FINANCIAL CONDUCT AUTHORITY

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Dear CEO,

Payment for Order Flow (PFOF)

In September 2016 the FCA published Market Watch 51 on Payment for Order Flow ("PFOF"). This followed on from the publication of our Finalised Guidance in 2012 and our Thematic Review on best execution and payment for order flow in 2014 (TR14/13).

Our view is that the practice of brokers demanding payments from counterparties as a condition for conducting client business with them substantially undermines a broker's ability to act as a good agent. We are writing to reiterate that firms who continue to charge PFOF will breach the new standards implemented in MiFID II, remind firms that they must take action now to ensure compliance and to warn against any attempted models that seek to avoid these rules.

PFOF arrangements introduce a conflict of interest which is likely to cause harm to clients and markets. We have repeatedly expressed our concerns about PFOF which we consider to be bad for our markets; it undermines the transparency and efficiency of the price formation process; it inhibits competition by enforcing a "pay-to-play" model on market makers; and leads to poor outcomes for end clients, as brokers are incentivised to pursue payments rather than best execution. Those market makers which do pay might be expected to offer better prices for end customers without the additional payment.

MiFID II

MiFID II further restricts the practice of PFOF. It reinforces the restrictions on third-party payments when executing orders on behalf of retail and professional clients. It also strengthens the conflicts of interest requirements, which will be significant for firms providing investment services to eligible counterparties, but are also equally relevant to professional and retail client business. These enhanced requirements place explicit emphasis on the obligation on firms to avoid or prevent conflicts from arising in the first place.

MiFID II also extends some general principles to the provision of investment services to clients categorised as eligible counterparties. In particular, firms are obliged to act honestly, fairly and professionally and communicate in a way that is fair, clear and not misleading.[1]

[1] MiFID II Policy Statement 17/5, pp 59 – 61

Action for you

Firms must take action now to ensure they comply with these requirements. This will be a priority area of supervisory focus after January.

We are greatly concerned by market intelligence which suggests that some brokers are seeking to avoid these rules through the design of structures which seek to avoid requirements that prevent them from charging market makers a fee in exchange for directing order flow to them e.g.:

- Linking charges to market makers for non-execution services, such as research products or market analysis software, to the amount of business transacted, in an attempt to replicate the PFOF previously received, or insisting that market makers subscribe to such non-essential services to continue to see the broker's flow.

- Establishing arrangements with intermediaries or overseas affiliates with a view to getting around FCA requirements on conflicts of interest, inducements and best execution in order to continue to charge PFOF from market makers.

- Only contacting market makers who have been required to send alternative order flows to brokers (which would not normally be executed through brokers e.g. hedge trades) for the sole purpose of generating a fee to replicate PFOF.

We will scrutinise any arrangements that seek to circumvent the rules, for example relying on contractual arrangements that do not reflect the economic reality of the relationship.

Any market makers who are approached by firms with proposals which attempt to circumvent the requirements (as set out above) should not engage in such arrangements and should make the FCA aware of these attempts.

Yours faithfully,

Marc Teasdale
Director, Wholesale Markets and Investment Management