FESE response to the AFM consultation on restriction on sale of turbos to retail investors

Brussels, 22nd January 2021

Introduction

FESE welcomes the opportunity to respond to the Dutch Authority for the Financial Markets (AFM) consultation on measures to restrict the marketing, distribution or sale of turbos.

Our Members fully share the AFM's objective of safeguarding investor protection and agree that some product intervention measures at European or national level might occasionally be necessary for specific products. As such, exchanges understand that the product intervention measures in relation to binary options and Contracts for Difference (CFDs), at ESMA level and subsequently at national level, constitute such measures of last resort given that the products in question are not suitable for retail clients.

However, it is important to note that securitised derivatives, including turbos, are very different from CFDs in many important and fundamental aspects. Even though the pay-out profile of CFDs and turbos is nearly identical above the total loss threshold, there are major differences in product and investor characteristics, trading models and regulatory requirements which need to be considered. ESMA acknowledged this when they explicitly excluded turbos from the product intervention measures on the provision of CFDs and binary options in 2018[1]. Thus, we consider the proposed AFM product intervention measures as inappropriate.

Securitised derivatives, including turbos, have a long history and cater to the investment needs of the retail investor, allowing for a more sophisticated risk/return approach to their investments. In the case of turbo certificates, experienced investors use them as a tool to hedge their portfolio risks. With above-average experience in investing and risk-taking, they are well-equipped to weigh chances against risks and to assess the characteristics and the complexity of turbo certificates.

To facilitate transparency, regulators and policy makers have established standards for product information which take into account what is appropriate for consumers and their demands. The information is comprehensive and easy to understand, while offering a sufficient level of precision and depth in a standardised format. Based on this, retail investors should continue to have wide access to different types of investment products. In short, product intervention measures restricting the sale of products to retail investors by supervisory authorities should only be used as a last resort.

FESE is concerned about the proposed "in and from" measures which would be applicable to any investment firm acting with a Dutch retail investor (i.e. measures limiting Dutch investor access "in" the Netherlands) and any investment firm, registered in the Netherlands, acting with retail investors anywhere in Europe (i.e. measures limiting EU investor access "from" the Netherlands).

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[1] ESMA. 2018. Questions and Answers on ESMA's temporary product intervention measures on the marketing, distribution or sale of CFDs and Binary Options to retail clients, p. 12 (Link).

Most notably, we believe that the proposals to apply the restrictions to "investment firms with their registered office in the Netherlands that provide investment services in another Member States" (point 10 of the AFM consultation) would be detrimental to EU investors' access to these services. Indeed, non-Dutch investors based in other EU Member States will be impacted and no longer have access to the services provided by Dutch investment firms.

The proposed national measures by the AFM will have an extra-territorial impact on other jurisdictions. These measures would allow for unfair treatment in the provision of services to investors in the EU, based on the registered office of the investment firm.

FESE believes this could be in breach of Art. 42 (2) of MiFIR, which states that a national competent authority (NCA) may undertake a product intervention measure if it:

- "Is proportionate taking into account the nature of the risks identified, the level of sophistication of investors or market participants concerned and the likely effect of the action on investors and market participants who may hold, use or benefit from the financial instrument, structured deposit or activity or practice" (point c);
- "Does not have a discriminatory effect on services or activities provided from another Member State" (point e).

The combination of "in and from" measures from the Netherlands would introduce complexity and could lead to a distorted EU market for turbos which could have an adverse negative impact on EU retail investors' access to turbo products.

1. Product characteristics: Exchange traded securitised derivatives have a long history and cater to the investment needs of retail investors.

Until the 1990s, there were no straightforward options for retail investors to profit from when, for instance, the price of an asset falls or in sideways markets. Also, tracking the performance of national indices, not to mention international markets, was limited to professional investors only. When the first securitised derivatives were introduced approximately 30 years ago, they catered to the investment needs of retail investors. Securitised derivatives, including leveraged products such as turbos, is now an established product category in the EU, used by retail investors as protection and distribution tools in their investment strategies.

In its consultation document, the AFM refers frequently to turbos as being comparable to CFDs. However, as previously indicated, even ESMA acknowledges significant differences in the product characteristics between CFDs and turbos[2]. While a variety of business and trading models are observed in the sector, CFDs brokers typically act as the counterparty to the client's trades. Some of these firms hedge their exposure according to their risk appetite or on a trade-by-trade basis, while others assume the full market risk against the client's position. This puts them in the position of making the market and the broker. This bears an inherent conflict of interest between the firm and the client, since the CFD broker benefits from the client's losses. In turbos markets, the roles of "broker" and "counterparty" are usually separated. Contrary to the AFM's assessment, firms which offer turbos do not benefit from the client's losses and consequently are not incentivised to act against their clients' best interest. The opposite is valid for CFDs, where there is an inherent conflict of interest as many CFD providers do not hedge their exposure and thus offload the full market risk onto the customer.

Being both market maker and broker at once, CFD brokers benefit directly from the client's losses – which is fundamentally different from turbo certificates where the broker does not benefit from customer anticipation errors.

[2] See footnote 1.

2. Investor characteristics: Investors' trading motives and the level of sophistication matter.

Turbos are by and large traded by self-directed investors that usually have an above-average level of financial literacy. As such, investors engaging in such trades know the associated risks of securitised derivatives products. Their investment objectives vary from investment to speculation or hedging purposes. These investor motives need to be taken into consideration when interpreting figures about investors' losses in trading with turbos. Furthermore, the total investment portfolio of retail clients also needs to be considered as this is closely connected to the use of turbos as hedging tools. This is an important aspect that the AFM's 2020 study ignores.

A recent study[3] on the German market reveals that investors' motives behind trading in securitised derivatives like turbos matter. The authors demonstrate that the performance of investors highly depends on the motives behind the trades. The study reveals that only investors classified as "hedgers" make losses in trading products like turbos. This is no surprise given the fact that this group of investors simply hedge their positions in underlying assets by purchasing turbos, thereby mitigating the risk of falling prices of the positions in underlying assets. In other words, the negative returns are offset or overcompensated by positive price developments of the underlying assets. Thus, it is not justified to claim that turbos are bad for investors just because of the appearance of negative returns. Since the level of financial literacy in Germany and the Netherlands is similar[4], it is reasonable to assume that this can also be applied to the Netherlands.

The study also provides insight into investors' experience and risk behaviour. It is shown that the average investor is significantly less risk averse than investors trading in other products and that they are four times more likely to trade in all other products, such as stocks and funds. The authors conclude by highlighting that these investors should be familiar with the features and the characteristics of the products they are trading, have trading experience and use the products consciously.

Following Art. 43(2)(d) of MiFIR, investors' level of sophistication has to be taken into account when it comes to defining the proportionality of a product intervention measure. The results shown above indicate that the investors' level of experience is high. Thus, we consider the proposed product intervention measures by the AFM as disproportionate.

3. Value of exchange trading: Full pre- and post-trade transparency, strict trading rules, independent market surveillance and a liquid market.

As transferrable securities, turbos are predominantly traded on regulated markets or MTFs with associated levels of trade transparency, strict trading rules and independent market surveillance. Investors benefit from price competition as they can choose between different issuers of securitised derivatives regardless of their broker security account or the trading venue. In contrast, CFDs are generally traded in a bilateral OTC environment. Exchange rules and regulations define quote obligations (e.g. size and order book presence) for liquidity providers and market makers to ensure that products can be bought and sold on a regular basis.

We disagree with the AFM's opinion regarding the provision of information being insufficient from an investor protection point of view. On the contrary, we see that turbos' investors are well informed. We acknowledge that turbos trades are usually executed without investment advice, but believe that this is because the average turbos' investor does not rely on

[3] Meyer, Steffen; Bövers, Kim; Johanning, Lutz. 2019. Leveraged Structured Financial Products: Trading Motives and Performance. (Link)

[4] See Klapper, Leora; Lusardi, Annamaria; van Oudheisden, Peter. 2015. Financial Literacy Around the World: Insights from the Standard & Poor's Rating Services Global Financial Literacy Survey (Link).

investment advice but takes his/her own, well thought out, trading decisions, as the above-mentioned study revealed.

We would like to also highlight that, according to trade statistics, there is widespread demand for highly leveraged products, which is currently met by turbos traded on regulated markets. However, the introduction of leverage caps for turbos is expected to remove supply from exchanges at the upper end of the leverage factors currently offered, leaving unmet demand that could force investors to use less suitable/more expensive instruments/strategies to hedge their investments or to look for alternatives in less/unregulated markets.

4. Regulatory environment: Comprehensive regulatory framework for the issuance and distribution of securitised derivatives.

The issuance and distribution of securitised derivatives is comprehensively regulated, inter alia through prospectus law, MiFID II/MiFIR and the PRIIPs regulation. The prospectus contains a comprehensive description of all product features, the issuer, and the risks associated with the issuer and product. This provides investors with an adequate, legally required level of information for securitised derivatives, thereby guaranteeing investor protection. The prior approval of the prospectus by the national competent supervisory authority ensures compliance with the provisions of prospectus law. This requirement to prepare and approve a prospectus clearly distinguishes securitised derivatives products from CFDs. As CFDs are not securities, there is no requirement to draw up a prospectus.

Securitised derivatives are part of a bank's standard range of products, and their design is very transparent for retail investors due to the provisions on the target market and cost transparency. Furthermore, there is a suitability test that clients need to pass to be able to trade these products, regardless of whether they are self-advised or not. Trading venues fulfil pre- and post-trade transparency requirements, have implemented strict trading rules and an independent market surveillance system. This differs from the non-standardised pricing and settlement of CFDs, as highlighted by ESMA. In addition, there is a common European standard on investor protection for securitised derivatives, this allows investors to understand the terms of the products.

In many European countries, national regulators have been very strict for many years about all marketing and educational material created and published by securitised derivatives issuers. Some NCA's require issuers to first obtain explicit approval before any document can be published, others have provided guidelines that issuers must respect. These measures ensure that issuers provide enough risk warning and not only focus exclusively on benefits of securities derivatives but also draw investors' attention to the risks of such financial instruments.

Conclusion

All in all, from our perspective, the existing regulatory environment is sufficient. Investors hedge open positions in the underlying assets by trading turbos. Furthermore, the characteristics of investors show that they are experienced traders who are familiar with financial products and trade frequently in other products. Therefore, they also know about the functionality of turbos, the use of stop losses and the functioning of underlying instruments and assets. The level of complexity is manageable, the relationship between return opportunities and risk should be known to investors.

We therefore believe that product intervention measures would be inappropriate and disproportionate.