

Best Execution and Payment for Order Flow

FINRA Reminds Member Firms of Requirements Concerning Best Execution and Payment for Order Flow

Summary

FINRA is issuing this *Notice* to remind member firms of longstanding Securities and Exchange Commission (SEC) and FINRA rules and guidance concerning best execution and payment for order flow, which the SEC has defined very broadly to refer to a wide range of practices including monetary payments and discounts, rebates, or other fee reductions or credits. Under these rules and guidance, member firms may not let payment for order flow interfere with their duty of best execution.

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Background and Discussion

General Background on the Duty of Best Execution

Best execution of customer orders is a key investor protection requirement. The SEC has explained that “[a] broker-dealer’s duty of best execution derives from common law agency principles and fiduciary obligations, and is incorporated both in SRO rules and, through judicial and Commission decisions, in the antifraud provisions of the federal securities laws. This duty of best execution requires a broker-dealer to seek the most favorable terms reasonably available under the circumstances for a customer’s transaction.”¹

FINRA has codified the duty of best execution in its rules—specifically, Rule 5310 (Best Execution and Interpositioning). Rule 5310 provides that, “[i]n any transaction for or with a customer or a customer of another broker-dealer, a member and persons associated with a member shall use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions.”

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Notice Type

- ▶ Reminder

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Senior Management
- ▶ Systems
- ▶ Technology
- ▶ Trading and Market Making

Key Topics

- ▶ Best Execution
- ▶ Customer Protection
- ▶ Equity Securities
- ▶ NMS Securities
- ▶ Odd Lots
- ▶ Order Handling
- ▶ Payment for Order Flow
- ▶ Regular and Rigorous Review

Referenced Rules & Notices

- ▶ FINRA Rule 5310
- ▶ Notice to Members 01-22
- ▶ Regulatory Notice 15-46
- ▶ Rule 605 of Regulation NMS
- ▶ Rule 606 of Regulation NMS
- ▶ Rule 607 of Regulation NMS
- ▶ SEA Rule 10b-10

Among the factors that will be considered in determining whether a firm has used “reasonable diligence” are:

- a. the character of the market for the security (*e.g.*, price, volatility, relative liquidity, pressure on available communications);
- b. the size and type of the transaction;
- c. the number of markets checked;
- d. accessibility of the quotation; and
- e. the terms and conditions of the order which result in the transaction, as communicated to the member and persons associated with the member.²

In the context of small-size retail customer orders, the SEC and FINRA have noted the ready accessibility of prices better than the prevailing best quote (the “national best bid and offer,” or the “NBBO”), and SEC rules require information about the frequency and magnitude of price improvement relative to the NBBO to be included in monthly public reports.³ While the SEC and FINRA have recognized that best execution is not concerned solely with price, price is undoubtedly a key concern for most retail customers.⁴ As discussed further below, compliance with Rule 5310 requires member firms to regularly evaluate the availability of reliable, superior prices and to assure that order flow is directed to markets providing the most beneficial terms for customer orders. 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.

Rule 5310 applies whether member firms act as agent or execute transactions on a principal basis,⁵ and it covers transactions for or with a customer or a customer of another broker-dealer.⁶ As FINRA has explained, this means that best execution obligations apply to member firms that receive customer orders from another member firm for purposes of order handling and execution, including wholesale market makers, in addition to member firms that receive orders directly from customers.⁷ A member firm cannot transfer its best execution obligations to another person or firm, although other firms may also acquire best execution obligations where they receive customer order flow for handling and execution. Accordingly, when a firm receives customer orders from a routing firm for purposes of order handling and execution, FINRA has explained that both the routing firm and the receiving firm have best execution obligations.⁸

Specific Guidance on Best Execution and Payment for Order Flow

Payment for order flow is defined broadly by the SEC and generally encompasses “a wide variety of cash or in-kind compensation structures that a broker may receive for directing its customers’ orders to a particular broker-dealer or trading venue.”⁹ Given its broad definition, payment for order flow may refer to, among other things, arrangements where

retail brokerage firms receive cash payments from wholesale market makers in exchange for customer order flow, as well as transaction fee rebates, credits, or discounts provided by exchanges.¹⁰ Payment for order flow is one form of economic inducement that has the potential to influence the way a member firm handles customer orders. The opportunity to trade as principal and internalize a firm's own customer orders is another form of economic inducement that the SEC has noted could similarly influence customer order handling.¹¹

Longstanding SEC guidance generally holds 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."¹² However, the SEC also has stated that payment for order flow may "raise concerns about whether a firm is meeting its obligation of best execution to its customer."¹³ And ultimately, the SEC has stated that "a broker-dealer must not allow a payment or an inducement for order flow to interfere with its efforts to obtain best execution."¹⁴

These same principles have been incorporated into FINRA's best execution rule. Specifically, Rule 5310 requires member firms to assure that they direct customer orders to markets that provide the most beneficial terms for such orders.¹⁵ To support this overarching objective, Rule 5310 requires member firms to compare any material differences in execution quality their customers will receive at competing markets—including markets they may have existing routing arrangements with, as well as those they do not.¹⁶

FINRA has provided member firms with detailed guidance on the execution quality review standards imposed by Rule 5310, including most recently in *Regulatory Notice 15-46*. As discussed more fully in *Regulatory Notice 15-46*, order-by-order review of execution quality is increasingly possible for a range of orders in equity securities and standardized options, and it is required for any orders that a member firm determines to execute internally.¹⁷ Where member firms may choose not to perform an order-by-order review, they must have procedures in place to ensure that they periodically conduct regular and rigorous execution quality reviews on a security-by-security, type-of-order basis.¹⁸

Under Rule 5310, when conducting their reviews of execution quality, member firms should consider: (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);¹⁹ (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.²⁰

FINRA discussed these and additional execution quality review factors in *Regulatory Notice 15-46*, including areas of particular focus where inducements such as payment for order flow arrangements or internalization exist. For example, the possibility of obtaining

price improvement is a heightened consideration when a member firm receives payment for order flow.²¹ In other words, it is especially important under these circumstances to determine that customers are receiving the best price and execution quality opportunities notwithstanding the payment for order flow.²² As FINRA has reminded member firms, when a firm is routing order flow for automated execution, or internally executing such order flow on an automated basis, the SEC has indicated that simply obtaining the best bid or best offer may not satisfy a firm's best execution obligation, particularly with respect to small orders.²³ In addition, FINRA cautioned that member firms would not satisfy their duty of best execution if they do not compare the execution quality they receive under their existing order routing and execution arrangements (including the internalization of order flow) to the quality of the executions they could obtain from competing markets.²⁴

Importantly, inducements such as payment for order flow and internalization may not be taken into account in analyzing market quality.²⁵ Accordingly, for member firms that receive payment for order flow, FINRA has stated that such firms should carefully evaluate the impact of the practice on execution quality.²⁶ Similarly, firms that provide payment for order flow for the opportunity to internalize customer orders cannot allow such payments to interfere with their best execution obligations.²⁷ In other words, order 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.²⁸ Such a practice would not be consistent with the requirement that member firms assure that order flow is directed to markets providing the most beneficial terms for their customers' orders.²⁹ It also would not satisfy a member firm's obligation to use reasonable diligence to ascertain the best market for a security, and to buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions.³⁰ Ultimately, as FINRA has noted, the existence of an order routing, handling and execution arrangement between firms in no way alters either firms' best execution obligation to analyze and review the execution quality of the orders routed pursuant to the arrangement.³¹

Finally, FINRA notes that member firms are not relieved of their best execution obligations because of related disclosure requirements. Several SEC rules require disclosure of payment for order flow practices. Exchange Act Rule 10b-10 generally requires that broker-dealers indicate on customer confirmation statements when payment for order flow has been received on a transaction, and also that the source and nature of the compensation received in connection with the particular transaction will be furnished upon the customer's written request. In addition, Rule 606 of Regulation NMS generally requires broker-dealers to post on their website quarterly public reports that identify the top ten venues to which they route orders for execution and to discuss material aspects of

payment for order flow arrangements. When the SEC amended Rule 606 in 2018 to require, among other things, new aggregate payment for order flow disclosures in broker-dealer's quarterly public reports, the SEC noted that "the amended rule requires disclosure of the details of any arrangement between a broker-dealer and a Specified Venue where the level of execution quality is negotiated for an increase or decrease in payment for order flow."³² Rule 607 of Regulation NMS further requires broker-dealers to disclose upon opening a new customer account and on an annual basis thereafter policies relating to payment for order flow and order routing.

These disclosures provide customers and the public with important information, and member firms must provide them as required.³³ However, FINRA notes that the SEC did not intend for order routing and execution disclosures to alter the legal duties that apply to a broker-dealer's duty of best execution,³⁴ and FINRA has stated that disclosure will not absolve a firm of potential best execution violations.³⁵

Conclusion

As described above, FINRA is publishing this *Notice* to remind firms of existing rules and guidance concerning best execution and payment for order flow. FINRA notes that the SEC has asked its staff to develop recommendations that could impact the standing rules or guidance discussed in this *Notice*.³⁶ FINRA recently expressed its support for the Commission's efforts to consider whether additional best execution requirements or guidance are needed to promote investor protection,³⁷ and FINRA may evaluate whether further changes to its best execution rule are necessary or appropriate.

Endnotes

1. See Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290, 48322 (September 12, 1996) (Order Execution Obligations Adopting Release).
2. Rule 5310(a)(1).
3. Specifically, Rule 605 of Regulation NMS requires market centers to publish monthly reports that disclose standardized statistical information concerning their order execution quality.
4. See Securities Exchange Act Release No. 43590 (November 17, 2000), 65 FR 75414, 75418 (December 1, 2000) (Disclosure of Order Execution and Routing Practices Adopting Release) (“The Commission strongly believes . . . that most investors care a great deal about the quality of prices at which their orders are executed . . .”).
5. See Rule 5310(e).
6. See Rule 5310(a)(1).
7. See, e.g., *Regulatory Notice 15-46* (November 2015) (discussing the best execution obligations of both routing and receiving firms); see also Securities Exchange Act Release No. 54339 (August 21, 2006), 71 FR 50959 (August 28, 2006) (Order Approving SR-NASD-2004-026) (clarifying the application of the best execution rule to firms that receive customer orders from other broker-dealers).
8. See *Regulatory Notice 15-46*. Under Rule 5310, there are narrow circumstances where broker-dealers do not acquire best execution obligations when they execute customer orders presented from other broker-dealers. Specifically, Supplementary Material .04 to Rule 5310 provides that a member firm’s duty to provide best execution in any transaction “for or with a customer of another broker-dealer” does not apply in instances when another broker-dealer is simply

executing a customer order against a member firm’s quote. Supplementary Material .04 is limited in two important ways: first, it applies only when customer orders are presented from another broker-dealer; and second, it applies only when the presenting broker-dealer is executing against a specific quote that the member firm has posted in the markets. Importantly, Supplementary Material .04 clarifies that best execution obligations *do* apply when a member firm accepts order flow from another broker-dealer for the purpose of facilitating the handling and execution of such orders.

In other words, where a receiving firm accepts order flow pursuant to a payment for order flow agreement or arrangement, such as where a receiving firm enters into a payment for order flow arrangement with the routing firm, Supplementary Material .04 does not relieve the receiving firm of its best execution obligations, because the receiving firm is accepting order flow for the purposes of facilitating the handling and execution of such orders. This remains true even if the terms of a payment for order flow agreement or arrangement call for the receiving firm to execute customer orders at prices derived from quotations. In such cases, the routing firm is not presenting customer orders to a specific quote posted by the receiving firm. Rather, the routing firm is directing customer orders to the receiving firm pursuant to an arrangement for the purpose of facilitating order handling and execution, and each firm owes the duty to provide best execution in this case. FINRA underscored the narrowness of the exception for executing broker-dealers in Supplementary Material .04 when it explained that “the failure to apply the Best Execution Rule to recipient broker-dealers is contrary to the interests of the investing public as

- well as the general intent of the Best Execution Rule itself.” See Securities Exchange Act Release No. 54339 (August 21, 2006), 71 FR 50959, 50960 (August 28, 2006) (Order Approving File No. SR-NASD-2004-026).
9. See memorandum to the SEC Equity Market Structure Advisory Committee (EMSAC) from the SEC Division of Trading and Markets, [Certain Issues Affecting Customers in the Current Equity Market Structure](#) (January 26, 2016), at pg. 5 (citing Exchange Act Rule 10b-10(b)(8), which defines “payment for order flow” to include “any monetary payment, service, property, or other benefit that results in remuneration, compensation, or consideration to a broker or dealer from any broker or dealer, national securities exchange, registered securities association, or exchange member in return for the routing of customer orders by such broker or dealer to any broker or dealer, national securities exchange, registered securities association, or exchange member for execution, including but not limited to: research, clearance, custody, products or services; reciprocal agreements for the provision of order flow; adjustment of a broker or dealer’s unfavorable trading errors; offers to participate as underwriter in public offerings; stock loans or shared interest accrued thereon; discounts, rebates, or any other reductions of or credits against any fee to, or expense or other financial obligation of, the broker or dealer routing a customer order that exceeds that fee, expense or financial obligation”).
 10. See *id.* at pp. 5-6 and p. 6 n.18 (discussing both forms of payment for order flow).
 11. See Securities Exchange Act Release No. 34903 (October 27, 1994), 59 FR 55014 (November 2, 1994) (Internalized/Affiliate Practices, Payment for Order Flow and Order Routing Practices Proposing Release) (noting that “the internalization of order flow by broker-dealers presents issues similar to those commonly associated with payment for order flow”).
 12. 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”).
 13. See Payment for Order Flow Adopting Release, *supra* note 12, at 55009.
 14. See *id.* at 55009; see also In the Matter of Robinhood Financial, LLC, Securities Exchange Act Release No. 90694 (December 17, 2020) (repeating that “[a] broker-dealer must not allow payment for order flow to interfere with its efforts to obtain best execution” and stating that the firm “did not take appropriate steps . . . to assess whether its higher payment for order flow rates were adversely affecting customer execution prices”).
 15. See Rule 5310.09(b).
 16. See *id.*
 17. See *Regulatory Notice 15-46*.
 18. See Rule 5310.09(a). Where member firms conduct periodic regular and rigorous reviews instead of order-by-order reviews, the periodic review must be performed on a quarterly basis at a

minimum; however, as noted in Supplementary Material .09, firms should consider, based on their business models, whether more frequent reviews are needed. As noted in *Regulatory Notice 15-46*, where firms conduct their reviews more frequently than quarterly, most conduct their reviews monthly.

19. Prior to the adoption of Regulation NMS, the SEC explained that “[p]rice disimprovement can occur, for example, because of quote exhaustion—the cumulative volume of orders is greater than quoted size and the market center does not provide liquidity enhancement.” See Disclosure of Order Execution and Routing Practices Adopting Release, *supra* note 4, at 75432. However, as FINRA has subsequently noted, “given the requirements of Regulation NMS, trades at prices outside the best bid and offer for smaller orders should be rare,” and “[f]irms should avoid and address such trades.” See *Regulatory Notice 15-46* at n.24.
20. See Rule 5310.09(b).
21. See *Regulatory Notice 15-46* (citing Payment for Order Flow Adopting Release, *supra* note 12, at 55009).
22. See Rule 5310.09(b) (“[A] member must determine whether any material differences in execution quality exist among the markets trading the security and if so, modify the member’s routing arrangements or justify why it is not modifying its routing arrangements.”).
23. See *Regulatory Notice 15-46* (citing Order Execution Obligations Adopting Release, *supra* note 1, at 48323). Small orders naturally include odd lot and fractional share orders. Given the obligation in Rule 5310 for member firms to use reasonable diligence to ascertain the best market for a security, firms should consider information reasonably available to them about quoted prices and price improvement opportunities for such small size orders. As FINRA has noted, the exercise of reasonable diligence can be affected by the market data, including specific data feeds, used by a firm. For example, a firm that regularly accesses proprietary data feeds, in addition to consolidated data from the Securities Information Processors (SIPs), for its proprietary trading, would be expected to also use these data feeds to determine the best market under prevailing market conditions when handling customer orders. See *Regulatory Notice 15-46* at n.12. Although transactions in odd lots are disseminated, odd lot quotations are not currently included in the NBBO or distributed in SIP data. However, proprietary data feeds often do include odd lot quotations, which sometimes are priced better than the NBBO. As previously stated in *Regulatory Notice 15-46*, if a member does access proprietary feeds, it would be expected to also use those feeds to ascertain best execution for a customer, including for odd lot orders.
24. See *Regulatory Notice 15-46*. See also, e.g., TradeStation Securities, Inc., Letter of Acceptance, Waiver and Consent (FINRA Case No. 2014041812501) (March 2021) (describing violations of FINRA’s best execution rule where the firm “did not exercise reasonable diligence to ascertain whether the venues where it routed certain equity and option customer orders [pursuant to payment for order flow arrangements] provided the best market for the subject securities as compared to the execution quality that was being provided at competing markets”); Robinhood Financial, LLC, Letter of Acceptance, Waiver and Consent (FINRA Case No. 2017056224001) (December 2019) (describing violations of FINRA’s best execution rule where the

- firm routed its customers' orders to four broker-dealers that all paid for the order flow, and "did not exercise reasonable diligence to ascertain whether these four broker-dealers provided the best market for the subject securities to ensure its customers received the best execution quality from these as compared to other execution venues"); E*Trade Securities LLC, Letter of Acceptance, Waiver and Consent (FINRA Case No. 20130368815-01) (June 2016) (describing violations of FINRA's best execution rule where the firm lacked sufficient information to reasonably assess the execution quality it provided to its customers because, among other things, the firm "did not take into account the internalization model employed by the firm" and "was overly reliant on comparisons of the firm's overall execution quality with industry and custom averages, rather than focusing on comparisons to the actual execution quality provided by the market centers to which the firm routed orders").
25. See *Notice to Members 01-22* (April 2001) (noting that "[i]f a broker/dealer . . . 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 tak[en] into account in analyzing market quality").
 26. See *Regulatory Notice 15-46*.
 27. In discussing the factors to be taken into account in conducting a regular and rigorous review of execution quality, *Notice to Members 01-22* specifically referred to "[t]he existence of internalization or payment for order flow arrangements (*which must not interfere with a firm's best execution obligation* [emphasis added])."
 28. See *Regulatory Notice 15-46* at n.25 ("For example, if a firm obtains price improvement at one venue of \$0.0005 per share, and it could obtain midpoint price improvement at another venue of \$0.025 per share, the firm should consider the opportunity of such midpoint price improvement on that other venue as part of its best execution analysis."); see also *Order Execution Obligations Adopting Release*, *supra* note 1, at 48323 (stating that "where reliable, superior prices are readily accessible . . . broker-dealers should consider these prices in making decisions regarding the routing of customer orders," and noting further that "broker-dealers must regularly evaluate whether prices or other benefits . . . are reasonably available for purposes of seeking best execution of . . . customer orders").
 29. See Rule 5310.09(b).
 30. See Rule 5310(a)(1).
 31. See, e.g., *Regulatory Notice 15-46* at n.22 (stating further that a member firm should ensure that such agreements "do not inappropriately influence or constrain the firm in making its routing decisions based on the results of its regular and rigorous reviews for best execution"). FINRA has emphasized this principle regularly in its annual regulatory priorities and examination findings reports. See, e.g., [2021 Report on FINRA's Examination and Risk Monitoring Program](#) (noting examination findings where firms did not "consider[] and address[] potential conflicts of interest relating to routing of orders to affiliated broker-dealers, ATSS, or market centers that provide PFOF or other routing inducements, such as PFOF from wholesale market makers and exchange liquidity rebates"); [2019 Report on FINRA Examination Findings and Observations](#) (noting similar findings relating to order handling

- conflicts); [2018 Report on FINRA Examination Findings](#) (reiterating concern from FINRA's 2017 examination findings report "that firms should not allow conflicts of interest relating to financial benefits from routing orders to particular venues adversely to affect the objectivity of their 'regular and rigorous' review"); [2017 Report on FINRA Examination Findings](#) (noting that "[i]f a broker-dealer receives an order routing inducement, such as payment for order flow, or trades as principal with customer orders, it must not let those factors interfere with its duty of best execution nor take them into account in analyzing market quality," and expressing concern, among other things, about firms that "fail[] to compare the quality of the executions firms obtained via their order routing and execution arrangements (including the internalization of order flow) against the quality of the executions they could have obtained from competing markets"); [2015 Regulatory and Examination Priorities Letter](#) (discussing FINRA's sweep to "assess whether trading-fee rebates create conflicts of interest that compromise the execution quality of customer orders").
32. See Securities Exchange Act Release No. 84528 (November 2, 2018), 83 FR 58338, 58376 n.397 (November 19, 2018); see also [Responses to Frequently Asked Questions Concerning Rule 606 of Regulation NMS](#), SEC Division of Trading and Markets, at Questions 14.01 and 14.02.
33. See [2021 Report on FINRA's Examination and Risk Monitoring Program](#) (discussing exam findings related to inadequate SEC Rule 606 disclosures); see also TradeStation Securities, Inc., Letter of Acceptance, Waiver and Consent, *supra* note 24 (describing violations of Rule 606 of Regulation NMS where the firm failed to disclose all of the material aspects of its payment for order flow arrangements).
34. See Disclosure of Order Execution and Routing Practices Adopting Release, *supra* note 4, at 75418.
35. See [Regulatory Notice 15-46](#) at n.51 (noting that the disclosure of order handling procedures that are unfair or otherwise inconsistent with a member firm's best execution obligations would neither correct the deficiencies with such procedures nor absolve the firm of potential best execution violations).
36. See [Prepared Remarks of Chair Gary Gensler](#) at the Global Exchange and FinTech Conference (June 9, 2021) (noting the Chair's request for "staff to make recommendations for the Commission's consideration on best execution, Regulation NMS, payment for order flow (both on-exchange and off-exchange), minimum pricing increments, and the NBBO, with the aim of continuing to make our markets as efficient as possible").
37. See [Written Statement of Robert W. Cook](#) Before the Financial Services Committee U.S. House of Representatives (May 6, 2021) (also noting FINRA's support for any SEC efforts to consider enhancements to the disclosure obligations that help support the oversight of best execution).