

To: [consultation-03-2022@iosco.org](mailto:consultation-03-2022@iosco.org)

Subject: IOSCO Retail Market Conduct Task Force Report

Dear Members of the IOSCO Retail Market Conduct Task Force,

Deutsche Börse Group (DBG) appreciates the opportunity to provide feedback on the IOSCO Retail Market Conduct Task Force's Consultation Report.

In order for individuals to manage their finances and invest appropriately, it is critical that they understand the risks and benefits of investing and the various options available to them. Against this background, fact-based and comparable information on investment options is critical to ensure that every retail investor can clearly understand the risks and costs associated with specific investments.

A 2018 study by the European Commission concluded that financial services for consumers are consistently among "the poorest performing services market". This could even be accelerated by the practice of payment for order flow (PFOF). Given the inherent conflict of interest that it entails, both the U.S. Securities and Exchange Commission (SEC) and the European Union (EU) are currently assessing a ban on this practice. DBG supports such a ban, because we believe that PFOF is detrimental to retail investors and has an impact on market structure and price efficiency on lit trading venues.

Another risk for retail investors is related to marketing via social media or the Internet in general, which the U.S. SEC informed about back in 2014. Marketing often plays a significant role in investor information, and misleading information should be avoided at all costs. It is generally easy to create a website, account, email, etc. that looks and feels legitimate, but is actually set up by a fraudster. With this in mind, we share IOSCO's findings about the risks to retail investors by social media driven share trading.

Moreover, DBG recognizes the importance of product intervention powers for regulators to safeguard financial stability and investor confidence in financial markets, including available financial services and instruments. Product intervention measures under MiFIR allow regulators in the EU to prohibit or restrict the marketing, distribution or sale of certain financial instruments, financial activities or practices. The introduction of such measures may therefore have significant adverse effects on the financial instruments or activities concerned. DBG therefore believes that product intervention measures should generally only be used as ultima ratio and only if other corrective measures fail.

Finally, we caution against a ban on short selling practices as a regulatory tool during periods of market turmoil, as our evidence shows that markets with a ban have fallen more and recovered less compared to markets without a ban.

In our response, we focus on a few selected questions. We hope that our feedback will prove useful to you and remain at your disposal for further information.

Kind regards,

Deutsche Börse Group

**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?**

As mentioned in the IOSCO report page 13 section 2.6.1, some recent volatility events have raised questions about market structure but also investor protection; in particular the “Gamestop” volatility event early 2021 in the US raised concerns for retail investors trading among other via the broker Robinhood which gets paid by some market makers to route its order flow to them (“payment for order flow or PFOF” practice). As per Robinhood S1-filing for IPO, the company’s revenue tripled to \$959 million from 2019 to 2020 and three-quarters of that came from rebates it earned for sending trade orders to market makers, making PFOF Robinhood’s key revenue driver<sup>1</sup>. However, with the main argument that PFOF creates an inherent conflict of interest, the U.S. Securities and Exchange Commission (SEC) is considering a full ban on PFOF, according to their chairman Gary Gensler. In Europe, like in the United States, the retail market has grown in recent years, and similar discussions about PFOF and its impact on investors and market structure have led the European Commission to propose a ban on PFOF for investment firms in its [proposal](#) for the MiFIR Review. PFOF is already banned in the United Kingdom (UK) and in the Netherlands.

DBG supports a ban of PFOF as we believe it is detrimental to retail investors, the market structure and the price efficiency on lit venues. PFOF occurs when a broker systematically routes his retail order flow to a single market maker, a systematic internaliser (SI), or other execution venues in exchange for payment. PFOF has resulted in re-directing retail order flow from multilateral exchanges to dealer-driven venues and SIs. We believe that PFOF schemes are harmful to investors and the market for the following reasons:

**1. PFOF creates conflicts of interest incompatible with best execution requirements (investor protection issue)**

The broker that has a contractual relationship with execution venues that pay to receive his clients’ order flow will be incentivized to steer the order flow to those venues. Competition will shift from execution costs for investors to payments received by the broker; the broker’s duty to ensure best execution is therefore compromised. In practice, some brokers would even eliminate all non-PFOF venues from their best execution policies and order entry masks, or their clients would have to pay a mark-up fee for executing their order on a non-PFOF execution venue.

**2. PFOF leads to an unlevel playing field between brokers domestically and across borders (regulatory arbitrage issue)**

Due to of the different implementation of PFOF across the EU, the current environment creates an unlevel playing field between retail brokers in Europe and opportunities for regulatory arbitrage.

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<sup>1</sup> <https://www.sec.gov/Archives/edgar/data/1783879/000162828021013318/robinhoods-1.htm>

The recent takeover of a Dutch broker by a German broker illustrates this aspect: after the takeover, the broker (now under German law) was able to receive PFOF with a competitive advantage compared to other Dutch brokers, even though PFOF is banned in the Netherlands.

Even if some Member States may not feel affected as they do not observe PFOF execution venues in their jurisdiction at this stage, we believe it will only be a matter of time once PFOF execution venues will start to attract order flow outside their jurisdiction, potentially circumventing the local requirements to apply the existing MiFID II rules.

### **3. PFOF hinders competition between execution venues on the basis of best execution principles (competition issue)**

The success of a new execution venue is conditional to the level of payment this venue can offer to brokers: only where this venue is willing to make a higher payment than the one offered by the incumbent venues, it may successfully enter the market (pay to play models). This system de facto limits competition and favours concentration with only big players able to “buy” the order flow without offering the best results for retail investors.

### **4. PFOF accentuates the segmentation of retail vs. institutional flow and impacts the price formation process (market structure issue)**

With the extensive steering of order flow by most retail brokers towards dealer-driven venues/SIs making payments, the retail flow is no longer part of the price formation process on lit venues. Because competition on prices no longer exists under PFOF-schemes, such a model is only beneficial for market makers and brokers. In the medium to long run, with a combination of lower liquidity and higher concentration of informed traders, the asymmetry of information increases and pushes market participants to quote higher prices to sell shares and lower prices to buy shares on lit venues; the difference between the best bid and the best ask prices (bid-ask spread) widens on the reference market translating in higher costs for all investors.

As mentioned earlier, the European Commission has proposed to ban PFOF. The proposed text takes the perspective of the investment firm acting as a broker and the ban of PFOF extends to all parties addressed by the investment firm when sending their clients flow, i.e. it is not limited to any specific players such as neo-brokers or zero-commission brokers, who are often associated with PFOF even though PFOF is a much more widely spread practice as highlighted above. Only a ban of PFOF (covering all PFOF-players), will help to solve the above-mentioned issues and

- i. ensure PFOF is compliant with MiFID II rules, clearly avoiding any conflict for interests;
- ii. create a level-playing field and avoid regulatory arbitrage between EU Member States;
- iii. support price-based competition and no longer payment-based competition and;
- iv. support price efficiency for the benefit of all 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?**

In the context of brokers using hidden revenue raising mechanisms, DBG would also like to raise IOSCO's awareness to investment firms (IFs) designing and offering OTC-derivatives, such as CFDs, marketed and distributed to retail clients via their own online OTC-trading platform. After an investigation by ESMA in 2017, insight was provided on certain shortcomings particularly in these OTC markets. We fear that conflicts of interests for these IFs are not fully resolved yet, leading to potential adverse effects for retail investors, who often cannot assess the perceived arbitrary price setting mechanism in Contracts for differences (CFD) markets. In addition, the concept of implicit costs in these markets may often not be clear to retail investors, when zero costs are implied or advertised.

It appears that the majority of such IFs designing and offering OTC products, for example CFDs, to retail clients through their own OTC-trading platform charge their retail clients an additional spread on their transaction, meaning they charge a spread mark-down on the bid price and a spread mark-up on the ask price. The spread is thereby applied to a reference price received from a third party, such as financial market data providers, who source their price feeds from the relevant trading venues. However, the IF acts as the sole market maker and thus controls the liquidity situation, including the size of the bid-ask spread, on the OTC-trading platform, and does not necessarily need to adhere to the reference price provided by third parties; hence the IF can quote wider bid-ask spreads in accordance with their economic interest and contrary to the best interest of their retail clients.

The conflict of interest stemming from adjusting prices for CFDs on their OTC-trading platform to cater for individual interests is further exacerbated, where the IF acts as sole counterparty to retail client's transactions without hedging against the market risk of these positions. In this case, the firm's profits are directly correlated with the retail client's losses, incentivizing the IF to quote prices which are not in the retail client's best interest.

In order to increase investor protection, it is key to address and highlight to retail investors the implicit costs they might face, be it in the sense of a bid-ask mark-up/down or because risk management aspects were not adequately addressed and reflected in the cost/price advertised. To allow retail investors to choose in an informed way product, increased literacy in financial market mechanisms and products need to go in tandem, in order to allow for a healthy investment culture where retail investors do not end up comparing apples and pears.

Overall, it is important to foster trading on trading venues also for retail investors, as proclaimed in the G20 objectives of shifting more trading onto multilateral trading venues. Apart from the issue of PFOF, especially lit trading venues do not face these types of conflicts of interest and allow retail investors to participate in a brokered fashion and embedded in a mechanism of safeguards of a neutral trading platform, to reap the benefits of market transparency and market integrity also for retail investors.



**Q7: Are the main fraud types covered correctly (e.g., crypto-asset scams, boiler room scams, clone investment firms, and misleading information and promotional material)? What are the fraud patterns that cause/have potential to cause most retail investor harm? Are there other types of frauds or scams that regulators should consider?**

An increasingly observed phenomenon is the emergence of fraudulent websites copying the brand of regulated markets to deceive retail investors. These fraudulent websites emerge regularly and typically use an amended version of the regulated market's name, often also parts or logos of the regulated market's website, to create a trustworthy image for their fraudulent intentions or to even pretend an affiliation to the regulated market. Using this image, these fraudulent websites often present themselves as innovative online brokers to retail investors. It is assumed that these websites are promoted via social media or placed in retail forums to gain retail investors' attention. Once retail investors have registered, it is assumed that either their personal data or financial data are used against their will to the benefit of the fraudsters.

These fraudulent websites may undermine the trust of non-professional retail investors in the regulated markets. They also require regulated markets to constantly monitor the internet for frauds and to take legal actions if possible. As the initiators of these frauds, who are often located outside of the EU, can be hardly legally pursued in third countries, the legal actions are limited to the extent that only a shutdown.

**Q10: What may be the concerns or issues that regulators should ask for disclosure of (at both firm and product level), keeping in mind the balance between quantity of disclosure and the ability of retail investors to absorb such disclosure? Should markets continue to seek to put in place special arrangements that could encourage companies during stressed market events to provide disclosures and updates that help retail investors better evaluate current and expected impacts of such events? If so, what may be the practical options to achieve this, including who should provide this information? Are there specific technological measures or non-technological measures (e.g. changing the timing, presentation of the information) you would suggest to enhance the ability of retail investors to process the disclosure?**

One of the regulations aiming to protect retail investors with the help of providing the information with regards to investment products that might be distributed to retail investors is the EU Packaged Retail and Insurance-based Investment Products Regulation (PRIIPs). The PRIIPs Regulation aims to increase transparency for retail investors, facing an increasingly wide range of available investment products. To improve transparency around these products, the PRIIPs regulation demands the creation of so-called key information documents (KIDs), establishing a common standard of information to be provided to retail investors across the European Union. According to PRIIPs, exchanges as manufacturer for Exchange-Traded Derivatives (ETDs) are required to publish KIDs on the official website.



We understand that policy makers are focusing on more transparency for retail investors and we find it reasonable that ETDs are considered to be complex products and retail investors may need aggregated documents that would explain futures, call options and put options, differentiating between short and long sides, i.e. six KIDs in total which unfortunately often provide identical information that can add further complexity for the retail investor. As already proposed by the European Commission in the consultation on the retail investment strategy for Europe last year, financial literacy in the EU and worldwide shall be improved as well as further information and explanation regarding trading complex products shall be provided by distributors and financial advisors.

Pursuant to Art. 25 (2) and Art. 25 (3) MiFID II, investment firms such as intermediaries must assess the suitability or appropriateness of their clients in relation to the specific type of product and service. The assessment involves investment firms ensuring that their clients have sufficient knowledge and experience of the specific product or service to ensure that the client is aware of all risks. Investment firms distributing ETDs to retail investors are therefore required to thoroughly assess in advance whether a new retail investor understands these financial products and shall continue to do so.

**Q11: Where product intervention powers exist, what factors should regulators consider to determine 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?**

DBG acknowledges the importance of product intervention powers for regulators in order to secure financial stability and investors' confidence in financial markets, including available financial services and instruments.

Product intervention measures pursuant to MiFIR allow regulators in the EU to prohibit or restrict the marketing, distribution or sale of certain financial instruments, financial activities or practices. The introduction of such measures can thus have significant adverse effects on financial instruments or activities in scope. DBG is therefore of the view that product intervention measures should generally only be employed as ultima ratio and only if other correcting measures fail.

So far, product measures have been introduced in the EU with regards to derivatives traded in over-the-counter (OTC) markets, i.e. CFDs and binary options. These product interventions measures imposed by EU regulators have been welcomed by DBG in order to address the significant investor protection malpractices that had been present in these markets.

However, DBG has observed that regulators appear to increasingly focus with their product intervention measures also on exchange traded products, in particular exchange traded derivatives (ETD), such as futures and options. Not only were certain ETD already taken into scope of the CFD product intervention, but BaFin in Germany also recently proposed to introduce targeted product interventions measures regarding futures with additional payment obligations marketed and distributed to German retail clients.



In this context, DBG would like to emphasize that derivatives that are traded on exchanges, i.e. regulated markets according to MiFIR/MiFID II, are embedded in a resilient framework, composed of high regulatory, functional and technical standards. Regulated markets under MiFIR /MiFID II offer a non-discriminatory, multilateral trading environment for exchange traded products. Transparent order books and continuous trading ensure a transparent and orderly formation of prices. Exchange traded products, and specifically for derivatives contracts, are standardized contracts that fulfil the needs of the markets as well as the regulatory requirements for the admission of products and address all high investor protection standards relevant for exchange trading. Besides the highly regulated trading environment, ETDs also benefit from risk-adjusted margin requirements that are set by so-called central counterparties, i.e. CCPs. This framework ensures that investors are protected and can execute their orders and manage their risks in a transparent, fair, orderly and efficient manner.

Against this background, DBG asks regulators to carefully consider, if exchange traded product do indeed pose investor protection concerns that would justify an intervention, as the applicable regulatory framework for exchanges already ensures that the highest investor protection standards are being respected. In addition, DBG would like to highlight that the goal of the regulatory framework as per MiFIR/MiFID II is to facilitate exchange trading. Subjecting ETDs that have been designed to fit the exchange traded products frameworks would impair this objective.

Going forward, DBG would welcome if regulators acknowledge the high investor protection safeguards of regulated markets and consider the trading venue of a product as a distinctive product feature to the purely product-related classification approach that is currently enshrined in the product intervention powers as per MiFIR. Purely product related classification criteria, such as the leverage of a product as proposed by IOSCO, will lead to misleading conclusions, if the trading venue is not considered.

For example, the leverage of OTC derivatives is often set irrespective of the volatility of the underlying, which can have detrimental effects on the P/L of retail investors. In contrast, the leverage of ETDs, in particular futures, is inversely related to the volatility of the underlying. This is ensured by the margining rules that are applied to ETDs by the CCP. For example, the leverage of a futures contract results from the amount of initial margin that must be deposited for each futures contract. The amount of the initial margin for futures is set by the CCP. The CCP calculates the amount of initial margin required for each futures contract on the basis of historical and simulated risk scenarios. This procedure is also referred to as “risk-based margining”. This method of calculating initial margin calculation results in the amount of the initial margin being inversely related to the volatility of the underlying of a future. The more volatile the underlying is, the higher the initial margin requirement by the CCP and thus the lower the leverage of the respective product. Equity index futures therefore typically have a higher initial margin requirement than futures based on interest rate derivatives or FX derivatives and thus lower leverages. Therefore, DBG does not view the addition product related classification criteria as additional factors for regulators to consider as necessary. More emphasis should be rather laid on the trading environment of a product to avoid unintended consequences.



**Q13: Are the above regulatory tools appropriate, proportionate, and effective? Are there other regulatory tools regulators might consider? What new technologies may help regulators as they continue to address misconduct and fraud (including online/via social media)?**

While we acknowledge that IOSCO's consultation paper focuses on different aspects of retail market conduct, we also see some value in raising awareness for the overall integrity of price formation that we consider from a market operator's perspective as an essential element of markets that serve the best interests of retail clients.

Overall short selling is a critical underpinning of efficient price discovery and liquidity provision. Moreover, a great many investments and risk management strategies rely on the ability to take 'long' and 'short' positions. These benefit a wide range of retail investors as well as ordinary investors including pension funds and local governments. The loss of these benefits would need to be carefully balanced before determining that any intervention to prevent short selling is appropriate.

Short-selling bans are only one element from a larger toolkit for competent authorities to ensure orderly trading conditions and avoid risks to market stability and integrity; they add to trading venues' mandatory arrangements designed, applied and constantly amended to prevent disorderly price changes of a financial instrument. Exchanges have various arrangements in place to prevent those which were used extensively during the market turmoil 2020 but proved their effectiveness to contain the increased volatility and to maintain and restore market confidence.

Existing safety measures to protect the integrity of the price discovery process such as volatility interruptions and risk controls effectively fulfil the regulatory purpose of preventing prices from declining in a disorderly fashion and serve as efficient lines of defense to ensure orderly trading conditions and to protect efficient, fair and transparent price discovery process.

Academic literature confirms the detrimental impact of imposing bans on covered short selling positions. The WFE's review of the academic literature has compiled empirical evidence which almost unanimously points towards short-selling bans being disruptive for the effective functioning of markets, as they are found to reduce liquidity, increase price inefficiency and hamper price discovery<sup>2</sup>. This evidence suggests that banning short selling during periods of heightened uncertainty exacerbates market volatility.

To the contrary, imposing a ban on short-selling activities faces the challenge of determining a causal relationship between price declines and short selling activities and hence to state a clear and unambiguous justification for regulatory intervention.

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<sup>2</sup> <https://www.world-exchanges.org/news/articles/world-federation-exchanges-academic-review-short-selling-concludes-bans-are-disruptive-markets>