Nothing in Life is Free

Robinhood, the ultra-popular online trading platform, has helped usher in a new era of commission-free trading. It has also pushed established financial institutions to follow suit, with similar charging structures for retail traders.

Sadly though, there is no such thing as a free lunch. In a world of commission-free trading, brokers still need to make money on their clients' trades somehow. One of the most lucrative, and controversial options, is a practice called Payment For Order Flow (PFOF).

"Payment for order flow enables commission-free trading," said Robinhood chief executive Vlad Tenev during his Congressional testimony in February 2021 following the Gamestop debacle, for which PFOF became both infamous and common knowledge.

While retail traders can clearly be tempted by zero commissions, the practice is controversial with government regulators. They claim it can lead to suboptimal execution prices on trades and conflicts of interest for brokers. However, it is only currently banned in the UK, Canada and Australia.

In the USA, the Securities and Exchange Commission (SEC) fined Robinhood $65 million in late 2020 for routing trades to market makers that didn't offer the highest price, and also for misleading its customers as to what was going on.

Despite this, the issue isn't going away anytime soon and retail investors will continue to be unable to get best value when trading commission-free.

What Is Payment for Order Flow?

It used to be very expensive to play the stock market.

Remember the Dot Com bubble in the late 1990s? In order to buy and sell shares of Pets.com, traders were typically paying commissions of around $40 per trade. Back in the early 1980s, an average investor might have to pay a $200 commission on a stock trade.

More recently, fierce competition among discount brokers pushed trading commissions steadily lower. By the late 2010s, many brokers had eliminated trading fees altogether.

Of course, these companies are not operating charities. They turned to payment for order flow to generate revenue.

When an investor submits an order to buy or sell a stock, their broker passes the order along to a third party to execute the trade and perform the transaction.

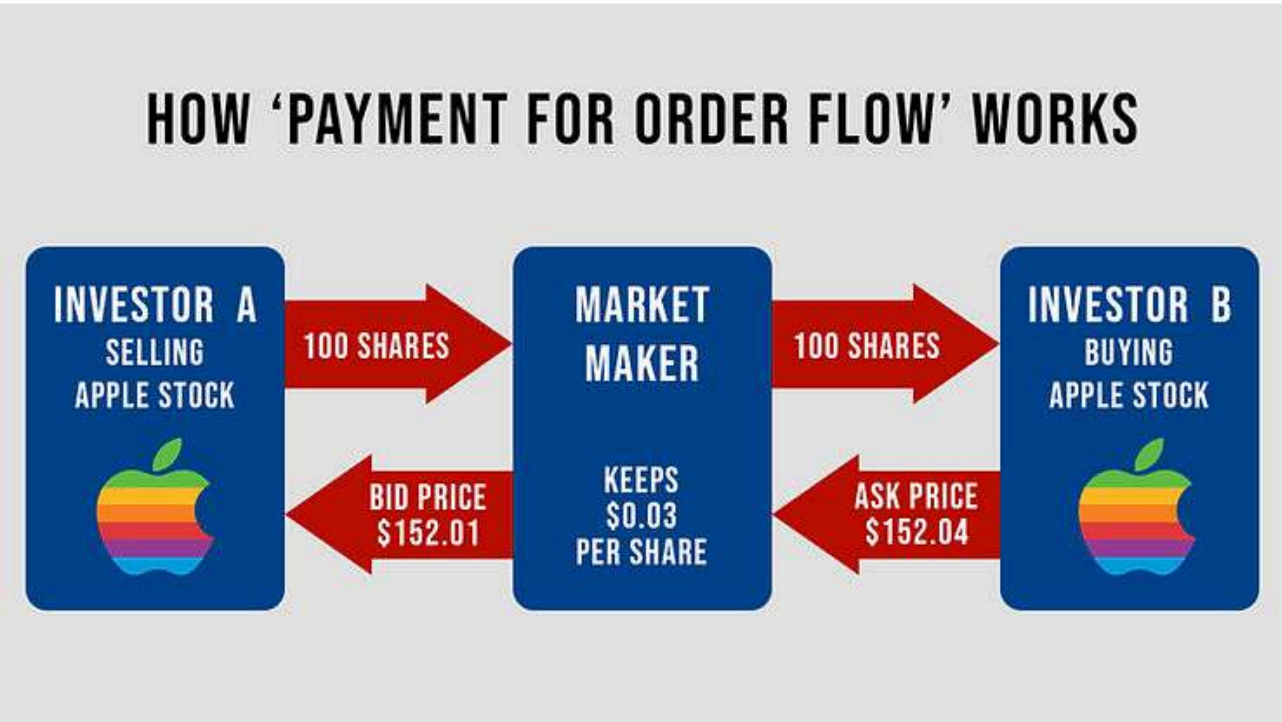
This third party is known as a market-maker and these are large financial institutions, such as Citadel Securities (another company inked to the Gamestop situation), that provide liquidity to the market by both buying and selling securities.
The market-maker pays the brokerage a small commission to fill the customer's order. Since the market maker is both buying and selling stocks and other securities, it can set its own purchase and sales price.

A market maker buys shares of stock at a lower price than the price at which it sells shares, a difference known as the bid-ask spread.

How Does Payment for Order Flow Work?

The more order flow the market makers receive from the likes of Robinhood, the more profit they can generate from the bid-ask spread. Brokerages earn more when they send more trades to the market makers.

Let's say a market maker purchased 100 shares of Apple stock from a retail seller for $152.01 per share, and then turned around and sold the stock to a retail buyer at a price of $152.04 per share.



In this example, the market maker would make only a $0.03 profit on the orders, but market makers process millions of orders a day.

In fact, one of the biggest motivations behind zero-commission trades is to encourage more active trading by retail traders, so brokerages have more order flow to sell! Which explains Robinhood's (now removed) exploding confetti and gamification of their app in order to encourage traders to make more trades.
And business is booming! The 12 largest U.S. brokerages earned a total of $3.8 billion in payment for order flow revenue in 2021, according to Bloomberg Intelligence, a 33% jump from a year earlier. Robinhood alone took in $974 million, or about half of its total revenue for the year.

Criticism of Payment for Order Flow

The main problem with payment for order flow arises from the prices at which retail trades are being executed.

In the USA, the SEC oversees broker execution standards and guards against actions that might disadvantage investors, including offering misleading information.

This was at the crux of the 2020 Robinhood settlement.

“Robinhood failed to seek to obtain the best reasonably available terms when executing customers’ orders, causing customers to lose tens of millions of dollars,” said Joseph Sansone, Chief of the SEC Enforcement Division’s Market Abuse Unit.

According to the SEC, Robinhood sold order flow to the market maker that gave it the best rebate rather than the one that offered the best price for Robinhood’s clients.

Regulators Are Taking a Hard Look at Payment for Order Flow

Regulations governing ‘payment for order flow’ may soon be strengthened.

Again, taking the USA as an example, in June, SEC chair Gary Gensler said it was one of several areas the SEC is investigating to identify potential changes to market structure to make things fairer and more transparent for retail traders.

“Payment for order flow can raise real issues around conflicts of interest,” said Gensler. “Certain principal trading firms seeking to attract Robinhood’s order flow told them that there was a tradeoff between payment for order flow and price improvement for customers.”

The SEC is currently looking into a system of open and transparent public auctions for order flow that could serve as an alternative to the practice, and has also proposed creating its own best execution rule for equities and other securities that could further clarify the brokers’ pricing responsibilities.

The SEC is also exploring how to mitigate conflicts of interest, and considering ways to improve transparency by providing a way for retail investors to compare execution quality on a broker-by-broker basis to determine which brokers are filling orders at the best prices.

Will Payment for Order Flow Be Banned?

Although unlikely to be banned, PFOF is likely to be seriously curbed though new rules. This of course would significantly affect the profitability of companies like Robinhood.

More transparency and better pricing are clearly on the way and each regulatory authority around the world is likely to come up with its own set of rules. Many, of course, will follow the SEC.

But at the end of the day, wouldn't you rather know what a person or company is getting paid to provide the best possible service to you rather than what are effectively 'under the table' payments between the market-maker and the broker that normally only benefit those two parties and not you, because you don't get the best price and they are only motivated by the number of trades you make?