Remarks Of

Richard Y. Roberts
Commissioner*
U.S. Securities and Exchange Commission
Washington, D.C.

"Payment for Order Flow"

The 1993 Ray Garrett Jr. Corporate
And Securities Law Institute
Chicago, Illinois
April 29, 1993

---

*/ The views expressed herein are those of Commissioner Roberts and do not necessarily represent those of the Commission, other Commissioners or the staff.

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

"Payment For Order Flow"
Ray Garrett Institute

I. Introduction

I appreciate the opportunity to participate in a Ray Garrett Institute program. It is an honor to be involved in this prestigious securities annual event. Present company excluded, it appears that another outstanding program has been arranged.

During my part of the program, I intend to focus on the subject of payment for order flow. This subject has been debated and considered for some time without being addressed in any meaningful fashion. That is unfortunate and conjures up the image of the proverbial snail sprinting past the Commission in a race. I anticipate that the Commission will have to confront this issue, particularly once the Market 2000 Study is completed. At this juncture, it may be helpful to briefly discuss both the general and the regulatory history of payment for order flow.

II. Description of Payment for Order Flow Practices

The practice of payment for order flow evolved in part from fees traditionally paid by wholesale market makers to their correspondents. Historically, regional correspondents have been paid a fee per share for handling trades with other local firms on behalf of the wholesale firm. At times, these regional correspondents also have been paid for sending their order flow to the wholesale firm. As competition for over-the-counter ("OTC") order flow increased, wholesale firms began to approach other retail firms, particularly discount brokers, to assure themselves a steady stream of orders. To compensate retail firms for guaranteeing such order flow, wholesalers began paying for this order flow. With regard to exchange-listed stocks, competition among regional specialists and third market makers similarly led to payment for order flow over the past several years.

Generally, firms that have payment for order flow arrangements with other firms pay a small fee, usually between one and two cents per share, for retail orders routed to them.

While payment for order flow has been for some time a common practice for OTC market makers in OTC securities, an increasing volume of retail orders is now subject to such arrangements. In addition, although this practice originated with wholesale firms with no direct retail order flow, some integrated firms are also now paying for order flow. Moreover, some OTC market makers and some exchange specialists are paying for order flow in exchange-traded securities.

In this connection, many OTC and third market makers have developed automated execution systems that provide their customers with quick, efficient and comparatively inexpensive executions at the best displayed quotation. These automated execution systems have enhanced firms' ability to execute small orders, for which the costs of execution may be a much higher percentage of the cost to the customer than for larger-sized orders. As competition among firms providing automatic execution systems has increased, it appears that firms increasingly use payment for order flow as a means of attracting order flow to their automated execution systems.

III. Regulatory History

When the Commission first became aware of payment for order flow practices in the OTC market in late 1984, the Division of Market Regulation ("Division") wrote to the National Association of Securities Dealers ("NASD") to express its concerns and to request that the NASD "consider possible measures to address any problems observed in this area."[1] In the ensuing years, the Commission has requested information from the NASD and the exchanges to determine the extent of payment for order flow practices.

In July of 1989, when payment for order flow practices were beginning to draw the attention of many members of the securities industry, the Commission held a Roundtable on Commission Dollar and Payment for Order Flow Practices ("Roundtable"). With the Roundtable, the Commission brought together leading authorities representing diverse perspectives to discuss the issue in an open forum. The exchange among market participants initiated by this meeting yielded, in the ensuing years, a large body of professional and academic literature on the subject.

The NASD has examined, and apparently continues to examine, the issue of payment for order flow. The NASD submitted a proposed rule change in April of 1990, which would require enhanced disclosure of payment for order flow to customers.[2] Subsequently, after discussion with the Division, the NASD amended its proposal to make it more consistent with Exchange Act Rule 10b-10. The NASD's rule proposal remains pending with the Commission

In 1991, the NASD appointed a special committee , headed by former SEC Chairman David Ruder ("Ruder Committee"), to study payment for order flow practices in the securities industry. The Ruder Committee issued its report in July of 1991. In brief, this report: (1) concluded that cash payments for order flow are not significantly different from other inducements for order flow; (2) recommended that the NASD revise its Best Execution Interpretation to recognize a presumption that best execution will be obtained by executions at the best bid or offer for small orders; and (3) recommended that the NASD revise its rule proposal to require disclosure of all inducements for order flow.

In May of 1990, the Midwest Stock Exchange ("MSE") filed a petition for rulemaking with the Commission requesting that the Commission propose new Rule 11Ac1-4 under the Securities Exchange Act of 1934 ("Exchange Act") and amend Exchange Act Rules 10b-10 and 11Aa3-1. The MSE's proposal apparently intended to address payment for order flow practices by requiring that payment be remitted to the ultimate customer, but the MSE subsequently withdrew its petition.

In 1991, two academic studies conducted by professors from the University of Michigan and the Wharton School of the University of Pennsylvania examining payment for order flow were disseminated.[3] While these two studies conclude that more favorable executions may be obtained on the primary exchange than on some, but not all, of the regional exchanges or in the OTC market, academic debate on this issue is by no means complete.[4] Many academics have not yet expressed an opinion, and I understand that other studies have been or are being conducted.

Two weeks ago, on April 14, the Subcommittee on Telecommunications and Finance of the House Energy and Commerce Committee held a hearing to review the progress made toward achieving the national market system goals established by Congress in the Securities Act Amendments of 1975. While the Commission did not testify at the hearing, all the exchanges and the NASD did; and apparently payment for order flow was a principal focus of the hearing.[5]

As I indicated earlier, to date, the Commission has not taken a position with respect to payment for order flow practices, and market participants remain deeply divided on the subject.

IV. Issues Raised by Payment for Order Flow

As a threshold issue, it seems to me that it must be determined whether payment for order flow practices are consistent with just and equitable principles of trade. Some argue that payment for order flow raises the fundamental concern that a brokerage firm's execution decisions will be influenced by the payment of compensation by one market or market maker. According to such an argument, the practice of payment for order flow should be prohibited as being akin to commercial bribery. While I am not prepared at the present to agree with this argument, I will say that whenever the subject of payment for order flow practices comes before an investor audience in my presence, the audience indicates general unawareness of the practices and judges those practices to be unsavory. Thus, at a minimum, I am interested in increasing investor awareness of the practices; and I am uninterested in defending the practices.

Broadly speaking, the potential conflict of interest inherent in the receipt of such compensation does raise disclosure, best execution, agency, and market structure issues, all of which I will attempt to briefly discuss.

A. Disclosure

A firm receiving payment for order flow must, at least, meet certain minimum disclosure requirements under existing rules. The Commission's confirmation disclosure rule, Exchange Act Rule 10b-10, requires that confirmations sent to customers for agency transactions disclose the "price" at which the order was executed, as well as the remuneration paid to the broker-dealer by the customer in the trade. Subparagraph (a) (7) (iii) of Rule lOb-10 also generally requires broker-dealers to disclose the source and amount of any other remuneration received in connection with a transaction. In most transactions, however, the Rule permits broker-dealers merely to state "whether any other remuneration has been or will be received" and to furnish the source and amount of such other remuneration on written request.

Thus, Rule 10b-10 currently requires a broker-dealer to indicate specifically if it is receiving payment for order flow in connection with a particular customer trade but allows the broker-dealer to omit the description of this payment from the confirmation. Further, while Rule 10b-10 does not limit disclosure to cash remuneration, that is apparently the disclosure practice which has developed.

As I indicated earlier, the NASD has filed with the Commission a proposed rule change, subsequently amended, that would require enhanced disclosure of payment for order flow to customers. Specifically, the proposed amendment to the NASD's Rules of Fair Practice would require members receiving compensation for sending customer orders to a particular market center or market maker to give or send to each customer, at or before the completion of each transaction, written notification disclosing the following, in bold print:

> The firm receives remuneration for directing orders to particular broker/dealers or market centers for execution. Such remuneration is considered compensation to the firm, and the source and amount of any compensation received by the firm in connection with your transaction will be disclosed upon request.

Allowing post-confirmation description of additional compensation would ease the difficulty for broker-dealers of disclosing diverse additional compensation arrangements; however, this disclosure method may not effectively inform customers of factors influencing the broker-dealer's execution of their orders. Unless a confirmation clearly indicates that payment for order flow is in fact received, the customer will not be aware that the arrangement exists, much less that there is more information about the arrangement available from the broker-dealer. Ambiguity on this score, combined with the requirement that the customer request the description in writing, in practice may not adequately disclose to customers payment for order flow practices. Further, the NASD rule proposal would not appear to enhance disclosure with respect to some non-cash inducements. Thus, it is questionable whether the NASD rule proposal appreciably improves customer awareness of payment for order flow practices.

I believe that there is a clear need for accurate and complete disclosure to customers of payment for order flow practices. A broker-dealer's payment for order flow practices may be significant to a customer in choosing a broker-dealer and may affect how the customer deals with a broker-dealer. For instance, if a customer were aware that its broker-dealer directed orders in exchange-listed stocks to a third market maker or exchange market in return for payment for those orders, that customer may choose to direct the broker-dealer to route its order to a particular market. In the alternative, a customer may try to negotiate a lower commission to reflect the fact that its broker-dealer received payment for execution of its orders. Therefore, the means of assuring adequate disclosure to customers is an important issue, and one that the Commission should and could address in a timely fashion.

B. Best Execution

Broker-dealers are under a duty to seek to ensure that their customers obtain the "best execution" of their orders. Thus, at a minimum, firms accepting remuneration from a market maker for directing order flow to that market maker still must fulfill their duty of best execution to their customers. Indeed, the NASD repeatedly has noted that pursuant to its rules, NASD members who receive payment for order flow are under an obligation to ensure that these customers obtain "best execution" of their orders.

While the Commission has never explicitly defined "best execution," it has discussed the concept in numerous contexts. Although price is a paramount consideration, the Commission has acknowledged that best execution involves the consideration of numerous factors. For example, some market participants may be more concerned with speed and certainty of execution than with the price obtained. In describing a brokerage firm's best execution obligation, the Commission has noted that:

> (while) brokers have not been held by the Commission, the self-regulatory organizations or the courts to an absolute requirement of achieving the most favorable price on each order[,] [w]hat has been required is that the broker endeavor, using due diligence, to obtain the best execution possible given all the facts and circumstances. These factors include, among other things, the size of the order, the trading characteristics of the security involved, the availability of accurate information affecting choices as to the most favorable market in which execution might be sought, the availability of technological aids to process such data, the availability of economic access to the various market centers and the costs and difficulty associated with achieving an execution in a particular market center.[6]

Apparently most firms that pay for order flow guarantee, at a minimum, executions at the prevailing displayed best bid or offer. Such quote-derived executions in many ways are not materially different than automatic execution systems operated by regional exchanges for years, and automatic execution systems do offer extremely fast and assured executions and prompt reports back to the customer.

On the other hand, orders sent to an exchange for manual handling and, to a lesser extent, those sent to an OTC dealer for manual handling, may have a greater opportunity for an execution between the spread than do orders that are routed to automated execution systems (either on an exchange or in the OTC market). In addition, it is not clear that all OTC market makers who pay for order flow permit two agency orders to interact at prices between the bid and the offer price.

C. Agency Concerns

The Commission has on numerous occasions found derivatively priced automatic execution systems consistent with the Exchange Act.[7] Nevertheless, there exists concern that the availability of payments in return for order flow commitments may color the evaluation by a brokerage firm of the most advantageous market or market maker to whom to route its customer order.

For example, I understand that concerns have been raised that a broker's acceptance of a payment concerning the subject of the agency relationship, in other words, the customer's order, may be a breach of the broker's fiduciary duty. Some argue that the acceptance of the payment creates a conflict between the agent and principal that is not permitted under general principles of agency law.

D. Market Structure Issues

Payment for order flow also raises market structure issues. In many respects, these issues may be the most significant and the most difficult to address. Some argue that payment for order flow: (1) has an effect on pricing efficiency in the markets; (2) is inconsistent with the goal of fair competition as set forth in Section 11A of the Exchange Act; (3) reduces market maker quote competition for orders; and (4) improperly diverts customer orders to automated execution systems where they cannot be executed without the participation of a dealer.

The first market structure issue is what effect, if any, payment for order flow arrangements have on the pricing efficiency of the markets. The amount that dealers, who pay for order flow, are willing to pay for orders is not publicly disseminated, either in the dealers' quotations or in transaction reports of the execution of those orders. Does this mean that the actual prices at which transactions are effected are not publicly available?

In addition, some argue that payment for order flow practices contravene the statutory directive that the national market system be designed to assure fair competition among brokers and dealers and between exchange markets and markets other than exchange markets. They argue that a market maker or specialist that does not pay for order flow cannot effectively compete with one that does, primarily because receipt of these payments reduces the cost of doing business for the broker who accepts them.

Payment for order flow also may reduce market maker quote competition for orders. To the extent that a market maker receives order flow regardless of the competitiveness of its quote, the market maker has less need to seek order flow through competitive quotes. Thus, if payment for order flow arrangements provide a market maker with substantial order flow on a non-quote basis, they may reduce the market maker's incentive to quote a narrower spread. Indeed, increased commitments by market makers to execute order flow derivatively at the best bid or offer may provide direct incentives to widen quotations. Of course similar arguments can be made with respect to specialists and certain order routing arrangements.

However, it is possible that because automated executions can be obtained from nearly any participating market maker at the inside quote, fewer orders may be directed for execution to the market makers actually competing based on price. The theoretical result could well be a widening of spreads, thus reducing the pricing efficiency of the market and raising costs of trades for those securities.

E. Related Practices

I am aware that industry participants have entered into a variety of other arrangements in which order flow is traded for non-monetary services or other value. Examples include: reciprocal practices, including the swapping of order flow between market makers and between specialists in different stocks, the swapping of options and futures business for order flow in stocks, and the swapping by exchange specialists of exchange lay-off business; reduced clearing fees to correspondents; exchange of research packages for order flow; exchange of secretarial services, business machines, and office space for order flow, typically provided by clearing firms; the provision of subordinated debt for order flow; adjustment of trading errors by exchange specialists for order flow; offers to participate as underwriter in public offerings for order flow; stock loans and shared interest accrued thereon for order flow; and offers of fee discounts, waivers, and volume and automation discounts by exchanges for order flow.

There are also practices within an organization or between affiliated organizations that seek to direct order flow in a particular manner such as the internationalization of a firm's own order flow, and the direction of order flow from broker-dealers to affiliated exchange specialists.

Certainly before any comprehensive Commission action in the payment for order flow area can be completed, the Commission should determine what practices raise conflict of interest issues similar to payment for order flow. However, this does not mean that the Commission cannot act incrementally through one of a series of actions, beginning with an enhanced disclosure proposal aimed principally at transactions based payments and resulting, through the series, with the completion of a comprehensive response with respect to all inducements for order flow.

F. Economic Benefits of Payment for Order Flow Practices

Some have argued that firms routing a regular order flow to a market or market maker are providing value that is very different than the value provided in routing a single order. They argue that a regular flow of orders to a market maker permits that firm to profit through the regular receipt of the "dealer's turn" (i.e., buying at the bid, selling at the offer). In essence, under this argument, the payments received by order routing firms are similar to volume discounts, and, thus, the payments are fair compensation for their channelling of the individual orders to market makers. I do not agree with this argument. I am of the view that customer orders should not be a saleable asset.

Some also argue that payment for order flow enhances competition within the securities markets. They argue that use of automated execution systems and related practices have increased competition within the markets as envisioned by Congress in enacting Section 11A of the Exchange Act. They further argue that, within this context, payment for order flow practices have developed to allow wholesale dealers to compete with exchanges and vertically integrated firms. This competition, they argue, has resulted in a reduction of execution costs in all markets, including exchanges, which have responded with reduced exchange fees and specialist charges. Moreover, they argue that this competition has resulted in lower commission costs. While I generally agree with this line of argument, the customers who are placing the orders are not necessarily receiving all the benefits of this competition at the present, which does trouble me.

V. Proposed Responses

There are several Commission alternatives available to address some of the issues raised by the subject of payment for order flow. For example, if the Commission were to conclude that, on balance, payment for order flow is detrimental to customers or the markets as a whole, there are a number of possible responses, four of which I will mention.

First, the Commission could conclude that enhanced disclosure should be provided to customers and to the market. At a minimum, the Commission should take this action in my judgment. Second, the Commission could adopt a proposal to require that payments be passed through to customers, as was set forth in the now withdrawn MSE petition. Third, the Commission could require the adoption of a decimal-based system for the pricing and reporting of all securities for which transactions are reported on the consolidated tape. Finally, the Commission could conclude that payment for order flow practices are inconsistent with the Exchange Act and with SRO rules that require adherence to just and equitable principles of trade. This response would ban the practice altogether and is fairly easy to grasp. However, it may be helpful to discuss in more detail the first three of these potential responses.

A. Enhanced Disclosure

The Commission could seek enhanced disclosure of payment for order flow practices to achieve two objectives. The first would be to enhance customer awareness of the practice, and the second would be to enhance the pricing efficiency of the markets. Both of these objectives are sound ones in my view and should be pursued.

The Commission could amend Rule lOb-10 to require that specific disclosure be made on customer confirmations of the amount of any payments with respect to exchange-traded securities received from a dealer that are attributable to that customer's order. As an alternative, the Commission could approve the NASD proposal to enhance confirmation disclosure.

Until the NASD either acts upon or responds to the Ruder Committee recommendations, the Commission may be reluctant to finally consider the NASD's rule filing. Any approval order could indicate though that enhanced disclosure of payment for order flow practices would be a clear benefit to customers while the Commission considers the larger issue of what, if any, further responses are necessary. Such order could also indicate that Commission approval of the NASD's disclosure proposal should not be taken as a signal that the Commission either approves or disapproves of payment for order flow practices, nor would it preclude further Commission action on the issue.

The Ruder Committee suggested that payment for order flow is one of many types of inducements for order flow and cannot be evaluated independently. I respectfully disagree to some extent with that suggestion. Where I come from, cash talks; and, more often than not, everything else walks. Thus, it is possible that transactions based payments, such as cash payments, fee rebates, and volume discounts, can be handled independently from the less "hard" types of inducements. However, I do agree that the Commission should attempt to address the issues raised by all types of inducements, although not necessarily with one action.

Unfortunately, probably neither of the two enhanced disclosure steps mentioned will satisfactorily improve customer awareness of payment for order flow practices. Payment for order flow by its nature consists of payment for orders in the aggregate with the market maker seeking to obtain a guaranteed stream of orders. Although this stream is made up of individual customer orders and its disposition has consequences for these individual orders, it is the stream, rather than the particular order, that is the subject of the arrangement between the market maker and the broker. Therefore, even when payment is made on a per share or per order basis, mere disclosure of the compensation for an individual order may not adequately or fairly communicate the nature of the arrangement.

Possibly the existing confirmation requirement should be supplemented or replaced by an annual or semi-annual disclosure by the broker to customers whose orders result in payments for order flow. This disclosure could provide the circumstances in which the broker receives payment for order flow and the terms of this payment, on an overall or per order basis.

As an alternative, the Commission could consider more comprehensive and direct disclosure. One possible approach would be to require that broker-dealer firms, accepting payment for order flow, send to each new customer a separate document containing a written statement clearly disclosing the circumstances in which the firm accepts payment for order flow and the policies and procedures followed by the firm in handling such orders. The broker-dealer could be required to provide additional disclosure subsequently by separate notice distributed either annually or with each confirmation of a transaction involving payment for order flow. The rule could further require that customers sign or initial the disclosure language.

While imposing some compliance costs, disclosure of this latter nature may provide far superior disclosure than a statement on a confirmation. Such disclosure would provide customers with the opportunity to make an informed choice as to whether they will do business with a particular broker. Furthermore, because not all brokers accept payment for order flow, customers, in reality, do have a choice; and, if they object to their broker accepting payment for order flow, they can take their business to another broker.

At a minimum, it appears to me that the Commission should take action to enhance disclosure to customers and to the market of payment for order flow practices. Of course this action would serve only as one of a sequence of actions flowing from the recommendations contained in Market 2000 and resulting hopefully in a comprehensive response.

B. MSE Proposal

Another alternative would be to adopt the MSE's aborted rulemaking petition. As I understand it, the MSE proposed requiring a broker or dealer, who acting as agent, receives cash payments from any market maker for directing order flow to the market maker, to remit those payments to customers. This proposal would not prohibit a market maker from making cash payments for order flow. It would, however, prohibit a broker-dealer from retaining these payments for its own benefit. Obviously this response is limited only to cash payments and does not cover other inducements.

C. Decimal Pricing

Some have argued that the fact that some market makers and specialists are willing to pay for order flow indicates that currently disseminated spreads are too wide.[8] I believe that this argument is probably accurate.

Under current exchange rules, prices are reported and quotations disseminated in multiples of an eighth of a point (or 12.5 cents). Thus, payments of an additional penny or two cannot be reflected. In a decimal-based system, however, prices are reported in multiples as small as one-hundredth of a point (one cent). At least one prominent investment banker has recommended that a decimal pricing system be adopted.[9] Adoption of such a system would permit narrowed spreads and greater flexibility in the pricing of securities. As a preliminary observation, it appears to me that the implementation of a decimal pricing system has some merit and is worthy of consideration. Of course, such a system could be adopted currently by any SRO.

Disadvantages of a decimal pricing system include the cost to the market of conversion to such a system. I submit that this cost is a major impediment to the implementation of such a system. Second, decimal pricing does raise certain time priority questions. Third, significantly narrowed spreads would result in lower profits for market-makers, which may or may not be a problem. I am just not sure. Furthermore, at the Roundtable, it was stated that market makers are not willing to make payments for every order they receive and that the payments are, in effect, compensation to retail firms for bulk order flow. As such, the payments may not be reflected in quotations. Under this analysis, decimal pricing would not change current practices. Finally, because it provides no mechanism for accounting for reciprocal arrangements or other practices of concern, decimal pricing would have no impact on "soft dollar" practices.

VI. Conclusion

Certainly payment for order flow raises important investor protection concerns which the Division currently is examining. While the issue is closely related to other, broader questions relating to the pricing of customer orders, competition among markets, and quality of markets, which hopefully will be addressed through the Market 2000 Study, the Commission could and should require, as a part of any comprehensive response, some form of enhanced disclosure of the practice.

ENDNOTES

1. Letter from Richard G. Ketchum, Director, Division of Market Regulation, SEC, to John E. Pinto, Senior Vice President, NASD, dated October 5, 1984.

2. File No. SR-NASD-90-22. Securities Exchange Act Release No. 28020 (May 15, 1990), 55 FR 21284. The NASD also filed an amendment to the proposed rule change on December 19, 1990. Securities Exchange Act Release No. 28774 (January 14, 1991), 56 FR 2573.

3. <u>See</u> C. Lee, <u>Purchase of Order Flows and Favorable Executions: An Intermarket Comparison</u> (September 15, 1991) ("Michigan Study"); <u>and</u> M. Blume & M. Goldstein, <u>Differences in Execution Prices Among the NYSE, the Regionals and the NASD</u> (September 1991) ("Wharton Study").

4. For example, one criticism of the studies is that they do not include data from 1991, when significant improvements were implemented in several exchange and OTC execution systems. During 1991, the MSE and Madoff Securities added price improvement algorithms to their automated execution systems. These markets argue that data from 1991 or later would demonstrate an increase in the percentage of executions between the spread. Also the studies do not account for the cost savings and improvement to primary market spreads that have arisen from competition by the regional exchanges and the OTC market.

   I am not suggesting that the results of the studies are wrong, but only that these studies should serve as a starting point for analysis and review. They should not be used to foreclose further empirical study of the issue in my opinion.

5. <u>See</u> Vise, "NYSE Chief Urges Ban on Cash Payments," <u>The Washington Post</u> (April 15, 1993), at D11.

6. SEC <u>Second Report on Bank Securities Activities: Comparative Regulatory Framework Regarding Brokerage-Type Services</u> 97-98, 98 n.233 (February 3, 1977), <u>as reprinted in</u> Senate Comm. on Banking, Housing & Urb. Affs., 95th Cong., 1st Sess., <u>Report on Banks Securities Activities of the SEC</u> 145, 251-52, 252 n.233 (Comm. Print 1977).

7. <u>See</u>, <u>e.g.</u>, Division of Market Regulation, <u>Automation in U.S. and Foreign Securities Markets</u> (November 1989).

8. Coffee, "Brokers and Bribery," N.Y.L.J. (September 25, 1990), at 5.

9. *See* letter from Anson M. Beard, Jr., Managing Director, Morgan Stanley & Co., to Thomas E. Haley, Chairman, Consolidated Tape Association ("CTA"), dated January 11, 1989.