Bachelor Thesis Exposé

**An Analysis of Payment for Order Flow in European Financial Markets**

The rise of commission-free trading and the challenges for regulators and operators in the EU

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**Bachelor Thesis Exposé**

# Abstract

This bachelor thesis analyzes the practice of "Payment for Order Flow" (PFOF) in European financial markets. The aim of this work was to fundamentally explain PFOF and to examine relevant European legislation and its transposition into national law with a particular focus on Germany. Important financial and legal terms are introduced first, before loopholes or misconceptions in the European law are disclosed. Thereafter key opportunities and risks of Payment for Order Flow, that are proven by recent studies, are presented. In the last part of this thesis, solution approaches to the previously defined risks are introduced and evalutated ending with a best option proposal for all stakeholders.

# Problem formulation

The following questions are to be answered within this bachelor thesis:

1. What is meant by the term "Payment for Order Flow" (PFOF) and who are the bodies involved?
2. What regulations are there on the subject of PFOF in Europe and how are they implemented in national law? Can loopholes or misconceptions be found in the European and/or German legal framework?
3. What are the opportunities and risks of Payment for Order Flow?
4. What possible solutions are there to limit the risks?

# Target setting

In recent years, the practice of payment for order flow has become increasingly widespread in Europe. However, the legal treatment of PFOF varies greatly between the European member states and is still subject of intensive debates, as the impact of PFOF on the investor and the market is not yet clear.   
  
The subject is rarely addressed in the specialist literature. However, it has been highlighted in numerous studies and scientific papers.

The aim of this thesis is to explain the topic of Payment for Order Flow fundamentally and to identify challenges for the European legislator. Therefore the following topics are examined more closely: definition, mechanism, actors, European legislation, and its transposition in national law, legal loopholes, and misconceptions, opportunites and risks of PFOF and a final exposition and evaluation of possible solutions.

# Structure

This bachelor thesis can be divided into four parts: (1) explanation of terms and background on the subject of payment for order flow, (2) legal analysis, (3) opportunities and risks of PFOF and (4) solution approaches.

After an introduction in the first part to topic-specific terms and principles, the second part examines the relevant European legal framework and its transposition into national law with a particular focus on Germany searching for loopholes or misconceptions. After opportunites and risks of the PFOF practice have been determined, this work closes with a presentation of solution approaches to the previously determined risks of PFOF.

To see where the focus lies within this bachelor thesis, here is a proposal of page counts for each part:

(1) Explanation of terms and background: 7

(2) Legal analysis: 15

(3) Opportunities and risks: 5

(4) Solution approaches: 10

# Accurals

This bachelor thesis defines some important terms and basics on the subject, but does not provide a complete glossary of all related financial terms.

This thesis also focuses on an analysis of payment for order flow in European financial markets with a special focus on German financial markets, since an examination of other financial markets would go beyond the scope of this thesis.

Furthermore, it should be noted that the last part of this work shows only a part of all possible solutions of the PFOF debate. Certainly, other solutions can be found.

# Content of each part

## (1) Explanation of terms and background on the subject of PFOF

To fully understand the concept of PFOF, I will introduce all involved actors within its practice and provide definitions and references from the European legal framework before explaining the business model and mechanism. As few important financial terminologies are mentioned, I will also explain them in more detail. Further, the functionalities and properties of the "Maker-Taker" pricing system, in which payment for order flow is an elementary component, should also be explained. At the end of the last chapter, the general cost structure of a trade should be explained.

## (2) Legal analysis

In the legal analysis, the current legal situation in Europe will first be introduced, then important legal terms and the legal framework relevant to the PFOF topic will be presented. Subsequently, all subject-specific regulations are to be examined and legal gaps identified.

## (3) Opportunities and risks of PFOF

On the basis of the legal analysis, all advantages and disadvantages should then be comprehensively shown. Those benefits include increased market stability, commission-free trading and price improvement for retail investors and reduced competition among investment firms. The risks may include the distortion of market efficiency, failure to deliver best execution, misleading user interface and lack of transparency, reduced competition, and conflict of interest.

## (4) Solution approaches

In the last part of the bachelor thesis the following solution approaches to the PFOF debate shall be presented:

1. Consolidated Tape as proposed by the EU law

2. Increased transparency requirements for investment firms routing order flow

3. Change of execution policy

4. Redesign of the conflict-of-interest resolution

5. Measures to maintain liquidity in the market

Since Boerse Stuttgart would like to publish a white paper on the last point, I have decided to explain it in more detail.

The bachelor thesis concludes with one or a combination of several proposed solutions for the PFOF debate.