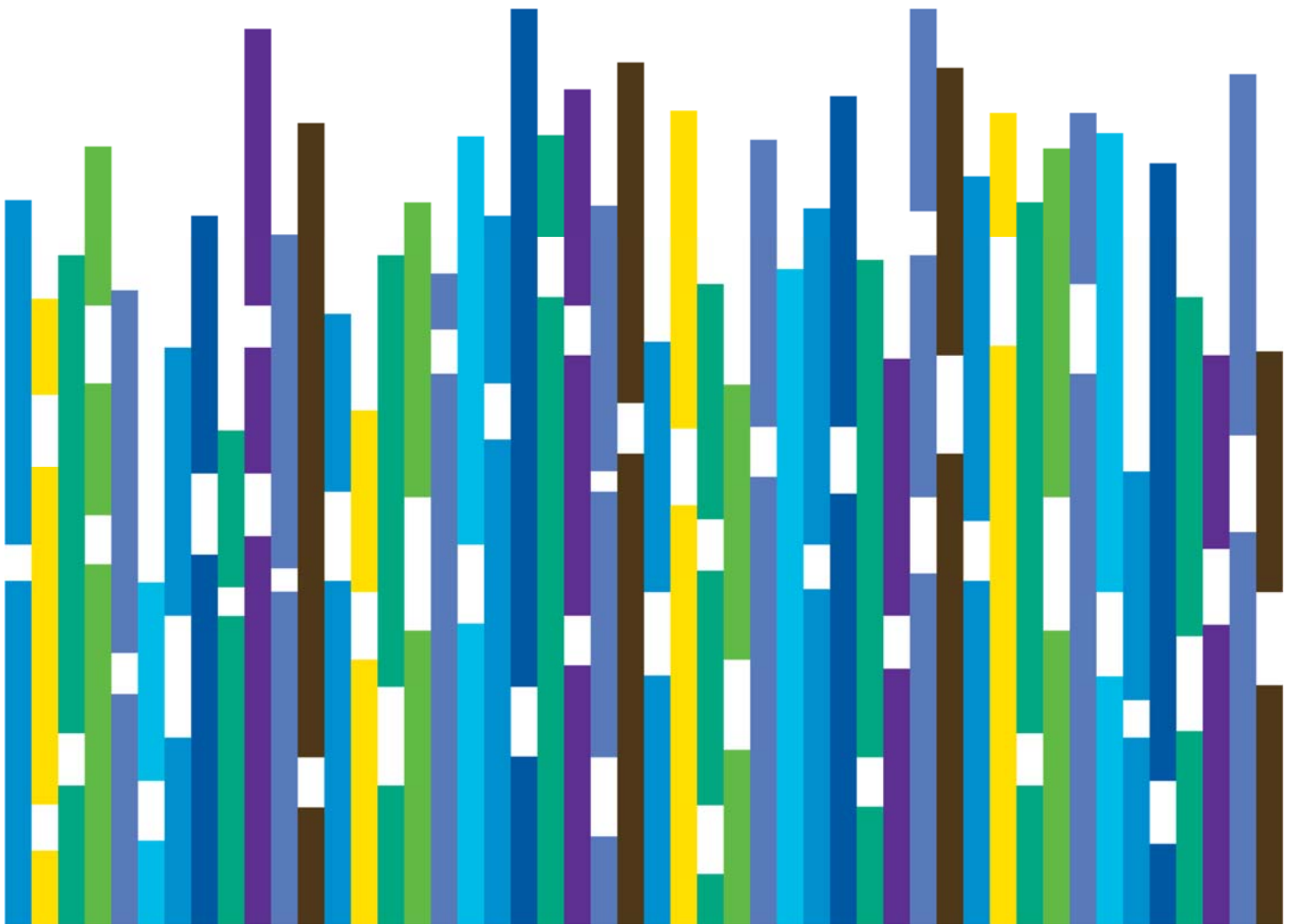




POLICY BRIEF

PAYMENT FOR ORDER FLOW

Internalisation, Retail Trading, Trade-Through Protection,
and Implications for Market Structure



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Summary

Payment for order flow (PFOF) is the practice of wholesale market makers paying brokers (typically retail brokers) for their clients' order flow. By acquiring order flow in this way, market makers are able to trade profitably against client orders (on average) while clients may benefit from reduced trading costs because the commissions retail brokers charge may be subsidized by the payments they receive from wholesale market makers.

Critics of PFOF argue that this arrangement creates a conflict of interest in brokers' best execution obligations to their clients. Specifically, brokers may be incentivized to route customer orders to the highest bidder rather than to the market maker or trading venue offering the best prices and fastest execution. Clients in the United Kingdom face another potential disadvantage because market makers engaging in PFOF could seek to recover these payments by increasing the spreads they offer.

In 2012, the UK Financial Services Authority (FSA)¹ issued a clarification of its rules on PFOF arrangements. In its guidance paper, the FSA argued that the conflict of interest between the broker and its client under PFOF arrangements was unlikely to be compatible with the FSA's inducement rules and risked compromising compliance with best execution rules. As a result, the FSA effectively banned PFOF in its updated guidance. In its *Payment for Order Flow* report, CFA Institute studied the impact of the 2012 FSA ruling on PFOF. The rule clarification provides a unique opportunity to examine the impact of PFOF arrangements on execution quality for investors. Specifically, we analysed the proportion of retail-sized orders executing at the best quoted price in the UK primary market—the London Stock Exchange (LSE)—before and after the FSA's updated guidance in May 2012. We posited that the explicit removal of a potential source of revenue for brokers (and with it, a removal of potential agency conflicts) should lead to more efficient order-handling practices and a more competitive market for retail-sized orders.

We observed an increase in the proportion of retail-sized trades executing at best quoted prices from 65% to more than 90% between 2010 and 2014, which is consistent with our hypothesis. In addition to the prohibition of PFOF arrangements, the coincident growth of lower-cost internet execution-only accounts and the limited profitability for brokers of servicing retail clients may have caused the UK retail equity market to become a more competitive, utility-like service.

¹In 2013, the FSA was disbanded and succeeded by the Financial Conduct Authority (FCA).

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Background

The main argument in favour of payment for order flow (PFOF) is that it allows retail investors to benefit from the value of their order flow. The payments that retail brokers receive from market makers under PFOF arrangements indirectly benefit retail investors because these payments can subsidise the commissions that brokers charge to their customers. In comparison, on an exchange, retail investors would likely have to cross the spread to trade and the value of their order flow would be distributed among the market. Internalisation, facilitated by PFOF arrangements, represents a significant proportion of overall trading activity in the United States and is thought to account for almost 100% of all retail marketable order flow.

The United Kingdom has a very different model from the United States. First, retail trading is based on the retail service provider (RSP) model, which is essentially an internal market of market makers that each broker cultivates for processing retail orders. A retail order placed with a broker is announced to the RSP network of market makers. Market makers bid for the retail orders, and the best price will be selected for the client as per best execution requirements. Firm prices and sizes must be quoted, and investors have complete execution certainty. Second, there is less retail trading in the UK compared with the US, with individual day traders (for example) more likely to use spread betting and contract for difference (CFD) platforms because of the requirement to pay stamp duty (i.e., a tax) on equities in the UK. Furthermore, the cost of data and post-trade settlement in the UK is large relative to that in the US. Retail trades, which are not netted, would thus have to pay potentially high clearing fees.

Policy Developments

In May 2012, the Financial Services Authority (FSA), the precursor to the Financial Conduct Authority (FCA), issued updated guidance on the practice of PFOF in the UK. The FSA posited that brokers operating on a regulated market and acting on behalf of a client under PFOF arrangements are unlikely to satisfy the relevant rules on inducements and best execution—in effect, banning PFOF. Although PFOF was not widespread in the UK, the FSA was concerned that the practice was becoming more prevalent, particularly on the London International Financial Futures and Options Exchange (LIFFE). Additionally, it was implied that best execution obligations were not being prioritised sufficiently.

The relevance of this rule change—and our related study—for other jurisdictions, particularly those that currently permit PFOF, was highlighted by the US Securities and Exchange Commission (SEC). In a speech on 11 May 2015, SEC Commissioner Luis A. Aguilar commented that

...the Commission should monitor the experience of other jurisdictions, such as the United Kingdom, that have prohibited payments for order flow entirely. In particular, the Commission should determine whether the pervasive deficiencies that led the UK's Financial Conduct Authority (FCA) to ban these payments outright also exist in this country. Further, the Commission should work with the FCA to monitor how brokers respond to the ban. For example, the ban is an opportunity to test brokers' claims that payments for order flow are vital to keeping retail customers' commissions low. The ban also offers an opportunity to determine whether, as some have claimed, market participants will react to the ban by merely seeking alternative ways of providing compensation to those who send them business.

Findings

We investigated the impact of the PFOF regime in the UK by calculating the percentage of retail-sized trades that execute at the best quoted price on the London Stock Exchange (LSE) before and after the 2012 ruling. We posited that a market ecosystem that does not have PFOF (and its associated incentive structure) will provide less scope for wholesale market makers to capture retail order flow by offering price improvement (internalising trades within the spread between the best bid and best offer price).

Furthermore, without regulatory trade-through protection of the displayed quote in the UK (in contrast to the US where orders cannot trade at a worse price than the national best bid and offer), retail-sized orders rely on competition between market makers and best execution obligations to achieve good outcomes. Absent a regulatory requirement enforcing executions at the best price in the UK, it is intuitive to examine the proportion of trades executed at, better than, and worse than the best price before and after the PFOF ruling. By calculating these statistics, we can determine whether the UK market has become any more or less competitive for retail-sized orders following the PFOF ruling in 2012

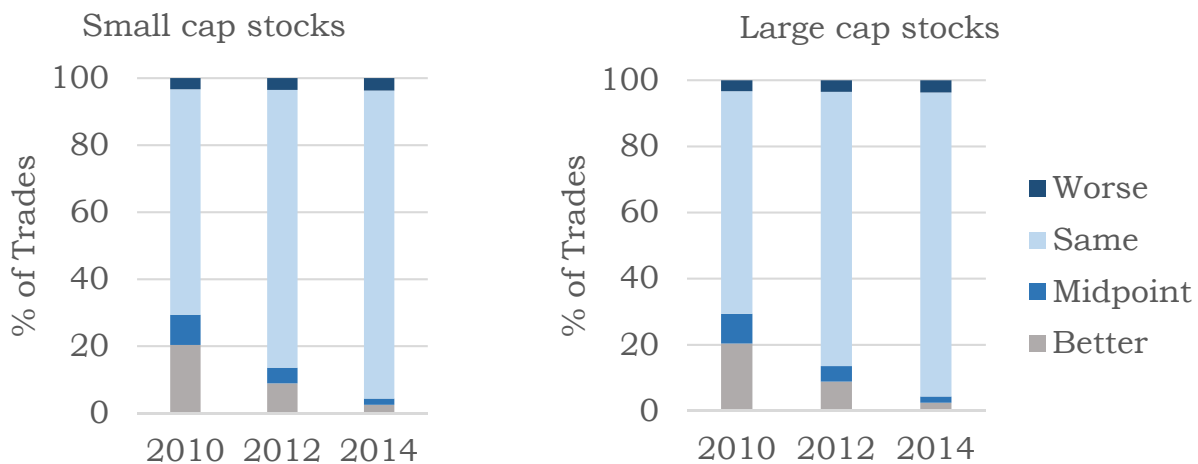
As shown in **Figure 1**, we found that the proportion of trades executing at the best quoted price has increased between 2010 and 2014, which is consistent with a market for retail-sized orders that has become more competitive and undifferentiated. Note that this increase is largely at the expense of trades executed with price improvement (a reduction in “better” and “midpoint” trades in Figure 1). Nominally, the reduction in price improvement trades implies a worse outcome for retail investors. However, quoted spreads narrowed for large-cap stocks between 2010 and 2014 (small-cap spreads were little changed). In particular, the quoted spread for large cap stocks for trades executed at the best price narrowed from 6.8 bps in 2010 to 4.6 bps in 2014. Furthermore, for trades executed with price improvement, spreads fell by one-third over the same period (for midpoint trades, the associated spread fell by more than 40%).

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Consequently, the potential savings to retail investors from trades executed with price improvement were markedly smaller after the PFOF ruling, with better touch prices for all investors. The implication is that without PFOF, and coincident with the continuing growth of internet execution-only accounts, the market has become more efficient and utility-like (the price you see is the price you trade at).

We believe this change is positive for market integrity because it implies that displayed liquidity providers are rewarded with executions at the price they quote. This reward mechanism upholds market integrity by supporting the incentive to post the displayed limit orders on which price discovery is based, and it should lead to more competitive pricing. Indeed, the narrowing of spreads over the period and better touch prices for investors underscores this outcome. By contrast, this outcome may be jeopardized in markets with PFOF arrangements in which market makers internalising order flow are able to step ahead of the quoted price on the order book by offering price improvement. This outcome also supports the view put forward by the FSA in its 2012 guidance that under PFOF, market makers may widen their quoted prices to recover their payments to brokers.

Figure 1: Trade Executions at Best Quoted Prices on LSE



It appears that the current best execution regime in the UK is working well despite the lack of a US-style trade-through rule that explicitly prevents executions away from the best quoted price. Our study of the UK experience may allow lessons to be learned for other global markets, particularly in relation to whether trade-through protection is necessary. Our results suggest that best execution can be achieved without a trade-through protection rule in the absence of PFOF.

Conclusions and Considerations

Our findings suggest that the loss of a potential source of revenue from retail PFOF arrangements across asset classes, combined with the low profitability of servicing retail clients—particularly given the continued popularity of internet execution-only services—has resulted in retail-sized equity order execution becoming a competitive, utility-like service.

The implication is that the current best execution regime appears to be working well, despite the lack of a US-style trade-through rule that would explicitly protect quotes at the top of the order book. It is possible that markets that do have trade-through protection, such as the US market, may not need this explicit quote protection to maintain best execution as long as PFOF is banned as well.

This suggestion is interesting given that some market participants in the US argue that trade-through protection may ultimately harm investors by increasing the technical complexity of the market ecosystem and possibly damaging market quality by incentivising the use of predatory high-frequency trading strategies. Our findings suggest that a simpler market structure can also achieve good best execution outcomes as long as a holistic approach is taken.