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The Council's position on Payment For Order Flow, a territorial approach instead of the Capital Markets Union – How did we get here, what is the way out?

This Debate paper was drafted under the responsibility of Robert Ophèle[1], President of the Advisory Committee for Debate Papers of the AEFR.

This Debate Paper investigates a paradox: as part of the MiFIR review, a file that is instrumental to the building of the long-awaited Capital Market Union, one of the compromises explored to bridge a contentious issue (to curb or not to curb the practice of "payment for order flow", or PFOF), is a territorial option that is in direct contradiction with the principles of the Single Market. The opt-out solution proposed – individual Member States could lift the ban on PFOF for intermediaries licensed in their jurisdiction, but only for their resident clients – is an unprecedented configuration, essentially negating freedom to provide services across the Union, a pillar of the Single Market.

Before analysing the risks entailed by the territorial option for PFOF, this Debate Paper dwells on the reasons that explain how it came to that. It appears that it is a mixture of:

- *a contentious file, on which Member States positions are orthogonal – which as such is not an unprecedented situation in a level 1 negotiation for financial services, especially MiFIR where different actors in the "order to venue" value chain have naturally opposed interests, and*
- *a growing frustration from Host countries in the context of the swift rise of neobrokers and subsequent "platformisation" of retail investment, whereas all the while a common regulatory and enforcement vision between supervisors could not be delivered by ESMA.*

In doing so, this paper digs into the underlying case for and against a PFOF, presenting its intrinsic flaws, to explain why it has generated such heated disagreements. In doing so, it does not reflect a consensual view on PFOF, which as mentioned above does not exist, nor does it pretend to represent all aspects of the case. Rather it articulates the necessity to preserve a pan-european framework if one truly wants to trigger a Capital Markets Union.

As a disclaimer, when addressing these issues, the paper focuses (i) on retail trades flows, as opposed to institutional flows, and (ii) on market structure and practices for cash equity stocks and ETFs, leaving aside listed derivatives (warrants, options, turbos). Apart from the angle of the "PFOF-backed privatisation" of retail flows, the paper refrains from entering the debate on competition between transparent and dark trading venues, apart from advocating for a sound basis for competition, which is not the case with the current practice of PFOF in the EU, and certainly will not be resolved by the compromise proposed by the Council, that avoids tackling the substantive issue and does not ensure a level playing field.

[1] The purpose of this Debate Paper is to initiate a discussion on a use case related to the CMU. It has benefited greatly from comments by institutional and market stakeholders, who are to be thanked for their valuable input, whether or not this paper reflects their views.

All European players have something to lose from the infringement of the principles of the Single Market, and failure to resist such a flawed compromise would set a precedent detrimental to pan European market operators, be them trading venues, market makers and brokers, notwithstanding the retail investor community.

While this issue is currently being debated in the trilogue between the co-legislators, it will without doubt rebound, both on perimeter – the EU Parliament has expressed strong doubts about the wisdom of the territorial option – and on substance, as proposals to define a common framework for PFOF have emerged, so far to no avail. They in turn raise important unresolved questions as to the conditions and definition of best execution, which are not discussed here, as they would warrant their own debate paper. Meanwhile, the recent draft of the Retail Investment Strategy of the EU Commission that was recently leaked will prolong the show, as it proposes to ban inducements paid to distributors for execution-only sales, where no advice relationship between the investment firm and the client exists: a situation that covers orders executions by definition and would thus… ban PFOF.

The paper ends with proposals to get out on top, which are easy to champion but more difficult to enforce: tackle the substantive issues by resolving the debate with a harmonised position – the ban being the preferred choice, as it is supported by a large majority – and advance on common supervision across capital markets, which would facilitate such a resolve by keeping entrenched positions at bay. A difficult task but a necessary one, otherwise trust in EU cross-border investment will eventually fade and the CMU will be doomed to fail.

The Council's position on PFOF

On December 20, 2022, one year after the European Commission published its Capital Markets Union (CMU) legislative package, the Council agreed on a mandate to enter into negotiations with the European Parliament on the review of the Markets in Financial Instruments Regulation (MiFIR).

As with the initial proposal (European Commission, 2022) made by the European Commission, the text endorsed by the Member States (Council, 2022) introduces a restriction of payments for routing client orders in the European Union (EU) – a so-called "ban on Payment For Order Flow (PFOF)".

As a reminder, PFOF typically occurs when a broker that executes orders for its' clients receives a fee not only from the client at the origin of the order but also from the counterparty with whom the trade is executed. This practice was thrust into the limelight following the GameStop trading frenzy in January 2021. This episode of extreme volatility in the US financial markets, mainly driven by retail trading, has raised issues related to the nuts and bolts of how brokers execute orders to buy and sell stocks.

It did not come as a surprise that the proposed ban led to an animated debate between Member States, with positions spread across a spectrum from a full ban, outright authorisation to a conditional framing (with varying degrees of exigence) of the PFOF practice. But it was striking to see the Council craft a compromise proposal that granted to individual Member States an inbuilt discretion of allowing PFOF to operate, but exclusively in their own countries – applicable only in respect of a client domiciled or established in that Member State.

This "territorial" Council's compromise reflects the inability of Member States, after fierce discussions, to reach a compromise that would ban or regulate PFOF. Moreover, it sets a precedent since the accepted solution leads to fragmenting the single market for financial services.

This debate paper aims to examine the main reasons for why Member States eventually, arrived at such a flawed solution for a file intended to foster the CMU – and why, really, it should not have been unexpected that it came to this. It also attempts to outline a few suitable ways out.

Article 39a - Ban on payment for forwarding client orders for execution **(European Commission)**

Investment firms acting on behalf of clients shall not receive any fee or commission or non monetary benefits from any third party for forwarding client orders to such third party for their execution.

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Article 39a - **(Council mandate)**

1.Investment firms acting on behalf of clients shall not receive any fee or commission or non monetary benefits from any third party for forwarding client orders to any third party for their execution.

The first subparagraph shall not apply to rebates or discounts on the transaction fees of execution venues that do not result in negative fees that are settled with a payment or a non monetary benefit.

2. A Member State may allow an investment firm acting on behalf of clients to receive any fee or commission, rebates, discounts, or non-monetary benefits from any third party for forwarding client orders to any third party for their execution only in respect of a client domiciled or established in that Member State.

The Member State may impose on the investment firm executing retail client orders as referred to in first subparagraph additional conditions to the conditions set out in Article 27(1) and (2) of Directive 2014/65/EU in its national law.

The Member State shall notify ESMA (European supervisory market authority) about its decision to use the discretion as referred to in first subparagraph. ESMA shall maintain a list of Member States using this discretion. The list shall be made available to public and updated regularly.

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Article 39a - **(European Parliament mandate)**

Investment firms acting on behalf of clients shall not receive any fee or commission or non monetary benefits from any third party for forwarding client orders to such third party for their execution.

The first subparagraph shall not apply to fees, commissions or non-monetary benefits related to the forwarding of professional clients' orders for execution, where permitted under the approved and public tariff structure of a regulated market or MTF.

A political outcome resulting from a market landscape disrupted by neobrokers

Providing a comprehensive explanation of the mandate for interinstitutional negotiations adopted by the Council in December 2022 would be impossible without taking into full account one of the most significant trends that has affected the investing landscape, namely the "platformisation" of retail investment and the swift rise of neobrokers.

Neobrokers encompass a new breed of digital financial entities offering retail investors direct and simplified access to trading.

In a context marked by the progressive disengagement of traditional banks from marketing direct equity markets participation to their clients and from training their commercial forces in equipping them with securities accounts, neobrokers have been using their specific features to successfully attract growing numbers of retail investors interested in capital markets.

Common features of neobrokers

While they do not hold a specific regulatory status, neobrokers have features that make them distinct from online and/or traditional banks/brokers.

⇨ *They are "neo" – neobrokers were established recently. They were created to complement services offered by already existing financial actors.*

⇨ *They promote low cost and fees – neobrokers typically back up their order execution service by agreeing to resell order flow to other market counterparties. Many, including prominent ones, are barely EBITDA positive and may even be in the red.*

⇨ *They display a cross-border dimension – in the European Union (EU), neobrokers operate under the freedom to provide services framework, enabling them to deploy a unique interface platform to an EU-wide customer base.*

⇨ *They design easy-to-use interfaces and resort to innovative engagement and advertisement strategies – neobrokers generally offer a browser-based web trader, coupled in several instances with a smartphone trading app, and make extensive use of online and social media channels. Meanwhile, they usually claim to operate under the "reverse solicitation" regime and rarely offer advice, thereby intending to simplify their compliance regime in order to qualify for the most lenient rules.*

⇨ *They satisfy new investment appetite by promoting instruments tailored for retail investors, such as ETFs and fractional shares. They offer round-the-clock trading and give access to US stocks.*

The best-known neobrokers active in Europe include notably Trade Republic, Scalable Capital (all first licensed by BaFin, Germany), BitPanda (first licensed by FMA, Austria), DEGIRO (first licensed by AFM, The Netherlands), and eToro (first licensed by CySec, Cyprus).

Even though online trading of stocks may no longer seem revolutionary, neobrokers are still disrupting the business. With their bold offers and simplified user experience, they are rejuvenating the investor pool and driving what could be a lasting increase of retail participation in equity markets. For this to happen, and for investors to have a high degree of confidence on financial markets, one should ensure they are offered the proper trading environment. As a matter of fact, their impressive commercial success appears to be linked to the use of PFOF – and therein likely lies the rub (Ophèle, 2021).

Is it serious, doctor?

In the United States (US), PFOF received special attention in 2021 following the GameStop saga, which shed light on the potential conflict of interest faced by neobrokers – notably Robinhood, which derives most of its revenues from PFOF – since their main clients actually turn out to be the market counterparties to which they redirect their execution orders, rather than the retail investors trading on their online platforms.

Ultimately, a U.S. District Court dismissed a related class action suit, ruling that there was no evidence of collusion, and the Security Exchange Commission (SEC) did not sustain charges against the execution venue, given the existing regulatory framework. However, in the eyes of the regulator, there was case for reform and the latest proposals that the SEC put forward (SEC, 2022) on the US market structure actually focus on curbing this practice.

When executing client orders in the EU, investment firms are required, pursuant to MiFID II, to obtain the best execution quality available across European execution venues in the financial instrument. Yet, because of the ambiguity on the meaning of "best execution", and while in principle it should mean getting the best execution price in the financial instrument for retail orders, the concept leaves room for interpretation.

Viewed from this angle, PFOF may be seen as an incentive to deviate from this requirement. Indeed, neobrokers might be tempted to favour venues that offer substantial PFOF but less advantageous execution prices. Therefore, ESMA stated (ESMA, 2021) in July 2021 that, in most situations, PFOF is not aligned with best execution requirements under MiFID II.

Studies mandated by neobrokers active in the EU (Trade Republic and Scalable Capital, 2021) have nonetheless tried to prove that PFOF may be beneficial to retail clients, taking into account explicit and implicit costs (i.e. fees charged to investors and the buying or selling price for the financial instrument).

Unsurprisingly, the results of these studies contradict the assessments made by several national regulators, as summarised below:

- An AFM (AFM) assessment (AFM, 2022) of March 2022 confirmed that two PFOF venues lowered the price available on the primary exchange by 4.8bps and 11.5bps (€1.44 & €3.46 for an order of €3,000);
- A CNMV analysis (CNMV, 2022) published in March 2022 showed that execution prices on PFOF led to a lower price 85.9% of the time with an average loss of 0.16%;
- In an analysis made in March 2022, the Autorité des marchés financiers (AMF, 2022) compared execution prices between Euronext Paris (without Best of Book) and Equiduct APEX, and noted that execution prices at the Equiduct's VBBO were less favourable than Euronext ones Paris for 17% to 34% of the volumes traded; and

- A BaFin study (BaFin, 2022) released in April 2022 concluded that PFOF appears to be advantageous from the client's point of view for a specific typology of orders that represents only 6.49% of the volume executed by PFOF venues.

A model that avoids small and mid-cap equities and affects market transparency

PFOF allows market makers to drive their main source of revenue from cross venue arbitrage between the PFOF venue and the primary exchange. More often than not, this is only possible when market makers execute quite aggressive orders, without any price requirement[2], on blue chip stocks, to have sufficient liquidity for real time arbitrage. On average, SME stocks therefore tend to be less represented in neo brokers' offerings. This also explains why PFOF seems more suited to liquid US stocks, such as GAFA stocks which, beyond margins from arbitrage activities, also allow for additional gains from euro/dollar currency conversions.

By routing retail flow towards counterparties that offer payment in exchange for preferential interactions with this flow, PFOF also amounts to the so-called "privatisation" of execution, as opposed to the execution on multilateral venues where orders are transparently displayed and there is a competition for execution. Such "privatisation" can be done on bilateral venues, for instance with systematic internalisers, or – and this is a specific feature of the version of PFOF applied in some EU Member States, via venues that are only optically multilateral, because there is only one market-maker for instance, so no real competition for execution. But, in all cases, PFOF relies exclusively on bilateral arrangements between retail brokers and their counterparties.

Some PFOF venues claim that they offer the best of both worlds – i.e. they provide the best execution price for retail orders and the cheapest execution fees – by relying on an execution price benchmark coming from primary exchanges that guaranty retail investors price quality. Nevertheless, this "real time" and pre-trade benchmark is often imported with a delay that is sufficient – including in the US where a consolidated tape already exists – to allow the highly sophisticated counterparty of the retail flow (the market maker or global broker) to "know" the price of best execution in advance and to provide liquidity only when there is a margin opportunity from arbitrage. This intrinsically conflicts with the retail investors' – unsophisticated, by definition – best interest.

In other words, retail flows executed with PFOF are likely to avoid transparent (so called "lit", as opposed to "dark" venues) and multilateral markets, thereby undermining the diversity of flows that are confronted in a central order-book and thus preventing appropriate price formation. From this perspective, PFOF does not merely represent a risk to retail investor protection but may also raise a more systemic issue concerning market transparency and quality. The impact is far from being theoretical, as exemplified by the situation in the US where, after only a decade of market structure transformation, more than 90% of marketable orders[3] for stocks listed on U.S. securities exchanges are routed to half a dozen off-exchange dealers, also known as wholesalers, two of

[2] Passive orders are trading orders for which the order price is different from the market price. Passive order happens when a trader sets a price that differs from the bid or ask price. A passive order sets a new price, and establishes a new level in the order book, waiting for other participants to hit it. A passive order comes with a time limit, after which, if the transaction is not executed at the specified price, the order expires (and the trader will have to place a new one). The further the price is from the market price, the more passive the order is said to be. Conversely, aggressive orders occur when a trader executes the order to buy or sell immediately.

[3] Marketable orders, the typical orders used by retail investors, are seeking to trade immediately at the best price available on the market.

whom concentrate two third of the flows. As a basis for the proposed changes in legislation, which would notably force back individual retail trades originated from retail to competitive mechanisms, the SEC estimates that the current set-up generate a 1,5bn$ "competitive shortfall" due to insufficient price improvement for retail participants (SEC, 2022), although the figure is highly contested by the market markets.

The debate on the merits and significance of PFOF is still raging. A majority of Member States favoured the ban but faced opposition from those which were comfortable with being home to PFOF neo-brokers, and reluctance from some others for an outright ban that could be seen as harming innovation and disincentivizing retail investor participation in capital markets. There was also a concern that a black or white solution would not be suited to address a continuum of practices and that a ban might encompass less questionable inducement practices. Faced with this conundrum, the Council preferred not to resolve the issue by granting Member States the possibility of allowing PFOF, though only within their own borders.

A blow to the progress of the CMU and to the spirit of the Single Market

By inherently heightening the risk of fragmentation and thus promoting a regulatory framework which may entirely vary depending on European jurisdictions, the Council's position on PFOF runs counter to the CMU's objective of further integrating national capital markets so that money can flow across the continent to the benefit of firms, investors, and consumers, regardless of their location.

If adopted in the final MiFIR Review text as defined in the Council General Approach, Article 39a would, more fundamentally and more worryingly, be a blow to the very essence of the EU Single Market. Indeed, in the field of financial services, the Single Market has so far been based on a system of passporting rights.

Within this framework which relies on the principle of mutual recognition, a financial institution authorised by a domestic authority is automatically granted the right to operate in any other European Economic Area (EEA) Member State without having to seek an additional authorisation or another license.

Furthermore, where a financial institution provides its services in a Member State other than the one in which it is established, the EU passporting system provides for the competent authority of the "home" Member State remaining responsible for its supervision.

By contrast to this setting, the "territorial" compromise foresees that a Member State may be granted an exemption from the ban as a "home" country (i.e. only for venues licensed in their territory) but only for those clients for which it is also "host" (i.e. domicile of the clients).

Member States wishing to protect their citizens from PFOF will be able to do so, Member States which would want them to "benefit" from PFOF will not, insofar as they do not have a say as a "home" of the venue (unless the proposed text intends to give home countries some say over non-domiciled venues as they operate on their soil, which would be another first). Under such a framework venue will have no choice but to devise an operational double-entry chart, that might be moving frequently. This looks like a mess and very far from the simplicity and powerfulness underlying the Single Market.

A compromise reflecting long-standing tensions between "home" & "host" Member States

Though the Council's position on PFOF seems to represent the defeat of EU thinking, it would be excessive to assert that Member States voluntarily intended to undermine the development of the EU Single Market.

A more credible analysis relates to the long-standing tensions between "home" and "host" Member States. More precisely, "host" Member States may have increasingly felt that, by being deprived of supervisory powers over entities accessing their national jurisdiction, the EU was letting the wolf into the fold and giving rise to supervisory shopping.
This traditional "home and host" tension has been further aggravated by increased recourse to freedom to provide services, superseding the previous template of freedom of establishment, which gave "host" countries some say on branches, while at the same time the "platformisation" trend gave it much more forceful impact.

In the case of PFOF, the negotiations in the Council proved unable to impose the initial proposal of an outright ban on Member States that are homes to the platforms operating under a PFOF business model. During the first semester of 2022, the French Presidency first tried to strike a deal by proposing a set of conditions under which PFOF could be allowed across the board in the EU. This attempt to find common ground failed to bring highly polarized positions together. On the one hand, Germany at one extreme refusing the foreseen restrictions, and the Netherlands on the other hand determined to enforce a full ban on their soil. Therefore, the French Presidency was forced to revert to a ban on PFOF as part of its final General Approach compromise.

When the Czech took over the Presidency, they started by proposing a toned-down version of the framework but ran into the same dead-end. A last-minute compromise was then brokered, seemingly at the behest of opponents of PFOF: it would be banned in principle but could be authorised within a purely national perimeter. The priority was thus given to host countries to protect investors against a non-desirable market practice, against the principle of the freedom to provide services, a well-established sacred cow of the EU Single Market.

Probably an unworkable compromise

The Council's position on PFOF does not come without serious supervisory issues. For example, if adopted, determining which current National Competent Authority (NCA) is responsible for supervision would be open for dispute.

In a "home" Member State that decides to allow PFOF, would the national supervisor be expected to inspect whether corresponding neobrokers refrain from using PFOF for clients domiciled in "pro-ban Member States" elsewhere in the EU? And how could "reverse solicitation" (the neobroker based in a Member State accepting PFOF receiving orders from a client from another country, but advocating that it has not marketed its services in this country) be handled? This also appears also unclear.

Furthermore, what about the possibility for a Member State to accept, for its residents, PFOF coming from a neobroker based in another EU country, that would itself not have allowed PFOF? Here again, there is no clear

answer, at least in the initial wording of the Council mandate.

Last but by no means least: if PFOF comes at the expense of correct price formation, would it be legitimate to accept that stocks under the supervision of a jurisdiction banning PFOF in the EU could be executed using PFOF in a border Member State? It does not seem like this question has been thoroughly thought through.

These enforcement concerns tend to indicate that the Council's position was probably not meant to be set in stone. Even some of its supporters were communicating at the outset that trilogue negotiations would likely side-line it and that the compromise had been made to "kick the ball rolling". But bad ideas sometimes refuse to die and the mere fact that such preposterous wording has been approved by the Council is already telling and concerning with regards to the ability of Member States to forge constructive compromises at the EU level.

There is talk of similar compromises being floated regarding other divisive legislative files, as well as more sophisticated, though still "territorial", versions of compromise being tested by the Swedish presidency, which took over from the Czech Presidency at the beginning of 2023. At the time of writing of this paper, the Swedish Presidency was indeed tabling a version of the "territorial" compromise that still relies on a territorial optionality, only improving it by clarifying that the option applies to venues under the jurisdiction of the opting-out Member State, and by introducing a common framework of conditions to be met to opt for PFOF. Whether these conditions are appropriate, or even more dangerous than useful, is another story. But one thing is certain: this proposal still leaves the principles of passporting and the common market in disarray.

In any case, the draft agreed on by the Member States remains a poor choice, as it would prevent the establishment of a reliable, less complex, and genuinely European legal framework that could incentivise cross-border investments without hampering retail investor protection. It is especially problematic that the MiFIR review, expected to contribute to a deeper CMU, sets a precedent in signalling a loss of priority for maintaining the fundamental principles of the functioning of the Single Market.

The debate on substance will meanwhile go on, as illustrated by the recent leaked Retail Investment Strategy of the EU Commission. It includes a proposal for a ban on inducements paid to distributors for execution-only sales, where no advice relationship between the investment firm and the client exists: a situation that covers orders executions by definition and would thus, without question… ban PFOF.

Getting out of the legislative rut

While PFOF may attract new investors and boost investment in capital markets, this practice mainly used by neobrokers also carries high stakes when it comes to preserving best execution for investors, freedom to provide services, and improving the competitiveness of the EU and its Single Market in general and of the CMU in particular.

The Council would therefore be wise to shift its substantive position on PFOF in the course of the trilogue negotiations. In this respect, aligning its stance with that of the European Parliament (European Parliament, 2022) – which simply, following the initial proposal by the Commission, bans PFOF – would have the merit of clarity and consistency.

Besides encouraging financial services to embrace innovation while keeping best execution practices, and to more fully integrate within the post-trade landscape, another intellectually sound approach would be to put in place strong and unified supervision at the EU level, which would also reinforce the development of the Single Market.

One should keep in mind what led to the proposal to ban PFOF in the first place: the impossibility of enforcing a common interpretation of best execution principles in the EU, resulting in different views between NCA and enforcing practices. ESMA went so far as to publish a strong warning against PFOF in 2021, but PFOF operating Member States and their regulators were surprised by the declaration since they knew that ESMA lacked the legal mandate to act upon it.

Since turning ESMA into a real EU single supervisor will likely take years, the MiFIR review should at least be the opportunity to enhance the EU passporting system by strengthening coordination and sharing of information mechanisms between "home" and "host" competent authorities in cases where companies infringe on rules in host Member States.

Otherwise, trust in EU cross-border investment will eventually fade and the CMU will be doomed to fail.

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