FINRA Shows Subtle Shift On Evaluating Best Execution

By **Elizabeth Hogan and Alexander Madrid** (July 19, 2021)

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On June 23, the Financial Industry Regulatory Authority issued Regulatory Notice 21-23 on best execution and payment order flow.

Most of the material in the notice reminds member firms of existing rules and guidance found in prior FINRA notices and U.S. Securities and Exchange Commission releases about best execution.

There are three new concepts, however, that merit discussion: (1) a new position that payment for order flow, or PFOF, arrangements may not be taken into account in analyzing market quality, contradicting existing guidance; (2) a prohibition on PFOF contractual arrangements that may reduce price improvement opportunities; and (3) a warning that disclosures cannot cure weak best execution compliance.

A theme running through each of these new assertions — as well as the rest of the notice — is that FINRA stakes price as the primary consideration, above the many other criteria, for evaluating execution quality.[1]

This position marks a subtle but important shift away from prior guidance that emphasized a more holistic best execution analysis, where price was only one of many factors a firm should consider in determining whether it is satisfying its obligations.

FINRA's isolated emphasis on best prices and price improvement opportunities, at times to the exclusion of other considerations in this new guidance, fails to assess the overall economics of the transactions and relationship that might otherwise provide the "most favorable terms reasonably available in the market under the circumstances,"[2] as required by the duty of best execution laid out in FINRA Regulatory Notice 15-46.

The notice also arrives amid calls from the SEC for recommendations on how to address best execution, PFOF, the reliance on the National Best Bid and Offer, or NBBO, and market structure concerns more broadly.

The industry will need to watch to see whether those recommendations support or diverge from the guidance FINRA has collected and issued here.

The Notice Provides Specific Guidance on Payment for Order Flow Versus Best Execution

Notice 21-23 compiles and organizes FINRA and SEC guidance regarding best execution and PFOF from a number of sources, including FINRA Rule 5310, Notice 15-46, several SEC releases, as well as some previously settled matters.

This compilation will serve as a valuable resource as firms review their routing practices and compliance with their best execution obligations — not only in response to elevated scrutiny resulting from the recent market volatility that introduced the acronym PFOF to the broader public — but equally as part of firms' routine compliance hygiene and response to regulatory

examinations.

Although Notice 21-23 does not, on its face, purport to provide new guidance to market participants, three specific assertions warrant close attention.

1. An order flow arrangement may not factor into an execution quality analysis is contrary to existing rule language.

First, Notice 21-23 states, "Importantly, inducements such as payment for order flow and internalization may not be taken into account in analyzing market quality."

This statement is derived from guidance in a Q&A response embedded in an April 2001 notice, which states:

> 9. Must a member firm only perform a regular and rigorous review on orders for which it receives payment for order flow?
>
> This obligation to perform a regular and rigorous review applies to all broker/dealers that route orders for execution regardless of whether they receive payment for directing that order flow. If a broker/dealer, however, receives an order routing inducement, such as payment for order flow, or trades as principal with customer orders, it must not let that inducement interfere with its duty of best execution nor may that inducement be taking [sic] into account in analyzing market quality.[3]

By excerpting only the highlighted language, Notice 21-23 loses the broader message present in both the original guidance and more recent iterations that "a broker-dealer does not violate its best execution obligation solely because it receives payment for order flow or trades as principal with customer orders," as stated in an SEC final rule,[4] but that it "must not let that inducement interfere with its duty of best execution."[5]

The excerpted language in isolation is also at odds with the specific language of Supplementary Material .09 to FINRA Rule 5310, which identifies "the existence of internalization or payment for order flow arrangements" as one of the specific criteria that firms should analyze "[i]n reviewing and comparing the execution quality of its current order routing and execution arrangements to the execution quality of other markets."[6]

Indeed, the subsequent sentence in Notice 21-23 notes that "for member firms that receive payment for order flow, FINRA has stated that such firms should carefully evaluate the impact of the practice [PFOF] on execution quality."

Thus, FINRA has both explicitly and implicitly acknowledged that PFOF or other internalization arrangements must be part of the overall analysis, and firms taking the conservative approach should continue to evaluate how those arrangements impact their execution quality.

2. Members cannot negotiate away price improvement opportunities for PFOF.

There is long-standing guidance from both the SEC and FINRA that the duty of best execution is not per se incompatible with PFOF arrangements.

In the notice, however, FINRA asserts that certain contractual PFOF arrangements that negotiate away price improvement opportunities would be automatic violations of the duty:

> [O]rder routing firms and firms receiving customer orders from other firms for handling and execution must regularly evaluate whether reliable, superior prices are readily accessible for the customer orders they handle, and these firms may not negotiate the terms of order routing arrangements for those customer orders in a manner that reduces the price improvement opportunities that otherwise would be available to those customer orders absent payment for order flow.[7]

In this new commentary, FINRA appears to be instructing its members that they cannot negotiate away price improvement opportunities in exchange for payment for order flow.

This guidance raises new questions, on which the notice is notably silent: What about other execution quality metrics? Could a firm contract away its likelihood of executions for limit orders, or execution speed, or other transaction costs? What if a routing arrangement reduces transaction costs for an individual investor far beyond what an opportunity for price improvement might provide?

FINRA's isolated focus on price improvement and payment for order flow arrangements fails to account for the economics of the complete transaction and seems contrary to FINRA's prior guidance, reiterated in the notice, that "best execution is not concerned solely with price."

3. Disclosures may not cure poor best execution compliance.

Third, the notice emphasizes that members are not relieved of their best execution obligations because of related disclosure requirements.

While disclosures related to PFOF "provide customers and the public with important information, and member firms must provide them as required," these disclosures "will not absolve a firm of potential best execution violations," according to the notice.

This is another example where FINRA seems to distance itself from the fact-and-circumstances analysis long used — at FINRA's direction — to determine whether a firm used reasonable diligence to achieve best execution under prevailing market conditions.[8]

Here, FINRA makes a blanket statement that members cannot disclose their way out of best execution obligations. Yet simultaneously, the language of Rule 5310 specifically instructs FINRA members to consider "customer needs and expectations" when evaluating and comparing execution quality.[9]

If customer expectations are informed in large part by disclosures, shouldn't the disclosures be part of the holistic facts-and-circumstances analysis, rather than dismissing their import across the board?

In sum, the notice underscores FINRA's concern that PFOF arrangements may deprive customers of the best available prices.

No matter whether such arrangements or other internalization practices have other benefits, the notice warns that order routing relationships cannot reduce price improvement opportunities — or else they violate the duty of best execution.

Similarly, it appears that firms should not rely on disclosures concerning PFOF to reduce their risk of a potential best execution violation.

An open question is whether this guidance will withstand the many calls for reform and rulemaking in this space.

The Notice Follows Recent Meme Stock Volatility and Move to Zero-Commission Trading

This notice does not arise out of a vacuum, of course. January 2021 witnessed a sharp increase in retail trading of so-called meme stocks, largely through no-fee online and app-based trading platforms.

The attendant volatility in those symbols quickly led to media, legislative and regulatory scrutiny.

As regulators opened investigations and Congress organized hearings, on Feb. 1, the 2021 Report on FINRA's Examination and Risk Monitoring Program[10] was released.

In the exam report, FINRA referred back to a targeted sweep begun the year prior in February 2020 of firms' decisions to move to zero-commission trading.

The exam priorities noted that the sweep was still underway, and is evaluating:

- "[W]hether the 'zero-commission' model adversely affected firms' compliance with their best execution obligations;

- [H]ow firms used other practices, such as Cash Management Accounts and PFOF, to potentially offset lost commission revenue; and

- [W]hether firms prominently communicated restrictions and limitations of 'zero-commission' structures and other fees charged to customers."

FINRA noted it will share findings from that sweep in a future publication.

It seems unlikely that this new notice is a substitution for that report, which undoubtedly has been complicated or at least delayed by the regulatory response to the market volatility this past January.

Rather, Notice 21-23 reads like a preview of those findings; in large part a regurgitation of existing guidance, but with a clear emphasis on a single element of execution quality: price.

This price emphasis comes at the same time that current and former SEC commissioners have similarly signaled their focus on price measurement in connection with best execution.

Calls for Recommendations on Best Execution, PFOF and the NBBO

On June 9, in remarks before the Global Exchange and FinTech Conference, SEC Chair Gary Gensler posited: "Broker-dealers are obligated to seek the best execution for their customers' orders — not just better execution. ... But it's best execution in comparison to

what?"[11]

The next day, in prepared remarks delivered at a meeting of the SEC Investor Advisory Committee, Gensler reiterated his thoughts on the requirements for best execution in the context of the NBBO.

He noted his concern that the NBBO "is not a complete enough representation of the market" for firms to determine the best available price when fulfilling their best execution requirement.

Highlighting that nearly half of the trading interest in the equity market either is in alternative trading systems or internalized by wholesalers, Gensler noted that "a significant portion of retail market orders happens away from the [public] markets," which may affect bid-ask spreads.

As a result, he stated he has asked his staff to make recommendations on best execution, PFOF and the NBBO, "with the aim of continuing to make our markets as efficient as possible."

In prepared remarks for the same committee meeting, Commissioner Elad Roisman shared his position that the SEC should "provide non-prescriptive guidance on, or an interpretation of, the requirements for best execution."

This guidance should articulate relevant factors, explain key terms such as "reasonably available" — under SEC guidance, a broker must execute customer orders at the most favorable terms reasonably available under the circumstances — and discuss methods to assess alternative execution venues.

At the same June 10 committee meeting, former Commissioner Paul Atkins opined that Regulation National Market System has "fostered a near-exclusive focus on price as the measure of execution quality," leading "not to order protection, but to order discrimination."

Atkins stated the NBBO is a "flawed standard" because the "concept of 'best execution' depends on many factors, such as certainty, speed [and] ... size." Atkins advised that the SEC should take a "comprehensive view of equity market structure" that includes a "hard look at Reg NMS" and the effects it has had on the markets in order to meet its mission of fair, orderly and efficient markets.

Where Will Regulators Go From Here?

Notice 21-23 is surely not the last of FINRA's guidance on best execution and PFOF; as noted, FINRA's sweep related to no-commission trading is expected to yield further findings in this area.

That said, the notice offers not only a comprehensive summary of prior guidance but useful insight into FINRA's direction as it continues to focus on this priority area.

Although the notice does nod to prior guidance that price is not the only factor in determining whether a firm has met its duty of best execution, the specific points of emphasis in the notice reveal a keen regulatory focus on whether PFOF arrangements affect the prices customers receive.

Indeed, the notice provides that "member firms' best execution procedures must be

reasonably designed to identify the best prices and obtain best execution for customer orders under prevailing market conditions."

In the notice, FINRA acknowledges that the SEC has asked its staff to develop recommendations that could impact the standing rules or guidance discussed in the notice.

Recently, FINRA has expressed support for the commission's efforts to consider whether additional requirements or guidance are needed to promote investor protection. And in Notice 21-23, FINRA stated that it "may evaluate whether further changes to its best execution rule are necessary or appropriate."

Industry observers will continue to watch and wait to see where both FINRA and the SEC will focus following unprecedented attention on these issues.

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Disclosure: Although some of the cases cited in the footnotes of the guidance discussed in this article were brought by the FINRA enforcement group that Hogan led, she was not involved in the drafting or issuance of this guidance.

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[1] FINRA Regulatory Notice 21-23, "FINRA Reminds Member Firms of Requirements Concerning Best Execution and Payment for Order Flow" (June 2021) ("Accordingly, member firms' best execution procedures must be reasonably designed to identify the best prices and obtain best execution for customer orders under prevailing market conditions")(emphasis in original), https://www.finra.org/rules-guidance/notices/21-23 ("Reg Notice 21-23").

[2] FINRA Regulatory Notice 15-46, "Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets" (Nov. 2015) ("while a firm is required to seek the most favorable terms reasonably available under the circumstances of the transaction, such terms may not necessarily in every case be the best price available") https://www.finra.org/rules-guidance/notices/15-46 ("Reg Notice 15-46").

[3] NASD Notice to Members (01-22), "NASD Regulation Reiterates Member Firm Best Execution Obligations And Provides Guidance To Members Concerning Compliance" (April 2001), https://www.finra.org/rules-guidance/notices/01-22 ("NTM 01-22").

[4] See Disclosure of Order Execution and Routing Practices Adopting Release, supra note 4, at 75420; see also Securities Exchange Act Release No. 34902 (October 27, 1994), 59 FR 55006, 55009 n.28 (November 2, 1994) (Payment for Order Flow Adopting Release) (stating the SEC's belief "that bulk order routing based, in part, on the receipt of payment for order flow is not, in and of itself, a violation of [best execution] duties").

[5] NTM 01-22.

[6] FINRA Rule 5310, "Best Execution and Interpositioning," Supplementary Material .09 ("In reviewing and comparing the execution quality of its current order routing and execution arrangements to the execution quality of other markets, a member should consider the following factors:

(1) price improvement opportunities (i.e., the difference between the execution price and the best quotes prevailing at the time the order is received by the market);

(2) differences in price disimprovement (i.e., situations in which a customer receives a worse price at execution than the best quotes prevailing at the time the order is received by the market);

(3) the likelihood of execution of limit orders;

(4) the speed of execution;

(5) the size of execution;

(6) transaction costs;

(7) customer needs and expectations; and

(8) the existence of internalization or payment for order flow arrangements.")

[7] Reg Notice 21-23.

[8] Reg Notice 15-46 ("As demonstrated by the language of Rule 5310, the determination as to whether a firm exercised reasonable diligence to ascertain the best market for the security and bought or sold in that market so that the resultant price to the customer is as favorable as possible under prevailing market conditions necessarily involves a "facts and circumstances" analysis.").

[9] FINRA Rule 5310.

[10] 2021 Report on FINRA's Examination and Risk Monitoring Program, https://www.finra.org/rules-guidance/guidance/reports/2021-finras-examination-and-risk-monitoring-program.

[11] See Prepared Remarks of Chair Gary Gensler 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.