SPOTLIGHT ON

Advisors' Disclosure Duties in the Payment-for Order-Flow Context

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BACKGROUND

On August 5, 2020, the Securities and Exchange Commission ("SEC") settled an action against two affiliated registered investment advisers for $1 million in penalties over material misrepresentations made to their clients about the compensation they received in an institutional payment-for-order-flow arrangement.[1]

WBI Investments and Millington Securities acted as advisors to several mutual funds and ETFs, while Millington also served as the primary introducing broker for WBI. Millington agreed to route WBI's client orders to certain brokerage firms that had agreed to remit $0.0125 to $0.0150 per share to Millington as payments for order flow. As a result, the brokerage firms executing WBI's client trades adjusted the execution prices by $0.02 to $0.03 per share higher for buy orders and lower for sell orders. Millington and the brokerage firms mutually understood that the adjusted execution prices allowed the brokerage firms to recoup their payments to Millington and generate profits.

WBI and Millington, however, on at least three occasions, falsely assured the boards of the mutual funds and the ETFs that these institutional payment-for-order-flow arrangements did not adversely affect the funds' execution prices. The SEC found that WBI and Millington made misleading statements to their institutional clients about this material conflict of interest in violation of Section 206(2) and 206(4) of the Investment Advisers Act and Rule 206(4)-7 thereunder. WBI was ordered to pay a penalty of $750,000, while Millington will pay a penalty of $250,000.

DISCUSSION

What is a payment-for-order-flow ("PFOF")?

Rule 10b-10(d)(8) of the Exchange Act defines PFOF to include **any monetary payment, service, property, or any other benefit** that results in remuneration compensation or consideration to a broker or dealer in return for the routing of customer orders. PFOF also includes **non-monetary compensation**, such as clearing services or reciprocal order swapping arrangements.[2] The SEC has taken the view that monetary

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[1] See *In the Matter of WBI Investments, Inc. and Millington Securities Inc.*, August 5, 2020, available at https://www.sec.gov/news/press-release/2020-175.

[2] See 17 C.F.R. §240.10b-10(d)(8)

and non-monetary inducements are alternative payment methods to attract order flow and are economically equivalent. Additionally, PFOF includes any credit, rebate, or discount against execution fees that exceeds the fee charged for executing the order.

The definition is designed to be comprehensive. Typically, a brokerage firm may arrange with a market marker or exchange to receive certain compensation per share on every customer order to buy or sell securities that the firm routes to that market venue.[3]

What is the regulation of PFOF?

Under SEC rules,[4] a broker-dealer must inform a customer when the account is opened and annually thereafter, about its policies regarding the receipt of PFOF, including whether the firm receives PFOF, and a detailed description of the nature of the compensation received. The broker-dealer is required to disclose on confirmations that PFOF is received and that its source and nature will be furnished on the customer's written request. However, a broker-dealer is NOT required to disclose the amount of the PFOF that it receives, either on a trade-by-trade or an aggregate basis. The PFOF rules apply to securities listed on a stock exchange or quoted on Nasdaq as well as securities quoted on automated interdealer quotation system, such as the Nasdaq Capital Market and the OTC bulletin board.

How does PFOF implicate the duty of best execution? [5]

A broker-dealer owes its customers a duty to execute their orders to buy and sell securities at the most favorable terms and price reasonability available under the circumstances. The firm generally fulfills this obligation by ensuring that its orders are executed at the National Best Bid and Offer ("NBBO"). The firm is not required to get the best possible price on every customer's order. Instead, the test of best execution is a totality test that requires a brokerage firm to use due diligence to obtain the best execution possible, <u>given all the facts and circumstances</u>. The lowest executing price or receipt of PFOF alone is not the determinant factor of best execution.

PFOF is essentially a tax on customer orders paid in lieu of more vigorous price and quality competition.[6] Therefore, the practice of PFOF may raise a conflict of interest between the broker-dealer and its customers, where the broker-dealer fails to obtain the execution of the customer order at a better price than the NBBO or on a cheaper venue.

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[3]See Fanto, Gross and Poser, *Broker-Dealer Law and Regulation*, §6.04 Payment for Order Flow to broker-Dealers, (5th ed, 2020-2 supp).

[4] §242.607(a)(2), §240.10b-109(a)(2)(i)(C).

[5] See Fanto, Gross and Poser, *Broker-Dealer Law and Regulation*, §6.04 Payment for Order Flow to broker-Dealers, (5th ed, 2020-2 Supp).

[6] See Bines and Thel, *Investment Management Law and Regulation*, §902, The Effect of Commission Rate Structure on Best-Execution Standards, (3rd ed, 2020 supp).

What does this mean for investment advisers?

With respect to PFOF, while the compliance burden falls most heavily on broker-dealers, self-regulatory organizations, and market centers,[7] investment advisers also have the duty to make full and fair disclosures to their clients about PFOF arrangements. In the *WBI and Millington* case, the SEC found WBI and Millington in violation of the Advisers Act's antifraud provision not because Millington received PFOP, but because they made materially misleading statements to their fund clients about clients' execution prices being negatively affected by the PFOF arrangement in place. WBI had disclosed on its Form ADV 2A that Millington received PFOF in connection with orders placed by WBI. They also informed the fund clients of the PFOF rate paid to Millington and the amount of PFOF received by Millington on a trade-by-trade basis.

WBI and Millington, however, failed to explain that as part of the PFOF arrangements, WBI's trades were executed on a net basis that adversely affected the executing prices. Instead, WBI and Millington falsely assured their fund clients on several occasions that PFOF did not have a negative impact on the orders and that price execution was not compromised by PFOF. Therefore, the SEC found that WBI and Millington defrauded their fund clients by making misleading statements about PFOF.[8]

Investment advisers should adhere to their written policies and procedures when selecting a brokerage firm, seeking to execute securities transactions for clients in such a manner that the total cost or proceeds of client transactions are the most favorable under the then-prevailing market conditions. If the investment adviser is aware of or participates in its brokerage firm's practice of PFOF, the investment adviser should disclose this arrangement to its clients and explain the implications and costs of this arrangement on executing prices. For more information about best execution, please refer to GACS's *Spotlight on Best Execution and Trade Allocation Guidance*.

[7] Id.

[8] See *In the Matter of WBI Investments, Inc. and Millington Securities Inc.*, August 5, 2020, available at https://www.sec.gov/news/press-release/2020-175.