CONSULTATION PAPER 347

Proposed amendments to the prohibition on order incentives in the ASIC market integrity rules

August 2021

About this paper

This paper sets out our proposal to amend the prohibition on order incentives in Part 5.4B of the ASIC Market Integrity Rules (Securities Markets) 2017. The purpose of our proposed amendments is to close a regulatory gap in the current rules, to circumvent the emergence of payment for order flow arrangements in Australia.

We are seeking the views of interested stakeholders on our proposal.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Document history

This paper was issued on 25 August 2021 and is based on the legislation as at the date of issue.

Disclaimer

The proposals, explanations and examples in this paper do not constitute legal advice. They are also at a preliminary stage only. Our conclusions and views may change as a result of the comments we receive or as other circumstances change.

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The consultation process

You are invited to comment on the proposals in this paper, which are only an indication of the approach we may take and are not our final policy.

As well as responding to the specific proposals and questions, we also ask you to describe any alternative approaches you think would achieve our objectives.

We are keen to fully understand and assess the financial and other impacts of our proposals and any alternative approaches. Therefore, we ask you to comment on:

- the likely compliance costs;
- the likely effect on competition; and
- other impacts, costs and benefits.

Where possible, we are seeking both quantitative and qualitative information. We are also keen to hear from you on any other issues you consider important.

Your comments will help us develop our policy on prohibiting order incentives such as payment for order flow. In particular, any information about compliance costs, impacts on competition and other impacts, costs and benefits will be taken into account if we prepare a Regulation Impact Statement: see Section D, 'Regulatory and financial impact'.

Making a submission

You may choose to remain anonymous or use an alias when making a submission. However, if you do remain anonymous we will not be able to contact you to discuss your submission should we need to.

Please note we will not treat your submission as confidential unless you specifically request that we treat the whole or part of it (such as any personal or financial information) as confidential.

Please refer to our privacy policy for more information on how we handle personal information, your rights to seek access to and correct personal information, and your right to complain about breaches of privacy by ASIC.

Comments should be sent by 3 November 2021 to:

Natalie Boulizos, Senior Manager
Market Supervision
Australian Securities and Investments Commission
GPO Box 9827
Brisbane QLD 4001
email: MIRsubmissions@asic.gov.au

What will happen next?

Stage 1	25 August 2021	ASIC consultation paper released
Stage 2	3 November 2021	Comments due on the consultation paper
Stage 3	Q4 2021 – Q1 2022	Amended rules made and feedback report released
Stage 4	Q1 2022	Regulatory Guide 265 *Guidance on ASIC market integrity rules for participants of securities markets* (RG 265) updated

A Payment for order flow and our current prohibition

Key points

'Payment for order flow' means an arrangement where one person sells their client orders to another person.

In Australia, a market participant is prohibited from making a cash payment to another person for that person's orders, if the cash payment results in a 'negative commission'.

This rule was introduced as a proactive measure in response to the harms associated with payment for order flow arrangements, which are commonplace in some other jurisdictions.

Overview of this paper

1 In this paper, we are seeking feedback on our proposal to amend the current prohibition on payment for order flow, which is set out in Part 5.4B of the ASIC Market Integrity Rules (Securities Markets) 2017 (Securities Markets Rules).

2 We have identified that this prohibition does not deal with certain payment for order flow scenarios. We are proposing to close this regulatory gap and, in doing so, also simplify the concept of 'negative commission' in the current rules.

3 Our policy position on payment for order flow arrangements is well established. In our view, the harms associated with these arrangements outweigh the benefits. Our proposed amendments are a proactive measure intended to circumvent the emergence of payment for order flow arrangements in Australia.

4 This section describes:

(a) payment for order flow arrangements, including the benefits and the harms associated with this practice;

(b) payment for order flow in the Australian market and in markets outside Australia; and

(c) our current prohibition, including the consultation process we undertook.

5 In Section B, we set out our proposal to amend the rules and our rationale, including any potential impacts on competition.

6 In Section C, we discuss our current approach to soft dollar incentives and seek your feedback on whether ASIC should make changes to this approach.

7 We note that we have provided an extended period in which to respond to our proposals in this paper as we recognise the challenges the pandemic-related lockdowns create for stakeholders.

Payment for order flow arrangements

What is 'payment for order flow'?

8 'Payment for order flow' means an arrangement where a person receives an incentive from another person, in exchange for sending their clients' orders to that other person. These incentives can be in the form of direct cash payments or soft dollar incentives (e.g. the provision of free services such as research or technology).

9 Payment for order flow arrangements can exist between market participants or other market intermediaries such as securities dealers or liquidity providers, or a combination of both.

10 Buying client order flow may be appealing for various reasons. Retail order flow is viewed as less informed than institutional order flow. It has lower adverse selection risk and is likely to be more profitable for a wholesale market intermediary to trade against. It also gives the purchaser a preview of order flow data before sending it to market. This can give them an informational advantage.

What are the associated benefits?

Reduced costs

11 Payment for order flow arrangements are most prevalent in the United States. They have facilitated the rise in zero-cost brokerage offered by certain firms in the United States, as the payments subsidise the broker for not charging its clients brokerage.

12 Zero-cost brokerage may seem attractive. However, it has been shown to encourage excessive trading and speculation among retail investors (often fuelled by social media forums). This may harm investor financial well-being.

13 Findings from academic literature have shown that retail traders typically lose money, with excessive trading correlating with bigger losses.

Note: See B Barber & T Odean 2002, '[Trading is hazardous to your wealth: The common stock investment performance of individual investors]', *The Journal of Finance*, vol. 55, no. 2, pp. 773–806.

Price improvement

14 Payment for order flow arrangements can provide retail investors with access to more competitive prices on their trades, compared to the best prices available at the national best bid and offer (NBBO) on exchange markets.

15 In December 2020, price improvement averaged at around 24.5% of the spread across all trades reported by the top five wholesalers in the United States (i.e. Citadel, Virtu, Susquehanna, Two Sigma, and Wolverine), all of whom use payment for order flow arrangements. In aggregate, the value of price improvement in the United States in 2020 amounted to US$3.57 billion.

Note: See H Mittal & K Berkow 2021, *The good, the bad and the ugly of payment for order flow* (PDF 1.89 MB), BestEx Research, 3 May, and A Rampell & S Kupor 2021, *Breaking down the payment for order flow debate*, a16z, 17 February.

16 However, orders submitted to exchanges can also benefit from price improvement, such as through odd lot orders or dark orders.

What are the associated harms?

Poor client outcomes

17 Payment for order flow arrangements create conflicts of interest because they can result in the payment recipient directing a client order to the market intermediary that provides the best incentive rather than the best execution outcome for their client. The client may receive a worse overall outcome as they typically do not receive the payment for order flow and the execution price does not capture sufficient price improvement.

18 For example, where a payment is made to attract an order that a market intermediary would not otherwise obtain (e.g. because they are not offering the best price) the client may receive a price that is disadvantageous.

Note: See FCA 2012, *Guidance on the practice of 'payment for order flow'* (PDF 179 KB), finalised guidance, May.

19 Payment for order flow arrangements also incentivise the gamification of investing, which is the process of designing client trading applications to maximise user attention, engagement and trading frequency. Low cost or zero brokerage can encourage the gamification of investing, which increases the payment recipient's payment for order flow revenue. However, excessive trading has been found to harm investor financial well-being.

20 In recent enforcement action taken by the US Securities and Exchange Commission (SEC) against Robinhood Financial LLC (Robinhood) that settled for US$65 million, the SEC alleged that Robinhood:

(a) misled customers about its revenue sources when it made statements that trading was 'commission free'; and

(b) failed to satisfy its duty of best execution.

21 According to the SEC's order, the SEC found that certain firms seeking to attract Robinhood's order flow informed Robinhood during negotiations that there was a trade-off between payment for order flow and price improvement for customers. Robinhood explicitly offered to accept less price improvement for its customers in exchange for receiving higher payment for order flow for itself. The SEC found that Robinhood customer orders subsequently received poor execution quality.

Note: See SEC 2020, *SEC charges Robinhood Financial with misleading customers about revenue sources and failing to satisfy duty of best execution*, press release, 17 December.

22 The European Securities and Markets Authority (ESMA) recently stated that some firms receiving payment for order flow from execution venues have been attempting to circumvent best execution obligations by soliciting specific client instructions.

Note: See ESMA 2021, *ESMA warns firms and investors about risks arising from payment for order flow*, public statement, 13 July.

Negative impacts on market quality

23 Payment for order flow can also have wider market impacts, resulting in:

(a) a concentration of market share among one or more market intermediaries, impacting competition; and

(b) a diversion of retail client orders (i.e. 'uninformed' orders) to off-market execution, leading to a greater proportion of informed trading on exchange markets and an increased risk of adverse selection for other investors.

24 Currently, retail trading activity in the Australian equity market occurs almost solely on exchange markets. Retail investors constitute a significant proportion of trading activity in the Australian equity market, accounting for 15.3% of traded value in June 2021. If a substantial proportion of retail order flow was diverted, we expect that on-market trading volumes and liquidity would decline significantly, which is likely to increase trading costs for other investors and harm the overall price formation process.

25 Flow-on effects include widening spreads and reduced access to liquidity for all investors on the lit exchange market. For example, liquidity providers may adjust their prices (i.e. increase the bid-ask spread) to compensate for the risk of trading against informed investors. Wider spreads on lit markets can also negatively impact prices for off-market execution which reference lit market pricing.

26 A study in the United States showed that narrower spreads could be obtained if more retail order flow was transacted on exchange markets rather than being diverted to off-market execution. It estimated that NBBO spreads in the US equity market would decrease by 25% if retail marketable orders were submitted to exchanges rather than internalised.

> Note: See H Mittal & K Berkow 2021, *The good, the bad and the ugly of payment for order flow* (PDF 1.89 MB), BestEx Research, 3 May.

27 Further, if price improvement for off-market execution is based on wider spreads, it may not actually be an improvement on the price that could have been achieved had there been no payment for order flow.

> Note: See H Mittal & K Berkow 2021, *The good, the bad and the ugly of payment for order flow* (PDF 1.89 MB), BestEx Research, 3 May.

Payment for order flow in markets outside Australia

28 Payment for order flow arrangements are common in the US equity and options markets. It has been reported that in 2020, the top seven retail brokers received US$2.6 billion in payment for order flow revenue from wholesalers.

> Note: The top seven retail brokers are: TD Ameritrade, Robinhood, E*Trade, Charles Schwab, Webull, TradeStation and Ally Invest. See Daytradingz 2021, *Payment order for flow: Statistics and insights*, daytradingz.com, 31 July.

29 The SEC is currently scrutinising payment for order flow arrangements. The SEC Chair has stated that the SEC is currently reviewing the impact of features commonly found in retail investor trading apps—such as gamification, behavioural prompts, predictive analysis and differential marketing—on investor behaviour.

> Note: See SEC 2021, *Testimony before the House Committee on Financial Services*, 6 May.

30 The U.S. House Committee on Financial Services has also recently introduced a range of bills in response to the market volatility observed in relation to GameStop earlier this year. The proposed legislation being considered aims to strengthen investor protection and market integrity.

> Note: See U.S. House Committee on Financial Services 2021, *Waters Opening Statement at July Full Committee Markup*, press release, July 28.

31 While payment for order flow has been observed in North American and European markets, it is currently not a feature of markets in the Asia-Pacific region.

32 Payment for order flow arrangements are prohibited in several peer jurisdictions, including the United Kingdom and Canada, due to concerns around potential conflicts of interest and non-compliance with best execution requirements.

Note: See, for example, FCA 2012, *Guidance on the practice of 'payment for order flow'* (PDF 268 KB), finalised guidance, and N Saminather 2021, *Canada stock market rules curb platforms linked to churning US stocks*, Reuters, 10 February.

33 The UK Financial Conduct Authority (FCA) has found that some firms may be circumventing restrictions by routing client orders to overseas affiliates who received payment for order flow on those orders.

Note: See FCA 2019, *Payment for order flow*, final report, 23 April.

34 Recently, ESMA has stated that it considers the majority of payment for order flow arrangements are unlikely to be compatible with MiFID II and its delegated acts—particularly the requirements on:

(a) taking all sufficient steps to obtain the best possible result for their clients;

(b) conflicts of interest; and

(c) inducements.

35 ESMA has also given a specific warning to 'zero-commission brokers' that have begun to emerge in the European Union of the investor protection risks associated with their payment for order flow arrangements—such as less transparency for the client and the potential to distort retail clients' investment incentives—and the consequent impact on the firm's ability to comply with MiFID II.

36 Given the concerning observations of ESMA on the business operations of firms receiving payment for order flow in some EU member states, and the impact of payment for order flow on retail client activity in the US market, ESMA has requested the National Competent Authorities to prioritise payment for order flow in their supervisory activities over the next year.

Note: See ESMA 2021, *ESMA warns firms and investors about risks arising from payment for order flow*, public statement, 13 July.

Our current prohibition on order incentives

37 Arrangements involving direct cash payments do not appear to be commonplace in the Australian market.

38 In 2013, we introduced a prohibition on order incentives. This was a proactive measure that was intended to circumvent the emergence of payment for order flow arrangements in the Australian market. Our view was that the harms associated with these arrangements outweighed the benefits.

39 Under Part 5.4B of the Securities Markets Rules, if a market participant handles or executes an order as the result of an arrangement with another person to direct orders to the market participant, the market participant must not, directly or indirectly, make a cash payment to the other person for the opportunity to handle or execute those orders if the cash payment leads to the net cost—calculated as set out in Rule 5.4B.1(2)—being less than the value of the reported price for the transaction(s) the subject of the orders: see Rule 5.4B.1(1).

40 Under Rule 5.4B.1(2), the net cost is calculated as follows:

> Net cost = (**Commission** less the dollar value of any cash payment to the other person) + **Reported Price**
>
> where:
>
> ***Commission*** means the dollar value of any payment received by the Market Participant (including commission received from a client of the other person) for the opportunity to handle or execute the other person's Orders; and
>
> ***Reported Price*** means the total dollar value of the transaction(s) that are the subject of the other person's Order or Orders as executed on a Market or, if applicable, reported to a Market operator under Rule 6.3.1, or if applicable, set out in a [trade] confirmation provided to the other person under Rule 3.4.2.
>
> Note: Rule 3.4.2 permits a market participant to accumulate multiple transactions in a single trade confirmation and specify a volume weighted average price (VWAP) for those transactions in specified circumstances.

41 Rule 5.4B.1 in effect means that a market participant cannot pay more for order flow than the commission received by the market participant for those orders—that is, it prohibits a 'negative commission': see Regulatory Guide 265 *Guidance on ASIC market integrity rules for participants of securities markets* (RG 265) at RG 265.516.

Industry consultation on the current prohibition

42 In March 2013, we released Consultation Paper 202 *Dark liquidity and high-frequency trading: Proposals* (CP 202) and Report 331 *Dark liquidity and high-frequency trading* (REP 331).

43 In CP 202, we proposed a number of changes and additions to the ASIC market integrity rules in response to the impact of dark liquidity and automated trading activities on the Australian market.

44 This included, among other things, making a new rule that:

(a) expressly prohibited a market participant from paying direct cash payments or cash rebates to other market participants or Australian financial services (AFS) licensees for the opportunity to handle or execute their orders; and

(b) allowed soft dollar incentives for arranging the execution of orders in certain circumstances only (see Proposal D4 in CP 202).

45 We also proposed to include additional guidance on how the obligations in the proposed rule may affect securities dealers and other AFS licensees.

Industry feedback

46 The response from industry to this proposal in CP 202 was mixed. While some respondents supported the proposal to ban hard dollar payments, others noted that it can be of commercial benefit to clients: see paragraphs 61–63 of Report 364 *Response to submissions on CP 202 Dark liquidity and high-frequency trading: Proposals* (REP 364).

47 We also received limited feedback from industry on our proposed treatment of soft dollar incentives. Some respondents raised concerns about the application of the draft rule in this regard—for example:

(a) whether the draft rule would require disclosure before each order; or

(b) whether soft dollar benefits need to enhance the quality of each order or a number of orders (see paragraph 63 of REP 364).

Our regulatory response

48 Following consultation, we amended the proposal to its current form. We also issued guidance on order incentives, including soft dollar incentives, in updates to our regulatory guide: see RG 265 at RG 265.514–RG 265.524.

49 In REP 364, we stated that we would continue to monitor the nature of payment for order flow in our markets and take further regulatory action if we formed the view that conflicts were not being adequately managed in relation to those payments.

B Amending the prohibition on order incentives

Key points

Our position on payment for order flow arrangements is well established. In our view, the harms outweigh the benefits.

The current prohibition on order incentives does not deal with certain payment for order flow scenarios, such as payments that occur between non-market participants.

To close this regulatory gap, we are proposing to amend the rules and our guidance. In doing so, we are also proposing to simplify the concept of 'negative commission'.

Our proposal is a proactive measure in response to evolving market practices, and the increasing scrutiny of payment for order flow in other jurisdictions.

Proposal

B1 We propose to amend the prohibition on order incentives in Part 5.4B of the Securities Markets Rules to:

(a) simplify the concept of 'negative commission', which is currently set out in Rule 5.4B.1(2) (and referred to as 'net cost');

(b) include in the current prohibition, payments that are made to an 'associate' (defined in Rule 5.4B.1(2)) of the other person;

(c) require a market participant to take reasonable steps, in circumstances where the market participant handles or executes orders as a result of an arrangement with another person, to ensure that the other person has not made a cash payment to a third party (or an 'associate' of the third party) for that third party's orders (or their client's orders), where the value of that cash payment exceeds any payment made by the third party to the other person for directing those orders to the other person; and

(d) prohibit a market participant (or an 'associate' of the market participant, defined in Rule 5.4B.1(4)) from accepting a cash payment from another person for directing the market participant's orders to that person, where that cash payment exceeds any payment made by the market participant to the other person for directing those orders to the other person.

See draft Rule 5.4B.1 in the appendix to this paper.

Your feedback

B1Q1 Do you agree with our proposal? Please give reasons for your answer.

B1Q2 Do you think there are other ways that entities may seek to circumvent the rules (including the proposed amendments) and engage in payment for order flow? For example, where payment for order flow occurs between two entities that have no direct relationship to the market participant. Do you think we should make further amendments to our rules or take other steps, such as updating our guidance, to address this?

B1Q3 Will the proposal result in any changes to your systems and procedures or increased one-off or ongoing compliance or administrative costs? Please outline the impact and give an estimate of these costs.

B2 We propose to update our guidance in RG 265 to reflect the proposed amendments and to clarify our expectations around what constitutes adequate 'reasonable steps': see paragraph 60.

Your feedback

B2Q1 Do you agree with our guidance on what might constitute 'reasonable steps' for the purposes of draft Rule 5.4B.1(1)? Do you think we should include other steps?

Rationale

50 Our policy position on payment for order flow arrangements is well established. These arrangements can result in poor client outcomes due to conflicts of interest. They can also impact liquidity and pricing on lit exchange markets and pricing for off-market execution which references lit market prices. In our view, these harms outweigh the benefits: see paragraphs 11–26.

51 Payment for order flow is not commonplace in the Australian equity market. Our current prohibition was introduced in 2013, as a proactive measure to circumvent the emergence of this practice in Australia.

52 Since then, we have observed continued growth of payment for order flow arrangements, mostly in the United States. There is also increasing scrutiny from other regulators: see paragraphs 28–36.

Closing the regulatory gap

53 Non-market participants are not subject to the market integrity rules. This could lead to the emergence of payment for order flow arrangements among these entities: see Example 1 below.

54 The current prohibition also does not prohibit a market participant from selling client order flow to another person: see Example 2 below. In the US market it is common for retail brokers to sell retail client order flow to wholesale brokers.

55 We also understand that there may be circumstances where the payment for order flow is paid to an 'associate' of the person that is selling the client

order flow. For example, a market participant buys client order flow from a non-market participant and the market participant pays the non-market participant's subsidiary. In this example, our current prohibition only prohibits the market participant from paying the non-market participant.

56 To ensure that we continue to take a proactive approach in circumventing the emergence of payment for order flow in the Australian market and the harms associated with it, we propose to amend the rules to close this regulatory gap.

57 We are mindful that, notwithstanding our proposed amendments, there may be other business models or payment structures that emerge, which sit outside our rules (current or proposed). We will continue to monitor developments in the Australian market and take appropriate steps as required.

The concept of 'negative commission'

58 The current definition of 'net cost' under Rule 5.4B.1(2) in effect means that a market participant cannot pay more for order flow than the commission received by the market participant for those orders—that is, it prohibits payment for order flow if it results in a 'negative commission'.

59 In closing this regulatory gap, we are also proposing to simplify this definition. The underlying regulatory intent is the same.

What are 'reasonable steps'?

60 For the purposes of draft Rule 5.4B.1(1), 'reasonable steps' might include one or more of:

(a) incorporating terms or clauses in the market participant's agreement with that person that deal with the requirements under Part 5.4B;

(b) asking the person (e.g. during the on-boarding process) whether that person does, or intends to, engage in a payment for order flow arrangement that contravenes Part 5.4B;

(c) obtaining an undertaking from that person (e.g. during the on-boarding process) that the person will not engage in a payment for order flow arrangement that contravenes Part 5.4B; and

(d) obtaining an annual declaration from the person that the person has not engaged in a payment for order flow arrangement that contravenes Part 5.4B.

61 We will update our guidance in RG 265 to reflect the proposed amendments, and to clarify our expectations around what may constitute 'reasonable steps' for the purposes of draft Rule 5.4B.1(1).

Examples of payment for order flow scenarios

62 The following examples illustrate the types of payment for order flow scenarios that our proposal seeks to address.

Example 1

Payments between non-market participants

ABC Broking (a market participant) has an arrangement with XYZ Trader (a liquidity provider). Under this arrangement, XYZ Trader directs orders through to ABC Broking.

XYZ Trader has a separate arrangement with SD Pty Ltd (a securities dealer). Under this arrangement, XYZ Trader:

- charges SD Pty Ltd $10 to direct client order flow through XYZ Trader;
- pays SD Pty Ltd $11 for its client order flow (i.e. a payment for order flow arrangement); and
- crosses SD Pty Ltd's client orders and reports the transaction, or otherwise sends SD Pty Ltd's client orders to the market, through ABC Broking.

The payment made by XYZ Trader to SD Pty Ltd (of $11) for the client order flow exceeds the cost (of $10) charged by XYZ Trader to SD Pty Ltd (i.e. a negative commission).

Under draft Rules 5.4B.1(1) and (2), ABC Broking must take reasonable steps to ensure that XYZ Trader is not engaging in this payment for order flow arrangement with SD Pty Ltd.

Example 2

A market participant sells client order flow

ABC Broking (a market participant) has an arrangement with XYZ Trader (a liquidity provider). Under this arrangement, XYZ Trader directs orders through ABC Broking.

XYZ Trader has a separate arrangement with MP Broking (a market participant). Under this arrangement, XYZ Trader:

- charges MP Broking $10 to direct client order flow through XYZ Trader;
- pays MP Broking $11 for its client order flow (i.e. payment for order flow); and
- crosses MP Broking's client orders and reports the transaction, or otherwise sends MP Broking's client orders to the market, through ABC Broking.

The payment made by XYZ Trader to MP Broking (of $11) for the client order flow exceeds the cost (of $10) charged by XYZ Trader to MP Broking (i.e. a negative commission).

The sale of client order flow by MP Broking is therefore prohibited by draft Rules 5.4B.1(3) and (4).

Competition effects

63 Arrangements involving direct cash payments do not appear to be commonplace in the Australian market. Therefore we expect that our proposal will have a limited impact on the current business models of market participants and other market intermediaries. This is consistent with the view we took when we introduced the current prohibition in 2013.

Note: See *Regulation Impact Statement: Australian market structure: Further proposals* (PDF 1.57 MB), June 2013, at paragraph 378.

64 If implemented, our proposal could impede new entrants to the market that had intended to establish payment for order flow arrangements which would now be prohibited or constrained. From our engagement with industry we understand that new entrants are observing the outcome of developments in the United States, before taking further steps in Australia. Therefore, we consider the impact of our proposal on new entrants to be minimal.

65 Payment for order flow arrangements can result in a concentration of market share among one or more market intermediaries (e.g. those that offer the best incentives). For example, in the United States, the top two internalisers (Citadel Securities and Virtu Financial) have higher market share than either the New York Stock Exchange or NASDAQ.

Note: See H Mittal & K Berkow 2021, *The good, the bad and the ugly of payment for order flow* (PDF 1.89 MB), BestEx Research. 3 May.

66 This concentration of market share can have a negative impact on competition. This is because it gives those market intermediaries an excessive competitive advantage and can push other smaller market intermediaries out of the market.

67 The introduction of payment for order flow arrangements in our market can benefit retail clients in the form of lower-cost or even zero-cost brokerage. In Australia, we have already observed a significant reduction in brokerage costs. Lower-cost brokerage may benefit consumers who make smaller and more regular contributions to their portfolio, or rebalance their portfolios at low-to-no cost.

68 However, further reductions in brokerage, or zero-cost brokerage, may also encourage retail investors to trade excessively or to take a short-term gambling mentality, rather than longer term accumulation, which could harm their financial wellbeing: see paragraphs 11–13.

69 We consider that any benefit obtained from lower brokerage facilitated by payment for order flow would be more than offset by poor execution price, and negative impacts on liquidity and market integrity: see paragraphs 11–26.

C Soft dollar incentives for order flow

Key points

The current prohibition on order incentives applies to cash payments (i.e. monetary benefits) only.

Soft dollar (i.e. non-monetary) incentives are dealt with under RG 265.

We seek feedback on our current approach to soft dollar incentives for order flow.

Our current approach to soft dollar incentives for order flow

70 Soft dollar incentives for order flow can take a number of forms, including:

(a) free or subsidised business equipment or services, such as technology offerings (e.g. trading software) and information technology support;

(b) the provision of services in conjunction with trade execution, such as data and analytical tools; and

(c) payment of a security dealer's settlement fees.

71 Under RG 265, a market participant is required to consider the following circumstances when giving or receiving soft dollar incentives for handling and executing orders:

(a) ensure there is no impact on the market participant's best execution obligations under Chapter 3 of the Securities Markets Rules and as discussed in Section G of RG 265;

(b) disclose to clients details of any incentives offered to and received by the market participant in a comprehensive, accurate and understandable way before the service is provided; and

(c) ensure the incentive enhances the quality of the financial service provided to the client: see RG 265 at RG 265.521–265.524.

Feedback sought on our current approach

Question

C1 We seek your feedback on our current approach to soft dollar incentives in the context of payment for order flow.

Your feedback

C1Q1 Do you think our current guidance on soft dollar incentives in RG 265 adequately addresses the risks and harms associated with soft dollar incentives for order flow?

C1Q2 Do you think we should incorporate the controls on soft dollar incentives (that are currently provided in our guidance in RG 265) expressly within our rule framework? If so, do you think our guidance can be directly transferred into our rules or do you think these controls need to be further revised?

C1Q3 Alternatively, do you think we should make further amendments to Part 5.4B to expressly prohibit soft dollar incentives? If so, what forms of soft dollar incentives should be prohibited? Please give reasons for your answer.

D Regulatory and financial impact

72 In developing the proposals in this paper, we have carefully considered their regulatory and financial impact. On the information currently available to us we think they will strike an appropriate balance between:

(a) promoting a fair and efficient market structure; and

(b) enhancing investor confidence in the market.

73 Before settling on a final policy, we will comply with the Australian Government's regulatory impact analysis (RIA) requirements by:

(a) considering all feasible options, including examining the likely impacts of the range of alternative options that could meet our policy objectives;

(b) if regulatory options are under consideration, notifying the Office of Best Practice Regulation (OBPR); and

(c) if our proposed option has more than a minor or machinery impact on business or on the not-for-profit sector, preparing a Regulation Impact Statement (RIS).

74 All RISs are submitted to the OBPR for approval before we make any final decision. Without an approved RIS, ASIC is unable to give relief or make any other form of regulation, including issuing a regulatory guide that contains regulation.

75 To ensure that we are in a position to properly complete any required RIS, please give us as much information as you can about our proposals or any alternative approaches, including:

(a) the likely compliance costs;

(b) the likely effect on competition; and

(c) other impacts, costs and benefits.

See 'The consultation process', p. 4.

Appendix: Draft amended Part 5.4B of the ASIC Market Integrity Rules (Securities Markets) 2017

This appendix sets out the draft amended Part 5.4B.

Part 5.4B Order incentives

5.4B.1 Prohibition on Order incentives

(1A) In this Rule ***Order*** means an instruction to purchase or sell, or an instruction to amend or cancel a prior instruction to purchase or sell:

(a) an Equity Market Product; or

(b) a CGS Depository Interest.

(1) Where a Market Participant handles or executes an Order as a result of an arrangement with another person (the ***other person***) to direct Orders to the Market Participant, the Market Participant:

(a) must not, indirectly or directly, make a cash payment to the other person or an associate of the other person for the opportunity to handle or execute those Orders, if the cash payment is greater than the dollar value of the Market Participant's Commission in relation to the Orders; and

(b) must take reasonable steps to ensure that the other person has not, indirectly or directly, made a cash payment to a third party (the ***third party***) or an associate of the third party to procure the handling or execution of Orders from the third party or a client of the third party, if the cash payment is greater than the dollar value of any payment made, or to be made, by the third party (including a payment made, or to be made, by a client of the third party) to the other person, for directing the Orders to the other person.

(2) For the purposes of subrule (1):

associate of the other person or third party includes any director, officer, employee or associated or related company of the other person or of the third party, as the case may be.

Market Participant's Commission in relation to the Orders means the dollar value of any payment received, or to be received, by the Market Participant (including commission received, or to be received, from a client of the other person) for the opportunity to handle or execute the Orders.

(3) Where a Market Participant directs an Order to another person (the ***other person***) as a result of an arrangement for the Market Participant to direct Orders to the other person, the Market Participant must not, and must procure that its associates do not, indirectly or directly, accept a cash payment from the other person for directing Orders to the other

person, if the cash payment is greater than the dollar value of any payment made, or to be made, by the Market Participant (including a payment made, or to be made, by a client of the Market Participant) to the other person, for directing the Orders to the other person.

(4) For the purposes of subrule (3), an ***associate*** of a Market Participant includes any director, officer, employee or associated or related company of the Market Participant.

Key terms

Term	Meaning in this document
AFS licensee	A person who holds an Australian financial services licence under s913B of the Corporations Act Note: This is a definition contained in s761A of the Corporations Act.
ESMA	European Securities and Markets Authority
FCA	Financial Conduct Authority (UK)
MiFID II	Markets in Financial Instruments Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014, on markets in financial instruments
NBBO (national best bid and offer)	The highest bid (best buying price) and the lowest offer (best selling price) for a product that is available across all pre-trade transparent order books at the time of the transaction
payment for order flow	An arrangement where a person receives a payment from another person in exchange for sending its clients' order flow to them. This can include payments between market participants or other market intermediaries such as securities dealers or liquidity providers, or a combination of both
SEC	Securities and Exchange Commission (US)
Securities Markets Rules	ASIC Market Integrity Rules (Securities Markets) 2017
VWAP	Volume weighted average price

List of proposals and questions

Proposal	Your feedback
B1 We propose to amend the prohibition on order incentives in Part 5.4B of the Securities Markets Rules to: (a) simplify the concept of 'negative commission', which is currently set out in Rule 5.4B.1(2) (and referred to as 'net cost'); (b) include in the current prohibition, payments that are made to an 'associate' (defined in Rule 5.4B.1(2)) of the other person; (c) require a market participant to take reasonable steps, in circumstances where the market participant handles or executes orders as a result of an arrangement with another person, to ensure that the other person has not made a cash payment to a third party (or an 'associate' of the third party) for that third party's orders (or their client's orders), where the value of that cash payment exceeds any payment made by the third party to the other person for directing those orders to the other person; and (d) prohibit a market participant (or an 'associate' of the market participant, defined in Rule 5.4B.1(4)) from accepting a cash payment from another person for directing the market participant's orders to that person, where that cash payment exceeds any payment made by the market participant to the other person for directing those orders to the other person. See draft Rule 5.4B.1 in the appendix to this paper.	B1Q1 Do you agree with our proposal? Please give reasons for your answer. B1Q2 Do you think there are other ways that entities may seek to circumvent the rules (including the proposed amendments) and engage in payment for order flow? For example, where payment for order flow occurs between two entities that have no direct relationship to the market participant. Do you think we should make further amendments to our rules or take other steps, such as updating our guidance, to address this? B1Q3 Will the proposal result in any changes to your systems and procedures or increased one-off or ongoing compliance or administrative costs? Please outline the impact and give an estimate of these costs.
B2 We propose to update our guidance in RG 265 to reflect the proposed amendments and to clarify our expectations around what constitutes adequate 'reasonable steps': see paragraph 60.	B2Q1 Do you agree with our guidance on what might constitute 'reasonable steps' for the purposes of draft Rule 5.4B.1(1)? Do you think we should include other steps?

Question	Your feedback
C1 We seek your feedback on our current approach to soft dollar incentives in the context of payment for order flow.	C1Q1 Do you think our current guidance on soft dollar incentives in RG 265 adequately addresses the risks and harms associated with soft dollar incentives for order flow? C1Q2 Do you think we should incorporate the controls on soft dollar incentives (that are currently provided in our guidance in RG 265) expressly within our rule framework? If so, do you think our guidance can be directly transferred into our rules or do you think these controls need to be further revised? C1Q3 Alternatively, do you think we should make further amendments to Part 5.4B to expressly prohibit soft dollar incentives? If so, what forms of soft dollar incentives should be prohibited? Please give reasons for your answer.