

22 July 2021

## **Circular: ESMA warns firms and investors about risks arising from payment for order flow and from certain practices by “zero-commission brokers”**

### **Background and Scope**

Payment For Order Flow (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.

The European Securities and Markets Authority (ESMA) has issued a [statement](#) to remind firms that the receipt of payment for order flow (PFOF) touches upon a number of key MiFID II obligations aimed at ensuring that they act in their clients’ best interest when executing their orders. In light of the serious investor protection concerns 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.

### **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. 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.

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, on conflicts of interest and on inducements, as further detailed in the ESMA [statement](#).

## **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 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 ESMA [statement](#), 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<sup>1</sup> 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.

### **Target Audience**

The content of this circular and the ESMA [statement](#) applies to all financial brokers but it is mainly targeted to Online Brokers.

### **Contacts**

Should you have any queries regarding the above, please do not hesitate to contact: [mcsuinvestments@mfsa.com.mt](mailto:mcsuinvestments@mfsa.com.mt).

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<sup>1</sup> 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](https://www.esma.europa.eu/sites/default/files/library/esma35-43-349_mifid_ii_qas_on_investor_protection_topics.pdf)