, 2021), <https://financefeeds.com/australia-wants-ban-pfof-practice-comes-greater-scrutiny/> [<https://perma.cc/2TGH-S9TQ>].

<sup>183</sup> See Kevin Stankiewicz, *Fidelity Says It Won't Pay for Zero Fees by Selling Your Trade Executions to the Highest Bidder*, CNBC, <https://www.cnbc.com/2019/10/11/fidelitys-kathleen-murphy-explains-move-to-offer-zero-trading-fees.html> [<https://perma.cc/YL48-75QP>] (Oct. 11, 2019) (stating Fidelity's policy of not accepting payment for order flow on equity orders); Pimentel, *supra* note 173 (discussing Public's decision to stop accepting payment for order flow).

<sup>184</sup> See Stankiewicz, *supra* note 183 (stating Fidelity does not accept payment for order flow for equity orders); Declan Harty, *Schwab CEO: Fidelity's Payment for Order Flow Claims 'Not the Whole Story'*, S&P GLOBAL (Oct. 22, 2019), [https://www.spglobal.com/marketintelligence/en/news-insights/trending/IiJL9zOpAk76f\\_BrDunluA2](https://www.spglobal.com/marketintelligence/en/news-insights/trending/IiJL9zOpAk76f_BrDunluA2) [<https://perma.cc/9E6K-GZPU>] (stating that Fidelity was "the sole major U.S. online broker that does not accept payment for equity order flow"). Fidelity advertises its non-receipt of payment for order flow to contrast with competitors TD Ameritrade, Charles Schwab, and E\*Trade. *Commitment to Execution Quality*, *supra* note 165. Nevertheless, it is important to note that Fidelity does accept payment for order flow for options contracts. Barbara A. Friedberg, *Fidelity vs. Robinhood*, INVESTOPEDIA, <https://www.investopedia.com/fidelity-vs-robinhood-4587945> [<https://perma.cc/C6UV-FEAZ>] (Jan. 12, 2023) (stating that Fidelity makes, on average, roughly \$0.65 per option contract through payment for order flow). Fidelity justifies payment for order flow receipt for options as opposed to equities, claiming that options markets are "structurally different than equities." Harty, *supra*. According to a Fidelity spokesperson, this difference is largely because option trading must take place on exchanges. *Id.*

ment for order flow will eliminate zero-commission fee models.<sup>185</sup> Fidelity argues that electing not to accept payment for order flow ensures that it acts in the best interests of its customers and saves its clients more money compared to competitors.<sup>186</sup>

Brokerage firms that refuse to accept payment for order flow also argue that eliminating payment for order flow results in better execution quality.<sup>187</sup> Joining Fidelity, online U.S. brokerage firm Public stopped accepting payment for order flow in 2021, shortly after Robinhood froze stock trading.<sup>188</sup> Public now advocates that eliminating payment for order flow leads to better execution for investors.<sup>189</sup> To support this claim, Public cites the measurement effective/quoted spread (EFQ), which measures price improvement received after placement of

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<sup>185</sup> See Stankiewicz, *supra* note 183 (discussing Fidelity's decision to eliminate commission fees while refusing to accept payment for order flow). Fidelity generates revenue from "interest earned from cash, margin interest, portfolio margining, and stock loan programs." Friedberg, *supra* note 184. Fidelity's decision to operate without accepting payment for order flow caused a very public dispute with Charles Schwab's CEO who questions the honesty of Fidelity's marketing of this model. See Harty, *supra* note 184 (outlining the dispute between Charles Schwab and Fidelity).

<sup>186</sup> See Harty, *supra* note 184 (stating Fidelity's position that their business models puts customer interests first, in contrast to Charles Schwab's model); Stankiewicz, *supra* note 184 (quoting Fidelity's CEO as claiming that the company saved its clients more money).

<sup>187</sup> See Felix Salmon, *A New Case Against Payment for Order Flow*, AXIOS (Dec. 2, 2021), <https://www.axios.com/a-new-case-against-payment-for-order-flow-d356e569-7163-49df-8135-74a3a851f6f1.html> [<https://perma.cc/FKE9-2RUT>] (discussing the U.S. brokerage firm Public's decision to eliminate payment for order flow receipt and the statistics indicating better execution as a result).

<sup>188</sup> *Id.* Public cites conflicts of interest, issues with best execution, and lack of price transparency as key reasons for ending its payment for order flow practice. Rachel Curry, *Payment for Order Flow (PFOF), and Why It Matters to Investors*, PUBLIC, <https://public.com/learn/payment-for-order-flow-pfof-explained-and-why-it-matters> [<https://perma.cc/6VYV-KGGW>]; Stephen Sikes, *Delivering on Price Execution Without PFOF*, PUBLIC (Dec. 2, 2021), <https://medium.com/the-public-blog/delivering-on-price-execution-without-pfof-27f0e6098a2f> [<https://perma.cc/KP7C-ZVZ7>]. One of Public's co-founders also noted that one reason Public decided to stop accepting payment for order flow was because Public's investor base is different from that of Robinhood. Pimentel, *supra* note 173. Public states that its investment platform focuses on long-term investing whereas other brokerage firms focus on day traders. *Id.* Public notes that the shift away from payment for order flow transforms a revenue driver into a cost center. Curry, *supra*. To compensate for the lack of revenue from payment for order flow, Public offers voluntary tipping to cover the costs of order routing. *Id.* Such tips may exceed the costs of execution in payment for order flow business models. Salmon, *supra* note 187. Tipping, however, is not mandatory and not every investor currently tips on the platform. Pimentel, *supra* note 173. Public also generates revenue from interest on cash balances in investor accounts and securities lending. Oliver, *How We Make Money, and Introducing Tipping*, PUBLIC, <https://help.public.com/en/articles/4849181-how-we-make-money-and-introducing-tipping> [<https://perma.cc/868W-X8R2>]. Public routes all orders directly to public exchanges for execution instead of market makers, further distancing itself from payment for order flow. *Id.* Some scholars argue that execution on public exchanges would be better for market orders because it would reduce the NBBO spread. MITTAL & BERKOW, *supra* note 153, at 13–14. Public's CEO also argues that selling data, content, or other services might generate revenue and make up for the loss of payment for order flow. Geron, *supra* note 140.

<sup>189</sup> Sikes, *supra* note 188.

an order in which a lower EFQ signals improved execution.<sup>190</sup> Public's current EFQ, after eliminating payment for order flow, is 33 compared to its previous EFQ that ranged from 40 to 60 with payment for order flow.<sup>191</sup> For comparison, Robinhood's current EFQ is 44 and the industry average is almost 55.<sup>192</sup> A study in the United Kingdom analyzing order execution quality following the implementation of its payment for order flow ban provides further support for Public's argument that eliminating the practice results in better execution.<sup>193</sup> That study saw an increase in the percentage of orders executed at the best quoted price from 65% in 2010, two years prior to the ban, to 90% in 2014.<sup>194</sup>

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<sup>190</sup> *Id.*; see also *Execution Quality*, E\*TRADE, <https://us.etrade.com/trade/execution-quality> [<https://perma.cc/RN6X-R4AT>] (defining effective/quoted spread (EFQ)). EFQ is the effective spread divided by the quoted spread. *Execution Quality*, *supra*. This calculation results in a percentage that measures the price improvement received. *Id.* The effective spread is a comparison of the investor's price paid compared to the midpoint of the NBBO of a security that is then doubled. *Id.* Subtracting the highest National Offer from the lowest National Bid results in the quoted spread. *Id.* An EFQ closer to one hundred indicates that an investor's received order was closer to the NBBO—a negative result indicating lower price improvement—and a number closer to zero indicates that the order was closer to execution at the midpoint between the National Best Bid and Offer—a positive result for the investor. *Id.* Robinhood agrees that a lower EFQ is a better result for investors. See *Our Execution Quality*, ROBINHOOD, <https://robinhood.com/us/en/about-us/our-execution-quality/> [<https://perma.cc/A27N-CUSY>] (stating that a lower EFQ percentage is better).

<sup>191</sup> Salmon, *supra* note 187.

<sup>192</sup> See *Our Execution Quality*, *supra* note 190 (stating Robinhood's EFQ); *Execution Quality*, MERRILL, <https://www.merrilledge.com/investing/best-execution-trading> [<https://perma.cc/45WR-4YZG>] (providing the industry average EFQ of 54.96). For further comparison, Merrill Lynch's EFQ is 32.65. *Execution Quality*, *supra*. E\*Trade's EFQ is roughly 54. *Execution Quality*, *supra* note 190. Public's customers also received execution at or better than the NBBO for about 97.34% of shares as opposed to Robinhood's 96.78%. Sikes, *supra* note 188. Online brokerage firm WeBull outperforms both Public and Robinhood with 99.68% of all shares executed at or better than the NBBO. *Id.*

<sup>193</sup> See generally SVIATOSLAV ROSOV, CFA INST., PAYMENT FOR ORDER FLOW IN THE UNITED KINGDOM: INTERNALISATION, RETAIL TRADING, TRADE-THROUGH PROTECTION, AND IMPLICATIONS FOR MARKET STRUCTURE (2016), <https://www.cfainstitute.org/-/media/documents/article/position-paper/payment-for-order-flow-united-kingdom.ashx> [<https://perma.cc/5E4V-TJMT>] (studying the effects of the United Kingdom's payment for order flow ban on order execution).

<sup>194</sup> *Id.* at 1. According to the study, the absence of payment for order flow as a revenue source resulted in "competitive, utility-like" execution of orders. *Id.* at 21. Dutch regulators also recently concluded that investors receive best execution after eliminating payment for order flow. See *AFM Examines Quality of Order Execution on PFOF Trading Venues*, AFM (Feb. 9, 2022), <https://www.afm.nl/en/professionals/nieuws/2022/februari/kwaliteit-orderuitvoering-pfof> [<https://perma.cc/9JLN-5VDV>] (stating Dutch regulators' findings related to execution quality and payment for order flow); Philip Stafford, *Retail Investors Lose Out When Brokers Sell Their Orders, Dutch Regulators Warn*, FIN. TIMES (Feb. 9, 2022), <https://www.ft.com/content/4d5866b6-b723-416e-92b2-940d28d303a6> [<https://perma.cc/HM5G-8GGS>] (stating that, according to the Dutch study, investors received better execution in the absence of payment for order flow).

### III. THE SEC'S BEST COURSE OF ACTION IS BANNING PAYMENT FOR ORDER FLOW

Recall that under common law of agency principles, a broker owes investors a duty of loyalty that requires the broker to act in the investors' best interests at all times.<sup>195</sup> Under this duty of loyalty, a broker may not receive a material benefit—like payment for order flow—while acting for the investor unless they receive adequate consent.<sup>196</sup> Banning payment for order flow is the best regulatory solution because: (1) within the current regulatory structure, payment for order flow still incentivizes a broker to act disloyally to their investors in violation of their common law duty; (2) other proposed changes to those regulations are insufficient to rectify common law agency problems; and (3) arguments that a ban would result in elimination of zero commission fees are likely overstated.<sup>197</sup>

First, the SEC's current reliance on disclosure and best execution regulation is inadequate because it does not ensure that brokers comport with the requirements of the common law of agency.<sup>198</sup> The common law of agency does

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<sup>195</sup> RESTATEMENT (THIRD) OF THE L. OF AGENCY § 8.01 (AM. L. INST. 2006); see Strine, *supra* note 76, at 666 (stating that the duty of loyalty requires an agent to act in the best interests of the principal).

<sup>196</sup> See RESTATEMENT (THIRD) OF THE L. OF AGENCY § 8.02 (prohibiting receipt of material benefits by an agent when acting on behalf of their principal); *id.* § 8.06 (allowing a principal to consent to otherwise disloyal acts resulting in the authorization of those acts). When an agent receives a material benefit, their personal motivations for such receipt do not matter. *Id.* § 8.01 cmt. b. Rather, the permissibility of receiving the benefit depends on the principal's consent. See DeMott, *supra* note 81, at 398 (noting that a principal's consent to a breach of fiduciary duty requires particularity). Without that consent, the agent remains liable to the principal in restitution. See RESTATEMENT OF THE L. (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 43 (AM. L. INST. 2011) (imposing liability on an agent for breach of a fiduciary duty owed to their principal). Note that contract law also imposes restrictions on the receipt of material benefits by one contractual party when it comes at another's expense. See Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595, 625 (July 1997) (stating that, similar to fiduciary duties, the law of contracts restricts which benefits one contractual party can receive). Consent to the receipt of a material benefit that would normally be barred, however, is far easier to obtain when done solely under the existence of a contractual relationship rather than a fiduciary one. *Id.* at 626. Consent under the law of agency for fiduciaries requires adherence to stricter disclosure requirements than those demanded by contract law. *Id.*

<sup>197</sup> See U.S. SEC. & EXCH. COMM'N, *supra* note 2, at 12 (noting that payment for order flow can create conflicts of interest for broker-dealers); Observations from Market Maker Review, *supra* note 176, at 6, 8 (noting that the conflict of interest for brokers emerging from payment for order flow can cause brokers to violate duties they owe to investors and that the easiest way to resolve the conflict is to eliminate payment for order flow); Robinhood Fin., LLC, Securities Act Release No. 10906, Exchange Act Release No. 90694, at 6–7 (Dec. 17, 2020) (stating that Robinhood's payment for order flow contracts caused it to violate their duty of best execution); Salmon, *supra* note 187 (stating that a payment for order flow ban would not eliminate Robinhood's zero commission model); *infra* notes 198–221 and accompanying text (arguing that the SEC's current regulatory regime and proposed reforms are inadequate).

<sup>198</sup> See Observations from Market Maker Review, *supra* note 176, at 8 (stating that disclosure is an inadequate solution to payment for order flow conflicts of interest); Ferrell, *supra* note 16, at 1071–

not permit a broker, as an investor's agent, to act adversely to the interests of the investor.<sup>199</sup> Yet, payment for order flow incentivizes brokers to send investor orders to market makers that provide the largest payments in return, regardless of the presence of better execution opportunities that may exist in the open market.<sup>200</sup> This results in a conflict of interest between the agent and principal.<sup>201</sup> Although the existence of this conflict of interest by itself is not a violation of the duty of loyalty, it raises questions about whether brokers are fulfilling their best execution duty when accepting payment for order flow, especially when better price improvement opportunities may exist in the market.<sup>202</sup>

When the broker receives a material benefit from payment for order flow, they must receive consent from the investor before keeping it.<sup>203</sup> Recall that the common law of agency allows a principal to consent to a disloyal action—like an agent's improper receipt of a material benefit related to a transaction—only when the agent acts in good faith in receiving that benefit, discloses sufficient material facts, and acts fairly to the principal at the time of receipt.<sup>204</sup> The

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72 (noting that disclosure is insufficient to resolve conflicts of interest stemming from payment for order flow).

<sup>199</sup> Strine, *supra* note 76, at 666; see RESTATEMENT (THIRD) OF THE L. OF AGENCY § 8.01 (establishing the duty of loyalty).

<sup>200</sup> *Payment for Order Flow Internalization in the Options Market*, U.S. SEC. & EXCH. COMM'N (2000), <https://www.sec.gov/news/studies/ordpay.htm> [<https://perma.cc/E83T-JUUh>]; see Note, *supra* note 14, at 1678 (stating that the receipt of payments for customer order flow induces brokers to put their own interests ahead of the investor's).

<sup>201</sup> See U.S. SEC. & EXCH. COMM'N, *supra* note 2, at 2 (noting the existence of a conflict of interest for brokers who receive payment for order flow); FIN. SERVS. AUTH., *supra* note 175, at 2 (stating the United Kingdom's position that payment for order flow arrangements create a conflict of interest for brokers); Stankiewicz, *supra* note 183 (stating Fidelity's reason for choosing to forego payment for order flow as a desire to eliminate conflicts of interest).

<sup>202</sup> Johnsen, *supra* note 82, at 1549 n.16 (2009) (stating that although conflicts of interest exist when the agent's interests are contrary to the principal's, a breach of the agent's duty of loyalty only exists if the agent acts on those adverse interests); see Observations from Market Maker Review, *supra* note 176, at 6 (noting that payment for order flow can induce brokers to violate their duty of best execution). The SEC's investigation into Robinhood shows the validity of these questions. *Robinhood Fin., LLC*, Release Nos. 10694, 10906, at 6–7 (stating that Robinhood violated its duty of best execution after receiving payment for order flow). The SEC's proposed Rule 615 also seems to recognize that the current regulatory system of payment for order flow results in poorer execution by changing the current rules and requiring a number of orders to be exposed to execution by parties outside of payment for order flow agreements, like public exchanges. U.S. SEC. & EXCH. COMM'N, *supra* note 116, at 170.

<sup>203</sup> See RESTATEMENT (THIRD) OF THE L. OF AGENCY § 8.02 (stating that an agent cannot receive a material benefit while acting on behalf of a principal in a transaction); *id.* § 8.06 (permitting a principal to consent to an otherwise disloyal act of an agent); Note, *supra* note 14, at 1686 (stating that a broker must disclose payment for order flow and receive consent before keeping the payment).

<sup>204</sup> RESTATEMENT (THIRD) OF THE L. OF AGENCY § 8.06. It is important to note that even though Robinhood argues that it makes full disclosure through Rule 606, the consent received would not be sufficient under the common law of agency because section 8.06 aims to ensure that the principal receives the intended results of the agency relationship. See *id.* cmt. b (noting that the common law will not enforce consent when it goes against the principal's intent of forming the agency relation-

SEC's 2020 investigation of Robinhood demonstrates that a broker's receipt of payment for order flow often occurs when they are not acting in good faith to their principal.<sup>205</sup> The broker acts in bad faith by routing the principal investors' orders to market makers with which the broker maintains payment for order flow arrangements, regardless of better price improvement opportunities in the market.<sup>206</sup> Current Rule 606 disclosures also fail for purposes of consent because they do not give sufficient information to investors—namely, comparisons of how their trades would perform in the market if the broker did not route their order to the chosen market maker—required by the investor to make a fully informed decision in ratifying the broker's actions.<sup>207</sup>

Second, regulatory solutions, like improvements to best execution and enhanced disclosure requirements, would fall short of solving the problems posed by payment for order flow because they are either too difficult to enforce, unlikely to resolve conflicts of interest, or because many investors in the current market lack the time and technical expertise to understand the infor-

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ship). Investors entrust brokers to get them the best deal possible and thus expect best execution. *See* *Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 271 (3d Cir. 1998) (noting that investors who place their orders with their brokers expect to receive the maximum economic benefits available); *Best Execution*, FINRA (Dec. 6, 2017), <https://www.finra.org/rules-guidance/guidance/reports/2017-report-exam-findings/best-execution> [<https://perma.cc/QTZ5-ZFWX>] (stating that brokers must execute orders to secure the best terms possible for the customer). As such, if Robinhood's Rule 606 disclosures indicate failure to receive best execution for the investor as a result of payment for order flow, then the investor's consent to its receipt is no longer enforceable because they did not receive the intended results of the agency. RESTATEMENT (THIRD) OF THE L. OF AGENCY § 8.06 cmt. b (explaining that not all consent will be enforceable under the common law); *Newton*, 135 F.3d at 271 (describing an investor's intent in establishing an agency relationship with the broker).

<sup>205</sup> *See* Note, *supra* note 14, at 1686 (noting that investors likely have a strong case that payment for order flow constitutes an impermissible material benefit under agency principles); *Robinhood Fin., LLC*, Release Nos. 10694, 10906, at 3 (noting that Robinhood violated its duty of best execution even though market makers made Robinhood aware that its high payment for order flow arrangements would result in less price improvement for investors).

<sup>206</sup> *See* Dolgoplov, *supra* note 16, at 498 (stating that although payment for order flow resulted in many brokerage firms moving to zero-commission trading, it may result in execution of customer orders at venues offering inferior prices); Stafford, *supra* note 194 (quoting Dutch regulators' findings that payment for order flow results in worse prices for investors in comparison to execution in competitive markets).

<sup>207</sup> *See* RESTATEMENT (THIRD) OF THE L. OF AGENCY § 8.06 (requiring disclosure of sufficient information for adequate consent); *GameStop Hearing, Part 2, supra* note 111, at 0:21:25 (suggesting that everyday investors are unable to compare order execution between competing brokerage firms); Gellash, *supra* note 162, at 7 (noting the shortcomings of current disclosure requirements in giving investors access to comparable data); Ferrell, *supra* note 16, at 1072–73 (noting that the conflicts of interest arise from investors' inability to compare brokerage commissions). Here, the lack of comparable data in Rule 606 disclosures is insufficient for an investor to give consent because they lack the requisite information to consent to the receipt of payment for order flow, namely, what other firms are receiving and what level of execution quality they are missing out on by granting consent. *See* RESTATEMENT (THIRD) OF THE L. OF AGENCY § 8.06 (noting the requirements for proper consent); Dolgoplov, *supra* note 16, at 509 (noting that payment for order flow raises questions about foregone price improvement opportunities at other venues).

mation provided.<sup>208</sup> Proposed changes to best execution would be difficult to enforce because best execution requires an analysis of a multitude of factors, making it difficult for individual retail investors to determine that their broker breached their duty of best execution.<sup>209</sup> In addition, changes to best execution measurement do not resolve brokers' conflicts of interest because they fail to eliminate broker's incentives to route orders to market makers paying the highest amount for order flow.<sup>210</sup> Rather, the best and easiest way to ensure investors receive best execution would be to eliminate payment for order flow, as numerous studies support the notion that order execution improves in the absence of payment for order flow.<sup>211</sup> Some payment for order flow proponents argue that the practice only costs pennies to the investor.<sup>212</sup> But this argument misses the larger point of incentivizing best execution and reducing potential investor harm that occurs when brokers ignore better price improvement opportunities.<sup>213</sup>

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<sup>208</sup> See BETTER MARKETS, *supra* note 153, at 1 (stating that the current best execution regulatory regime is too flexible to properly resolve payment for order flow conflicts of interest); Observations from Market Maker Review, *supra* note 176, at 8 (describing the ineffectiveness of disclosure as a tool for managing conflicts of interest considering it is far easier to eliminate the conflict by stopping receipt of payment for order flow); Wang, *supra* note 17, at 44 (noting that users of online investment services target less sophisticated investors); Fallon, *supra* note 93, at 432 (noting that Robinhood's clients are generally inexperienced investors); Popper, *supra* note 126 (stating that part of Robinhood's business model is pushing inexperienced investors to engage in riskier trading).

<sup>209</sup> See DIV. MKT. REGUL., U.S. SEC. & EXCH. COMM'N, *supra* note 62, at V-2 to V-3 (stating all the factors a broker must consider in determining best execution); BETTER MARKETS, *supra* note 153, at 1 (stating that the current best execution regulation is difficult to enforce because it is multifaceted).

<sup>210</sup> See Observations from Market Maker Review, *supra* note 176, at 6 (noting the insufficiency of best execution in controlling payment for order flow conflicts of interest). The SEC's investigation into Robinhood makes this point quite clear. See *Robinhood Fin., LLC*, Release Nos. 10694, 10906, at 6 (noting that Robinhood continued to receive high rates of payment for order flow while on notice that doing so resulted in less price improvement for investors). Even though Robinhood was aware that its agreements with market makers requiring higher payment for order flow resulted in less price improvement for investors, Robinhood still chose to receive the higher payments. *Id.* In doing so, Robinhood chose to forego its duty of best execution because of incentives from market makers to do so. *Id.*

<sup>211</sup> See ROSOV, *supra* note 193, at 1–2 (showing execution quality improvements following the United Kingdom's payment for order flow ban); *AFM Examines Quality of Order Execution on PFOF Trading Venues*, *supra* note 194 (stating the findings of Dutch regulators that investors receive better execution without payment for order flow); Sikes, *supra* note 188 (noting Public's improved execution quality following its elimination of payment for order flow).

<sup>212</sup> See Kaissar, *supra* note 122 (arguing to maintain payment for order flow because it only costs a penny); Levine, *supra* note 131 (same). Even if we accept the argument that payment for order flow is a negligible cost to investors, breaches of fiduciary duties do not require harm to establish liability. See RESTATEMENT OF THE LAW (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 43 cmt. d (AM. L. INST. 2011) (requiring no harm to the principal to establish a claim of restitution for breach of a fiduciary duty).

<sup>213</sup> Ferrell, *supra* note 16, at 1058 (stating that the cost to investors of payment for order flow is potentially missing out on better price improvement opportunities); Dolgoplov, *supra* note 16, at 530 (stating that there is harm to investors when they do not receive "industry-standard" price improve-

Furthermore, although proposed changes that aim to refocus best execution measurement on price improvement in the market address some concerns, most retail investors will still lack the tools necessary to bring private rights of action because of disclosure deficiencies.<sup>214</sup> Proposals to enhance disclosure requirements under Rule 606, like those of FIF, are insufficient to address these problems because many investors lack both the time and the financial background to understand the information disclosed.<sup>215</sup> The often labor intensive process of individual retail investors scouring each individual firm's website to locate the data makes accessing and comparing disclosures of various brokerage firms to monitor best execution compliance practically impossible.<sup>216</sup> As the United Kingdom's regulators adequately stated, it is far easier to resolve the problems posed by payment for order flow by simply preventing their existence in the first place.<sup>217</sup>

Finally, arguments that a payment for order flow ban would result in the elimination of zero commission fee trading are likely overstated.<sup>218</sup> Because investors in the marketplace, especially those that are younger and have less income, are accustomed to zero-commission trading, brokerage firms are unlikely to revert back to commission fee models and risk losing out on a large

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ment, even if there is a zero-commission model). This is especially important for retail investors who receive worse execution at a higher rate compared to large institutional investors. *See* Ferrell, *supra* note 16, at 1058 (finding that retail investor orders get misrouted at a higher rate than institutional investor orders). Furthermore, retail investors are often unaware of foregone price improvement opportunities and losses resulting from a lack of competitive pricing among market makers. *Id.* In addition to reduced stock market efficiency, one commentator notes that the current payment for order flow regulatory regime fails to treat all investors, regardless of portfolio size, equally. *Id.* at 1034.

<sup>214</sup> *See* BETTER MARKETS, *supra* note 153, at 7 (noting the difficulty retail investors have in determining whether they received best execution based off current disclosures); *GameStop Hearing, Part 2, supra* note 111, at 0:21:25 (implying that retail investors do not have the ability under current disclosure requirements to compare execution quality among brokers).

<sup>215</sup> *See GameStop Hearing, Part 2, supra* note 111, at 0:21:25 (stating that although institutional investors may have the ability to access and go over Rule 606 disclosures, retail investors do not); Wang, *supra* note 17, at 44 (noting that users of Robinhood are less sophisticated investors).

<sup>216</sup> Gellash, *supra* note 162, at 7–8 (noting how difficult it is to find brokerage firm Rule 606 disclosures on their websites).

<sup>217</sup> Observations from Market Maker Review, *supra* note 176, at 8.

<sup>218</sup> *See* Salmon, *supra* note 187 (stating that Robinhood's zero-commission model would not go away with a payment for order flow ban). Elimination of payment for order flow would also take away a broker's incentive to get investors to trade more frequently. *Id.* This could help resolve some of the issues surrounding the gamification of trading. *See* Fallon, *supra* note 93, at 458–59 (discussing problems with the gamification of trading as a result of Robinhood's business model). Robinhood's business model, predicated on high trade frequency, leads to aspects of its platform inducing retail investors to constantly trade. *Id.* at 459. These inducements include push notifications, celebratory graphics when an investor completes a trade, and platform design. *Id.* at 458–59. Utilization of these tactics poses threats to retail investors who may incur substantial losses from frequent trading. *Id.* at 461. One scholar argues that current SEC regulations do little to address these risks. *Id.* at 462.

subsection of the market.<sup>219</sup> Rather, it is far more likely that brokerage firms would adopt business models that focus on revenue generation in other services.<sup>220</sup> The fact that many brokerage firms, outside of Robinhood, generate a majority of their revenue from non-trading sources would further suggest that firms could maintain their zero-brokerage fee models without payment for order flow.<sup>221</sup>

## CONCLUSION

As agents of their investors, brokerage firms owe their investors the duty of loyalty and must act in the best interests of these investors at all times. The receipt of payment for order flow by brokerage firms like Robinhood poses a conflict of interest between the investor and the broker because of perverse incentives to route investor orders to market makers offering the highest payments and not those providing the best execution. As such, payment for order flow poses a threat to the interests of investors. Current SEC regulations focused on disclosure and a broker's duty of best execution are inadequate to address these conflicts of interest because they fail to align the interests of the broker with that of the investor. Proposed changes to these regulations also fall short of resolving this conflict. The SEC's best regulatory solution would be to

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<sup>219</sup> Levine, *supra* note 131 (noting that it is unlikely that Robinhood would start charging commission fees as a result of a payment for order flow ban because of customer expectations).

<sup>220</sup> *See id.* (stating that Robinhood could maintain the zero-commission-fee business model while moving away from payment for order flow); Salmon, *supra* note 187 (stating that Robinhood's business model would survive). Nevertheless, an outright ban of payment for order flow would likely have an outsized impact on Robinhood compared to other brokerage firms. Trefis Team, *Down 60% from Its IPO Price, Is Robinhood Stock a Steal?*, FORBES (Feb. 2, 2022), <https://www.forbes.com/sites/greatspeculations/2022/02/02/down-60-from-its-ipo-price-is-robinhood-stock-a-steal/?sh=41ca056a6ff7> [<https://perma.cc/C9B9-3TZU>]. This is largely due to Robinhood's disproportionate reliance on payment for order flow for revenue. *Id.* Other firms' business models, while utilizing payment for order flow, generate revenue through interests and services. *Id.* Another option for Robinhood would be to internalize all orders it receives. Levine, *supra* note 131. That is, Robinhood would pair up its own investors who are buying and selling the same securities on the platform. *Id.* Robinhood would then capture the spread between the bid price and the sell price—the same process market makers engage in—and execute it at the midpoint consistent with its duty of best execution. *Id.* In countries with payment for order flow bans, internalization of customer trades is already common and allows zero-commission firms to continue operating. *Id.* Robinhood itself admits that internalization of customer orders is a viable solution to move away from reliance on payment for order flow. Eleanor Terrett & Charlie Gasparino, *After Robinhood's IPO, Twist to Business Model May Come*, FOX BUS. (July 28, 2021), <https://www.foxbusiness.com/markets/robinhood-ipo-twist-business-model> [<https://perma.cc/U3DD-5BU9>].

<sup>221</sup> *See* Jessica Mathews, *Schwab and TD Ameritrade Brace for Revenue Cuts After Dropping Commissions*, FIN. PLAN. (Oct. 2, 2019), <https://www.financial-planning.com/news/schwab-and-td-ameritrade-to-take-big-revenue-cuts-after-dropping-commissions> [<https://perma.cc/PXS6-ZSE8>] (stating that the majority of TD Ameritrade's and Charles Schwab's revenue came from sources other than transaction related fees); Levine, *supra* note 131 (noting that Robinhood generates almost eighty percent of its revenue from payment for order flow); *supra* notes 183–187 and accompanying text (discussing the revenue generated by brokerage firms from payment for order flow).

follow the path of other foreign regulators in banning payment for order flow to eliminate the conflict of interest that exists for broker-dealers and improve execution received by investors.

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