Neo-brokers in the EU: Developments, benefits and risks

ESMA webinar, 17 July 2024
Background

Rise in use of neo-brokers

Neo-brokers are a new generation of digital financial entities that enable consumers, mostly retail, to trade real-time in financial products.

Rapid growth in client assets but from a low base; ~ EUR 1tn in 2023

Widespread use suggests many small investors

Globally, highest-valued firms include:

- eToro (EUR 8 bn)
- Robinhood (EUR 8 bn)
- TradeRepublic (EUR 5 bn)
New entrants may change market structure, affecting trading conditions

Some firms known to receive Payment for Order Flow (PFOF)

• In 2021, ESMA warned investors of risks around PFOF, including around potential conflicts of interest and limited transparency, e.g. where firms claim to offer ‘zero-commission’ trading

Neo-brokers are innovative users of technology, with gamified features in some cases

• In 2023, ESMA published a discussion paper on investor protection aspects of digitalisation, including on ‘dark patterns’
• Potential to harness new technology to promote retail investor participation
Working with NCAs, ESMA carried out a market survey in 2023

**Sampled firms**
27 EU-based neo-brokers, authorised by 11 NCAs
Firms in sample identified as neo-brokers based on supervisory judgement

**Client coverage**
~ 10 million client accounts, mostly EEA retail clients
3 firms provide 72% of these accounts
Neo-brokers invest in process automation and user-friendly features

• Aim to curb costs and attract clients

Some offer additional services beyond trading, e.g. portfolio and wealth management, investment advice, custody and safekeeping

Most common types of financial instruments traded:

• Shares
• ETFs
• Fractional shares/ETFs or other contracts replicating shares and ETFs
• CFDs
• Derivatives
• Crypto assets
Business models

Execution model depends on instrument type

Neo-broker execution models
Neo-brokers may execute orders on venue or over-the-counter (OTC)

Option 1: On venue execution
Neo-broker as intermediary
Neo-broker acts as intermediary, directing the order flow to specific trading venues. The respective instruments can be transferred to another account outside the platform.

Option 2: OTC execution
Neo-broker as counterparty
The orders get executed on the neo-broker's platform. The instrument purchased represents a contract between the client and the respective neo-broker. Where the neo-broker acts as counterparty, the order typically cannot be transferred to another platform (i.e., selling the instrument is often the only way to exit).

Note: Schematic account of different execution models available to investment firms, including firms considered as ‘neo-brokers’ for the purpose of this article.
Source: ESMA
Main sources of revenue:

- order based commission fees
- bid-ask spread
- currency conversion fees
- Payment for Order Flow (PFOF)
- fees for other services

Since the period studied, an EU-wide ban on PFOF has been put in place

- However, transitional provisions apply till June 2026
Trade volumes
High market concentration within sample

Focus on US-based share issuers, but EEA issuers gaining ground

– Shares/ETFs: 5 firms with 90% of total trade volume in sample (2022 figure)
– Crypto: 2 firms with 97% of volumes
– CFDs: 86% among 3 firms

Total traded share volumes among neo-brokers were only 1.5% of EU total volumes
Trade volumes
Smaller venues often used

Neo-brokers tend to route many trades in shares and ETFs to small venues.

Research suggests that such fragmentation could affect the spreads applied by market makers.

Glosten and Milgrom (1985) find the spread applied by market makers decreases in the proportion of ‘noise traders’, as the market maker has less need to protect itself against informed trading.
Risks and benefits

Potential consequences for consumers

Risks

• Complex/risky products (e.g. crypto) may be offered
• Gamification of investment could exploit investor biases
• Social media may be integrated into platform; risk of misleading information
• Some products may not bestow the holder with the same rights as others (see ESMA Statement on fractional shares)

Potential benefits

• Encouraging retail participation in EU financial markets
• Far more convenient for many consumers
• Potential to promote financial literacy
• Greater competition; potential for lower trading fees
Neo-brokers in the EU: Developments, benefits and risks

ESMA webinar, 17 July 2024