

## Background

On 27 July 2021 the European Commission sent to ESMA a request for advice asking ESMA to assist the European Commission in the development of its strategy for retail investments and to make appropriate adjustments to the legislative framework. ESMA was asked to deliver the report to the Commission services by 30 April 2022.

On 1 October 2021, [ESMA issued a Call for Evidence On the European Commission mandate on certain aspects relating to retail investor protection](#) to help ESMA draft technical advice to assist the European Commission in the development of its Retail Investment Strategy to be issued in H1 2022.

Virtu submitted the comments below on 2 January 2022 in response to ESMA's 1 October 2021 Call for Evidence on the European Commission's mandate on aspects relating to retail investors protection.

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## 2 January 2022

### Introduction

Virtu Financial Europe (collectively 'Virtu') is a group of investment firms authorised in both the EU and UK which carry out a range of MiFID activities including market making, proprietary trading, brokerage services, acting as a systematic internaliser and the operation of POSIT MTF.

**Q28: Are you familiar with the practices of payment for order flow (PFOF)? If yes, please share any information that you consider might be of relevance in the context of this call for evidence.**

Virtu is familiar with the practice of PFOF and believes that PFOF can be a beneficial mechanism to both the market and the retail investor where the broker and the market appropriately manages the potential conflicts of interest and seeks to achieve the best possible outcome for clients and market participants.

Properly disclosed and transparent PFOF can:

1. Reduce barriers to entry for small retail brokers and increase competition in the marketplace; and
2. Help to provide more open markets with a variety of competitive and cost-efficient financial services and products such as low or no cost trading; and

Markets with regulatory regimes designed to enhance execution quality transparency have a robust and competitive execution ecosystem. This holds true in a market where there are both brokers that accept and do not accept PFOF. However, the current opaque nature of PFOF arrangements in Europe makes it difficult to measure whether these obligations are being met and impedes competition which is a key tenant of efficient markets.

In general, products and services which are beneficial when used appropriately and harmful when not should be subject to properly designed regulation rather than an outright ban. Instead of moving to ban PFOF based on the experience of its sub-optimal use in Europe, ESMA and the European Commission should instead look to the US to understand how a properly configured PFOF eco-system can be beneficial for both the retail investor and the market at large.

## **MiFIR Proposal**

We strongly object to, and are disappointed by, the [MiFIR proposal on payment for order flow](#), as currently drafted, which targets systematic internalisers offering payment for order flow. The review states the belief that this proposal would:

"end the controversial practice that certain high-frequency traders, organised as SIs on account of their large transaction volumes, pay retail brokers in exchange for the latter channeling their retail orders to the high-frequency trader for execution."

Virtu has concerns in relation to the nexus of this proposal for two primary reasons:

- We are not aware of any systemic practice amongst SIs regarding payment for order flow. In fact, we're not aware of any examples of this practice at all and believe this is a ban geared more towards the US market structure; and
- The proposal entirely disregards practices within the Union that are referred to or effectively function in a manner similar to 'payment for order flow' and raise material concern in terms of investor protection.

The proposal, as currently drafted, neither provides a regulatory structure for PFOF to ensure activities within the Union that are referred to as PFOF meet investor protection best practice nor does it provide a broader, principles-based prohibition to protect retail and institutional investors from improper use of PFOF practices where investor protection, best execution and inducement requirements do not appear to be in line with MiFID II requirements.

## **EU Market Structure**

1. **Scope and supervision** – In relation to the EU we observe practices across different types of financial instruments (equities and non-equities) as well as structured products. The current unlevel playing field between Member States is a consequence of inconsistent and conflicting interpretations of the EU Single Rulebook between NCAs and an associated absence of supervisory convergence on these matters.
2. **Best execution** – Article 27(1) of MiFIR requires an investment firm to take all sufficient steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature and any other consideration relevant to the execution of that order. Nevertheless, where there is a specific instruction from the client the investment firm shall execute the order following the specific instruction.
3. **Consolidated Tape** – not currently in place.
4. **Disclosure of order execution information** – the current format of the execution quality reporting (RTS 27 & 28) has been deemed not fit for purpose and is under review.
5. **PFOF** - in contrast to the US, in the EU PFOF is used in a non-transparent manner with discriminatory, non-competitive practices and no open price discovery. In this regard, we are aware of two distinct forms of PFOF that occur in the EU:
  - (i) **Broker-to-retail exchange PFOF**: This is where a broker enters into an agreement to receive PFOF when it routes orders to a specific trading venue. This trading venue has a single dedicated market maker model who has an obligation to execute at a local reference market price or better. Retail

orders are sent as quote requests, with the market maker having the ability not only to opt not to respond but even to withdraw from the trade after the client has accepted the quote (i.e., a last look facility). This is a 'closed' trading venue model where no other market maker is permitted to compete to provide liquidity in the same trading segment. Alongside this, we are aware that brokers release themselves from best execution obligations by stating e.g., in the customer agreement that:

*The customer must instruct [the broker] at which of the execution venues offered its order is to be executed. This is true due to the restricted selection of execution venues described above, even if only one Execution venue is offered. ....As a result, [the broker] is not obliged to comply with this Execution Policy to achieve the best possible result (best execution).*

- (ii) **Broker-to-investment bank PFOF:** This is where a broker enters into an agreement with an investment bank offering execution and clearing services, to route its client orders to the investment bank in exchange for lower (or zero) custody and exchange fees. This is primarily seen in the listed derivatives (ETD) space where trades are pre-arranged and internalized to the maximum extent permitted by exchange rules.

## US Market Structure

Some key market structure differences in the US enable a healthy and transparent PFOF ecosystem, adding quantifiable benefit to retail investors<sup>1</sup>, namely:

1. **Scope and supervision** – the U.S. practices set out below are specifically in relation to equities and options and are consistently regulated and supervised by the SEC and FINRA.
2. **National Best Bid and Offer (NBBO)** - the U.S. Regulation NMS establishes a comprehensive set of regulations that include requirements for market centers to disseminate their quotations to the Consolidated Quotation System which establishes an NBBO.
3. **Transparent disclosure of order execution information:** Rule 605 of Regulation NMS, requires all market centers, including off-exchange wholesale markets, to publish statistical information designed to allow the public to assess the relative quality of these competing market centers. Execution quality is benchmarked to what an order achieved versus the NBBO at the time a market center received the order. Against this benchmark, less liquid markets fair worse if there are insufficient shares to fill an order at the NBBO. Retail brokers use public and private statistics about how their orders fair to determine which market center to route orders. It is Execution quality that drives decisions about where to route orders.
4. **PFOF:** - under the US model, PFOF is disclosed, transparent and based upon an open model allowing for competition between liquidity providers. Brokers set a single payment rate and multiple wholesalers (i.e., market makers) compete to win order flow based on their ability to offer the most competitive execution quality based on transparent and quantifiable criteria.
  1. Brokers route orders to many wholesaler execution providers and allocate orders among them based on their relative performance to each other and to the NBBO.
  2. Brokers conduct ongoing and regular reviews of each wholesaler's execution quality to ensure the allocation of orders that the broker is awarding to each wholesaler is in line with each wholesaler's level of execution quality. This creates a competitive environment where wholesalers strive to deliver high execution quality that each other.
  3. Brokers typically use a 'directed' routing model and concurrently route to many execution partners and exchanges mitigating single-point-of-failure risk.

The US structure, formulated to ensure competition, best execution, and transparency, is not evident in the current EU market practices surrounding PFOF.

To better improve the transparency framework, Virtu is advocating for the establishment of disclosure and reporting requirements, as contained in the MIFiR Review proposals, to allow investors to benchmark their performance against other providers across the Union which would incentivize competition among brokers and market makers.

Under the US PFOF model, market makers compete to achieve the best execution quality (price above the NBBO) which delivers real and rewarding price and size improvement for retail investors. Brokers route orders based on their Best Execution policy and their routing protocol. They review who provides the best execution quality and price improvement based on a defined measurement period and allocate future flow to the best performer(s).

<sup>1</sup> In 2020, the top 5 market making firms in the US provided aggregated price and size improvement on the NBBO of nearly \$11bn. In general, this shows that the retail investor is getting a better price and size than what they could have gotten on a traditional securities exchange. (Source: Public Rule 605 reports, Virtu Financial)

### **Conflict of Interest & Best Execution Concerns**

We acknowledge the concerns that the practice of PFOF could, in the absence of appropriate investor protection measures – as is the case in EU today, result in poor outcomes, specifically regarding competition, conflicts of interest and best execution. However, as evidenced by the successful utilisation of PFOF in the US, we also believe that PFOF could be used to deliver significant, quantifiable benefits to investors across the Union. With this in mind, we are encouraged by, and optimistic that, a number of investor protection measures currently under consideration / consultation would, in large part, address concerns about PFOF and ensure it is used in a manner beneficial to investors.

In addition, we welcome the establishment of the Consolidated Tapes for equity and fixed income asset classes. The Consolidated Tape, properly utilised, could simplify best execution analysis and facilitate greater competition in our markets.

First, a Consolidate Tape will provide transparency as to the actual quality of the execution received compared against the best prices across the Union, regardless of the structure of the market where the trade was executed. Secondly, a standardised benchmark opens the door for organic competitive pressures to push brokers to execute orders at the EBBO (or better) to ensure best execution for retail customers in scenarios such as PFOF.

Separately, ESMA's ongoing 'Review of the MiFID II framework on best execution reports' (ESMA35-43- 2836) have proposed improved execution disclosure requirements. We believe that these proposed transparency measures will significantly enhance the best execution regime and address the widely accepted shortcomings of the current regime.

In the context of a potential European market structure where PFOF is a feature, subject to the aforementioned enhanced investor protection measures and consistent with the MiFID II requirements in relation to the disclosure of conflicts of interest "as a last resort", we advocate for explicit, prominent and unambiguous disclosures to all clients of retail brokers who are in receipt of PFOF. Such disclosures should include an accounting of the percent of a broker's orders that it allocated to each market center including the details of the economic arrangement between the broker and each market center. Additionally, brokers should disclose their order routing policy and its process for determining best execution when selecting where to route a customer's order.

We consider it critical that a harmonized EU approach to PFOF be adopted to create an ecosystem with inherent checks and incentives for brokers and to ensure a level playing field and fair competition across Member States.

While banning PFOF might sound like a simple path forward, we caution that doing so is not simple and risks encouraging new and less transparent and inefficient alternatives to be created. Most importantly, and as supported by academics, a ban on PFOF would harm retail investors. The right outcome is to appropriately and consistently regulate PFOF activity in a harmonized manner across the EU.

Such a policy approach would then be in recognition of the fact that, *subject to robust and effectively and consistently supervised requirements to ensure investor protection and fair and open competition*, PFOF can in fact be a useful mechanism to both retail investors and the wider the market. I.e., via reducing barriers to entry for small retail brokers and thus increasing competition between different brokers; and by making more cost-efficient financial services provision available for retail investors (low cost trading) as implicit execution costs are reduced for retail investors with more of the cost borne by the wholesale broker via competition.

However, this is predicated on brokers appropriately managing the potential conflicts of interest and seeking to achieve the best possible outcome for clients in a competitive market structure and against an objective, transparent, and appropriately disclosed benchmark. We reiterate that none of this can currently be found among the existing PFOF practices in the EU.

As fundamental red-lines, such a policy approach would require core market structure features that achieve comparable outcomes as those in the US, i.e. a transparent and competitive system where optimal execution outcomes for retail investors can be objectively evidenced against a market-wide benchmark (i.e., the EBBO) and which is coherently and consistently supervised in the same way across the Union by ESMA.

- Ideally such an approach would include a well-designed and well-functioning Consolidated Tape (at least offering post-trade, real-time price information for each financial instrument for which PFOF were to be allowed under such a system). If properly utilised, such a Consolidated Tape could address the best execution concerns referenced in our comments above, by providing transparency as to the actual quality of the execution received compared against the best prices across the Union, regardless of the structure of the market where the trade was executed. Secondly, a standardised benchmark opens the door for organic competitive pressures to push brokers to execute orders at the EBBO (or better) to ensure best execution for retail customers in scenarios such as PFOF.
- Additionally, and in the absence of an operating consolidated tape, it would require the availability of a significantly improved best execution disclosure regime, including explicit, prominent, unambiguous and easy-to-understand disclosures to all clients of retail brokers which are in receipt of PFOF. ESMA's ongoing 'Review of the MiFID II framework on best execution reports' (ESMA35- 43-2836) offers some promise of enhancing the EU best execution regime and addressing the widely accepted shortcomings of the current regime.

**Q29: Have you observed the practice of payment for order flow (PFOF) in your market, either from local and/or from cross border market participants? How widespread is this practice? Please provide more details on the PFOF structures observed.**

See answer to 28

**Q30: Do you consider that there are further aspects, in addition to the investor protection concerns outlined in the ESMA statement with regards to PFOF, that the Commission and/or ESMA should consider and address? If so, please explain which ones and if you think that these concerns can be adequately addressed within the current regulatory framework or do you see a need for legislative changes (or other measures) to address them.**

As described previously, markets with regulatory regimes designed to enhance execution quality transparency have robust and competitive execution ecosystems.

To remedy these issues, we recommend:

1. enhancing rules relating to best execution and transaction cost disclosure to allow for transparent, comparable, and understandable product information;
2. strict supervisory enforcement for brokers who do not abide by the investor protection rules; and
3. introducing specific recordkeeping and reporting requirements for distributors of retail investment products to provide a breakdown of products distributed, thus allowing for supervisory scrutiny and better enforcement of the existing rules on inducements.
4. Specific disclosure obligations on retail brokers engaging in PFOF, including an accounting of the percent of a broker's orders that it allocated to each market center including the details of the economic arrangement between the broker and each market center. Additionally, brokers should disclose their order routing policy and its process for determining best execution when selecting where to route a customer's order.

These enhancements would bolster the CMU's objective of introducing more retail investors to Capital Markets. Allowing for properly disclosed, transparent PFOF would allow retail investors to trade simplified and risk appropriate products, such as equities and ETFs, on transparent trading venues with minimal implicit and explicit costs. Increased participation in these markets would allow the markets to become more liquid and transparent, thus making less appropriate products attractive to fewer investors.

**Q35: The increased digitalisation of investment services, also brings the possibility to provide investment services across other Member States with little extra effort. This is evidenced by the rapid expansion of online brokers across Europe. Do you observe issues connected to this increased cross-border provision of services? Please elaborate.**

We agree that the increased digitalisation of investment services brings about the possibility to provide investment services across other Member States with little extra effort. In and of itself, we view this as a positive development. However, to the extent that regulatory divergence exists between one or more European NCAs regarding the application of prevailing regulatory requirements, or interpretations thereof, the ability to passport digital services on a freedom of services basis facilitates the most liberal interpretation of regulatory requirements prevailing across the Union, so called "*regulatory arbitrage*". The provision of regulated services through digital means exacerbates the scale of regulatory arbitrage and stifles competition by rewarding geographic footprint rather than innovation.

With reference to the single market maker trading model referred to in our response to question 28, the ability for retail brokers to distribute their services across the Union digitally, exposes retail clients across the Union to this single market maker trading model, which essentially constitutes PFOF (albeit the payment of the inducement is between the market maker and the RM / MTF operator rather than the market maker and the retail broker), despite the fact that some Member States, such as the Netherlands, have banned PFOF outright.