FESE

The issue of payment for order flow

Brussels, 25th May 2021

Payment for order flow (PFOF) has become more and more widespread over the last years and has recently gained significant attention,[1] following the GameStop short squeeze in the US and related developments like the growth of discount brokerages. A PFOF arrangement is one in which a broker systematically routes its retail order flow to a single market maker, a systematic internaliser (SI) or other execution venue in return for a payment. PFOF is however detrimental for the investor as it may increase bid-ask spreads, distort competition, and make the price formation process less transparent and efficient. Although the broker is obliged to act in the best interest of its clients, it has an economic incentive to direct order flow to the execution venue that offers the highest payment to the broker. Consequently, the best execution duty of the broker gets compromised. This conflict of interest is systematic in the retail market and FESE believes that it is currently not appropriately addressed. Whilst in some Member States PFOF is banned, such as in the Netherlands, other Member States are less strict. This creates regulatory arbitrage opportunities in the EU.

FESE calls for action to foster supervisory convergence in the EU: first, transparency around current market practices in Member States is needed. If regulators conclude that they have no means of proper oversight of these market practices, FESE recommends a policy change to bring supervisors into a position where they have access to information through stricter rules on broker information disclosures. Second, if the conclusion would be that requirements under the current regulation regarding best execution and conflicts of interest are not adhered to systematically, FESE suggests that regulators explore the possibility to change MiFID II/MiFIR and ban PFOF across the EU.

1. Payment for order flow can be inconsistent with best execution

Whilst PFOF may imply lower explicit trading costs, this does not mean that investors are obtaining the best possible execution quality. The best execution regime under Article 27 of MiFID II establishes that investment firms executing (or arranging for the execution of) trades on behalf of clients must take all reasonable steps to obtain the best possible result for their clients. These steps include, amongst others, considering the price, fees, speed, and probability of execution of the order, explaining execution policies in detail, and disclosing the top execution venues used and the quality of execution. Any remuneration, discount, or non-monetary benefit for routing client orders to a particular venue that would infringe the requirements on conflicts of interest or inducements is banned. Investment firms are also obliged to inform and obtain the consent of clients for executing orders on SIs or over-the-counter (OTC).

As a result, while some platforms may offer commission-free trading, they do not always provide best execution and may cost more to retail investors, as they can lose out in terms

[1] Steven Maijoor, “ECON Exchange of Views in Relation to GameStop Share Trading and Related Phenomena” (European Parliament, 2021).

beyond the execution price for their order.[2] Furthermore, as brokers are incentivised to route orders to the bidder offering the highest payment rather than to the venue offering the best execution, there may be price deterioration.[3] Retail brokers may even limit the choice of venues for retail investors to only those that offer PFOF. When choosing an execution provider, retail investors are thus best served by finding a broker that will execute their orders on the venue that offers the best execution conditions for the client, taking also into account transaction costs, the natural liquidity present on the venue, and the overall quality of execution.

2. Payment for order flow harms competition and transparency

PFOF leads to an environment where there is no longer competition on transparent prices but only on market makers and execution venues paying for getting order flow. Hence, PFOF has a clear connection with competition and transparency issues. Transparent trading plays a central role in price formation as a well-functioning market is where information is easily available. But trading in dark venues reduces the information available for the price formation process and the depth in limit order books, which can have adverse selection risks and result in higher spreads.[4] By intercepting retail order flow, SIs and other execution venues face no competition and deprive the main market of liquidity with uninformed orders being diverted from transparent venues, increasing spreads.[5] Consequently, the optimal balance between those price referencing models with limited pre-trade transparency and transparent systems is undermined.

PFOF should be contrasted with rebate and retail liquidity provider models in which choice and competition prevail. These schemes apply only for market makers dealing on own account, happen in a transparent and non-discriminatory manner, and contribute to enhanced liquidity. This is in contrast to models that implement solutions that allow liquidity providers to provide quotes that can be filled only against retail order flow.

3. Payment for order flow creates conflicts of interest

PFOF raises several conflicts of interest:[6]

- Brokers may seek to maximise PFOF revenue at the expense of best execution given the incentive to direct order flow to the execution venue that offers the highest payment.
- The income the SI or other execution venues receive increases with spreads, which may increase with internalisation and lower transparent trading.
- Market makers may have an informational advantage stemming from an advanced understanding of order flow.

---

[2] See Christine A. Parlour and Uday Rajan, "Payment for Order Flow," *Journal of Financial Economics* 68, no. 3 (June 1, 2003): 379–411, https://doi.org/10.1016/S0304-405X(03)00071-0. This is especially relevant without requirements like the U.S. order protection rule.

[3] CFA Institute, "Payment for Order Flow in the United Kingdom" (London, 2016).

[4] Carole Comerton-Forde and Talis J. Putniņš, "Dark Trading and Price Discovery," *Journal of Financial Economics* 118, no. 1 (October 1, 2015): 70–92, https://doi.org/10.1016/j.jfineco.2015.06.013.

[5] Parlour and Rajan, "Payment for Order Flow."

[6] See also Robert H. Battalio and Tim Loughran, "Does Payment for Order Flow to Your Broker Help or Hurt You?," *Journal of Business Ethics* 80, no. 1 (June 13, 2008): 37–44, https://doi.org/10.1007/s10551-007-9445-x.

Consequently, the MiFID II requirements on conflicts of interest and inducements may be incompatible with PFOF. Concretely, according to Article 23 of MiFID II, investment firms must take all appropriate steps to prevent or manage conflicts of interest and establish a policy that sets out the measures taken to ensure that. Article 24 of MiFID II establishes the obligation of investment firms to act honestly, fairly, and professionally in accordance with the interests of its clients and provide information that is not misleading to clients. As per the Article, inducements must be justified by a higher level of service; must not benefit the firm without tangible benefit to the client; and for ongoing inducements, there must be ongoing benefits to the client. In addition, firms must disclose and keep records of those inducements. However, the obligation of the broker to act in the best interests of its client may hereby be compromised where PFOF prevents clients from getting best execution.

4. A way to address payment for order flow

Whilst MiFID II/MiFIR put in place some safeguards against conflicts of interest and poor execution practices as outlined above, a review of PFOF models should be undertaken with a view to ensuring that best execution is achieved and conflicts of interest are avoided.

FESE, therefore, welcomes that ESMA and the European Commission intend to assess PFOF practices' compatibility with MiFID II/MiFIR provisions. As part of this process, particular attention should be paid to commission-free trading.

Should ESMA and the Commission conclude that regulators and supervisors have no means of proper regulatory oversight of these market practices, rules on broker information disclosures, for example around fee schemes, could be strengthened. Further, should ESMA and national competent authorities come to the conclusion that MiFID II requirements of best execution and conflicts of interest are not adhered to systematically, they might want to consider recommending a change of the Level 1 text as part of the upcoming review of MiFID II/MiFIR to clearly prohibit PFOF.

As such a review will take some years until the application of policy changes, complementary actions could be considered in the medium term: based on the regulatory scrutiny as outlined above, ESMA might want to consider using its strengthened tools of supervisory convergence. The sharing of supervisory practices across national competent authorities would help ensure a common understanding of PFOF practices and enhance investor protection. If needed, according to the current legislation, national competent authorities have the discretion to prohibit PFOF where they find that MiFID II rules on conflict of interests and inducements are not met. In fact, this has already been done in the UK when it was still part of the EU, and in the Netherlands.

The Federation of European Securities Exchanges (FESE) represents 35 exchanges in equities, bonds, derivatives and commodities through 18 Full Members from 30 countries, as well as 1 Affiliate Member and 1 Observer Member.

At the end of April 2021, FESE members had 9,112 companies listed on their markets, of which 14% are foreign companies contributing towards European integration and providing broad and liquid access to Europe's capital markets. Many of our members also organise specialised markets that allow small and medium sized companies across Europe to access capital markets; 1,263 companies were listed in these specialised markets/segments in equity, increasing choice for investors and issuers. Through their RM and MTF operations, FESE members are keen to support the European Commission's objective of creating a Capital Markets Union.

FESE is registered in the European Union Transparency Register: 71488206456-23.

FESE
Avenue de Cortenbergh, 116, 1000 Brussels — info@fese.eu — +32 2 551 01 80