CARLTON FIELDS

Stopping GameStop Games: Regulators Eye Payment for Order Flow

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The SEC and FINRA have been busy of late in efforts to address issues associated with payment for order flow (PFOF) and the consequences of the trading halt in GameStop shares last January. PFOF has potentially significant implications not only for broker-dealers but also for investment managers and advisers.

The SEC defines PFOF to encompass "a wide variety of cash or in-kind compensation structures that a broker may receive for directing its customers' orders to a particular broker-dealer or trading venue." As such, PFOF may provide an economic incentive that can potentially influence a firm's order handling, creating a potential conflict of interest with the firm's best execution obligations. Although the receipt of PFOF does not constitute a per se violation of a firm's best execution obligations, it does raise concerns.

In November 2015, FINRA published Regulatory Notice 15-46 to reiterate the best execution obligations of member firms in light of increasingly automated markets and advances in trading technology, including PFOF.

In response to GameStop, in June 2021, FINRA published Regulatory Notice 21-23 specifically reminding firms of their best execution obligations in the context of PFOF. In particular, firms were reminded that under FINRA's best execution rule (Rule 5310), PFOF may not be considered in determining the best market for a subject security but may be considered as part of the firm's regular and rigorous review of execution quality, as well as any price improvement received.

Other rules require disclosure of PFOF arrangements to customers. Under the Securities Exchange Act of 1934, firms must provide written notification to customers at or before completion of a transaction that PFOF is being received and that the source and nature of the compensation will be furnished upon request. Firms are further required by Regulation National Market System to make publicly available each calendar quarter a report on the member's routing practices to include the aggregate amount of any PFOF received, both as a dollar amount and per share, and a description of any arrangement for PFOF.

Reviewing the recent congressional testimony of SEC Chair Gary Gensler and FINRA CEO Robert Cook following GameStop, it is clear that both are committed to adapting the existing regulatory regime to advances in technology and new business models.

This commitment means that, even after GameStop, there will not likely be significant limitations or prohibitions against PFOF, at least in the near term. Instead, the regulators will continue to focus on enforcing the best execution rule under the PFOF model, which includes a requirement for conducting regular and rigorous reviews of execution quality across competing markets. The disclosure rules also may be updated to require immediate post- trade information regarding PFOF and any price improvement received.

For more detail about this important subject, please see our recent article "Regulators Consider Payment for Order Flow and the Gamification of Trading After GameStop."

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