SUMMARY OF FEEDBACK RECEIVED

<table>
<tr><td>Consultation title</td><td>Proposed guidance on Payment for Order Flow (PFOF)</td></tr>
<tr><td>Date of consultation</td><td>12 October-23November 2011</td></tr>
<tr><td>Summary of feedback received</td><td>

We received 34 responses from across the industry, including trade associations and execution venues.
While we did receive some response from the cash equities market (which were supportive of the guidance), the majority were from participants in the traded options and derivatives market (LIFFE).
The views expressed by participants in the LIFFE market are polarised. The brokers are in favour of their existing arrangements, which involve receiving payments from market makers when arranging transactions in the call around market (this is where there is insufficient liquidity in the central order book and the broker has to call market makers for prices). They argue that they provide a service to market makers. The market makers disagree strongly, arguing that no service is provided and that they are paying for each order.

LIFFE brokers
The trade bodies (Futures and Options Association, FOA and the Association for Financial Markets in Europe, AFME) and LIFFE argue in favour of the brokers’ position as follows:

The brokers are providing a service to the market makers in return for which it is proper to charge a fee.
The ‘service’ includes providing information on trading, research and on occasions, helping the market maker to unload a position by finding a counterparty.
When executing a client order, they sometimes involve other clients (in addition to market makers) as the counterparty and that other client is naturally charged a commission so why should the brokers not treat market makers in the same way as clients and charge the market makers a commission?
Transactions with market makers amount to crossing between two clients, both of whom are charged a commission.
The commissions paid by market makers are small in relation to the price.

LIFFE market makers
With one exception the market makers were strongly opposed to the views of the brokers and so were supportive of the PFOF Guidance paper. Their arguments are as follows:

No service is received by market makers from brokers (rather, it is the market makers that are providing a service – the provision of liquidity).
The commissions charged are essentially a subsidy for the broker’s client.

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	• When the broker helps a market maker to unload a position by finding a counterparty, the market maker is not usually charged a commission (i.e. pays commission when no service is provided but pays no commission when a service is actually provided). • The commissions paid by market makers do affect the prices they offer (in two cases, we have been told that the total of such payments is comparable to their overall trading profit – so clearly, it is a substantial cost). • The market makers indicated that they were aware of examples of situations that disadvantage the broker's client because of the need for the market maker to pay commission to the broker. • The commissions paid by market makers to brokers amount to a payment for each order. • In some cases, brokers charge their clients no commission but do charge market makers. We have also been informed that commissions charged by brokers to their clients (this does not relate to charges to market makers) have reduced by 80% since trading moved away from the LIFFE floor. • Commissions vary in amount depending on the broker.
Response to feedback received	We welcome the feedback received and appreciate the effort and time respondents have taken. We understand the strong feeling our guidance has provoked from both market makers and brokers. However, primarily it serves to underscore the importance of firms to carry out due diligence to ensure they are applying the relevant COBS rules in the right way. These COBS rules, derived from MiFID, have been in place since 2007. Therefore, the finalised guidance does not outline new or additional obligations on firms but seeks only to reiterate that broker firms must reference these rules in the context of receiving payments from market makers when a client is relying on them to act on their behalf. • It is clear that there is disagreement between brokers and market makers about whether a service is being provided. While commission or fees charged by brokers to market makers vary, such charges appear to be applied more heavily to market makers than to the client of the broker initiating the transaction. • It is clear what service is being provided to the client of the broker initiating the transaction but less clear what service is being provided to market makers when the broker engages with the market maker to arrange execution of its client order. Crucially, we note that many clients of the brokers will rely on the broker to act on their behalf. • This is clearly different from the inter-dealer broker market where neither client of the broker looks to the broker to act on their behalf. We note the CESR guidance outlined in its Best Execution Q&A[1], which makes clear the circumstances where a client can legitimately rely on the broker. • The Payment for Order Flow guidance sets out the circumstances of how and when the COBS rules apply to third party payments.

[1] Best Execution under MiFID: CESR Q&A May 2007 (Ref:CESR/07-320)

	• Nothing has arisen as a result of the responses received that warrants any modification to the guidance.
Changes made to the guidance as a result of feedback received	• Our guidance remains unchanged but we have made some minor additions to clarify that where a client relies on the broker to act on their behalf, the broker must consider whether the payment from the other side of the trade, in this case the market maker, complies with the inducements rules. • Any broker not currently disclosing the receipt of third party payments, will bear some incremental costs in order to comply with the disclosure part of the inducements rule. We note CESR comments on this.[2] • We anticipate that a broker would need to disclose its third party payments once only, unless there are changes in its payment arrangements in which case the disclosure would need to be updated. CESR has said that disclosure using bands is adequate for summary disclosures only. While the rule does not specify the medium through which these costs should be disclosed, CESR advises that it should be 'fair to the client'. • Referring to the original CBA[3] on the inducements rule, we note the estimated one-off incremental costs of £700,000. This estimate, however, was based on 2,500 MiFID firms. Therefore, we estimate the one-off cost for disclosure will be negligible at around £280 per firm. This estimate needs to be updated for inflation. Based on movements in the Consumer Price Index between August 2007 and February 2012 (the latest relevant period for which the index value is available), the one-off cost amounts to £325 per firm. • On-going costs would be limited to the costs associated with disclosing to new clients and any general costs related to on-going disclosure in either paper or electronic form. We think the marginal costs of these to the LIFFE and non-LIFFE brokers will be negligible. • If brokers cannot comply with the inducements rule, they may consider other arrangements which could include either i) forgoing these payments altogether; or ii) changing the way they are remunerated by increasing the charges applied to clients. In effect the commission is transferred or imposed on the end user client. The market maker as a result could offer a better price. As a consequence, the client gets a better price but pays a larger commission. The net effect is largely neutral, all other things being equal. However, there would be an overall benefit to clients in terms of improved information and efficiency. • Broker costs should be set at the level which is efficient and which the market naturally supports and should not be distorted in any way by opaque fees or commissions.

[2] Inducements: Report on good and poor practices, CESR, April 2010 (Ref: CESR/10-295)
CESR states that: Summary disclosure should thus provide enough information to the client to enable him to understand the situation, while the detailed disclosure goes a step further, providing the client with more in-depth information. For example:
while bands may be used in summary disclosures, it is the exact amount of payments and non-monetary benefits or method of calculating that amount (where the amount cannot be ascertained ex ante) that should be indicated in the detailed disclosure;
a summary disclosure may mention that the investment firm receives research from brokers to whom it transmits orders for execution, while the detailed disclosure should contain more detail, e.g. an estimate of the value of the investment research.

[3] CP 06/19: Reforming Conduct Business Regulation, Chapter 2, Annex 1

	• If these payments are rebalanced such that clients bear the cost directly of all brokerage charges, then the payment for order flow problem would not arise.
Full text of the guidance consulted upon can be accessed here	