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DATE
15 December 2021

SUBJECT
Response – Call for evidence on the European Commission mandate on certain aspects relating to retail investor protection

Optiver appreciates the opportunity to provide input to ESMA's call for evidence on investor protection topics.

As a global market maker that provides liquidity to end-investors on over 50 exchanges and trading platforms around the world from our offices in Amsterdam, Austin, Chicago, Hong Kong, London, Shanghai, Singapore, Sydney and Taipei, we believe that we are well-placed to provide input on current market trends and possible adjustments in relation to retail investor participation.

Optiver's mission as a market maker is 'to improve the market' and we continuously consider ways to shape and strengthen capital markets-based investment and financing for the real economy in the European Union. In the Annex we share our views in responses to some of your questions.

If you have any questions, feel free to reach out to us via Tarek Tranberg, Manager Public Affairs at Optiver, on tarektranberg@optiver.com or +31 20 708 74 93.

Kind regards,
Tarek Tranberg

Q1: Please insert here any general observations or comments that you would like to make on this call for evidence, including any relevant information on you/your organisation and why the topics covered by this call for evidence are relevant for you/your organisation.

Optiver is grateful for the opportunity to respond to this call for evidence by ESMA on its advice to the European Commission on retail investor protection in the context of the upcoming EU retail investment strategy. EU capital markets stand at a critical juncture. Against the backdrop of the Covid-19 pandemic and Brexit, competitive and integrated capital markets have never been more important. At the same time, whereas innovation and the development of new consumer-oriented trading technologies has lowered the barrier for access by retail investors, most retail investments – due to the current regulatory perimeter – flow into structured products or contracts-for-difference (CFDs), rather than into more transparent, less costly, and more liquid exchange-listed products. Optiver believes in open, fair, transparent, and competitive markets that deliver the most efficient and beneficial outcome for all market participants. As such, trading models that could undermine better execution for retail investors or suppress open competition – like Payment for Order Flow or PFOF – should be scrutinised, particularly where they result in a lack of open competition for order flow. In line with this, our comments are focused on those questions in this call for evidence that relate to the development of digital tools and channels.

Q23: Do you think that any changes should be made to MiFID II (e.g., suitability or appropriateness requirements) to adequately protect inexperienced investors accessing financial markets through execution only and brokerage services via online platforms? If so, please explain which ones and why.

We would recommend adjusting the suitability and appropriateness requirements for the sale/marketing of financial products to inexperienced retail investors in such a way, so as to prohibit the sale of structured products – like CFDs, turbos, warrants, or sprinters – to retail customers. These products bear larger inherent risks – including counterparty credit risk – than comparable exchange-traded products that would deliver the desired exposure to the same underlying. We would also question whether offering structured products that do not benefit at all, or to the same degree, from the liquidity and price improvement as exchange-traded products delivers investment outcomes that meet the spirit of ensuring genuine best-execution for end-investors. A broad change we would recommend is to introduce a new category of semi-professional investor in MiFID 2. Subject to a more stringent suitability, knowledge, and loss absorption capacity test, investors in this category would be permitted to invest in both exchange-traded products as well as structured products. Likewise, investors belonging to this category could be permitted to conduct margin trading in light of a higher experience/knowledge and loss absorption capacity requirement. Concurrently, policymakers should consider restricting the most inexperienced investor category – retail investors – to exchange-traded products that are more transparent, centrally cleared, and more liquid.

Q24: Do you observe business models at online brokers which pose an inherent conflict of interest with retail investors (e.g., do online brokers make profits from the losses of their clients)? If so, please elaborate.

A lot of attention has been given to the specific model of payment for order flow as it happens in the United States, where wholesaler arms of liquidity providers route the flow generated by their retail customers to their own internal execution platform. This in turn results in a situation where there is no genuine open competition for that order flow on the basis of best price improvement, which results in a worse comparative outcome for retail investors than if multiple liquidity providers had competed with one another for execution. Whilst this particular practice is – to our knowledge – absent in the EU, there are other market practices that result in equally uncompetitive outcomes, where it could be questioned whether retail investors are getting the best outcome on their orders in terms of price improvement. For instance, we have observed practices whereby retail brokers route their orders to execution venues that operate single market maker models – meaning that there is only one designated liquidity provider for individual product classes. In many cases the liquidity provider in this constellation pays a fee to the broker in exchange for routing its client orders to the particular exchange that the market maker is the single liquidity provider on. The payment of a fee to the broker is not necessarily the part that we feel results in conflicts of interest, but rather the fact that brokers route their orders to execution venues where there is no competition from multiple liquidity providers for those orders. This raises questions as to whether the brokers are delivering on their best execution obligations vis-à-vis their clients, and even if they are, whether their clients are getting the level of price improvement that genuine competition for the order flow between multiple liquidity providers would deliver.

Beyond the question of open competition for retail order flow, we are equally concerned by the product range that tends to be offered to inexperienced retail investors by online brokers, traditional brokers, and banks alike, which results in large retail investment volumes in Europe being pushed into CFDs or similarly leveraged products. As indicated in our response to question 23, Optiver believes that it would ultimately be in the better interest of retail investors to restrict their access to more complex structured products in favour of encouraging more retail investment to flow into more transparent, more liquid, centrally cleared on-exchange products like ETFs, futures, and options.

Q25: Some online brokers offer a wide and, at times, highly complex range of products. Do you consider that these online brokers offer these products in the best interest of clients? Please elaborate and please share data if possible.

The product range that is offered is very wide and we have doubts as to whether offering trading in structured products to inexperienced retail customers is truly in the best interest of brokers' clients, considering the less liquid, less transparent, more expensive, and riskier nature of some of these products. We would emphasise however that this is not a situation that is exclusive to online brokers. In fact many 'traditional' brokers are likely to offer similar product ranges, including the types of structured products that in our view are not sufficiently transparent, liquid, or accurately priced to be offered to retail investors. Moreover, it could be argued that online brokers are less conflicted in terms of their interests when offering their product range to customers than some of the manufacturers of structured products – typically banks – who also offer investment in these to their own client-base.

Q26: One of the elements that increased the impact on retail investors in the GameStop case was the widespread use of margin trading. Do you consider that the current regular framework sufficiently protects retail investors against the risks of margin trading, especially the ones that cannot bear the risks? Please elaborate.

The current suitability/investor knowledge test that has to be conducted in order to enable the opening of investment accounts does not appropriately inform investors of the leverage risk associated with margin trading. Whilst brokers require minimum initial margin to be posted into margin trading accounts, it is questionable whether inexperienced investors are sufficiently informed of the risks associated with margin trading in particular in relation to their capacity to absorb losses.

Q27: Online brokers, as well as other online investment services, are thinking of new innovative ways to interact and engage with retail investors. For instance, with "social trading" or concepts that contain elements of execution only, advice, and individual portfolio management. Do you consider the current regulatory framework (and the types of investment services) to be sufficient for current and future innovative concepts? Please elaborate.

We are concerned that the current regulatory framework insufficiently encourages investment by retail investors in innovative yet comparatively safer products. For example, retail investors in Europe have access to only a comparatively small number of ETFs due to the current MiFID 2 product governance and marketing requirements that stipulate that key information documents (KIDs) need to be made available in local languages. In practice this poses a cost barrier to ETF issuers when considering launching their products across the single market. In our view, limiting the language requirement to English – which is widely spoken and understood across the EU – would incentivise more ETF issuers to make their products available to EU investors.

Q28: Are you familiar with the practices of payment for order flow (PFOF)? If yes, please share any information that you consider might be of relevance in the context of this call for evidence.

Yes we are familiar with the practice of payment for order flow (see also response to question 23). In practice we observe multiple market practices in the EU – and in particular in Germany – that are characterised either by outright PFOF or by PFOF-like circumstances. We are aware of market practices that involve retail brokers routing their client orders to exchanges that operate single exclusive liquidity provider models in which the exclusive liquidity provider offers payment to the retail broker for routing their order flow to this particular venue. This means that the provision of monetary benefits from the liquidity provider to the retail broker does not result in direct routing of retail flow to the market maker, but in effect the resulting market structure is equally uncompetitive as the US PFOF market practice where client orders are internalised by firms with retail wholesaler and execution arms. We have likewise observed market practices where brokers offer their customers a choice of execution venue, but in their marketing/client-facing interfaces preference is given to one particular execution venue – normally one that operates a single market maker model as described above. Broadly speaking we would highlight that we do not view retail brokers receiving payment for their non-toxic client orders as a problem in itself. It is however an issue where the payment of fees or the provision of soft inducements results in a non-competitive outcome where client orders are segmented and execution does not take place on the basis of an open and transparent price improvement competition of multiple liquidity providers.

Moreover, we are aware of market practices, which are permissible under Article 24 (9) of MiFID 2, whereby clearing, trading, or custody fees are covered by a party when routing trading flow to them. Whilst this practice does not involve any direct payment of a monetary benefit to a retail broker in exchange for routing their client orders to a particular firm, it is in effect a cost-discount that incentivises brokers to send their client orders to specific institutions for execution. In our view, this runs counter to the spirit of the MiFID 2 framework on inducements, whilst also resulting in an uncompetitive market structure where flow is directed not on the basis of best price improvement, but on the basis of largest discount.

Q29: Have you observed the practice of payment for order flow (PFOF) in your market, either from local and/or from cross border market participants? How widespread is this practice? Please provide more details on the PFOF structures observed.

Please see response to question 28.

Q30: Do you consider that there are further aspects, in addition to the investor protection concerns outlined in the ESMA statement with regards to PFOF, that the Commission and/or ESMA should consider and address? If so, please explain which ones and if you think that these concerns can be adequately addressed within the current regulatory framework or do you see a need for legislative changes (or other measures) to address them.

As highlighted in question 28, PFOF and more concretely the non-competitive market structure it can result in are of concern. Whilst the lack of competition ultimately also touches on questions of investor protection and the possible absence of best execution, we are concerned that the resulting market structure stands in opposition to the principle of fair, transparent, and open capital markets, where market participants are able to compete on a level playing field. We do not believe that the current legislative framework is sufficient as the observed market practices we have described in previous questions have proliferated despite the implementation of MiFID 2/MiFIR. We would therefore encourage policymakers to implement a harmonised approach to PFOF that not only addresses situations where there are genuine conflict of interest concerns in relation to the payment of fees or non-monetary benefits to brokers in exchange for their client orders, but also situations that equally result in an anti-competitive market structure in which market participants are not able to compete for order flow purely on the basis of being able to offer the most accurately priced and improved two-sided quotes.

We therefore welcome the European Commission’s recent MiFIR review proposal, which seeks to put in place an EU-wide ban on payment for order flow. We are however concerned that the proposal in its current form would do little to address the uncompetitive market structures described above as its scope is limited to circumstances in which a liquidity provider offers direct payment or non-monetary benefits to a broker in exchange for direct routing of client flow to the liquidity provider. The proposal as it stands would do little to address other market practices that include an element of PFOF or PFOF-like inducements and which result in the absence of open competition for retail investment flow. If the political intention remains one where PFOF in all of its forms is prohibited, we would encourage ESMA and the co-legislators to broaden the scope of the proposed provisions by for example stipulating that investment firms are not permitted to receive monetary or non-monetary benefits in exchange for routing client orders to any third party for execution.

Q31: Have you observed the existence of “zero-commission brokers” in your market? Please also provide, if available, some basic data (e.g., number of firms observed, size of such firms and the growth of their activities).

We have observed the existence of zero commission brokers in our market. The numbers of such brokers across Europe have increased rapidly in the last 3-5 years, driven by the uprising of neo/online brokers. In our view, any brokerage service is incentivised to offer zero commission services in order to remain competitive and attract customers. In principle this is not something we feel regulators and policymakers should be concerned about, as this lowers the entry barrier to market access and contributes towards building a stronger retail investment culture in Europe in line with the goals of the CMU. What should be of concern, however, are uncompetitive market structures that have emerged as per our response to previous questions. We would highlight however that these market structures are not the direct result of zero commission trading being offered by brokers to their retail clients, but by the ability of third parties to direct or internalise the brokers’ retail trading flow.

Q33: Do you see any specific concern connected to "zero commission brokers", in addition to the investor protection concerns set out in the ESMA statement that the Commission and/or ESMA should consider and address? Please explain and please also share any information that you consider might be of relevance in the context of this call for evidence. Please also explain if you consider that the existing regulatory framework is sufficient to address the concerns listed in the ESMA statement regarding zero-commission brokers or do you believe changes should be introduced in the relevant MiFID II requirements.

We do not have a concern with the existence of zero commission brokers. In fact we believe that zero commissions is a natural and healthy innovation for retail clients and should be encouraged. We do however have concerns with offering complex, structured products to inexperienced retail investors and how best execution and best price improvement can be guaranteed with uncompetitive single market maker models – regardless of whether those are connected to zero commission brokers or commission charging brokers.

Q34: Online brokers seem to increasingly use gamification techniques when interacting with clients. This phenomenon creates both risks and potential benefits for clients. Have you observed good or bad practices with regards to the use of gamification? Please explain for which of those a change in the regulatory framework can be necessary. Do you think that the Commission and/or ESMA should take any specific action to address this phenomenon?

To the extent that retail investors that are looking to invest – i.e. with a longer term horizon – are subconsciously pushed by the design/interface of the trading application towards a gamification style trading this is a concern. However, for most retail investors that are drawn to this very active day-trading or gambling-like trading styles it tends to be a conscious choice. We are not convinced that regulatory intervention at this stage is needed, as the digitalisation of trading interfaces has significantly lowered the barrier of access for retail investors to the market. This, in our view, contributes to the overall objectives of Capital Markets Union and should be encouraged, so long as appropriate safeguards – e.g. restricting access to structure products, reinforced and enforced best execution requirements for brokers, and open competition for retail order flow even if segmented – are in place. In principle we feel that the approach being taken by online/app brokers is enabling more people to redirect their savings into capital markets, so long as investors are not overtly directed towards the kinds of structured products that in our view are not in their best interest. Accordingly, we do not feel that a change in the regulatory framework with respect to gamification techniques is the best approach. Instead, a stronger focus on fostering financial literacy, restricting access by the most inexperienced investors to structured products, and the creation of an open and competitive market structure for retail trading flow are the areas where the European Commission and the co-legislators ought to take action.

Q35: The increased digitalisation of investment services, also brings the possibility to provide investment services across other Member States with little extra effort. This is evidenced by the rapid expansion of online brokers across Europe. Do you observe issues connected to this increased cross-border provision of services? Please elaborate.

We are concerned that in the absence of truly harmonised rules (including in their enforcement) across the EU's single market, the ability to passport a MiFID licensed activity from one Member State across the EU27 could undermine investor protection and distort competition. The current situation where a non-competitive closed market structure exists that attracts retail order flow from brokers (either in exchange for direct PFOF or soft inducements) distorts competition in the single market to the extent that retail brokers in other member states that have taken a stricter stance on PFOF face the choice of either losing retail customers or also routing their client orders to single market maker exchanges in exchange for PFOF.

Equally, the ability of brokers to offer investment in structured products under the guise of investment in the underlying equity (e.g. as has been the case for some Cyprus-based CFD brokers) risks undermining investor protection in other member states in the absence of firmer rules on what is allowed to be sold (and in which manner it can be marketed in) to retail investors. As indicated in our responses to earlier questions, policymakers and regulators could consider addressing this by restricting the sale of structured products like CFDs or warrants to a more experienced class of investor. At the same time, the regulatory framework would need to provide for the protection of inexperienced retail investors from having complex products marketed to them or from being erroneously reclassified as more experienced investors for whom investment in complex structured products might be more appropriate.