Payment for Order Flow. Position statement European Investors-VEB

17-1-2022

European Investors-VEB ('VEB') wholeheartedly support the European Commission's ambition to create a transparent, competitive and harmonised capital market. VEB are, hence, in full support of the underlying objectives of the CMU.

On PFOF, VEB wishes to canvass the following views pertaining to certain crucial matters:

- **Is PFOF in breach of MiFID II?**

Entirely in line with ESMA's *public statement* on PFOF of 13 July 2021, European Investors-VEB (VEB) submit that it is in most cases unlikely that the receipt of PFOF is compatible with MiFID II. Thus, VEB stress their view that it is better to err on the safe side.

Put differently, VEB contend that PFOF is contrary to the spirit of MiFID II. More generically, VEB are strong advocates of a categoric and generic abolishment of inducements, in whatever form or under whatever guise.

- **What practical information is available for the relationship between PFOF and execution quality?**

It's difficult to understand the relationship between PFOF and execution quality since retail brokers have no standard for reporting execution quality.

Nevertheless, VEB wish to attract your attention to the following three findings:

- **Findings of the CFA Institute regarding PFOF in the United Kingdom**

In June 2016, the CFA Institute published a position paper concerning the 2012 ban on payment for order flow arrangements in the United Kingdom.[1] The CFA concluded that:

'over the period 2010–2014, the proportion of retail-sized trades executing at the best-quoted price increased from around 65% to more than 90%, suggesting that the integrity of the order book has improved.'

According to the CFA, the ban on PFOF has positive effects on the best execution practice in the UK:

'We believe this change (banning PFOF; ed.) *is a positive one for market integrity because it implies that displayed liquidity providers are rewarded with executions at the price they quote. This reward mechanism upholds market integrity by supporting the incentive to post the displayed limit orders on which price discovery is based and should lead to more aggressive quoting and competitive pricing.*

By contrast, this outcome may be jeopardised in markets with PFOF arrangements where internalisers are able to step ahead of the quoted price on the order book by offering price improvement. It appears

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[1] https://www.cfainstitute.org/-/media/documents/article/position-paper/payment-for-order-flow-united-kingdom.pdf

that the current best execution regime in the United Kingdom appears to be working well, despite the lack of a US-style trade-through rule that explicitly prevents executions away from the best quoted price.'

- **Public.com arguments for ending participation in PFOF**

Public.com is a US-based investing platform with over one million members. It is a small but upcoming competitor of Robin Hood, valued at over one billion US dollars.

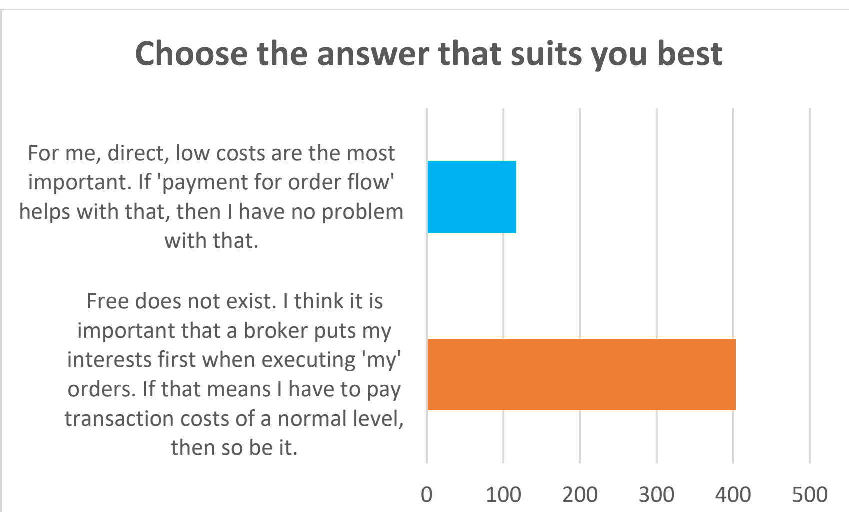
Public.com announced late February 2020 to be 'officially off PFOF'. Not participating in PFOF has become vital in the Public.com proposition 'to align our incentives with those of our members.'[2]

On 2 December 2021, Public.com disclosed evidence that 'better execution quality on average to customers (can be delivered) than (…) peers that accept PFOF form market makers. [3]

- **Survey under Dutch retail investors**

In December 2021, European Investors-VEB launched an online poll under a member group of retail investors asking their opinion about PFOF. With over 500 respondents, we consider this poll to be representative.

In a couple of questions, we asked our membership if a lack of alignment of interest, with the objective of guarantying them a lower cost of transactions, bothered them. More than 77 per cent of the respondents commented that there is more than just cost. Quality of service of the broker and transparency are vital to them, even if this results in slightly higher transaction costs compared to those in conformity with the markets.



European Investors-VEB poll among retail investors, 26-29 December 2021

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[2] https://medium.com/the-public-blog/were-officially-pfof-free-1232acf11ee8
[3] https://medium.com/the-public-blog/delivering-on-price-execution-without-pfof-27f0e6098a2f

➢ Are PFOF's conflicts of interest effectively addressed?

There is broad consensus that PFOF creates a conflict of interest between the firm and its clients. They incentivise the firm to execute its clients' orders with counterparties based on their willingness to pay commissions.

A broker can make a financial gain at the expense of its clients and have an interest in a transaction contrary to its clients' interests, which risks inferior execution outcomes and other potential consumer harms.

While the impact of PFOF may not be visible in bid-ask spreads for each transaction, it is likely to affect aggregate spreads as liquidity providers need to account for the payments made to brokers. These hidden costs make the price formation process less transparent and efficient.

In 2019, the Financial Conduct Authority published an update on its supervisory work regarding conflicts of interest and payment for order flow in the UK. This update focuses on how firms manage 'conflict of interest where they continue to charge a commission from market makers or liquidity providers (…).[4]

FCA concluded that 'most brokers we visited did not consistently identify the capacity in which they act in individual transactions. As a result, it was unclear whether they could identify the conflicts of interest that were specific to a given transaction, and so take all necessary steps to prevent or manage them through their policies and procedures.'[5]

This implies that brokers do not even come close to effectively addressing (potential) conflicts of interest between brokers and their clients regarding PFOF.

➢ What do retail investors think?

In VEB's view, there is a persuasive argument in favour of the categoric abolition of PFOF. In line with our view, noted above, that PFOF is against the spirit of MiFID II, VEB uphold that payment of PFOF risks an appearance of a conflicting interest. To VEB, this is self-evident. Where a financial service provider receives any payment for the service he provides to his principal from a party other than his principal, the latter is likely to fear that the service provider may have the interest of the payer prevail over his (*ie* the principal's). VEB promotes financial markets regulation that advances the integrity of the financial system. For the latter, retaining the confidence of retail investors should always be borne in mind as a critical element.

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[4] https://www.fca.org.uk/publication/multi-firm-reviews/payment-for-order-flow-pfof.pdf, p.3
[5] https://www.fca.org.uk/publication/multi-firm-reviews/payment-for-order-flow-pfof.pdf, 2.26