FESE comments to IOSCO Retail Market Conduct Task Force Report

Brussels, 23rd May 2022

Q1: In their risk analysis, should regulators specifically consider/target specific demographic profiles/groups for additional or enhanced investor protection measures? If so, should greater attention be focused on younger age groups or older age groups? Is there a tipping point in behaviors beyond which regulators should become concerned?

Policymakers need to consider both the complexity of the instrument being issued and the nature of the investor. There is a need to balance investor protection with potentially negative impacts arising from increased costs and administrative burdens, in particular reduced retail access to capital markets.

While FESE, representing European exchanges, does not directly deal with retail investors, as they access these venues through intermediaries, we believe that these investors need to be empowered by making investment practices simple, less costly, transparent, and taking steps to prevent conflict of interest and ensuring their protection.

The way retail investors are categorised plays a role in the notion of access to products. In the EU, for instance, investors are solely categorised as either professional or non-professional. MiFID II specifies that an investor may be categorised as professional if they comply with at least two of three criteria set out in the legal text: i) clients having carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters; ii) the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments exceeds EUR 500 000; and iii) the client works or has worked in the financial sector for at least one year in a professional position (…). Retail clients are those investors that do not fall under the category of 'professional investors'.

FESE believes that there is room for improvement in the way retail investors are categorised. With a specific reference to the European case, we believe that an introduction of an additional client category (e.g. 'semi-professional') would enable to increase accessibility to financial instruments that are currently out of reach to those investors. Consideration of demographic profiles should lead to an alleviation of existing rules for selected investors, not to more rules. In addition, given the variance in investment experience and knowledge across age groups, age is not a reliable proxy for regulatory intervention. Furthermore, when discussing retail investor protection and accessibility to financial instruments, policymakers should consider the amount of information available. The existing information requirements and related number of information documents may overwhelm some retail investors. It is important to strike a balance between ensuring retail investors' protection and facilitating their participation in capital markets. This balance should be kept in mind when discussing specific demographic profiles as well.

Q2: Does the consultation report capture accurately the important retail trends and the reasons for increased retail trading? Are there any missing concerns or issues and other potential risk magnifiers? What may be the current and potential long-term implications of increased retail participation in markets in your view?

The report broadly captures various drivers for increased retail trading. Increased retail investor participation is particularly positive for European investors, which remains behind other regions in the world, in particular the US. Policymakers should focus on how to benefit investors, rather than intermediaries, to ensure that retail investors can benefit and get sustainable returns from their participation in public capital markets. Further, FESE believes that a lack of trust may be one of the reasons that discourage retail investors to participate in capital markets. Transparency and effective price formation are key to ensuring long-term retail participation in well-functioning and trustworthy financial markets, which ultimately benefit the entire economy through increased capital flows.

Q3: What may be the potential implications of self-directed trading and gamification from a retail risk and conduct perspective? Should high risk aspects of these activities be regulated or prohibited, for example, certain risky gamification techniques?

While some elements of gamification could be considered positive, as they would facilitate retail investors' access to capital markets, other aspects are rather negative with respect to retail investor protection. Those elements include 'rewards' such as free stocks for new accounts, referral contests among investors, push notifications, instant availability of funds, social-media-like feeds, and other graphical effects. For instance, a recent study by Arnold et al. (2021)[1] finds that push notifications lead to investors taking higher risks and that this attention-induced risk-taking especially affects younger and inexperienced investors. In addition, some gamification techniques incentivise retail investors to trade more often, while paying the spread with each trade and therefore leading to lower returns, which may not be aligned with retail investors' long-term investment goals.[2] Thus, FESE welcomes that those risks regarding such gamification techniques are being monitored on European and international levels.

As gamification may drive more people into capital markets, regulators should however not prohibit gamification practices per se. They should rather focus on providing clear guidance on where to draw the line between those gamification practices that reduce the barriers for retail investors to participate in capital markets, and those practices of gamification that are detrimental to retail investor protection.

[1] Arnold, M., Pelster, M., & Subrahmanyam, M. G. (2021). Attention Triggers and Investors' Risk-Taking. Journal of Financial Economics.

[2] Reuters. (2021). Explainer: Robinhood makes most of its money from PFOF. What is it? Available at: https://www.reuters.com/business/finance/robinhood-makes-most-its-money-pfof-what-is-it-2021-07-29/

Q4: How should regulators consider whether to monitor crypto-asset trading by retail investors? Are there ways that the apparent data gaps with regard to retail investor crypto-asset trading could be filled or other protections for retail investors or ways in which regulators could begin to monitor crypto-asset trading? Are different approaches likely to be more or less effective in jurisdictions with different regulatory, statistical and other governmental and private sector approaches to data gathering?

In general, FESE believes that crypto-assets can offer new investment opportunities for (retail) investors, improve transparency, and enhance innovation and competition, amongst others. At the same time, it is important to apply the principle of technology neutrality in regulatory frameworks. Following this notion, the principle of "same business, same risks, and same rules" should apply to crypto-assets, both in terms of investor protection and to platforms offering crypto-assets. Providing a legally binding approach based on existing practices would provide legal certainty and reduce regulatory arbitrage, inconsistencies, and market fragmentation.

Along this line, it is important to define how crypto-assets should be assessed as either financial assets or non-financial assets. Such an assessment would facilitate the implementation of jurisdictions' regulatory approach to crypto-assets, ensuring that crypto-assets that act as financial instruments are considered as such for jurisdictions to then apply their existing financial provisions (with respect to principles on investor protection and market integrity) on the relevant crypto-assets services. The categorisation or definition of crypto-assets should be based on the nature of the assets that they represent rather than on different technical features provided by cryptography or its DLT technology.

Similarly, the recognition of some crypto-assets as financial instruments would allow for "crypto-assets service providers" to be subject to the same authorisation process as that of traditional trading venues when operating a trading platform. These "crypto-assets service providers" operating a trading platform should then have to comply with the existing regulatory framework, as well as with the specific requirements applicable to their respective services provided – as do other financial services providers.

As stated above, such a clear classification and distinction of crypto-assets that act like financial instruments and crypto-assets that do not act like financial instruments would help identify which investor protection provisions apply to the products and the market infrastructures where they are offered. Further, distinguishing the type of investor would enable providing a higher level of protection to retail investors than professional investors, as some crypto-assets might not be suitable for retail investors, like other financial instruments. Additionally, defining some crypto-assets as financial instruments ensures that they meet price formation and dissemination mechanisms that meet regulatory standards and thus ultimately benefit (retail) investors.

Overall, FESE supports the efforts conducted in generating a regulatory categorisation around crypto-assets, in particular at the EU level. This would enable regulators to have a common definition of crypto-assets and allow distinguishing between different types while bringing benefits to (retail) investors.

Q5: How should regulators approach these trends (e.g., both trading for crypto-assets or brokerages using hidden revenue raising mechanisms) and when should they seek to intervene?

FESE overall supports the increased retail investors' participation in the market but also acknowledges the need to monitor and scrutinise the developments around retail trading platforms' business models.

One of the hidden revenue models of brokerages less strongly covered in the report is that of payment for order flow (PFOF). PFOF models, which may be applied by online brokers but are not restricted to those, are detrimental to competition and the price building mechanisms, and it creates an inherent conflict of interest between the broker and the retail investor. Further, PFOF activities negatively affect competition between execution venues or market makers. PFOF creates a "pay-to-play" market. In the long run, those who pay any or the highest PFOF will prevail. This puts significant competitive pressure on exchanges as neutral and non-discriminatory platforms that want to compete on the best performance for investors rather than on the highest payment. Moreover, a non-uniform approach of NCAs regarding the authorisation or prohibition of PFOF distorts competition between brokers in the EU Member States and beyond. Currently, brokers from countries with strictly interpreted bans are disadvantaged by cross-border offerings from other brokers who cross-subsidise their offerings through revenues from PFOF.

PFOF can also undermine a core function of exchanges: the efficient and transparent price formation process on the basis of matching buy and sell orders. The creation of a "pay-to-play" market and the conflicts of interest inherent in PFOF lead to a reduction in transparency and worsen the price building mechanism to the detriment of investors but also for issuers raising capital in the financial market for growth and innovation. The execution against the market maker (so-called internalisation) often observed in PFOF practices implies the segmentation of the institutional flow and the retail flow and drains liquidity away from traditional exchanges. This is particularly problematic as traditional exchanges serve as reference markets for alternative execution venues regarding the price of a financial instrument and observing the growth of retail participation in capital markets. With a sub-optimal mix of retail and institutional flow on reference markets, implicit costs increase, and the price efficiency deteriorates. Thus, a spiral of decreasing price quality is set in motion at traditional exchanges as well as at PFOF execution venues.

To address the problem properly, policymakers should consider ensuring a harmonised approach. This would also support IOSCO's mission to protect investors, maintain fair, efficient, and transparent markets, strengthen market infrastructure and promote investor confidence in the integrity of securities markets.

Q6: Should regulators proactively monitor social media and online statements for retail investor protection and if so, when and how? Should social media be subject to additional regulatory obligations regarding securities trading and/or crypto-asset trading? How could such monitoring be implemented, and obligations enforced proportionate to the harm/potential harm? Are there any legal (e.g., data protection) or technical obstacles? What sort of risk assessment should regulators do to determine where to allocate their resources?

FESE supports the warning of investors about the risks of relying solely on social media information for investment decisions. At the EU level, ESMA raised awareness of certain regulatory requirements in order to avoid market abuse. This includes the dissemination of investment recommendations through any media and online platforms, as individuals using these platforms and the platforms themselves are subject to these regulatory requirements.

We support the efforts in monitoring and scrutinising the developments around retail trading platforms' business models. Social and mirror trading should be carefully monitored by regulators as it could create market integrity issues as well as significant losses for private investors following such trading practices. It should be ensured that social media platforms that offer market access, as well as online brokers, provide full transparency concerning risk checks, investor profiling, disclosure of costs and any agreement in place so as to offer no-fee trading. This includes PFOF, routing of orders, etc. The same rules and enforcement of these rules applicable to other providers should be applied to them.

Q9: Does the Consultation Report capture well the existing cross-border challenges? Are there any missing concerns or issues that are not highlighted? Are there any other novel ways of addressing cross-border challenges affecting retail investors? As an international body, what could be IOSCO's role in addressing the cross-border challenges highlighted in this consultation report?

FESE supports the efforts conducted in improving cross-border investments as well as enhanced convergence, especially when it comes to increasing consumer trust and empowering retail investors when buying services at home or abroad. Nevertheless, obstacles remain that not only may bring forward the issues set out in the consultation report but may also hinder more cross-border investments of retail investors. These include certain divergent taxation rules, legislative barriers and legal requirements across countries or EU Member States.

These diverging supervisory practices have a significant impact, especially in areas where there is a move to more cross-border business and competition. Thus, greater supervisory convergence efforts should be made in particular in those areas with strong cross-border characteristics. These efforts include following the goal to establish a level playing field, while identifying and recognising any situations in which there may be more than one way to achieve the objectives set out. Supervisory convergence should not lead to the erosion of national autonomy however: an understanding of local or regional cultures and habits, market players and business dynamics is essential for supervisors when dealing with cross-border activities.

Overall, FESE supports the aim of IOSCO to enhance cooperation among its members with regard to the issue of jurisdictional reach. However, convergence tools could be used more effectively where appropriate, particularly in areas such as investor protection. Efforts conducted by IOSCO such as the identified good practices within its 2020 report, for instance, could be broadened to the identified cross-border challenges set out in the retail market consultation report.

Q11: Where product intervention powers exist, what factors should regulators consider determining when it should be used and at what stage to ensure suitability and to mitigate investor harm? For example, should regulators monitor leverage levels in retail trading and/or seek the power to limit leverage? If so, is it possible to describe the kind of situation in which such powers could justifiably be used?

FESE fully shares the respective securities markets authority's objective of safeguarding investor protection and agrees that some product intervention measures might occasionally be necessary for specific products. In general, product intervention measures should be necessary, proportionate, and appropriate. For instance, FESE supports ESMA's product intervention measures on binary options and contracts for difference (CFDs). These products are not suitable for retail clients, the measures serve to promote investor protection and the intervention can be considered necessary, proportionate and appropriate.

Q12: Are the developments in retail investor behavior sufficiently significant and persistent to justify reviews by regulators of their current approaches to retail investor protection? If so, is that true globally or only in some markets? If some, what are the characteristics of the markets for which that is most true?

The significance and persistence of the developments in retail investor behaviour are not identical across all markets. For example, the developments have been more pronounced in the US than in the EU.[1] The review of the approach to retail investor protection should not solely be based on the actual or potential developments, but also on the scale at which they take place (in markets with low retail participation the approach cannot be the same as in markets with high retail participation, given the different economic consequences of the intervention).

Further, it would be important that future reviews address the need to enable retail investors to use capital markets more for long-term cost-effective investments (specifically pension investments) as investors with a long-term outlook are crucial for well-functioning capital markets. For example, financial incentives, such as tax breaks, or the elimination of the double taxation of dividends could be beneficial to enable long-term direct investment, as is the case for the EU.

[1] See for example ESMA (2021). Episodes of very high volatility in trading of certain stocks (statement ESMA70-155-11809). Available at: https://www.esma.europa.eu/sites/default/files/library/esma70-155-11809_episodes_of_very_high_volatility_in_trading_of_certain_stocks_0.pdf and Reuters (2021). Retail investor base doubles in Europe as U.S. meme stock mania spreads - Euronext.