BETTER FINANCE

The European Federation of Investors and Financial Services Users
Fédération Européenne des Épargnants et Usagers des Services Financiers

Transparency and Best Execution for Retail Traders and Investors

Position Paper on
Payment for Order Flows

May 2022

SUMMARY POLICY RECOMMENDATIONS

PFOF: At what cost do we trade without costs?

Retail trading must be simple, transparent, cost efficient, and done in the best possible conditions for individual, non-professional (“retail”) investors. To achieve this, BETTER FINANCE puts forward a series of recommendations in relation to best execution of retail orders and payments for order flows (PFOF or, more adequately PFROF: Payment for retail order flow).

Best solution:

Ban payments for routing "retail" trade orders

- Commissions, rebates, remunerations, and other forms of payments received for routing "retail" client orders to execution venues should be either prohibited or passed in full to the customer.

Alternatively

Require all retail brokers to offer clearly, easily, and on the same level at least one “lit” regulated market venue alongside “dark” ones to retail clients

- At least one “lit” market venue offer (in terms of matching rules, pre- and post-trade transparency of data, etc.) should be put on a strictly equal footing with the dark ones and the retail investor informed of the differences between “lit” and “dark”.

Impose adequate disclosure and reporting on PFROF

- Brokers must gather data and report the total amounts of PFOF that received from market makers, including the attribution split (broker - client) for each trade;
- Mantain and streghten RTS 27 and 28 reports;
- Brokers who receive PFROF and paying parties must report total amounts of PFROF for each beneficiairy and for each payor to NCAs and those must make them public as in the US.

Ensure best execution of retail client orders

- Strenghten best execution rules by defining it as obtaining the best price, net of commissions and other costs, for the retail tradeclarify best execution rules with best execution primarily defined as obtaining the best price, net of commissions and other costs, for the retail trade.

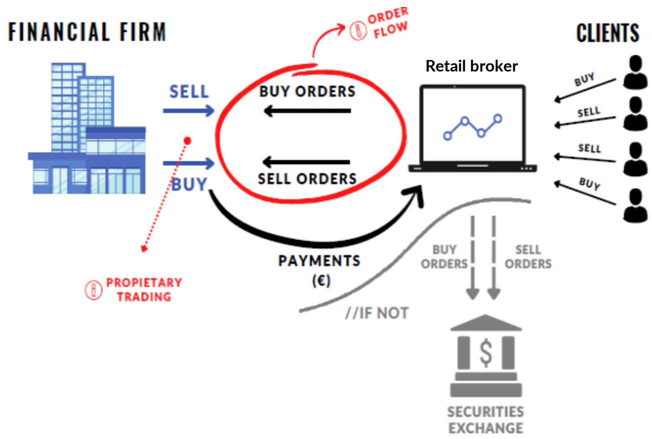
Impose a low LIS threshold for internalisers

- Require that systematic internalisers can only execute trades whose value is at least equal or higher to a Large-in-Scale (LIS) threshold.

INTRODUCTION

Payments for retail order flow ("PFOF" or more adequately "PFROF") are commissions paid by financial firms to brokers for directing their retail clients' orders (buy/sell) to them for execution. These financial firms execute the brokers' retail clients' orders, meaning they:

- act as a buyer for clients offering to sell financial instruments, or
- act as a seller for clients asking to buy financial instruments.



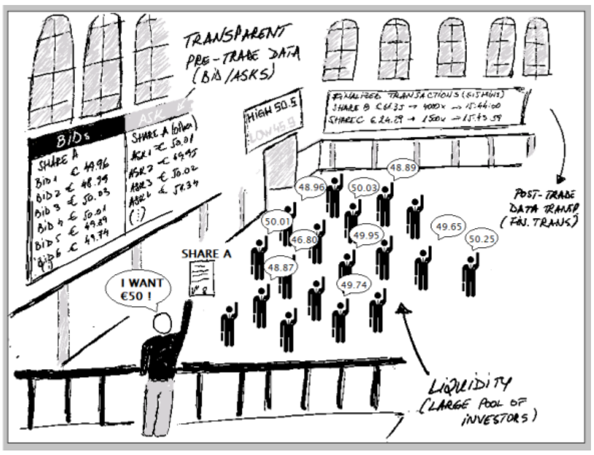
In such cases, brokers' clients do not trade with other investors on a regulated market (such as the Paris or Warsaw stock exchanges), but instead enter bilateral trades, called over-the-counter (OTC). These trades are opaque (non-transparent) and differ from the market price (potentially from the best execution price as well).

Source: © BETTER FINANCE, 2022

PFOF create a revenue stream for brokers, allowing them to reduce upfront (explicit) fees or even charge zero commissions for trading on their platform. However, as BETTER FINANCE firmly believes there is no "free lunch", this position paper presents our research and arguments against PFOF and internalisation for retail investors.

How are financial instruments traded?

Source: © BETTER FINANCE, 2021



Multilateral "lit" market venues (Securities exchanges and MTFs[1]) provide a trading place where a large number of sellers and buyers of financial instruments (shares, bonds, ETF units, etc.) can compete with one another in offers and bids. This competition is the basis of the *price discovery mechanism*, as the value of any financial instrument is determined by how much other investors are willing to pay for it. In exchange for using the marketplace,[2] securities exchanges charge participants a fee,[3] which is their main revenue source.[4]

[1] According to Art. 4(22) MiFID II, a multilateral trading facility (MTF) means "*a multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments–in the system and in accordance with non-discretionary rules–in a way that results in a contract in accordance with Title II of this Directive*".
[2] There are other services securities exchanges can offer to investors, but traditionally those three make the largest slice of the revenue.
[3] Retail investors cannot participate directly on the securities exchange, but only through intermediaries. Exchanges thus charge intermediaries, who pass the fees onto their clients.
[4] As explained in footnote 1 above, securities exchanges can have other revenue streams, for instance clearing, settlement, selling market data or providing research, but these are marginal sources of income.

In short, a securities exchange's algorithm will match a buy bid with the best available sell offer (in terms of price, volume, and timestamp) and vice versa.[5] On the other hand, financial firms can execute brokers' clients orders through proprietary trading: the firm receives (sees) the clients' order flows and will either sell/buy its own securities or sell/buy short, or go to the marketplace and buy/sell the necessary in order to satisfy the trading orders. This is called *internalisation* and the financial firm can turn a profit from the difference (*spread*) between the price at which the firm acquires or sells a financial instrument on the market (or with other dealers) and the price at which the firm sells or buys the financial instrument from the brokers' clients.

PFOF: Beneficial or not for retail traders?

Although it can bring several advantages, unfortunately PFOF can also create the illusion of free trading as it hides implicit costs,[6] leads to conflicts of interests over best execution, can distort competition and ultimately trigger an overall price deterioration for all investors.[7]

Several brokerage models have recently become very popular by using payments for order flows as a source of revenue to offer lower or no upfront costs for retail clients. While BETTER FINANCE supports digitalisation, financial innovation, and other new disruptive models that attract and enable more citizens to invest directly and cost efficiently into capital markets, we cannot but scrutinise those new practices that may have a recoil against non-professional investors and capital markets as a whole. Below, we lay down our policy recommendations and arguments as to why PFOF or internalisation of retail orders should be banned.

POLICY RECOMMENDATIONS

BEST solution: Ban payments for routing "retail" trade orders

In short, BETTER FINANCE's research suggests that:

- PFOF can lead to worse execution prices;
- most financial supervisors warn and strongly doubt the practice's compliance with the law;
- several brokers have previously received hefty fines for PFOF practices;
- PFOF can create a conflict of interest between brokers and clients;
- PFOF can hamper competition, price formation, and transparent trading, ultimately affecting issuers and investors.

In BETTER FINANCE's view, retail trading must be made simple, transparent and on the best terms for the "retail" client. Can this be the case where a market maker pays the broker to direct order flows to its execution venue whereas the broker should endeavour to find and obtain the *best possible result* for the "retail" client?

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[5] There are different types of orders. The most frequent one is called *market order*: where the order giver does not specify anything else than the name of the security he wants to buy or sell and the number of units. There are many other types of orders, such as limit orders, take, hit, without price, etc. For an overview of the types of orders and how these are settled, check the financial education publications of your local securities markets authority.

[6] Samuel Adams, Connor Kasten, Eric K. Kelley, *Do investors save when market makers pay? Retail execution costs under payment for order flow models.* (December 1, 2021), available at: https://dx.doi.org/10.2139/ssrn.3975667.

[7] Christine A. Parlour, Uday Rajan, 'Payment for order flow' (2003) Journal of Financial Economics 68(3), 379-411. Available at: https://www.sciencedirect.com/science/article/abs/pii/S0304405X03000710; Robert H. Battalio, Tim Loughran, 'Does payment for order flow to your broker help or hurt you?' (2008) Journal of Business Ethics 80, 37-44, available at: https://link.springer.com/article/10.1007%2Fs10551-007-9445-x.

The obligation to "*execute orders on terms most favourable to the client*" is laid down in [Art. 27(1) MiFID II]:

> investment firms (in this case, brokers) shall "*take all sufficient steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order*".

Research from the securities markets supervisor in the Netherlands indicates that PFOF-driven execution is inferior to non-PFOF venues. According to their study, two PFOF trading venues executed client orders at **worse** prices compared to a non-PFOF venue in between 68%-72% and 81%-83% of cases, leading to a €1.44 and €3.46 price deterioration for €3 000 transactions.[8]

The same finding comes from the Spanish financial supervisor, which applied the same methodology as the NL AFM, found "*an 86.4% of the trades in the PFOF TV fall under the worse execution category, with a price deterioration of 0.14%*" in comparison with the top 10 trading venues and 85.9% in comparison with the reference market, having a price deterioration of -0.16%.[9]

In the UK, the financial supervisor clarified that PFOF "*is unlikely to be compatible with our inducements rule and risks compromising compliance with best execution rules*".[10] In the same vein, the European Securities and Markets Authority (ESMA) also sent a strong message on PFOF and client disclosures in 2021 when it highlighted that:

- "*PFOF raises serious investor protection concerns*",
- "*in most cases it is unlikely that PFOF could be compatible with MiFID II and its delegated acts*", and
- urged national supervisors to step up efforts in investigating this practice.[11]

In a *Dear CEO* letter of December 2017, the UK FCA highlighted several statements that firmly condemn the practice of PFOF:

- "*firms that continue to charge payments for order flow will breach the new standards implemented in MiFID II*";
- PFOF is likely "*to cause harm to clients and markets*"; or
- PFOF "*substantially undermines a broker's ability to act as a good agent*".[12]

[8] Autoriteit Financiële Markten, Assessing the quality of executions on trading venues: The "Comparative Pricing Model – version 2" (March 2022), available at: https://www.afm.nl/nl-nl/nieuws/2022/februari/kwaliteit-orderuitvoering-pfof.

[9] Comisión Nacional del Mercado de Valores, *Payment for order flow: an analysis of the quality of execution of a zero-commission broker on Spanish stocks* (March 2022) Research and Statistics Department, pp. 13-14, available at: https://www.cnmv.es/portal/Publicaciones/verDoc.axd?t={7d545771-9e7b-4503-b65d-1a6053236df6}.

[10] Financial Services Authority, *Finalised Guidance: Guidance on the Practice of "Payment for Order Flow"* (May 2012), available at: https://www.fca.org.uk/publication/finalised-guidance/fg12-13.pdf

[11] European Securities and Markets Authority, *Public Statement: ESMA Warns Firms and Investors About Risks Arising from Payment for Order Flow and from Certain Practices by "Zero-Commission" Brokers* (13 July 2021) ESMA35-43-2749, available at: https://www.esma.europa.eu/sites/default/files/library/esma35-43-2749_esma_public_statement_pfof_and_zero-commission_brokers.pdf.

[12] United Kingdom Financial Conduct Authority, *Dear CEO: Payment for Order Flow (PFOF),* 13 December 2017, available at: https://www.fca.org.uk/publication/correspondence/dear-ceo-letter-payment-for-order-flow.pdf.

Other research publications pointed out issues on conflicts of interests, for instance highlighting that PFOF "*arrangements create a conflict of interest for the brokerage firms who must balance their own profit motives with their 'best execution' duties to their clients*".[13]

BETTER FINANCE shares this view as PFROF is just a specific kind of "inducements" (commissions, remunerations, rebates),[14] incentivising the broker to execute the order on the venue paying the most, not that offering the best price. In such cases, this would breach not only the best execution duty, but also the obligation to "*act honestly, fairly, and professionally in accordance with the best interests of the client*" (Art. 24(1) MiFID II).

PFOF sparked attention in recent years mostly due to fines applied by supervisors for breaching best execution rules. For instance, the broker that was sanctioned in the aftermath of the *GameStop*[15] case (January 2021), was also sanctioned before:

- by FINRA[16] (2019) for $1.25 million (€1.1 million) for:
  - failing to "*reasonably consider* (…) *execution quality factors*",
  - not performing "*systematic best execution reviews*" and
  - not having a supervisory system "*reasonably designed to achieve compliance with its best execution obligations*";[17] and
- by the US SEC,[18] imposing a fine for a total of $65 million (€52.7 million) for "*misleading customers about revenue sources and failing to satisfy duty of best execution*".[19]

Several other fines were imposed in the US market for similar breaches: for instance, the US Violation Tracker[20] shows 12 records of penalties incurred by another brokerage platform for breaches of investor protection rights[21] throughout the years.

Beyond execution quality on individual trades for retail investors, there is also the issue of *price discovery*, competition and trade transparency, affecting the market as a whole.[22] Diverting trade orders away from "lit" markets may systematically increase bid-ask spreads, which in the end will affect the execution price for investors and hamper adequate funding for securities issuers, i.e. the real economy.

[13] Samuel Adams, Connor Kasten, Eric K. Kelley, *Do Investors Save When Market Makers Pay? Retail Execution Costs Under Payment for Order Flow Models* (1 December 2021), p. 29, available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3975667.

[14] See BETTER FINANCE, *Evidence Paper on the Detrimental Effects of Inducements* (February 2022), available at: https://betterfinance.eu/publication/better-finance-evidence-paper-on-the-detrimental-effects-of-inducements/.

[15] See BETTER FINANCE Press Release, *GameStop Case Highlights Discrimination of "Retail" Investors in Stock Markets* (4 March 2021), available at: https://betterfinance.eu/wp-content/uploads/PR-GameStop-highlights-Discrimination-of-Non-professional-Investors-in-Stock-Markets-04032021.pdf.

[16] FINRA is the Financial Industry Regulatory Authority in the United States of America – see https://www.finra.org/about.

[17] Financial Industry Regulatory Authority, 'FINRA Fines Robinhood Financial, LLC $1.25 Million for Best Execution Violations' (19 December 2019), FINRA News Release, accessed 2 October 2021, available at: https://www.finra.org/media-center/newsreleases/2019/finra-fines-robinhood-financial-llc-125-million-best-execution.

[18] The US SEC (Securities and Exchange Commission) is the government oversight agency responsible for regulating the securities markets and protecting investors.

[19] US Securities and Exchange Commission, Press Release: SEC Charges Robinhood Financial With Misleading Customers About Revenue Sources and Failing to Satisfy Duty of Best Execution, 2020-321, available at: https://www.sec.gov/news/press-release/2020-321.

[20] Platform set us by Good Jobs First comprising all individual penalty records of companies in the US, see https://www.goodjobsfirst.org/.

[21] Good Jobs First, Violation Tracker Individual Record for E-Trade Securities LLC, available at: https://violationtracker.goodjobsfirst.org/violation-tracker/-e-trade-securities-llc-0, sourced from Financial Industry Regulatory Authority, 'FINRA Fines E*Trade Securities LLC $900,000 for Supervisory Violations Related to Best Execution and Protection of Customer Order Information' (2 June 2016) accessed 2 October 2021, available at: https://www.finra.org/media-center/news-releases/2016/finra-fines-etrade-900k-best-execution-and-protection-customer-order.

[22] In this sense, see FESE, *The Issue of Payment for Order Flow* (25 May 2021), p. 2, available at: https://www.fese.eu/blog/the-issue-of-payment-for-order-flow/.

ALTERNATIVE SOLUTIONS TO A PFROF BAN

Currently, EU rules on commissions in retail investment services oblige providers who accept such payments to either:

- fully pass them on to the consumer, or
- ensure that such payments are used to provide an additional and higher quality service, while observing the other rules on conflicts of interests (Art. 21(1) MiFID II) and acting in the best interests of clients (Art. 24(1) MiFID II).

Should the EU co-legislators shy away from a desirable outright ban on inducements, BETTER FINANCE puts forward four alternative complementary proposals to ensure that retail traders enjoy optimal conditions when investing in EU capital markets.

Require all retail brokers to offer clearly and easily and on the same level at least one "lit" regulated market venue alongside "dark" ones to retail clients

At least one "lit" market venue offer (in terms of matching rules, pre- and post-trade transparency of data, etc.) should be put on a strictly equal footing with the dark ones and the retail investor informed of the differences between "lit" and "dark".

Impose adequate disclosure and reporting of PFOF

EU and national supervisors cannot supervise what is not reported and known. Currently, investment firms (incl. brokers) must report to the client the nature, value, and source of commissions, without any obligation to aggregate and publicly report such data, at least to supervisory authorities.

We believe this is an important step for assessing best execution delivered by brokers as it can stand to show a fraction of the magnitude of the spreads trade venues speculate in order to pay for order flows.

For instance, in the US Rule 606 (a) of the Securities and Exchange Commission obliges broker-dealers to report quarterly such payments (their values and source). This enables clear overviews, as in the examples provided below:

Table 1. Top 10 PFOFs received by brokers in the US

Payment for Order Flow	year	Quarter_Q						
Brokerage	2020 Q1	2020 Q2	2020 Q3	2020 Q4	2020 Total	2021 Q1	2021 Q2	2021 Total
TD Ameritrade	$ 202,176,174	$ 324,211,345	$ 297,902,649	$ 324,260,334	$ 1,148,550,502	$ 428,923,484	$ 329,563,835	$ 758,487,319
Robinhood	$ 90,921,176	$ 180,264,396	$ 194,550,463	$ 221,358,956	$ 687,094,992	$ 330,862,253	$ 216,957,485	$ 547,819,737
E*Trade	$ 79,651,749	$ 110,327,376	$ 105,425,567	$ 107,089,267	$ 402,493,959	$ 139,403,087	$ 103,619,245	$ 243,022,332
Charles Schwab	$ 53,577,203	$ 66,142,015	$ 61,868,774	$ 63,875,993	$ 245,463,984	$ 78,081,154	$ 61,243,649	$ 139,324,803
Webull	$ 3,093,917	$ 10,705,128	$ 21,918,111	$ 28,136,747	$ 63,853,903	$ 46,021,618	$ 46,369,010	$ 92,390,628
TradeStation	$ 6,250,020	$ 10,030,145	$ 12,182,576	$ 13,382,114	$ 41,844,854	$ 17,143,896	$ 13,470,979	$ 30,614,875
Ally Invest	$ 3,178,083	$ 4,484,013	$ 3,792,074	$ 3,815,883	$ 15,270,053	$ 4,561,965	$ 3,247,113	$ 7,809,078
Grand Total	**$ 438,848,322**	**$ 706,164,417**	**$ 697,640,215**	**$ 761,919,294**	**$ 2,604,572,249**	**$ 1,044,997,457**	**$ 774,471,315**	**$ 1,819,468,772**

Source: https://daytradingz.com/payment-for-order-flow/

Table 2. Top 10 PFOF providers in the US

Payment for Order Flow	year	Quarter_Q						
	2020	2020	2020	2020	2020 Total	2021	2021	2021 Total
Venue	Q1	Q2	Q3	Q4		Q1	Q2	
Citadel	$ 164,207,937	$ 285,034,232	$ 293,979,316	$ 340,906,851	$ 1,084,128,336	$ 450,910,427	$ 309,948,638	$ 760,859,065
Global Execution Brokers	$ 53,223,175	$ 119,633,670	$ 132,587,614	$ 140,549,199	$ 445,993,659	$ 182,069,190	$ 151,769,336	$ 333,838,525
Virtu Americas	$ 53,022,423	$ 91,600,016	$ 88,488,780	$ 78,443,303	$ 311,554,521	$ 117,488,878	$ 72,613,607	$ 190,102,485
Wolverine	$ 36,987,302	$ 45,332,765	$ 51,784,294	$ 47,170,348	$ 181,274,709	$ 88,754,047	$ 95,069,086	$ 183,823,133
other	$ 47,351,443	$ 57,954,305	$ 28,249,423	$ 28,655,130	$ 162,210,301	$ 44,221,805	$ 37,161,811	$ 81,383,616
Two Sigma Securities	$ 6,771,950	$ 16,144,904	$ 14,623,228	$ 25,768,570	$ 63,308,651	$ 48,237,773	$ 30,343,341	$ 78,581,114
G1 Execution Services	$ 51,414,705	$ 50,778,470	$ 42,765,085	$ 49,920,601	$ 194,878,861	$ 43,806,916	$ 31,433,117	$ 75,240,033
Dash Financial Technologies	$ 17,616,719	$ 20,500,168	$ 31,260,986	$ 36,052,822	$ 105,430,694	$ 41,336,413	$ 27,690,621	$ 69,027,034
UBS Securities	$ 8,252,669	$ 19,185,887	$ 13,901,489	$ 14,452,470	$ 55,792,516	$ 28,172,008	$ 18,441,758	$ 46,613,767
Grand Total	**$ 438,848,322**	**$ 706,164,417**	**$ 697,640,215**	**$ 761,919,294**	**$ 2,604,572,249**	**$ 1,044,997,457**	**$ 774,471,315**	**$ 1,819,468,772**

Source: https://daytradingz.com/payment-for-order-flow/

At the same time, we recommend expanding the disclosure to client obligation regarding inducements to showing the amount of PFOF paid by the market venue to his broker on each trade confirmation with the explanation of what it is.

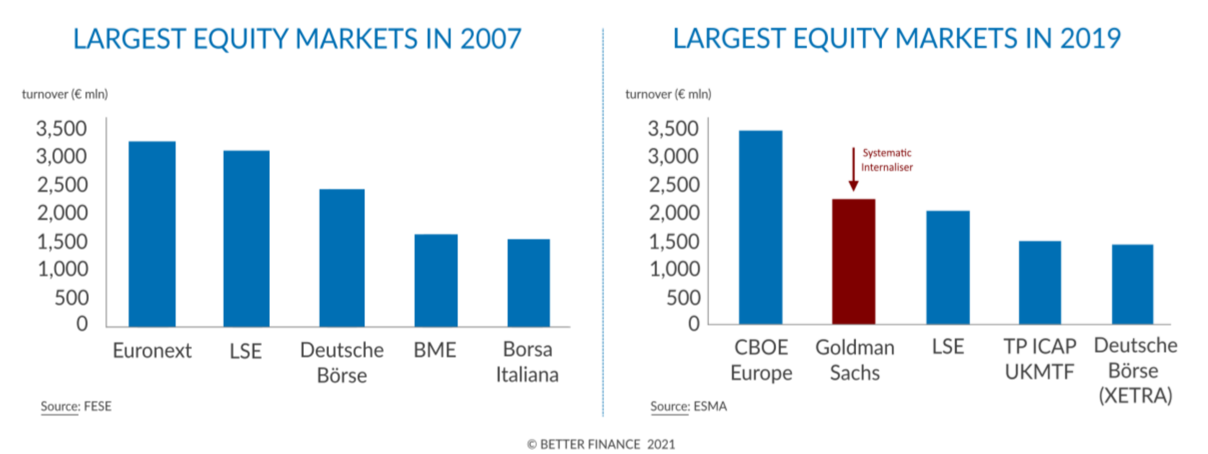
Ensure best execution for client orders

Retail investors must benefit of the best possible terms for the execution of their sell or buy orders when holding directly (not through packaged products) and trading in capital markets. In this sense, should payments for order flows be maintained, the EU co-legislators should clarify how best execution is achieved, with the advice of the European Securities and Markets Authority, so that clients and supervisors can much better compare execution terms and assess whether the best execution duty has been observed.

Impose a low LIS threshold for internalisers

As highlighted above, PFOF can also affect the price formation mechanisms, distort competition between trading venues and reduce the share of transparent (or "lit" trading).

When a market maker or an SI pays to capture large flows of trades, it internalises a part of the market and deprives "lit" markets of liquidity and depth in the order books. In the end, such a process will affect price formation and increase spreads on financial instruments. Unfortunately, in 2019, the second-largest equity execution market was in fact a systematic internaliser.



Source: BETTER FINANCE Report on Consumer Access to EU Equity Trade Data (2021)

In 2020, according to FESE/Big xyt, 80% of the trades executed on systematic internalisers were below the standard market size (SMS), with an average value of €3 000. Thus, we can assume that many of these trades are from retail investors, given their generally limited size, and this may be happening precisely because systematic internalisers or other intermediaries may be paying for order flows.

By amending the current MiFIR rules and obliging systematic internalisers to only handle *large-in-scale* (LIS) orders – purpose for which they were allowed by MiFID I, and facilitated further under MiFID II – , EU law can ensure that the average retail trade is no longer internalised and reaches liquid and transparent markets where the investor can benefit of the best available bids and offers.

Glossary of terms

Neobrokers
They represent the new generation of fully digital brokers aiming to facilitate the execution of low-cost stock market orders and trading services directly to individual investors.

PFOF
Payments made by market makers to brokers for directing their retail (retail only) clients' buy and sell orders for execution on their trading venues.

Over-the-counter (OTC)
A type of bilateral trade in financial instruments between two counterparties that takes place outside of formal execution venues.

Brokerage platform
A mechanism organised by an investment firm where client orders are not executed by the firm itself, but sent for execution to on the market or to dealers.

Systematic internaliser (SI)
A facility organised and managed by an investment firm where it trades, on its own account, with buyers and sellers of securities; official definition in Art. 4(1)(20) MiFID II.

Internalisation
The process through which a systematic internaliser captures buy and sell order flows and trades on its own account, instead of the orders being matched indiscriminately in the market.

"Lit" market
Securities exchanges and MTFs (Multilateral Trading Facilities) where all sell offers and buy bids (pre-trade), as well as executed trade prices (post-trade) are transparent and publicly available.

Spread
The difference between the price of buying (or selling) a financial instrument and vice versa with different counterparties.

"Dark" pools
Trading venues where the pre- and post-trade information (bid/offers and execution prices) and not transparent or publicly available.

Best execution
An obligation for brokers (Art. 27 MiFID II) to "*execute orders on terms most favourable to the client*".

Price discovery mechanism
The process through which investors compete with sell offers and buy bids for the same financial instrument, thus determining its fair market value or price.

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About BETTER FINANCE

BETTER FINANCE, the European Federation of Investors and Financial Services Users, is the public interest non-governmental organisation advocating and defending the interests of European citizens as financial services users at the European level to lawmakers and the public in order to promote research, information and training on investments, savings and personal finances. It is the one and only European-level organisation solely dedicated to the representation of individual investors, savers and other financial services users.

BETTER FINANCE acts as an independent financial expertise and advocacy centre to the direct benefit of European financial services users. Since the BETTER FINANCE constituency includes individual and small shareholders, fund and retail investors, savers, pension fund participants, life insurance policy holders, borrowers, and other stakeholders who are independent from the financial industry, it has the best interests of all European citizens at heart. As such its activities are supported by the European Union since 2012.