SEC's Upcoming Report on GameStop and Payment for Order Flow: What to Watch

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The Securities and Exchange Commission (SEC) will soon release its report and recommendations regarding the GameStop event last January and related equity market structure issues. In testimony before a Senate committee on September 14, SEC Chair Gary Gensler highlighted two concerns that will likely be addressed:

- How does the SEC facilitate greater competition and efficiency on an order-by-order basis when people submit orders to the marketplace; and
- How does the SEC address financial conflicts in the market, including conflicts associated with both payment for order flow[1] (PFOF) and exchange rebates?[2]

In prior statements, Gensler said that banning PFOF is "on the table"[3] and that he had concerns regarding equity market structure, transparency, and potential conflicts of interest.[4] In addition, Gensler has stated that he has directed his staff to put together a proposal to shorten the standard settlement cycle to reduce costs and risks.

This is what broker-dealers and wholesale market makers should watch for in the report:

Equity Market Structure Concerns

Segmentation of the Equity Market

Gensler has expressed concern that the equity market is *segmented*. There are the public exchanges, which handle about 53% of trade volume; off-exchange wholesale market makers, which handle about 38%; and alternative trading systems or dark pools, which handle the other 9%. Segmentation means that different rule sets apply. Exchanges, for example, compete with each other on an order-by-order basis to get the best prices available. Wholesale market makers, on the

other hand, price by referencing the national best bid and offer (NBBO), a less competitive benchmark, according to Gensler. And "dark pools" derive their own prices from order flow and the NBBO, typically using the midpoint. In addition, the NBBO used by the exchanges is priced in penny increments, while market makers and dark pools can transact in sub-penny increments. Gensler's view is that such segmentation creates an uneven playing field and may affect the width of the bid-ask spread.[5] Other critics say it not only results in a transfer of liquidity away from the exchanges but also in a reduction of liquidity across the entire market.[6]

Segmentation of the markets, however, allows investors to direct order flow to whichever segment is more appropriate to them, and thus the existence of different rule sets is likewise appropriate. For example, retail investors may wish to obtain price improvement by routing to a wholesale market maker, while institutional investors with large blocks of stock to trade may prefer a dark pool. Segmentation, in other words, offers choices and efficiencies to different types of investors with different needs. It does not reflect an uneven playing field; rather, it reflects several different playing fields, each featuring a different game.

Further, the effect of segmentation on overall liquidity in the markets is not clear. More liquidity generally means narrower bid-ask spreads[7] and thus better prices for buyers and sellers. Gensler argues that less segmentation in the markets may add liquidity and ultimately result in better prices overall. But where this extra liquidity would come from is not clear.

For example, a study by the CFA Institute concluded that the United Kingdom's banning of PFOF in 2012 resulted in an increase in the number of retail orders executed at the best-quoted prices, but less price improvement for retail investors.[8] The U.K., however, has a very different trading model from the United States and the ban occurred before zero-commission trading became popular. Notably, the study did not conclude that there was an overall increase in liquidity as a result of the ban.

Another study, by BestEx Research, concluded that better execution quality would result if all order flow were moved to a public forum. But that study relies on assumptions about the benign nature of the order flow presently going to wholesale market makers (i.e., small retail orders and largely balanced order flow) versus the more "toxic" order flow presently going to exchanges (i.e., larger, institutional or high-frequency orders and unbalanced order flow).[9] The study estimated that NBBO spreads would decrease (and thus prices to investors would improve) if the separate order flows were combined into one stream with less overall "toxicity" than presently goes to the exchanges. It also estimated that NBBO spreads would decrease if there were less aggregation of data by certain wholesale market makers. The study presented no hard data, however, to support a quantification of any effects on NBBO spreads and prices. Instead, it may be that combining separate order flows into one will simply benefit those who generate more toxic order flow at the expense of those who do not.

On the other hand, a study published by the Financial Research Network found that reducing retail order flow segmentation would improve liquidity *on the exchanges* but that retail investors, in return, would receive less price improvement, while high-frequency traders would earn higher revenues from trading fees.[10] Larry Tabb of Bloomberg Intelligence agrees, concluding that the present model keeps separate the smaller retail orders that are less likely to impact supply and demand and that wholesale market makers can execute those orders at tighter spreads than offered on the exchanges. He asks, "[w]hy should an investor sending an order that has no effect on supply and demand pay the same price as those that do move the market?"[11]

Finally, as venture capital firm Andreessen Horowitz puts it, "[t]he fragmentation of trading venues combined with the cutthroat pricing pressure placed on market makers actually works to give consumers good pricing."[12] Indeed, market makers can show that the current PFOF model has resulted in billions of dollars in price improvement for retail investors over the NBBO in 2020 alone.[13]

Thus, it is not clear that liquidity would increase if the market were not segmented. What is clear is that investors would lose the ability to choose the venue that works best for them in return for a "one-size-fits-all" approach. There is also a good chance that retail investors would pay more.

Concentration in the Wholesale Market Maker Segment

While Gensler has expressed concern that the equity market is *segregated*, he also has expressed concern, somewhat paradoxically, that the wholesale market maker segment is *concentrated*. Just seven market makers handle the vast majority of all trading in that segment. Gensler's concern is that such concentration deters healthy competition and innovation and increases systemwide risks in the event of a failure by one participant. In addition, the firms with the greatest market share tend to reap the profits from that concentration, he argues. Gensler has questioned whether both segmentation and concentration promote "fair, orderly, and efficient markets."

Such concentration, however, has only been achieved at great expense and risk to market makers in the pursuit of efficiencies. Free markets reward efficiency and innovation and punish inefficiency and lack of foresight.[14] If there were evidence that the dominant players engaged in fraudulent, unethical, or bad faith conduct to achieve their success, then action to right the wrong would be appropriate. But that is not the case, and no such action has been pursued or is warranted. More to the point, the "concentration" in the wholesale market making segment has not deterred healthy competition and innovation*; it is the result of it*. And while there is some traction to the argument that concentration increases systemwide risks in the event of a failure of a single significant participant, here there are numerous other wholesale market makers who, it appears, could handle the additional order flow without much disruption to the markets generally.[15] It seems, therefore, that the concern regarding concentration may dissipate with more light.

Aggregation of Data

Gensler has also expressed concern that the concentration of trading leads to the *aggregation of data* by certain market makers, which may provide those market makers with a competitive advantage over other market makers with less order flow and over the exchanges, which see only their own data. It appears that Gensler is referring to market makers aggregating their own proprietary data reflecting order flow to the market maker, not data the market maker may obtain from the exchanges, since that is available to all. But the same argument applies as before: the aggregation of data by wholesale market makers has not deterred healthy competition and innovation*; it is the result of it*. Thus, absent some evidence of fraudulent, unethical, or bad faith conduct in aggregating their *proprietary* data, it is hard to see a legitimate basis to challenge what market makers do with their own information.

Market Data Concerns

Gensler has expressed concerned that there is a lack of transparency in the markets, citing opaque segments of the market and trading data that reflects an imperfect NBBO. In addition, SEC Commissioner Caroline Crenshaw's December 9, 2020, "Statement on Market Data Infrastructure"[16] sets forth more granular concerns about the availability of market data.

Unlit Segments and the Imperfect NBBO

Gensler has expressed concerns that certain segments of the markets, i.e., dark pools and wholesale market makers, are opaque. The NBBO does not capture the orders in those segments, which is almost half of all trading, nor odd-lot orders or non-displayed orders on the exchanges. Instead, the NBBO only comprises orders from "lit" markets (e.g., the exchanges) in "round lots" (100 shares and more), which means that purchases in any market of fewer than 100 shares are not reflected in the NBBO. By April 2021, 70% of all trades in high-priced stocks were odd-lot trades, 47% of all trades in mid-priced stocks were odd lots, and 28% of all low-priced stocks were odd lots.[17] The phenomenon is even more acute with high-priced stocks, since they are less likely to trade in round lots. As such, Gensler has stated, the NBBO does not accurately reflect the prices on the exchanges, let alone the unlit segments.

Two-Tiered Market for Data

In addition, Commissioner Crenshaw has stated that there is a two-tiered market for trading data for traders, one for those who can afford faster and better quality proprietary feeds and one for those who cannot. And because the exchanges provide both feeds, she has argued, there is a potential conflict of interest working against bridging the gap in speed and quality because doing so may reduce demand for the exchanges' more expensive feeds.

Such data has value because it reflects the price discovery created by the exchanges.[18] "The existence of real-time quote data gives market participants information about the likely prices and quantities available in the market before they make their trading decisions."[19] Specifically, the exchanges sell "top of the book" quotation and market data to securities information processors (SIPs) that consolidate and make the information (e.g., "SIP data") publicly available to market participants. But the exchanges also sell proprietary market data products, including "depth of book" market feeds. Thus, the exchanges compete with each other in selling their various products at different price levels, for different types of market participants with different needs.[20] Wholesale market makers and other market participants can purchase both the SIP and proprietary data from the exchanges, develop algorithms to process it, and use it to inform order-handling decisions.[21] And the exchanges receive significant revenues for the data.[22]

According to Crenshaw, this results in public feeds that cannot compete with "prop" data feeds and tilts the system heavily toward the exchanges, which sell their prop data feeds at increasingly high prices without any meaningful competition from the public feeds. Thus, Crenshaw argues, the investing public ultimately pays the price.[23]

In her statement, Crenshaw described the SEC's rule changes to address both the NBBO and market data feed issues. The final rule amended Regulation NMS in several respects, with the effective date commencing June 8, 2021.[24] The changes include a new definition of "round lot" that results in the inclusion of odd-lot quotations, as well as improving the speed and content of the data in the SIP feed.[25] Round lots are now defined under a five-tiered system based on price, so that the round lot for the most expensive stocks ($10,000 or more) is "1," those between $1,000 and $10,000 is "10," those between $250 and $1,000 is "40," and those below $250 is "100." In so doing, the NBBO will reflect, as round lots, what were previously excluded from the NBBO as odd lots. Further, the improvement in speed and addition of some depth-of-book data in the SIP feed should reduce, to some extent, the alleged gap between the two tiers of data feeds. These changes, according to the SEC, will increase transparency in the markets and improve the NBBO as a useful metric for pricing information.

Potential Conflicts of Interest

Gensler has expressed concern that there is a potential conflict of interest for broker-dealers when choosing to route order flow between venues that provide the most PFOF for the firm and those that provide the best execution for the customer.

But FINRA has a long-standing rule requiring firms to provide best execution to customers[26] and has issued regulatory notices reiterating the requirement.[27] And both the SEC and FINRA have brought actions against firms for alleged best execution violations where the firm received PFOF.[28] Notably, only one SEC case involved allegations that best execution actually suffered as a result of PFOF.[29] In addition, firms are required to disclose PFOF arrangements. Under the Securities

Exchange Act of 1934, firms must provide written notification to customers at or before completion of a transaction that the firm will receive PFOF and that the firm will furnish the source and nature of the compensation upon request.[30] Under Regulation NMS, firms must make publicly available each quarter a report on the firm's order 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.[31]

It is also relevant that potential conflicts for broker-dealers are not limited to those involving PFOF. For example, potential conflicts may exist where retail brokers routing limit orders to exchanges in return for rebates make routing decisions based on maximizing the liquidity rebates generated from their limit order executions rather than execution quality for their customers.[32] And potential conflicts may exist where alleged rule violations include, say, best execution, interpositioning, suitability, trading ahead, churning, markups, outside business activities, or fraud. The industry deals with such conflicts by enforcement of the relevant rule, and public disclosure and mitigation of such conflicts, if possible. This approach is clearly reflected in recent enforcement actions[33] for violations of Regulation Best Interest, which also requires disclosure and mitigation, if possible, of potential conflicts.

Some critics, however, argue that the potential conflicts with PFOF *cannot* be adequately mitigated by disclosure and the requirements for best execution.[34] Nevertheless, the SEC's long-standing view, after studying the problem for several years, has been that disclosure alone *can* adequately address the potential conflicts — that "sunlight is the best disinfectant" — and that a broker-dealer does not necessarily violate its best execution obligation merely because it receives PFOF.[35] This leaves open the possibility, however, that the SEC will further amend Regulation NMS to increase disclosures related to PFOF.

It is unclear whether Gensler will continue to adhere to this view. He appears bent on overhauling market structure in ways that he thinks will make it fairer for retail investors.[36] But given the dearth of cases where best execution quality has been shown to have suffered as a result of PFOF, it appears the potential conflict of interest associated with the PFOF model is manageable under the current regulatory structure.

Conclusion

The upcoming report will likely include numerous proposals regarding market structure and conflicts issues. But looking at Gensler's most recent testimony, it appears that he is focused, as he said, on facilitating "greater competition and efficiency on an order-by-order basis," and not necessarily on banning PFOF or exchange rebates.

So there may be proposals regarding best execution to ensure that broker-dealers and wholesale market makers consider, on an order-by-order basis, all potential venues when routing or

internalizing orders to provide retail customers with the best prices available at any time between receipt of the order and execution, whatever data sources are used by the market maker. In addition, there may be proposals to bolster disclosures under Rules 605 and 606 of Regulation NMS to provide more granularity regarding PFOF arrangements and better mitigate potential conflicts. There may also be proposals regarding the tick size used on the exchanges to improve competitiveness with wholesale market makers. And there will likely be proposals regarding a change from a T+2 to a T+1 (or even T+0) settlement cycle. Given the recent changes to Regulation NMS that add odd-lot orders to the NBBO and improve market data available through the SIP, it is not clear that any additional proposals are likely regarding the NBBO or market data.

Stay tuned.

[1] Payment for order flow is compensation that retail broker-dealers receive for directing customers' orders to a particular trading venue.

[2] Testimony of Gary Gensler Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Sept. 14, 2021), available at https://www.banking.senate.gov/imo/media/doc/Gensler%20Testimony%209-14-21.pdf.

[3] "SEC's Gary Gensler Has a Big, New Vision for the Stock Market. There Are Too Many 'Inherent Conflicts of Interest,'" available at https://www.barrons.com/articles/sec-chief-gary-gensler-stock-market-51630626032?mod=hp_LEAD_2.

[4] Gary Gensler's Testimony Before the House Committee on Financial Services (May 5, 2021), available at https://www.sec.gov/news/testimony/gensler-testimony-20210505; Gary Gensler's Prepared Remarks at the Global Exchange and FinTech Conference (June 9, 2021), available at https://www.sec.gov/news/speech/gensler-global-exchange-fintech-2021-06-09; Remarks of SEC Chair Gensler at the Meeting of SEC Investor Advisory Committee (June 12, 2021), available at: https://corpgov.law.harvard.edu/2021/06/12/remarks-by-sec-chair-gensler-at-the-meeting-of-sec-investor-advisory-committee/; Gary Gensler's Prepared Remarks at London City Week (June 23, 2021), available at https://www.sec.gov/news/speech/gensler-speech-london-city-week-062321.

[5] Gensler's Remarks at SEC Investor Advisory Committee.

[6] Testimony of Dennis M. Kelleher, President and CEO Better Markets Inc., Before the U.S. House Committee on Financial Services, available at https://bettermarkets.com/sites/default/files/Kelleher%20HFSC%20Testimony%20GameStop%20Hearing%203-17-2021%20FINAL%20%282%29.pdf.

[7] Investopedia, "What Determines a Stock's Bid-Ask Spread?" available at https://www.investopedia.com/ask/answers/06/bidaskspread.asp.

[8] CFA Institute Policy Brief, “Payment for Order Flow,” available at https://www.cfainstitute.org/-/media/documents/issue-brief/payment-for-order-flow.ashx.

[9] “The Good, the Bad, and the Ugly of Payment for Order Flow,” available at https://f.hubspotusercontent10.net/hubfs/4982966/BestEx Research PFOF 20210503.pdf.

[10] “Regulating Dark Trading: Order Flow Segmentation and Market Quality,” available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2755392.

[11] “Why Payment for Order Flow is a Good Deal for Investors,” available at https://www.ft.com/content/b745ba00-ef1d-11e9-bfa4-b25f11f42901.

[12] “Breaking Down the Payment for Order Flow Debate,” available at https://a16z.com/2021/02/17/payment-for-order-flow/.

[13] “Citadel Securities Gets Almost as Much Trading Volume as Nasdaq,” available at https://qz.com/1969196/citadel-securities-gets-almost-as-much-trading-volume-as-nasdaq/.

[14] Interview with Adam Warren, Managing Director, NERA Economic Consulting (September 30, 2021).

[15] Interview with James J. Angel, Associate Professor Georgetown University McDonough School of Business (September 20, 2021).

[16] SEC Commissioner Caroline A. Crenshaw, “Statement on Market Data Infrastructure,” available at https://www.sec.gov/news/public-statement/crenshaw-statement-market-data-infrastructure-120920.

[17] “Odd Facts About Odd Lots,” available at https://www.nasdaq.com/articles/odd-facts-about-odd-lots-2021-04-22.

[18] “Understanding the Market for U.S. Equity Market Data,” available at https://www.sec.gov/comments/4-729/4729-4545881-176154.pdf.

[19] *Id.* at 5.

[20] *Id.* at 8.

[21] *See, e.g.*, *In re Citadel Securities LLC*, SEC Admin. Proc. No. 3-17772 (Jan. 13, 2017).

[22] “Global Exchange Revenues Total $38 Billion In 2020, Rising 6.7% on Higher-Than-Average Trading Volumes and Increased Demand for Reference Data - New Burton-Taylor Report,” available at https://www.prnewswire.com/news-releases/global-exchange-revenues-total-38-billion-in-2020--rising-6-7-on-higher-than-average-trading-volumes-and-increased-demand-for-reference-data---new-burton-taylor-report-301283076.html; SEC Release No. 34-90610, “Final Rule: Market Data Infrastructure,” available at https://www.sec.gov/rules/final/2020/34-90610.pdf.

[23] Crenshaw, “Statement on Market Data Infrastructure.”

[24] SEC Release No. 34-90610.

[25] *See* SEC Rule 600(21), (26), and (82), available at https://www.law.cornell.edu/cfr/text/17/242.600.

[26] FINRA Rule 5310, “Best Execution and Interpositioning,” available at https://www.finra.org/rules-guidance/rulebooks/finra-rules/5310.

[27] FINRA Regulatory Notice 15-46, “Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets,” available at https://www.finra.org/rules-guidance/notices/15-46; FINRA Regulatory Notice 21-23, “FINRA Reminds Member Firms of Requirements Concerning Best Execution and Payment for Order Flow,” available at https://www.finra.org/rules-guidance/notices/21-23.

[28] *In re Robinhood Financial,* SEC Admin. Proc. No. 3-20171 (Dec. 17, 2020), available at: https://www.sec.gov/litigation/admin/2020/33-10906.pdf; *Robinhood Financial*, FINRA Acceptance, Waiver and Consent (AWC) No. 2017056224001 (Dec.19, 2019), available at https://www.finra.org/sites/default/files/2019-12/robinhood-awc-121919.pdf; *TradeStation Securities*, FINRA AWC No. 2014041812501 (May 2, 2021), available at https://www.finra.org/sites/default/files/fda_documents/2014041812501%20TradeStation%20Securities%2C%20Inc.%20CRD%2039473%20AWC%

[29] SEC Admin. Proc. No. 3-20171.

[30] Securities Exchange Act of 1934, Rule 10b-10(a)(2)(i)(C), available at https://www.law.cornell.edu/cfr/text/17/240.10b-10.

[31] Rule 606 of Regulation National Market System (Reg NMS) under the Exchange Act (as amended in 2019 to provide more granular information to market participants regarding PFOF or other compensation received from trading venues), available at https://www.law.cornell.edu/cfr/text/17/242.606.

[32] Testimony of Robert Battalio, “Conflicts of Interest in the U.S. Equity Markets,” Before the U.S. Senate Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs, available at https://www.hsgac.senate.gov/imo/media/doc/STMT%20-%20Robert%20Battalio%20(20140612)1.pdf (citing study by Robert Battalio, Shae Corwin, and Robert Jennings, “Can Brokers Have It All? On the Relation Between Make-Take Fees and Limit Order Execution Quality,” available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2367462).

[33] SEC Press Release 2021-139, “SEC Charges 27 Financial Firms for Form CRS Filing and Delivery Failures,” available at: https://www.sec.gov/news/press-release/2021-139.

[34] Testimony of Dennis M. Kelleher, President and CEO Better Markets Inc., Before the U.S. House Committee on Financial Services, available at https://bettermarkets.com/sites/default/files/Kelleher%20HFSC%20Testimony%20GameStop%20Hearing%203-17-2021%20FINAL%20%282%29.pdf.

[35] SEC Division of Trading and Markets Memorandum to the Equity Market Structure Advisory Committee, "Certain Issues Affecting Customers in the Current Equity Market Structure" at 7, 8, and n.33, available at: https://www.sec.gov/spotlight/equity-market-structure/issues-affecting-customers-emsac-012616.pdf; *see also* Testimony of Robert Battalio.

[36] "SEC's Gensler Has a Big, New Vision for the Stock Market. There Are Too Many 'Inherent Conflicts of Interest,'" available at https://www.barrons.com/articles/sec-chief-gary-gensler-stock-market-51630626032?mod=hp_LEAD_2.

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