FINRA Clarifies Guidance on Best Execution and Payment for Order Flow

July 28, 2021

The Financial Industry Regulatory Authority (FINRA) recently issued a Regulatory Notice (Notice) reminding firms of their obligations with respect to best execution and payment for order flow.[1]

These topics received a great deal of attention in recent months from both regulators and the industry, as heightened levels of trading activity by retail investors impacted broader markets (for example, the GameStop "short squeeze" and other trading patterns in so-called "meme" stocks). Many of these retail investors placed their trades through low- or no-fee broker-dealers, which often generate significant revenue through payment-for-order-flow arrangements with executing brokers. In the Notice, FINRA reiterates existing Securities and Exchange Commission (SEC) and FINRA rules and guidance relating to payment for order flow and emphasizes that firms must not allow such arrangements to interfere with their duty to seek best execution for customer orders.

However, it remains to be seen whether FINRA will propose additional changes to its best execution rule or otherwise seek to curtail payment for order flow arrangements in the future.

Background on Best Execution

In general, broker-dealers have an obligation under SEC rules and guidance to "seek the most favorable terms reasonably available under the circumstances for a customer's transaction."[2] FINRA has codified certain specific requirements around best execution in Rule 5310 (Best Execution and Interpositioning).

Rule 5310 requires FINRA member firms to "use reasonable diligence to ascertain the best market" for a customer order for a securities transaction and to execute in such market to provide the customer with a price that is "as favorable as possible under prevailing market conditions."[3] Rule 5310 further provides a list of factors that should be considered by member firms in this best-execution analysis, including the properties or character of the market for the given security and the size and type of transaction requested by the customer.

The requirements of Rule 5310 apply to member firms whether they are acting as an agent for another broker or as a principal. Thus, best execution obligations apply not only when a member firm is handling direct orders from its own customers, but also when a member firm accepts customer orders from another broker and provides order handling and execution services to such broker. In this latter instance, both the routing firm and the receiving firm are obligated to seek best execution for the customer.

1 FINRA Regulatory Notice 21-21, "Best Execution and Payment for Order Flow" (June 23, 2021), available here ("Notice 21-21").

2 Notice 21-21, citing Exchange Act Release No. 37619A, 61 Fed. Reg. 48,290, 48,322 (Sept. 12, 1996).

3 FINRA Rule 5310(a)(1), available here.

Background on Payment for Order Flow

The SEC has defined payment for order flow in a manner that encompasses a wider variety of activity than just cash payment arrangements between brokers. While the definition certainly includes simple cash compensation arrangements, it also covers other in-kind compensation structures that a broker might receive for directing orders to a certain broker or venue. Payment for order flow may be structured, for example, as transaction fee rebates, credits or discounts provided to the routing broker.

The mere existence of a payment-for-order-flow arrangement does not violate a broker's best execution obligations. However, cash payments or other economic benefits received by a broker in exchange for order flow have the potential to create a conflict of interest as the firm might be influenced to allow such benefits to interfere with its efforts to seek best execution for customers.

Highlights of the Notice

The Notice provides an overview of guidance relating to payment for order flow, emphasizing the impact of such arrangements on best execution obligations. The Notice focuses in particular on reminding member firms of their obligations under FINRA Rule 5310 and related guidance and disclosure rules.

FINRA Rule 5310 and Related Guidance

Rule 5310, as described above, includes specific requirements for member firms relating to best execution and the impact of payment for order flow arrangements. Under Rule 5310, FINRA members must engage in reviews of execution quality by comparing actual execution achieved against the quality their customers might receive through other routing arrangements, including both the firm's existing arrangements and potential arrangements that might be established with other markets.

Over time, FINRA has issued additional guidance on execution quality reviews, including in prior Regulatory Notices.[4] Where a member firm decides to execute an order internally, it must engage in an order-by-order review of execution quality. In other cases, member firms need not analyze each individual order but must have in place procedures that ensure they regularly conduct reviews on a security-by-security, type-of-order basis.

In conducting execution quality reviews, Rule 5310 indicates that the following factors should be considered:

- potential for price improvement (i.e., based on the difference between execution price obtained and the best quotes prevailing at the time the market received the order);
- differences in price disimprovement (i.e., where a customer received a worse price than the best quotes prevailing at the time the market received the order);
- likelihood of execution;
- speed of execution;
- size of execution;
- transaction costs;
- customer needs and expectations; and
- existence of internalization or payment for order flow arrangements.

[4] In this regard, Notice 21-21 specifically cites FINRA Regulatory Notice 15-46, "Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets" (Nov. 2015), available here.

Where a firm engages in payment for order flow arrangements, certain aspects of the execution quality review must be analyzed with heightened consideration. For example, it becomes particularly important to review price improvement opportunities and ensure that benefits from payment for order flow arrangements do not improperly influence order routing decisions away from markets with the best available quotes for a particular transaction. Note that when a firm routes orders for automated execution or internally executes on an automated basis, the Notice indicates that the SEC has advised that simply obtaining the best bid or offer may not be sufficient to satisfy a firm's best execution obligations.

FINRA also cautions that member firms cannot meet best execution obligations unless they compare execution quality obtained from existing arrangements against quality that could be obtained from competing markets. Benefits received from payment for order flow arrangements may not influence a firm's analysis of market quality. Similarly, receiving firms that pay routing firms for the opportunity to internalize orders must regularly analyze whether opportunities for price improvement exist on competing markets and must not structure order routing and payment arrangements in a manner that reduces the price improvement opportunities that would be available without such arrangements.

In short, payment for order flow arrangements do not alter the routing and receiving firms' best execution obligations or the requirements that those firms engage in rigorous execution quality reviews.

Disclosure Requirements

Firms that engage in payment for order flow relationships have certain disclosure obligations, most notably under Rule 10b-10 under the Securities Exchange Act of 1934, as amended, and Rules 606 and 607 of Regulation NMS.[5] The Notice emphasizes that the existence of, and compliance by a broker with, these disclosure requirements does not modify its duty of best execution or mitigate a firm's violations of that duty, not does it relieve the firm of the need to conduct best execution analysis.

A Look Ahead

The Notice informs firms that the SEC has requested that FINRA "develop recommendations that could impact the standing rules or guidance" described above, in order to consider whether additional best execution requirements or guidance are needed "to promote investor protection." As such, FINRA may "evaluate whether further changes to its best execution rule are necessary or appropriate." Member firms should remain alert with respect to further developments in this area.

[5] Rule 10b-10 provides that broker-dealers must indicated on customer confirmations statements when payment for order flow has been received for a transaction, and alert the customer that the source and nature of the compensation can be obtained upon the customer's written request. Under Regulation NMS: Rule 606 requires that broker-dealers post quarterly reports on their public websites that list the top ten venue to which they route orders for execution and discuss material aspects of payment for order flow arrangements; and Rule 607 stipulates that broker-dealers must provide disclosure to customers regarding their policies relating to payment for order flow and order routing upon the opening of a new account and annually thereafter.

CONTACTS

For more information, contact your Katten attorney or any of the following attorneys in the Financial Markets and Funds or Securities Litigation practices.

Gary DeWaal
+1.212.940.6558
gary.dewaal@katten.com

Susan Light
+1.212.940.8599
susan.light@katten.com

Michael J. Lohnes
+1.312.902.5341
michael.lohnes@katten.com

Elizabeth Organ
+1.212.940.6561
elizabeth.organ@katten.com

7/28/21