

FINNIUS

The controversy surrounding payment for order flow (PFOF) – where are we heading?

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A while ago, the Dutch Financial Times (FD) [headlined](#) “*The Netherlands gets another German discount broker.*” The article discussed the earnings model of the broker in question. It explained that the broker was paid by a stock exchange in Munich for placing orders. This *payment for order flow* (PFOF) is prohibited for Dutch brokers but not for German brokers, according to the FD article.

The phenomenon of PFOF has led to discussions some time now between regulators, the European legislature and market participants themselves. There are fervent proponents and there are equally fervent opponents of this form of income for investment firms. But what makes PFOF – which is widespread in the U.S. and, according to regulators, is also gaining popularity in the EU – so controversial, and how exactly is it regulated under Dutch and European financial law? That’s what this blog is about.

The views of the AFM, ESMA and BaFin

In [Trendzicht 2023](#), published on November 3, 2022, the Netherlands Authority for Financial Markets (AFM) is actually positive about the rise of so-called *neobrokers*, defined by the AFM as investment firms that offer investment services in a low-threshold manner, usually fully digital and often strongly technology-driven. These low-threshold services may lead to more consumers finding their way to investing, according to the AFM. The AFM does then hasten to add that the AFM is investigating the revenue model of neobrokers, including the use of PFOF as a source of income, and that brokers do need to act in the best interest of the customer.

The obligation to act in the client’s best interest poses a challenge when it comes to PFOF, according to the AFM. PFOF involves a trading venue or market maker paying a fee to the broker in exchange for order flow, i.e. trades executed by clients of the broker. The AFM conducted an initial analysis of PFOF in early 2022, [concluding](#) that in many cases investors are worse off in terms of price if their trades are forwarded to a PFOF trading venue for execution.

The AFM opposes the PFOF model because, among other things, it results in opaque prices for investors. The AFM is by no means alone in its criticism of PFOF. In 2021, the European Securities and Markets Authority (ESMA) expressed its concerns about the application of PFOF in the EU in a [public statement](#). ESMA points out that PFOF creates an incentive for the broker to choose the best paying party rather than what is best for the investor. As a result, the use of PFOF may result in violation of MiFID II rules on best execution, conflicts of interest, inducements and cost transparency, ESMA said.

On the other hand, brokers using PFOF point to studies showing that reselling orders does produce better deals for investors.^[1] In addition, German regulator BaFin [concluded](#) from research last summer that the discussion is nuanced and that PFOF also has benefits for investors, such as lower transaction costs.

How can PFOF be illegal for Dutch brokers but not for German brokers?

Back to the statement from the FD article that PFOF is banned for Dutch brokers but not for German brokers. How can that be? And why is the AFM so concerned about this issue if PFOF is not allowed in the Netherlands anyway?

Here's the thing. The Netherlands has inducement rules that are stricter than the European MiFID II inducement rules. A Dutch broker may not receive any commission from a third party if that payment is related to an investment service to a private investor (for the enthusiast: this follows from article 168a BGfo). This means that a Dutch broker may not receive payments for forwarding order flows. After all, that would be a payment from a third party related to an investment service, namely the transmission and/or execution of orders in financial instruments.

MiFID II also contains inducement rules but in many cases those rules do not absolutely prohibit the receipt of payments by third parties. This can create differences between member states, as we now see in Germany and the Netherlands. Investment firms operating across borders in other member states must comply with the implementation of MiFID II rules in their home countries. Thus, brokers from countries with less strict commission rules that target Dutch investors online are, in principle, only required to comply with those less strict inducement rules – i.e., without an (explicit) PFOF ban.

The AFM considers this situation undesirable and has therefore been calling for an EU-wide ban on PFOF for some time.

Will there be a European ban on PFOF in the near future?

If it is up to the European Commission, that ban is going to happen. For some time there has been a European [legislative proposal](#) to add the following article 39a to MiFIR, the European regulation that contains investment rules in addition to MiFID II:

“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.”

MiFIR is directly applicable in all EU member states and thus does not require transposition into the laws of the Member States.

At this point, however, it remains to be seen whether this bill will pass. Germany has come out [against](#) a total ban on PFOF. The German regulator BaFin is also [opposed](#) to a blanket ban. The main reason: moving to a ban now is [premature](#); there is insufficient empirical evidence that such a ban is in the interest of investors.

According to the latest [reports](#), a compromise is now being considered in Brussels. This compromise would consist of, on the one hand, no absolute ban on PFOF, but on the other hand, the introduction of the obligation that brokers who are paid by PFOF equal or improve on the stock price offered in the wider market. However, it is far from clear whether this compromise will pass.

Such a compromise would not (completely) eliminate the uneven playing field between, for example, Dutch and foreign brokers. However, this uneven playing field is first and foremost the result of the choice of the Dutch legislature to have (much) stricter inducement rules than required under MiFID II. The tendency to be stricter than the rest (goldplating) is typically Dutch and the 20% bonus cap is a good example of this. It is noteworthy that the AFM's chairman of the board Laura van Geest recently [spoke](#) negatively about this tendency:

“Avoid gold plating (I also say that to the AFM itself), or a Dutch add-on on the rules, because that is expensive and often quickly competed away internationally.”

Be that as it may, the controversy surrounding PFOF will continue for the time being. For market participants and regulators alike, there is nothing to do but wait for white smoke from Brussels.

[1] See, for example, <https://fd.nl/financiele-markten/1435570/saxo-bank-ziet-licht-aan-het-einde-van-de-tunnel-na-binck-debacle-qdk2ca8rQwaV>.

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