The Role of Payment for Order Flow in The Rise of Commission-Free Trading Platforms

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Abstract

This paper examines how Robinhood Markets, Inc. has leveraged payment for order flow ("PFOF") as a core revenue-generating mechanism to sustain profitability while offering commission-free trading to retail investors. By eliminating traditional trading commissions, Robinhood disrupted the brokerage industry and catalyzed a broader shift toward zero-commission trading across the sector. However, this shift raised critical questions about the company's business sustainability and revenue model. Through a detailed analysis of Robinhood's business practices, industry standards, and regulatory complexities, this paper examines the significance of PFOF in the company's revenue structure and operational framework. The paper investigates how Robinhood monetizes trade volume by routing customer orders to market makers for execution in exchange for fees, the regulatory scrutiny and ethical implications associated with this model, and its impact on order execution quality. The paper further contextualizes Robinhood's approach within broader trends in fintech innovation and retail investor behavior. Ultimately, the paper concludes by suggesting that while PFOF has enabled Robinhood to scale rapidly and attract a new generation of investors, its ongoing dependence on PFOF puts the company under increasing regulatory watch, faces changing market conditions, and rising expectations from customers. Because of these dangers, Robinhood should shift away from the PFOF model and will need to be more open about how it operates, focus on giving users good trade execution, and work to earn investors' long-term trust as the industry changes.

Introduction

In January 2021, a Wall Street Bets subgroup calling themselves ("Ape") investors drove the stock prices of companies like GameStop and AMC to historic heights, challenging powerful Wall Street hedge funds. Then, on a pivotal Thursday morning, the trading app Robinhood, the very platform that promised to democratize finance, abruptly restricted its users from buying these volatile stocks, locking millions of retail traders out of the market. This sudden act, which became the subject of intense regulatory scrutiny and inspired films like *Dumb Money*, can be linked to Robinhood's use of the Payment for Order Flow system, which is when a brokerage receives a small payment from a market maker for sending its customers stock trades to that market maker for execution, allowing the broker to offer commission free trading while the market maker profits from the bid-ask spread. The incident forced investors to ask a simple and critical question that will be explored in part later in this paper: Does the broker's revenue from Payment for Order Flow mean its loyalties are fundamentally aligned with the market makers who pay it, rather than the retail users it claims to serve?

This review paper aims to provide a comprehensive analysis of PFOF, examining its mechanics, historical context, and overall impact on the modern financial world. Part I defines PFOF and identifies the key players involved, as well as the regulatory landscape that has allowed it to flourish. Part II explores the historical development of Robinhood Markets, Inc., as a central case study, detailing how the company's business model is built upon PFOF and the controversies the business endured along its journey. Part III analyzes how PFOF is used across the entire brokerage industry, comparing the practices of traditional brokers with those of commission-free platforms. Part IV weighs the benefits and drawbacks of PFOF. It assesses whether the practice truly serves the best interests of the retail investor by considering both the apparent advantages and the hidden costs. Ultimately, this paper argues that while PFOF has been a powerful engine for expanding access to financial markets, the use of PFOF likely does more damage to free market concepts than it does to aid them.

I. What is PFOF?

A. Definition and a Basic Explanation of Payment for Order Flow ("PFOF")

PFOF is a common but debated financial market transaction type in the U.S. stock markets. In essence, PFOF is the money a stock brokerage firm gets for sending its customers' orders to a certain market maker to be traded. Instead of sending an order to a public stock exchange, a broker sends it to a market maker in exchange for a fee, which is usually a very small amount of money per share. Economically, PFOF monetizes the lack of information among retail traders, as these smaller, less informed orders are less risky for market makers to fill than those from institutional players. The predictability in order flow from retail traders allows market makers to easily manage their risk, complete trades for a small profit, and earn money from the difference between the buy and sell prices.

The PFOF process is like a closed circle that occurs outside of public exchanges. When a regular investor places an order to buy or sell a stock through a PFOF-enabled broker, that order is not immediately sent to a public exchange like the New York Stock Exchange ("NYSE") or the National Association of Securities Dealers Automated Quotations ("NASDAQ"). Instead, retail orders are sent to a wholesale market maker, which is a big firm that trades electronically. The market maker gets the order, fills the order by trading it with its own inventory or matching it with another order, and pays the broker a small amount of money for each share. This PFOF process avoids the old exchange-based trading model and has created a powerful off-exchange system for retail trading. As noted by Battalio and Jennings (2022), this practice allows market makers to internalize retail orders that are typically uninformed, providing a source of liquidity distinct from public lit markets. The money made from PFOF has allowed many brokers to offer "commission-free" trading, which is a powerful way to get new customers and has completely changed the brokerage industry (Battalio and Jennings).

B. Key People Involved in PFOF Transactions (Brokers, Market Makers, Exchanges)

The PFOF system includes several key people, each with a different job and function in the transaction. The main people are the retail brokers, the wholesale market makers, and, in a less important role, the public exchanges.

Retail Brokers: These are the companies that serve regular, non-professional investors. Examples include large companies like Robinhood, Charles Schwab, and Fidelity. For these companies, PFOF has become a very important, and sometimes their biggest, source of money. By not charging trading fees, brokers can attract a huge number of new and active traders. A group of retail traders and their combined orders are the broker's most important asset. The broker's goal is to maximize profits from this asset, which means sending orders to the market maker that offers them the best financial deal. However, the broker's legal duty is to find the "best execution" for their customer. This duty means they must try to get the most favorable terms for the customer. PFOF may seem misaligned with the duties of brokers, as the goal of PFOF is to maximize profit, while the broker is obligated to fulfill the best trade for their customer as ordered.

Wholesale Market Makers: These are financial firms that specialize in filling orders and ensuring sufficient supply to trade. Examples include Citadel Securities and Virtu Financial, among others. Market makers' business model is based on always offering to buy and sell stocks and making money from the small difference between those prices, which is called the spread. PFOF gives them a steady and predictable flow of orders from regular people. The value of these orders is that they are not based on big, secret information that could move prices against them. By filling these orders away from the public exchange, market makers can often give a slightly better price than the best one available on an exchange. Brokers use better pricing to show they are fulfilling their "best execution" duty. The market maker makes a profit by keeping the bid-ask spread and the difference between the price at which they filled the order and the public market price.

Exchanges: Public stock exchanges, like the NYSE and Nasdaq, are the traditional places for stock trading. They are where buyers and sellers meet in a public and open marketplace. The rise of PFOF and off-exchange trading has greatly reduced the number of orders from regular people that go through these public markets. Because of the rise of PFOF, exchanges have had to change how they do business, often by offering their own money and discounts to attract orders. However, large retail exchanges are still at a disadvantage when it comes to getting business from regular people, since their open, auction-style markets often cannot compete with the profitable off-exchange model offered by market makers. This discrepancy in business advantage has caused exchanges to speak out against PFOF, saying that PFOF makes the market less open and fair by taking a large part of the trading activity away from public view. This market fragmentation is harmful because it siphons "uninformed" liquidity away from public venues, widening the bid-ask spreads for all participants and degrading the quality of public price discovery. When exchange liquidity is reduced, the remaining orders on the lit market, often from sophisticated, "informed" institutional players, become more expensive to execute, ultimately increasing the overall cost of capital and making the broader market less efficient.

C. Regulatory Framework and Legal Status of PFOF in the U.S. and Internationally

The rules and legal status of PFOF are very different in various parts of the world, showing a big disagreement on whether the practice is good or bad. Ultimately, the global landscape demonstrates that the existence of PFOF is a deliberate regulatory choice rather than an inherent market necessity.

In the U.S., PFOF is allowed but is heavily regulated. The main laws surrounding PFOF are managed by the Securities and Exchange Commission (“SEC”). Key rules include:

- SEC Rule 606: This rule requires brokerage firms to publicly show how they send their orders, including how much money they get for it. The goal is to be open and allow investors to see if their broker is doing its job of getting them the best trade. While this rule requires them to share information, it does not ban PFOF outright.

- Best Execution: Under rules from the Financial Industry Regulatory Authority ("FINRA") and the SEC, brokers must provide "best execution" for their customers' orders. Best execution means they must try to get the most favorable terms possible, including price, how fast the trade happens, and how likely the trade is to be completed. The core of the PFOF usage debate in the U.S. is about the best execution concept. Seemingly at odds is whether a broker gets PFOF commission and still honestly fulfills its duty to get the best trade for its customer, especially when another market maker might offer a slightly better price but without the added commission from PFOF. (European Securities and Markets Authority 2015)

In recent years, the PFOF practice has been more heavily scrutinized. In 2022, SEC Chairman Gary Gensler suggested some big changes to make the U.S. market more competitive and open. These proposals did not call for a total ban; instead, they focused on significantly restructuring PFOF by requiring retail orders to be sent to open auctions where multiple firms could compete to fill them, thereby reducing the dominance of private wholesale arrangements while stopping short of getting rid of the practice altogether. The SEC is worried about the problem of brokers having two competing goals and the possibility that a broker might care more about its own profit than its customer's best interest. The result of these ideas is not yet known, but they show that there could be a major change in the rules.

In contrast to the U.S., many other major financial places have either banned PFOF or made it very difficult to do.

- European Union (EU): Under the Markets in Financial Instruments Directive II ("MiFID II"), the EU has effectively banned PFOF. The rule-makers see PFOF as a problem that goes against a broker's duty to act in the best interest of its customers. MiFID II requires that firms act "honestly, fairly and professionally" when dealing with customers, and PFOF is specifically banned because it is seen as something that could harm this duty. While some small exceptions exist in certain countries, the general feeling in the EU is that PFOF is not good for protecting investors. (European Securities and Markets Authority 2015)
- United Kingdom ("UK"): The UK's approach, after leaving the EU, is very similar to the EU's. The Financial Conduct Authority ("FCA") has the same worries about the problem of competing goals and has taken steps to ban or severely limit PFOF, seeing it as a practice that could hurt investors.

The big difference between the U.S. and international markets showcases differing opinions on how to handle PFOF. This highlights that the current state of market structure is a product of specific policy choices: the U.S. has historically chosen to allow PFOF under the assumption that transparency and competition can mitigate risks, while the EU and UK have made the policy choice to prioritize the mitigation of conflicts of interest through prohibition. This dichotomy in approach can have drastically different outcomes for retail-based investors and their brokers.

II. Historical Overview of Robinhood Markets, Inc. and PFOF

A. The Origins of Robinhood Markets, Inc.

Robinhood Markets, Inc. was founded in 2013 by Vladimir Tenev and Baiju Bhatt, two Stanford graduates who previously built high-frequency trading platforms for financial institutions. Their unique experience exposed them to the stark inefficiencies and high costs that separated institutional investors from everyday retail traders. At the time, even basic stock trades often carried a commission of $5 to $10, making frequent trading and small investments uneconomical for a large segment of the population. Tenev and Bhatt were motivated by the idea of democratizing finance, with the explicit goal of making stock market participation accessible to everyone, regardless of their wealth or experience. Their vision was to build a mobile-first brokerage platform that eliminated commissions and simplified the trading process.

The company's launch in 2014 was met with immediate enthusiasm, attracting a long waitlist of users eager to trade for free. The name "Robinhood" itself was a deliberate nod to its mission of taking from the financial elite (high commissions) and giving to the masses (commission-free trading). The app's user interface was clean, intuitive, and designed to resemble a modern social media platform rather than a complex trading terminal. The app's gamified elements, such as confetti animations for a user's first trade and push notifications about market movements, were a stark contrast to the staid, formal platforms of legacy brokerages. Robinhood's user base grew rapidly, attracting a younger demographic that was new to investing. This explosive growth demonstrated a clear market demand for a product that broke down the traditional barriers to entry. While legacy brokers historically relied on transparent, per-trade commissions paid by the user, Robinhood's business model shifted the primary revenue source to PFOF, making the market maker, rather than the investor, the paying client. The core of Robinhood's disruptive strategy lay not in what it charged for trades, but in how it chose to make its money; a model that was initially opaque to its burgeoning user base and would later become the source of significant controversy. (Tan 2021)

B. How Robinhood uses PFOF to Make Money

Robinhood's central value proposition to its customers is the offer of "commission-free" trading. This is a powerful marketing tool that has been widely adopted across the industry since Robinhood's introduction. However, the term "commission-free" is a semantic distinction; it does not mean that the service is completely free, although it may be free to the trader. Instead, Robinhood's business model is almost entirely reliant on generating revenue from sources other than direct fees from its customers, and the most significant of these is PFOF. According to its public filings, PFOF has consistently accounted for the vast majority of Robinhood's total revenue, particularly in its earlier years as a private company and through its initial public offering.

The mechanism through which Robinhood generates this revenue is both straightforward and controversial. When a Robinhood customer places an order to buy or sell a stock or option, Robinhood does not route that order to a public exchange. Instead, Robinhood sells the order to a third-party, off-exchange market maker, such as Citadel Securities, Virtu Financial, or G1 Execution Services. These market makers pay Robinhood a per-share or per-contract rebate for the right to execute the trade. The market makers are willing to pay for this order flow because it is "uninformed" and predictable. Unlike institutional trading, which can involve massive, market-moving blocks of shares, retail orders are generally small and do not contain sensitive information. This predictability allows market makers to efficiently manage their risk and profit from a minimal difference between the bid and ask prices. By executing these trades internally, market makers can capture the spread and the PFOF fee, while often providing a fraction of a cent of "price improvement" on the trade, meaning the customer receives a price slightly better than the best available price on a public exchange. This price improvement is key to Robinhood's argument that it is fulfilling its "best execution" obligation to its clients. Critically, however, this marginal price improvement is often small relative to the total bid-ask spread captured by the market maker, leading to concerns that the hidden costs of wider spreads and lost execution quality may actually outweigh the visible benefit of the nominal price gain.

Beyond PFOF, Robinhood generates revenue from other sources as well, including interest on cash balances held by customers (securities lending) and premium services like Robinhood Gold. However, PFOF remains the cornerstone of its financial strategy, making it a powerful case study for how a modern brokerage can monetize its user base without charging explicit trading fees. This model, while lucrative for the company and attractive to its users, has also created a direct and quantifiable conflict of interest that has been at the heart of its most significant challenges.

C. Public Perception, Controversies, and Regulatory Scrutiny Regarding Robinhood's PFOF Practices

Robinhood's meteoric rise was accompanied by a growing public and regulatory debate over its business practices. The core of the controversy stems from the inherent conflict of interest created by PFOF. While Robinhood legally asserts that it seeks "best execution" for its customers, critics argue that the practice of selling orders creates a perverse incentive for the broker to prioritize its own financial gain over the best interests of its clients. The highest-paying market maker may not always be the one that provides the most favorable execution price or fastest service. This creates a moral hazard where the broker benefits from customer trading activity in a way that is not fully transparent to the user.

The most significant event that brought Robinhood's PFOF practices into the public spotlight was the "meme stock" trading frenzy of early 2021, particularly surrounding GameStop ("GME") and AMC Entertainment ("AMC"). As a collective of retail investors organized on social media platforms, they initiated a massive short squeeze against institutional hedge funds. The unprecedented surge in trading volume led to extreme volatility for these stocks. In response, Robinhood, along with several other brokerage firms, suddenly restricted its users from buying shares of these specific stocks, allowing only for the sale of existing positions. The company attributed this decision to the steep rise in capital requirements demanded by clearinghouses to cover potential settlement risks, a requirement directly tied to the high volume of volatile trading. However, this explanation was widely perceived as a betrayal of its "democratizing finance" mission. Critics alleged that the restrictions were imposed to protect the institutional market makers to whom Robinhood sells its order flow, as these firms were suffering massive losses from the short squeeze.

The fallout from the GameStop saga was immense. Robinhood faced public outrage, multiple lawsuits from its users, and congressional hearings. This event galvanized regulatory scrutiny. The Securities and Exchange Commission ("SEC") had already been investigating

Robinhood's business practices, and in December 2020, before the GameStop incident, the company paid a $65MM fine to settle charges that it had misled customers about PFOF. The SEC’s complaint stated that Robinhood had failed to disclose that it sold its customers' orders and that this practice resulted in worse execution prices for its users, effectively undermining its claim to offer the most favorable terms. These enforcement actions directly undercut Robinhood's public messaging of "democratizing finance" by revealing that the platform's financial success was built on a lack of transparency that cost its users more than they saved in commissions. This fine, coupled with a later $70MM fine from the Financial Industry Regulatory Authority (“FINRA”) for a series of operational failures, underscored the regulatory body's growing concerns. (U.S. Securities and Exchange Commission 2020, Financial Industry Regulatory Authority 2020)

In the aftermath of the GameStop controversy, SEC Chairman Gary Gensler openly questioned the value of PFOF to the average investor. Gensler has floated proposals for a major overhaul of market structure, including requiring off-exchange trading to go through auctions or even a potential ban on PFOF. These proposals include the Order Competition Rule and Regulation Best Execution. The first rule would require certain individual investor orders to be exposed to a "qualified auction" to promote competition for retail order flow and ensure better prices. The second rule would require broker-dealers to have written policies and procedures to achieve best execution for customer orders. While these proposals are not yet finalized, they represent a fundamental challenge to Robinhood’s business model and the entire ecosystem of commission-free trading. Robinhood’s journey demonstrates that while PFOF has been an engine for democratizing access to financial markets, it has also created profound ethical and regulatory questions that will continue to shape the future of the industry.

III. How PFOF is used in the brokerage industry

A. The Mechanics of PFOF in Modern Brokerage Operations

When an investor uses a free trading app to buy or sell a stock, a complex and quick process typically occurs to execute a stock trade. If a brokerage firm is utilizing PFOF, the trade process usually proceeds as follows:

1. The Investor Places an Order: The process begins when a regular person decides to buy or sell a security, like 100 shares of a company. They enter the order into their brokerage's app or website.
2. Order Routing: Instead of sending this order directly to a public stock exchange (like the NYSE), the brokerage firm sends it to a wholesale market maker. A market maker is a big financial firm that trades a lot of stocks very quickly. The brokerage has a deal with this market maker to send all of its customers' orders to them.
3. The PFOF Payment: When the market maker gets the order, it pays the brokerage firm a small amount of money for it. This payment is the "Payment for Order Flow." The fee is usually a fraction of a cent per share, but when you add up the millions of orders that a company like Robinhood handles every day, it becomes a very large source of income.
4. Order Internalization and Execution: The market maker then takes the order and fills it from its own supply of stocks (this process is "internalization"). The market maker acts as the buyer for a sell order and the seller for a buy order. They achieve this by offering

the investor a price that is typically slightly better than the best available on a public exchange. This tiny improvement is called "price improvement." The market maker makes money from this by keeping the small difference between the price at which they bought the stock and the price they sold it for, as well as by collecting the PFOF fee from the broker.

This system is different from direct routing or commission-based. In the old way, a broker would send an order to an exchange, where it would be matched with another order from another investor in an open and transparent auction. In the PFOF model, the trade happens in private, away from the public market. Market makers like this system because the orders from regular people are usually "uninformed," meaning they are not based on special knowledge that could hurt the market maker. This makes it easier for the market maker to predict prices and make money from a large number of small trades. The value of this kind of predictable order flow is why they are willing to pay so much to get it.

B. Major Industry Players and Their Approaches to PFOF

Different market makers and brokers utilize PFOF in different ways. The use of PFOF depends on how a brokerage chooses to make money. The major players can be divided into a few groups:

Commission-Free Platforms (e.g., Robinhood): These companies are the most famous examples of the PFOF model. For a company like Robinhood, PFOF isn't just one source of money; it's the main reason their business works. They offer trading for free, and in return, they use PFOF to make almost all of their money. This model allows them to attract millions of new and young investors who might not have been able to afford trading fees. For these companies, the ability to sell their customers' orders to market makers is their most important asset. Without PFOF, their business model would not be able to work as it does today. This singular reliance makes them the most vulnerable to regulatory shifts, as a ban or severe restriction on PFOF would essentially dismantle their primary revenue stream.

Hybrid Brokers (e.g., Charles Schwab, Fidelity): These are older, more traditional brokerage firms that have been around for a long time. In the past, they made their money from trading fees. As free trading gained popularity due to companies like Robinhood, these brokers had to adapt their business to stay competitive. They eliminated their own trading fees but did not fully transition to the PFOF model. Instead, they use a mix of PFOF and other ways to make money, such as interest on customer cash and management fees for investment accounts. This means they are not as dependent on PFOF as Robinhood is, which gives them more flexibility. They can still claim that their main goal is to get the best deal for their customers because PFOF is not the only way they make money. Because their income is diversified, they are better positioned to weather regulatory changes by pivoting back toward service fees or cash-sweep programs.

Full-Service Brokers (e.g., some smaller firms): These are brokerage firms that offer much more than just a place to trade stocks. They often provide financial advice and other services to their customers, generating revenue from high advisory fees. For these firms, PFOF is not a big part of their business, and some may not use it at all. Their customers are often wealthier and are willing to pay for expert advice, so the brokerage does not need to sell their orders to a market maker to make a profit. In this model, the relationship between the client and the broker is more personal, and there is less concern about the kind of conflicts of interest that PFOF can cause. These firms are effectively insulated from PFOF regulation, as their value proposition is built on expertise rather than low-cost execution.

C. Comparative Analysis of PFOF Practices Between Traditional Brokers and Commission-Free Platforms

The way PFOF is used by different types of brokerage firms is a key part of the modern debate over its use. A side-by-side comparison of the practices of new, free platforms and older, more traditional brokers helps to show the main differences.

Whether or not a broker or financial institution decides to utilize PFOF largely depends on whether such an arrangement fits within its business model and contributes to the profitability of the company. For free platforms like Robinhood, PFOF is the main reason they exist. PFOF provides a direct incentive for the broker to focus on its own profits. The more orders it sells, and the better the price it gets for those orders from market makers, the more money it makes. The profitability incentives from PFOF can sometimes go against the goal of getting the best price for the customer. In contrast, traditional and hybrid brokers have many different ways to make money and do not have to rely on PFOF. Such a lack of reliance on PFOF reduces the financial reason to get money from market makers and, in theory, makes it easier for them to prioritize their customers' best interests.

Government agencies like the SEC require all brokers to share information about their PFOF practices. However, how this information is shared and understood is different. New platforms often market themselves as being "free," which can make it hard for customers to understand how the company actually makes money. The details of the PFOF deals are often hidden in complex reports, and many customers are either unaware of or indifferent to finding them. Traditional brokers, on the other hand, have often been more open about their costs and fees for many years, so the move to a more PFOF-based model might be clearer to their customers. However, the problem of making the process easy for the average person to understand is a problem for the whole industry.

The wide use of PFOF by new, free platforms has completely changed the stock market. Because so many orders from regular people are now being sent to private market makers, a large amount of the trading in the U.S. now happens away from public exchanges. The use of PFOF has led to a more divided market, where it is harder to see all the buying and selling that is happening, which is a big concern for regulators, who worry that a fragmented market could be less fair and harder to watch. The structural vulnerability of purely commission-free firms highlights why current SEC proposals targeting order competition are so contentious; while a diversified hybrid broker might simply adjust its fee structure, a PFOF-dependent platform faces an existential threat to its core operating logic.

While PFOF has made stock trading free for millions of people, its use is very different across the brokerage industry. It is the very core of the business model for new platforms, but it is just one part of the business for older firms. The use of PFOF will continue to be a source of debate, as the desire to make investing accessible to everyone is weighed against the potential conflicts of interest and the changes it has caused to how the financial markets work.

IV. Is PFOF beneficial to the retail trader?

A. Advantages of PFOF for Retail Investors

One of the biggest benefits that retail traders and investors gain from PFOF is that no trading fees are charged to them. In the past, a single stock trade would cost anywhere between $5 to $10 per trade, and for a new investor with a small amount of money, these fees could be quite costly. A $10 fee on a $100 trade meant an instant 10% loss. In order for the position to become profitable, the stock value would have to appreciate to make up the difference. Brokerages that use PFOF have made it much easier for people to get started by not charging any fees for stock trades. This has allowed new groups of investors to join the market by letting them regularly invest small amounts of money and build portfolios over time. Getting rid of fees also lets investors trade more often without worrying about the cost, which can be helpful for those who want to buy and sell small parts of different stocks. However, this increased accessibility introduces complex behavioral consequences: the elimination of friction may encourage overtrading, where investors transact more frequently than is optimal, potentially leading to lower long-term returns and complicating the overall welfare analysis of zero-cost trading.

Another key advantage that brokerages often talk about is “price improvement”. When a brokerage sells a customer's order to a market maker, the market maker has a reason to provide a price that is slightly better than the best price on a public exchange. For example, if the best price to buy a share of a stock is $20.00, the market maker might fill the order at $19.998. These tiny savings are the "price improvement." While this amount is very small for one trade, brokerages argue that it can add up to a lot of money for investors who trade often. In this view, PFOF actually helps the customer by giving them a better price than they might have gotten on a public exchange, all while avoiding the fee they would have paid. This practice is seen as a way for the broker to follow its legal duty of “best execution” for its clients, making sure the client gets the most favorable terms for their trade.

In contrast, industry groups and many of the brokerages that use PFOF defend the practice by pointing to its overall effect. They argue that focusing on individual, tiny costs misses the bigger picture. By allowing millions of people to invest who would have been unable to afford it otherwise, PFOF has opened up finance and created a more inclusive market. From this point of view, the benefits of getting more people to invest are more important than the possible problems of a less-than-perfect execution price.

B. Disadvantages and Potential Conflicts of Interest for Retail Investors

Despite the claimed benefits, the PFOF model also has significant problems and a clear chance for conflicts of interest. At its core, PFOF creates a classic principal-agent problem: the investor (the principal) relies on the broker (the agent) to act in their best interest, but the broker’s compensation is tied to the market maker rather than the client. The most serious concern is that a brokerage's financial reason to make money from PFOF may not match its duty to provide the best service to its clients. This is an explicit conflict of interest because the broker is incentivized to route orders based on the highest rebate offered by a market maker, which may come at the expense of the investor receiving a superior execution price. The most profitable deal for the brokerage might not be the best deal for the investor. For example, a market maker who pays the most in PFOF fees might not offer the best prices. This creates a situation where the broker is paid to send its customers' orders to a specific firm, which could lead to a less favorable result for the customer. In addition, a brokerage may not disclose to its clients who is acting as the brokerage's market maker, and the clients may not have the ability to track how their trades are being executed. The opaqueness of the entire PFOF process on the client side means that retail trades may not know if their broker is working for their best interests or for the interests of the firm that is paying them.

Another major problem with PFOF is the lack of transparency about the true cost of a trade. While fees have been removed, the investor still "pays" in a different way. The market maker makes money by taking a small part of the "bid-ask spread, which is the difference between the highest price a buyer is willing to pay and the lowest price a seller is willing to accept. When a market maker fills an order from their own supply of stocks, they are capturing this spread, and the PFOF fee is basically a way to share that profit with the brokerage. The investor is often unaware that this is happening and has no way to know if the price improvement they received truly makes up for what the market maker is gaining from the spread. This hidden cost can add up, potentially exceeding the fees charged in the past.

The PFOF model also creates a problem that may raise regulatory concerns because the act of purchasing order flow from brokerages gives an informational advantage that undermines concepts of market fairness and openness. Market makers who buy order flow from brokerages get to see the orders before anyone else. They know that a stream of small, retail orders is coming. Even if market makers are not allowed to use this information to trade for themselves before filling the customer's order, they can use this information to adjust their prices. The receipt of trading information and order flow gives an advantage over other traders in the market, creating an unfair playing field. From the Investopedia article “SEC Considers Banning Payment for Order Flow”: “The U.S. Securities and Exchange Commission (SEC) is considering a full ban on the payment for order flow (PFOF). The reason is that this practice creates "an inherent conflict of interest," according to SEC Chairman Gary Gensler, in a recent interview with Barron's.” Given the PFOF practice, regulators are concerned about equal access and fair trading that may not be prevalent if market makers can have free rein over the pricing and execution of a large amount of retail investor trades.

One of the most important findings came from the Securities and Exchange Commission (“SEC”) in its December 2020 settlement with Robinhood. In the Press Release: “SEC Charges Robinhood Financial With Misleading Customers About Revenue Sources and Failing to Satisfy Duty of Best Execution”, the SEC accused the company of not being open about its PFOF practices. (U.S. Securities and Exchange Commission 2020) It found that, despite claiming to provide "superior" execution, Robinhood often sent its customers' orders to firms that gave worse prices than other market makers. The SEC found that this caused customers to lose more than they saved from not paying fees. This finding directly challenged the brokerage's main claim that PFOF was a good thing for its customers and showed the serious conflicts of interest that the model creates.

Conclusion

On its face, PFOF seemingly helps retail traders by offering them a way to trade without any “trading fees.” However, as Warren Buffett has said, “There is no free lunch”. This quote embodies his belief that you can't get something for nothing, and any desired or valuable outcome comes with a cost, whether in money, effort, or sacrifice. On one hand, PFOF has, without a doubt, opened up the world of investing to a wider group of people, getting rid of the direct cost of trading and providing a smoother experience. On the other hand, it has created a new kind of "cost" that is less transparent and involves significant conflicts of interest. This implicit cost is realized not through a visible commission but through reduced price improvement, which, when aggregated across millions of trades, transfers billions of dollars annually from retail investors to market makers.

Moreover, when so many trades bypass major exchanges, it breaks up the market, making it harder to find the true best price for a stock and granting dominant market makers an unfair informational advantage. The findings from regulators and experts suggest that these hidden costs can be substantial, and that the financial interests of the broker and the market maker may not always align with the best interests of the investor. In addition, the incentives of the main purveyors of PFOF, such as brokerages and the related market makers, may not be aligned with the greater good of the market as seen through the GameStop Controversy.

While Payment for Order Flow has been a powerful engine for expanding access to financial markets, its systemic conflicts of interest and hidden costs constitute a clear failure of market fairness, inflicting far more damage on the core principles of a free and open market than any benefit it provides.

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