Crystal Ball Series:

When Wealth Managers Control Order Routing * †

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"Case Studies" presents a case pertinent to contemporary issues and events in investment management, and the *Crystal Ball* sub-series looks beyond current market structures to consider how emerging technologies may reshape the practice of investment management. Insightful and provocative questions are posed at the end of each case to challenge the reader. Each case is an invitation to the critical thinking and pragmatic problem solving that are so fundamental to the practice of investment management.

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Securities tokenization – where ownership and transaction records are maintained on a public blockchain – is usually discussed as a way to accelerate settlement, reduce administrative costs, and broaden market access. However, its more disruptive effect may occur before settlement. If wealth managers can execute client orders directly on-chain, they may no longer need to route every order through a traditional broker. Instead, they could retain the authority to choose how an order is routed, and the economic value attached to that choice could migrate from brokerage firms to wealth management firms.

Traditionally, wealth managers exercise their discretionary authority to place orders through brokerage firms on behalf of their clients. Brokers hold clients' securities in street name, maintain records of the beneficial owners, aggregate orders, and decide where to route the orders for execution. Tradable security tokens – also known as tokenized securities – introduce another possible structure: the securities can be held in investors' whitelisted on-chain accounts, and orders to buy and sell security tokens can be submitted directly to a blockchain-based alternative trading system (ATS) without first passing through the client's customary broker.

The Arca U.S. Treasury Fund provides an early proof of concept. Launched in 2020, this registered closed-end fund directly issued its shares as ERC-20 compliant tokens,[1] known as ArCoins, which were transferable between whitelisted investors on the Ethereum blockchain.[2] Though broad adoption remained elusive at first, a blockchain-friendly administration soon followed… and now, in the conveniently distant enough (but hopefully not too distant) future, the *Crystal Ball Series* places us in an environment where blockchain-integrated transfer agents have

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[1] The ERC-20 token standard defines a standard interface for implementing fungible tokens. See Vogelstellar, Fabian, and Vitalik Buterin, "ERC-20: Token Standard," Ethereum Improvement Proposals, November 19, 2015, accessed at https://eips.ethereum.org/EIPS/eip-20.

[2] See Bovaird II, Charles Lloyd, "Arca Uses Ethereum In First SEC-Registered Fund For Digital Shares," Forbes, July 6, 2020, accessed at https://www.forbes.com/sites/cbovaird/2020/07/06/arca-launches-first-sec-registered-fund-to-offer-digital-shares/.

been broadly approved, blockchain records constitute the determinative ownership record, stablecoins are routinely used for payment and settlement, and an expanding universe of security tokens trades across competing on-chain ATS's.

Cydney, who heads strategic growth at the prominent wealth management firm Creative Frontier Advisors, has been following the latest developments in securities tokenization closely. She envisions a new era in which Creative Frontier could use its discretionary authority to determine not only which securities to buy or sell for its clients, but also whether to route the orders (i) directly to an on-chain ATS, market maker, or other liquidity provider, or (ii) through a brokerage firm, which would aggregate Creative Frontier's orders with orders from other clients and route them to an ATS or market maker.

Cydney argues that Creative Frontier's bargaining power would increase substantially under this new framework because the firm would no longer be confined to the execution arrangements offered by whichever broker already has custody of a given client's assets. Creative Frontier could instead choose among a broader set of brokers that compete for its order flow or route its orders directly to an ATS or liquidity provider. Brokers that continue to aggregate and monetize the flow may therefore have to share more of the execution-related economics with Creative Frontier. Cydney proposes that Creative Frontier move early, using some of the routing-related benefits to lower advisory fees and attract new clients.

Robin and Rick, founding partners of Creative Frontier, are intrigued but cautious. Robin notes that Cydney's proposal sounds like the Robinhood playbook for PFOF (i.e., payment for order flow). The arrangement could be quite lucrative, but it would introduce regulatory concerns in addition to the operational and financial risks inherent in implementing a novel business model. Robin's primary concern is whether, when, and how accepting compensation directly tied to securities transactions might place Creative Frontier in the SEC's crosshairs for wandering into the territory of effecting transactions as an unregistered broker. He also vaguely recalls a 2020 SEC enforcement action involving affiliated investment advisors that received PFOF and ultimately paid $1 million in penalties.

Rick, however, recalls the circumstances and points out that the SEC did not charge the advisory firms just for accepting PFOF but for the material misrepresentations they made regarding the arrangement.[3] According to the SEC's order,[4] the executing brokers paid between 1.25 and 1.5 cents per share of order flow with the mutual understanding that clients' execution prices would be adjusted by two to three cents per share to allow the brokers to recoup the PFOF and earn a profit. Although the advisors and executing brokers shared this understanding, the clients weren't informed of the arrangement and were even falsely assured that execution prices would not be adversely impacted.

Rick also notes that investment advisors already recommend brokerage firms to clients and may receive economic benefits associated with those relationships, subject to appropriate disclosure and management of the fiduciary conflicts that arise.[5] Thus, Rick hopes that an advisor's selection of execution providers and exercise of order-routing authority in exchange for PFOF won't be treated as fundamentally different from what non-broker investment advisors already do when exercising custodian-selection authority or influence.

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[3] See U.S. Securities and Exchange Commission (Press Release), "SEC Charges Affiliated Advisers for Misrepresentations About Payment for Order Flow Arrangements," August 5, 2020, accessed at https://www.sec.gov/newsroom/press-releases/2020-175.

[4] See U.S. Securities and Exchange Commission, "In the Matter of WBI Investments, Inc. and Millington Securities, Inc." August 5, 2020, Securities Exchange Act Release No. 89481 and Investment Advisers Act Release No. 5557, Administrative Proceeding File No. 3-19904, accessed at https://www.sec.gov/files/litigation/admin/2020/34-89481.pdf.

[5] See U.S. Securities and Exchange Commission (Staff Bulletin), "Standards of Conduct for Broker-Dealers and Investment Advisers Conflicts of Interest," August 3, 2022, accessed at https://www.sec.gov/about/divisions-offices/division-trading-markets/broker-dealers/staff-bulletin-standards-conduct-broker-dealers-investment-advisers-conflicts-interest.

Agreeing to set aside the conversation until they can consult counsel, Robin's next concern is the self-custody aspect of security tokens. Presumably, direct registration would require clients to maintain on-chain accounts and safeguard their private keys, which is impractical and scary. He and Rick agree that most clients would not accept this responsibility, undermining the scale necessary to make Creative Frontier's order flow valuable.

However, Cydney reassures them that on-chain ownership does not require clients to manage their assets personally, explaining that the widely adopted ERC-20 token standard, which forms the basis for securities tokenization on Ethereum and other compatible blockchains, includes an approval and allowance mechanism through which custody, investment discretion, and routing authority can be implemented as separable institutional functions. That is, a qualified custodian could maintain custody of the client's security-token holdings, while Creative Frontier could receive limited authority to initiate permitted transactions, such as order routing, on the client's behalf. Overall, security tokens allow Creative Frontier to separate investment advice from brokerage custody while recombining investment advice with routing authority.

With the managing partners in agreement, Cydney whispers a tiny *"yay"* and excitedly rushes off to map out the next steps.

Questions:

1. Could securities tokenization meaningfully shift order-routing authority from brokerage firms to wealth managers?
2. Why does the form of compensation – such as per-share payment versus a broader package or executive services that includes settlement, reporting, or fee concessions – matter?

3. When does a wealth manager that selects venues and monetizes order flow functionally or legally become a broker? That is, at what point do direct execution, transaction-based compensation, and smart order routing cross the line from investment advice into brokerage activity?

References

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