

## Guidance consultation

# Proposed guidance on the practice of 'Payment for Order Flow'

October 2011



## Proposed guidance on the practice of 'Payment for Order Flow'

1. This paper sets out our view about payment for order flow (PFOF) arrangements. We define PFOF as an arrangement whereby a broker receives payment from market makers, in exchange for sending order flow to them.
2. The paper describes i) the practice of PFOF and its possible advantages and disadvantages; ii) sets out what COBS and SYSC rules are relevant to this practice; and iii) provides guidance on the consistency of the practice with these COBS and SYSC provisions. This paper also explains why this issue is separate from that of the fee schedules of trading platforms.
3. As described below, we believe PFOF arrangements create a clear conflict of interest between the clients of the firm and the firm itself. Therefore, it is unlikely to be compatible with our inducement rules and risks compromising compliance with best execution rules.
4. This paper and the new guidance contained within it is subject to consultation, and we welcome industry views on PFOF arrangements and our proposed guidance. Below are some questions which we would appreciate feedback on:

### Questions

**Q1: For market makers- Do you pay for orders? If so, does this affect the prices you offer?**

**Q2: For brokers - Do you receive payment for orders? If so, are your clients aware of this?**

**Q3: Do you agree that the conflicts of interests that arise though this practice cannot be managed in a way that protects the client?**

**Q4: Do you agree that PFOF does not enhance the quality of service provided to the client as required under the third test of the inducements rule?**

**Q5: Do you agree that compliance with the best execution obligation is put at risk by PFOF?**

**Q6: What other advantages or disadvantages arise from this practice?**

**Q7: What are your views on how widespread this practice is?**

**Q8: What is the likely impact on those firms that receive payments for orders and on those firms which make these payments were this practice were to end?**

**Q9: What is the likely impact on clients if this practice were to end?**

### **Next Steps**

- We would be grateful if interested parties would respond to the questions raised in this paper by 9<sup>th</sup> November 2011.
- Currently, we propose to publish 'Finalised Guidance' in Q1 next year.

### Introduction

#### Payment for order flow

5. For many instruments (especially the most liquid), a broker executing a client order can choose from a wide number of market makers and execution venues. In a well functioning, competitive market, informed brokers would choose the market maker(s) and execution venues which enables them to achieve the best possible result when executing their clients' orders.
6. We have been made aware that certain market makers (but not all) make payments to brokers that direct order flow to the market maker. These payments usually take the form of a direct payment per order (but could take a softer form such as paying a broker's settlement fees or for their trading software). The effect is to divert the broker's flow to certain market makers who are willing to pay for the broker's orders.
7. PFOF creates a conflict of interest between the broker and its client, as the broker has an incentive to direct order flow to market makers offering PFOF arrangements over the interests of its clients. Where brokers are routing orders to only those market makers willing to pay for order flow, then the duty of brokers to act in the best interests of clients may be compromised. The client also faces another potential detriment because market makers engaging in PFOF may recover these payments by incorporating them into the spreads they offer.
8. The capacity to pass this additional cost on to the end investor is greatly enhanced where relatively unsophisticated or 'uninformed' investors, limited in their ability to monitor or evaluate their broker's execution performance, exist. The potential detriment posed to retail investors is therefore a concern. However, the concern arises for both retail and professional clients.

#### 1.1 Advantages and disadvantages of PFOF

9. The obvious advantage for the broker of a PFOF arrangement is that it will receive a payment in respect of a completed order in addition to commission charged to its client. By entering into PFOF agreements with only those market makers willing to pay for orders, it might be argued that the broker has also reduced the costs of 'searching' for market makers for the best result. However, unless the broker can demonstrate that it is still achieving best execution for its underlying clients through using these particular market makers, this would not be consistent with the broker's duty of best execution. The advantage to the market maker is that the payment encourages brokers to provide orders.
10. In theory, there may be no disadvantage to the 'uninformed' client of the broker receiving this payment, provided the price, all other things being equal, achieved for the client is no worse than the best price available from any other market maker including those that do not pay for order flow – best execution would be achieved in that circumstance. The obvious concern, however, is that the market maker offers this payment to attract orders that would not otherwise be obtained (i.e. by virtue only of the price offered by the market maker). If that is the case, then the client of the broker would be receiving a price that is disadvantageous. In some ways, such a result amounts to or is similar to the client being charged an extra commission although it is hidden in the form of a poorer price.

11. This would not be the case if the payment received by the broker were passed onto the client or used to offset against the fees or commissions charged by the broker to its client. Passing the full payment on to the client would make the whole process somewhat pointless. The result for the client would be the same as if there had been no payment for order flow in the first place (assuming that the client received the best price available).
12. It is possible that the market maker could offer the best price available in the market and at the same time make a payment to the broker introducing the order. But, if the market maker can offer the best price, all other things being equal, then the question arises why it would also be necessary to offer a payment to the introducing broker?
13. The concern (particularly for the client of the broker) is that the market maker needs to recover the cost of making a payment to the broker and does so by offering a price that is less advantageous to the broker's client and so such price would be poorer than the best price available.
14. This could amount to a serious disadvantage for the broker's client. The best available price might be a price, all other things being equal, from a market maker that does not pay for order flow or perhaps does pay for order flow but pays a lesser amount. However, if brokers are routing orders to only those market makers prepared to meet the broker's terms, these other market makers are effectively foreclosed from the market and prevented from putting forward alternative quotes.
15. Similarly, if the price achieved for the client is affected by the payment by the market maker to the broker then there are also implications for price formation in the market. The prices of transactions which involve payment for order flow will be distorted by the presence of such payments.
16. An argument might be made that restricting order flow through a particular market maker brings benefits in the form of economies of scale. Since the market maker receives a guaranteed flow of orders the costs of managing its position in the underlying market is reduced which potentially might lead to narrower spreads for the benefit of the broker's clients.
17. If there are economies of scale advantages to be derived from increased order flow, then these could be just as easily achieved by offering the best price, all other things being equal, rather than by paying brokers for order flow. A market maker should not need to make payments to guarantee flow in order to grow scale.
18. If this argument about scale were valid, then the largest market makers which already enjoy a scale advantage would be able to offer narrower spreads and so attract more business and squeeze out smaller competitors without the need to pay for order flow. But this is not observed in practice.
19. It has been posited that these payment arrangements allow a broker to invest in trading technologies which will ultimately confer benefits on the end clients. The argument here is that where 'softer' payments are made by market makers to brokers in the form of trading software this enables them to search the market for better prices more effectively.

20. In response however, we would observe that brokers should in any case be investing in these technologies in order to compete with one another and should not be looking for market makers to subsidise them in this way

#### **Price Formation and market efficiency**

21. The potential impact of PFOF on price formation and the efficiency of a market are not easy to assess and the impact may vary according to the nature of the underlying market in which payment for order flow is practised. This is particularly the case in today's markets which are often more open to competition, more hybrid in structure and which may be characterised by a range of trading incentives.
22. That said, PFOF is a cost that may potentially have a number of adverse implications for the operation of a market and for the end users of the market. It may result in spreads being wider than might otherwise be the case. It may make firms less willing to narrow their quoted spreads than would otherwise be the case. Additionally, it may reduce the incentive of brokers receiving payments to seek price improvements over a displayed quote.

#### **FSA rules**

#### **Conflicts of interest**

23. The receipt of PFOF gives rise to a conflict of interest between the firm's interests and the interests of its broking clients which may damage the interests of the clients. As set out in further detail below in the section on Inducements, in our view the payment of the PFOF could contravene our inducement rules (see below) and may incentivise the broker to put its own financial interests ahead of those of its client to the client's detriment. In other words, the receipt of the payment may encourage the broker to get the highest payment from a market maker rather than the best outcome for its client (see below).
24. Under SYSC 10.1.3R, the broker must take all reasonable steps to identify conflicts of interest between itself and its clients. Compliance with this rule should ensure that a broker identifies PFOF as giving rise to an obvious conflict of interest between the firm's interests and the interests of its broking clients.
25. SYSC 10.1.7R requires a broker to maintain and operate effective organisational arrangements with a view to taking all reasonable steps to prevent conflicts of interests from constituting or giving rise to a material risk of damage to the interests of its clients. A broker using PFOF arrangements should therefore have conflicts management procedures and arrangements in place to ensure that the PFOF arrangements do not damage its clients interests, taking into account (for example) its overall duty to act in the clients best interests, and its duty to achieve the best possible result when executing client orders.
26. Under SYSC 10.1.8R, if the arrangements to manage the conflicts are not sufficient to ensure, with reasonable confidence, that risks of damage to the interests of a client will be prevented, the firm must clearly disclose the general nature and/or sources of conflicts of interest to the client before undertaking business for the client. However, disclosure should only be used as a last resort, and if the

PFOF arrangement could lead to breaches of our inducements or best execution rules, disclosure would not be a legitimate way of addressing the conflict of interest inherent in PFOF arrangements.

27. We would therefore expect, and the broker would need to demonstrate, that it has implemented and maintains appropriate policies, procedures and organisational arrangements to manage such conflicts effectively with a view to avoiding any disadvantage to its clients.

### Inducements

28. The COBS rule on inducements is contained in COBS 2.3. The rule permits payments such as PFOF provided that such a payment satisfies each (i.e. all) of the following three tests<sup>1</sup>:

- 1) The payment must “*not impair the compliance with the firm’s duty to act in the best interests of the client*”;
- 2) That details of the inducement are disclosed to the client “*in a manner that is comprehensive, accurate and understandable, before the provision of the service*”; and
- 3) That the inducement is “*designed to enhance the quality of the service to the client*”.

29. In the context of a PFOF arrangement, to satisfy test 1), the broker would need to demonstrate that it had obtained the best possible price by complying with the best execution obligations (discussed further below). In our view, if best execution is not achieved as a result of orders being directed to a particular market maker under a PFOF arrangement, this would lead to a breach of the inducements rule as the PFOF arrangement would impair the compliance of the firm’s duty to act in the client’s best interest.

30. Test 2) of the inducements rule requires the firm to disclose details of the payment ahead of the provision of the service. Such disclosure would need to specify the amount of the payment in and would need to be given to the client before execution of any transaction. If the amount of the payment were to change, such change would need to be communicated to the client before any further transactions were executed for any client.

31. In addition, the firm would need to ensure that the disclosure is “comprehensive, accurate and understandable”. It would not be easy for a client to understand the arrangement unless it was described in terms of additional remuneration that is received by the broker. This should help the client understand the fees which are charged and so assist the client when selecting a broker to provide execution services.

32. Primarily the broker, is acting on behalf of its client to find the best result for their transaction. It is important for clients to understand how these payments are structured in order to understand how this might affect the broker's incentives. Not knowing the level and form of payment a particular market maker receives from a broker, or not being able to establish how this payment affects or distorts the

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<sup>1</sup> See COBS 2.3.1(2)

way in which their orders are routed, weakens the client's bargaining position and their ability to discipline the behaviour of their agents.

33. To satisfy test 3), the broker would need to provide a justification as to why the payment was designed to enhance the quality of service to the client. In its guidance on the inducements rule<sup>2</sup>, CESR made clear that in making this assessment the firm should also consider the nature and extent of the benefit (and any expected benefit) to the firm.
34. It is difficult to see how a firm could provide any justification that PFOF benefits the client directly. There are no obvious benefits save the one that the firm receives more remuneration from the provision of the execution services. However, this may be at the expense of the client so that in effect this may amount to no more than simply charging the client additional fees.
35. This argument that the client obtains a benefit because the firm receives a benefit is tenuous at best. The firm may not be able to rely on the additional revenue from PFOF. Some of the time, the best available execution opportunity may not be from a firm providing PFOF. The argument also ignores the increase in costs faced by the market makers.
36. So, it is difficult to see how the client would benefit from such an arrangement or how it is designed to enhance the quality of the service to the client.
37. The PFOF arrangements would involve extra costs for the broker. To manage the conflicts arising and to ensure the achievement of best execution, the broker would need to commit additional resources to monitoring and compliance as described above and below as a direct result of the additional complexity introduced by the PFOF arrangements.
38. It is worth clarifying that where a broker acts as an intermediary to bring together two principals then the broker charges both principals a commission. This is the practice of inter-dealer brokers. These commission payments would not be classified as 'payments for order flow'. Such commission would be a legitimate payment for an investment service provided by the broker and would not therefore be considered to be an inducement

### Best Execution

39. The best execution rule in COBS 11.2.1R states:

*"A firm must take all reasonable steps to obtain, when executing orders, the best possible result for its clients taking into account the execution factors".*

40. In the case of retail business, COBS 11.2.8G states:

*"For the purposes of ensuring that a firm obtains the best possible result for the client when executing a retail client order in the absence of specific client instructions, the firm should take into*

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<sup>2</sup> Document issued by CESR 'Inducements under MiFID' can be found at [http://www.cmvm.pt/CMVM/Cooperacao%20Internacional/Docs\\_ESMA\\_Cesr/Documents/07\\_228b.pdf](http://www.cmvm.pt/CMVM/Cooperacao%20Internacional/Docs_ESMA_Cesr/Documents/07_228b.pdf)

*consideration all factors that will allow it to deliver the best possible result in terms of the total consideration, representing the price of the financial instrument and the costs related to execution. Speed, likelihood of execution and settlement, the size and nature of the order, market impact and any other implicit transaction costs may be given precedence over the immediate price and cost consideration only insofar as they are instrumental in delivering the best possible result in terms of the total consideration to the retail client.”*

41. So to comply with the rule, the broker must obtain the best possible price available (where other relevant costs are equal). This will involve the broker in comparing prices from different market makers including those that do not pay for order flow. Given the possibility of receiving a payment for the order, it will be particularly important for the broker to be able to demonstrate that it had checked alternative execution possibilities (ie market makers) including those that do not pay for order flow and document that accordingly.
42. Under the best execution rule (COBS 11.2.29), the client has the right to ask the broker to demonstrate that it has executed the order in line with its policy for achieving best execution. The information described in the above paragraph would be essential in answering such a question were it to be raised.
43. The broker is also under an obligation under the best execution rule (COBS 11.2.27 and 11.2.28) to monitor the effectiveness of its execution arrangements and to review its arrangements on a regular basis.
44. In particular, to comply with these requirements, the broker will need to monitor the prices offered by the market maker(s) offering payments for order flow. We expect that the firm will compare the PFOF market maker's prices with prices from market makers that do not pay for order flow.
45. Where market makers pay for order flow then if brokers do not effectively manage the resulting potential conflict of interest between themselves and their clients there is a danger that they will not consistently obtain the best possible results when executing client orders. This could happen where the market makers paying for order flow, or paying the most for order flow, do not consistently offer the best quality of execution.

### **Trading venue fees and PFOF**

46. This guidance is about payments between market intermediaries. However, as part of their commercial relationships with trading venues, market participants will:
  - subscribe to the fee structure of the trading venue; and
  - may, from time to time, have the opportunity to participate in incentive schemes designed to support or encourage liquidity on the trading venue.



47. Such arrangements are supervised by the FSA, in order to ensure their compatibility with the obligations of a trading venue under MiFID<sup>3</sup>. For the avoidance of doubt, the FSA will continue to assess the acceptability of proposals relating to the fee structures and incentive schemes of trading venues in accordance with this tailored framework, such as to ensure the maintenance of fair and orderly markets.
48. It is noted that some forms of fee structure (such as a maker/taker fee structure)<sup>4</sup> and incentive schemes are designed to reward certain types of behaviour by market participants, for example liquidity provision. The proposed guidance on PFOF is not intended to affect the ability of a trading venue to operate structures that embed such rewards (e.g. a maker/taker model), where a proposed structure is otherwise compatible with the regulatory responsibilities of the trading venue (as outlined above). In many cases, the reward serves to reduce the net fee payable to the trading venue and therefore would not constitute PFOF. In the case of a liquidity incentive scheme involving a potential payment that was consistent with the fair and orderly trading obligations of the offer or venue, it is unlikely that the specific concerns raised in this paper would apply<sup>5</sup>.

### Our View

49. It is difficult to see any advantage in the PFOF arrangements for the end client. Where PFOF is demanded by a broker, it is easy to see how such arrangements would give rise to a significant conflict of interest that, if not satisfactorily managed, could lead to client detriment through breaches of our conflicts of interest, inducements and best execution rules. For this reason, PFOF is a serious concern for the FSA.
50. It is not at all clear what economic rationale there is in support of PFOF other than the receipt by the broker of additional remuneration. Moreover, this outcome could be achieved more straightforwardly and transparently by simply increasing the fees or commissions the broker charges upfront. This would be easier for the client to understand, would avoid conflicts of interest and any risks to the achievement of best execution.
51. Also, the extra requirements on brokers to collect information to demonstrate best execution to both clients (when asked) and our supervisors (who would need to take extra care when investigating such arrangements) will impose an additional cost on brokers. Obviously, such additional costs would not represent a benefit for clients.

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<sup>3</sup> For example, UK RIEs and investment firms operating MTFs are required to operate rules and procedures that allow for fair and orderly trading. The FSA provides guidance on the characteristics of incentive schemes that are considered to be consistent with this responsibility, which include a requirement that they are transparent, are not likely to encourage trading for improper purposes, are consistent with a reliable, undistorted price formation process and alleviate dealing or other identified costs associated with trading on the relevant trading venue.

<sup>4</sup> A structure which applies a charge to aggressive (liquidity taking) orders and pays a rebate to passive (liquidity making) orders.

<sup>5</sup> To meet its regulatory responsibilities, the trading venue would need to ensure that the scheme was transparent and was consistent with a reliable, undistorted price formation process, among other things.

52. It is not therefore clear to us how a firm could demonstrate that the payment for order flow is designed to enhance the quality of service as required under the third test of the inducement rule. Unless the test can be satisfied, payment for order flow would not be permitted under the inducements rules. We are also concerned that if the conflict to which such payments give rise is not properly managed this could result in firms not achieving the best possible result when executing client orders leading to consumer detriment.