esma European Securities and Markets Authority

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PUBLIC STATEMENT

ESMA warns firms and investors about risks arising from payment for order flow and from certain practices by "zero-commission brokers"

The European Securities and Markets Authority (ESMA) is issuing this statement to remind firms[1] that the receipt of payment for order flow (PFOF) touches upon a number of key MiFID II[2] obligations aimed at ensuring that they act in their clients' best interest when executing their orders. In light of the serious investor protection concerns[3] raised by PFOF and the multiple requirements applying to it, it is in most cases unlikely that the receipt of PFOF by firms from third parties would be compatible with MiFID II and its delegated acts.

PFOF is the practice of brokers receiving payments from third parties for directing client order flow to them as execution venues. The surge in retail client activity that has been observed over the past year has highlighted the use of PFOF. The practice appears to have been an important factor behind the surge in retail client activity observed in the US. While being less widespread than in the US, PFOF has also been observed in some Member States of the EU.

In this context, ESMA requests National Competent Authorities (NCAs), especially in those Member States in which PFOF has been observed, to prioritise this topic in their supervisory activities for 2021 or early 2022.

Investor protection concerns raised by PFOF

The receipt of PFOF from third parties by a firm executing client orders causes a clear conflict of interest between the firm and its clients because it incentivises the firm to choose the third party offering the highest payment, rather than the best possible outcome for its clients. For the execution of retail clients' orders, this best possible outcome is to be determined in terms of total consideration, representing the price of the financial instruments and the costs relating to execution.[4] ESMA also reminds firms that PFOF received from third parties when executing client orders constitutes an inducement received from third parties in connection with the investment service provided to the client.

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[1] Reference to "firms" include investment firms and credit institutions providing investment services to clients in accordance with MiFID II.
[2] Directive 2014/65/EU of the European Parliament and of the Council.
[3] Please note that this Statement focuses on the investor protection issues relating to PFOF and does not deal with any other potential issues and implications which PFOF may raise.
[4] See Article 27(1) of MiFID II. According to recital 101 of Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive: "*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.*"

Firms must thus rigorously assess whether, by receiving PFOF, they are able to comply with relevant MiFID II requirements, most notably those on taking all sufficient steps to obtain the best possible result for their clients[5], on conflicts of interest[6] and on inducements[7], as further detailed in the following paragraphs.

Conflicts of interest and best execution

The MiFID II conflicts of interest requirements oblige firms to take all appropriate steps to identify and to prevent or manage the conflict of interest caused by the receipt of PFOF.[8] ESMA emphasises that the consideration and eventual choice for a particular third party for the execution of client orders should be solely driven by the aim of obtaining the best possible result for clients and should in no way be influenced by the amount of PFOF the third party is willing to provide. To this end, when establishing their execution arrangements firms should consider both third parties willing to provide PFOF and those unwilling to provide PFOF, and the factors used to choose one third party over another should strictly relate to obtaining the best possible result for the client. ESMA reminds firms that for retail clients, the best possible result shall, in the absence of a specific client instruction, be determined based on total consideration, representing the price of the financial instrument and the costs relating to execution. The possible execution venues and factors used for their selection shall be clearly identified in the firm's execution policy, and the effectiveness of the firm's order execution arrangements shall be monitored on a regular basis. In particular, firms will need to regularly assess whether the execution venues included in their order execution policy provide for the best possible result for the client or whether they need to make changes to their execution arrangements.[9]

Importantly, ESMA expects firms to pay specific attention to the risk that receiving PFOF from third parties may affect the bid-ask spread offered by such third parties and result in a worse price for the client compared to the situation in which the third party would not provide PFOF.

ESMA is aware that some firms receiving PFOF from execution venues present a list of execution venues to their clients and ask their clients to choose the specific venue to execute their orders. The execution venues providing PFOF are presented in a prominent or more appealing manner. In doing so, the order is supposedly executed according to the specific choice made by the client and thus the execution of the order would fall outside the remit of the firm's best execution obligations.

ESMA emphasises that this practice raises investor protection concerns. By presenting the execution venues providing PFOF to the firm in a prominent manner, clients are systematically

[5] See Article 24(1) and 27(1) of MiFID II.
[6] See Article 27(2) of MiFID II
[7] See Article 24(8) and (9) of MiFID II.
[8] See Article 16(3), first subparagraph, and 23(1) of MiFID II.
[9] See Article 27(1), 27(4), 27(5) and 27(7) of MiFID II and Article 66 of Commission Delegated Regulation (EU) 2017/565.

induced to choose an execution venue that provides PFOF to the firm. In ESMA's view, such a choice does not constitute a proper specific instruction from the client.

Inducements regime and cost transparency

Regarding the MiFID II inducements requirements, firms receiving PFOF when executing client orders must comply with the quality enhancement and best interest requirements[10]: the former obliging PFOF to be designed to enhance the quality of the relevant service provided to the client, the latter requiring that PFOF does not impair compliance with the firm's duty to act in accordance with the best interest of its clients. Specifically, PFOF will not be acceptable if it results in distorting or biasing the provision of the relevant service to the client.[11]

In addition, firms are required to clearly disclose the existence, nature and amount of PFOF to the client on an ex-ante and ex-post basis.[12] In this respect, ESMA also highlights the importance of the requirement to provide information on all costs and charges to the client relating to the service and the financial instrument(s) for firms receiving PFOF from third parties.[13] Such disclosures would include, inter alia, information on the implicit costs (e.g. those included in the bid-ask spread offered by the third party) and the third-party payments received (e.g. PFOF).

Lastly, ESMA reminds firms providing the service of portfolio management and executing their decisions to deal in the management of clients' portfolios that a stricter inducements regime applies to them since these firms are not allowed to accept and retain inducements (other than minor non-monetary benefits) in relation to the provision of those services to clients.[14]

Specific concerns regarding certain practices by "zero-commission brokers"

ESMA has observed the existence in some EU Member States of some firms executing clients' orders and marketing their services as bearing no costs for investors. In fact, such firms charge no explicit commissions for the execution of client orders in certain or all financial instruments on offer. These firms (usually known as "zero-commission brokers") often receive PFOF from third parties, which may compensate for the lack of direct commissions charged to their clients. According to ESMA, it is important to take into account some investor protection risks, such as less transparency for the client and the potential to distort retail clients' investment incentives.

ESMA reminds "zero-commission brokers" of the MiFID II requirement to provide fair, clear and not misleading information to their clients and to provide information on all costs and

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[10] See Article 24(9)(a) and (b) of MiFID II.
[11] See Article 11(2), second subparagraph, of Commission Delegated Directive (EU) 2017/593 of 7 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to safeguarding of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or reception of fees, commissions or any monetary or non-monetary benefits.
[12] See Article 11(5) of Commission Delegated Directive (EU) 2017/593 and Article 50 of Commission Delegated Regulation (EU) 2017/565.
[13] See Article 24(3) and 24(4) of MiFID II.
[14] See Article 24(8) of MiFID II.

charges to the client relating to the service and the financial instrument(s). As clients of "zero-commission brokers" will always incur costs (e.g. implicit costs and third party payments received by the firm), ESMA emphasises that the marketing of the service as "cost-free" in the circumstances described above, will infringe the firm's compliance with these requirements and it could incentivise retail investors' gaming or speculative behaviour due to the incorrect perception that trading is free.

As clarified in the previous section, firms receiving PFOF from third parties shall comply with the MiFID II inducements requirements, inter alia requiring PFOF to be designed to enhance the quality of the investment service to the client. On this aspect, ESMA issued a Q&A clarifying some basic principles, such as the need that the quality enhancement provided should go beyond aspects of the firm's organisation or services that are legally required or that can be considered as essential for its functioning.[15]

Conclusion and prioritisation of PFOF in NCAs' supervisory activities in 2021/early 2022

PFOF raises serious investor protection concerns. In light of these concerns and of the multiple requirements applying to PFOF, ESMA considers that in most cases it is unlikely that PFOF could be compatible with MiFID II and its delegated acts.

Hence, ESMA requests NCAs to prioritise PFOF in their supervisory activities for 2021 or early 2022, especially in those Member States in which PFOF has been observed. These supervisory activities should aim at assessing the actual impact of PFOF on firms' compliance with the best execution, conflicts of interest and inducements requirements including whether firms receiving PFOF are able to demonstrate that they consistently achieved the best possible result for retail clients when executing their orders, also taking into account, where relevant, firms' cross-border activities.

[15] See ESMA Q&As on MiFID II and MiFIR investor protection and intermediary topics: Q&A 12.8, https://www.esma.europa.eu/sites/default/files/library/esma35-43-349_mifid_ii_qas_on_investor_protection_topics.pdf