FIA EPTA
EUROPEAN PRINCIPAL TRADERS ASSOCIATION

2 January 2022

FIA EPTA response to the ESMA Call for evidence On the European Commission mandate on certain aspects relating to retail investor protection

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.

The FIA European Principal Traders Association (FIA EPTA) appreciates the opportunity to provide feedback to the European Securities and Markets Authority (ESMA) on the call for evidence On the European Commission mandate on certain aspects relating to retail investor protection

FIA EPTA represents 30 independent European Principal Trading Firms (PTFs) which deal on own account, using their own money for their own risk, to provide liquidity and immediate risk-transfer in exchange-traded and centrally-cleared markets for a wide range of financial instruments, including shares, options, futures, bonds and ETFs.

Our members are independent market makers and providers of liquidity and risk transfer on trading venues and end-investors across Europe. Market making and liquidity provision (also referred to as principal trading or dealing on own account) is a distinct activity that is undertaken by non-systemic investment firms rather than banks, in a highly dispersed and varied ecosystem of independent Principal Trading Firms. These firms operate in an innovative and competitive fashion leading to a vibrant, dynamic and diverse ecosystem which massively reduces interconnectedness and increases substitutability. This fundamentally reduces systemic risk whilst improving market quality and lowering costs for retail and institutional investors alike.

FIA EPTA members appreciate ESMA's consideration of our comments and stand ready to provide any further input as required.

Q2: Are there any specific aspects of the existing MiFID II disclosure requirements which might confuse or hamper clients' decision-making or comparability between products? Are there also aspects of the MiFID II requirements that could be amendedto facilitate comparability across firms and products while being drafted in a technology neutral way? Please provide details.

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Q3: Are there specific aspects of existing MiFID II disclosure requirements that may cause information overload for clients or the provision of overly complex information? Please provide details.

Q4: On the topic of disclosures, are there material differences, inconsistencies or overlaps between MIFID II and other consumer protection legislation that are detrimental to investors? Please provide details.

Q5: What do you consider to be the vital information that a retail investor should receive before buying a financial instrument? Please provide details.

FIA EPTA's combined response to Q2-5 follows below:

Warrants, structured products and CFDs

Retail investors have a wide choice of financial products for investing. FIA EPTA members believe that simple and transparent products, traded on transparent and competitive exchanges, are best suited for retail investors. Crucially, investors should be made aware of product characteristics, benefits and risks. The trade-offs when trading these products should be made clear to retail investors and they should be protected against anything that disadvantages them and creates a market structure that favours issuers. Below we offer our comments on the specific investor protection issues we observe in relation to these different products:

Warrants

Warrants are one of a wide variety of structured products that are available to trade in Europe. The structured products market is large and extensively traded particularly by retail investors, with warrants being leveraged products which can be listed on trading venues. Warrants are very similar to exchange-listed options in that both give the holder the right, but not the obligation, to buy or sell the underlying instrument at a set price on, or before, a set date in the future.

There are key differences with simpler, listed, options though. With warrants, retail investors' orders are matched and settled bilaterally against the one market maker who is the exclusive counterparty to the retail orders. In terms of pricing, the issuer has a monopoly on all liquidity provision. By contrast, the options market is an open market where multiple market makers can register to provide liquidity and where there is diverse selling and buying interest in a transparent market environment.

The implications for retail warrant investors are clearly set out in FIA EPTA's research published in 2020.[1] This research found that investors trading on Europe's warrants markets are collectively losing millions of euros a year because of the warrants market's 'closed shop' structure which inflates prices compared to comparable products on more open and competitive ETD markets.

Furthermore, when warrant investors trade, they trade these back-to-back with the issuer. As a result, they have credit risk to that institution. Such risk is not present in the listed options market as all contracts are centrally cleared and there is a greater degree of safety as they are backed by the Central Counterparty (CCP). Additionally, warrants carry liquidity risk (unlike listed options). As the liquidity in the warrants market is only provided by the issuer it creates the risk that the liquidity picture could change over the life of the warrant and investors may not be able to unwind their positions and are at

[1] https://www.fia.org/sites/default/files/2020-11/FIA%20EPTA_Insights%204_2020%29_Warrents_%20price%20analysis%20and%20recommendations_FINAL_0.pdf

the mercy of that one provider. This often happens in times of stress and there is then no liquidity for retail investors who hold warrants to hedge or close their positions. This risk is substantially reduced on the listed options market.

FIA EPTA concludes that warrants markets operate as a closed shop with many investment firms prevented from trading and bringing more liquidity, price transparency and competition to the market and to investors. Retail investors have to pay above the odds and face increased risk due to the lack of transparency and central clearing involved. Our research findings are significant enough for us to caution retail investors to interact with the warrants markets until exchanges enable true competition, central clearing, and improve liquidity and more competitive pricing. In this regard, we also consider that further regulatory assessment of the warrants market by ESMA would be justified.

Turbos, Speeders, Sprinters

Turbos, Speeders and Sprinters are structured products that are equally popular with retail investors, likely also as a result of significant marketing efforts by issuers. These instruments are exchange-traded derivatives with a leverage component, based on an underlying asset (typically a stock or commodity). The leverage component makes these instruments much more volatile compared to the underlying asset. Most of these products, therefore, contain a built-in *stop-loss*. This means that the issuer can unwind the instrument in case a certain degree of loss is incurred. The leverage is created with a loan component in the instrument, which carries interest. This is reflected in the price of the instrument and is not always readily apparent to the retail investor.

These structured products carry the same problematic characteristics as warrants: pricing and liquidity provision is effectively restricted to a single market maker, often the issuer or an affiliate. There is no true price competition and retail investors are subject to the whims of such professional counterparties, who control the characteristics of the instrument, when – and importantly: how – the *stop loss* is triggered and the instrument is unwound, and pricing. In pricing, an issuer often has a significant information advantage over investors, for instance by taking much longer to price an instrument compared to continuously priced listed options.

As a consequence, Turbos, Speeders and Sprinters are leveraged, costly instruments, with complex characteristics, lacking competition on price. FIA EPTA members would strongly recommend ESMA to address the structural investor protection concerns related to this product class. As a minimum, we consider that stricter regulatory requirements should be put in place to improve explicit and easy-to-understand and information provision on risks to retail investors and on conflicts of interest with the issuer or affiliates. Along with this, we would suggest that retail brokers should be forced to disclose the percentage of clients that lose money from these instruments much in the same way CFD and spread betting firms have to disclose this to their clients. Additionally, we consider an open and competitive market structure for these types of products should be mandated, permitting multiple market makers to provide liquidity so as to make pricing truly competitive (including the possibility to short the instrument).

CFDs

CFDs are probably the most troublesome category of retail products. Underpinned with heavy marketing campaigns, CFD issuers appear to offer ‘trading’ in ‘stocks’ on an ‘exchange’, while CFDs are contracts offered by the CFD issuer that pays the change in the price of the underlying asset. These CFDs can be leveraged, inverse or otherwise complex, but it is of eminent importance to note that

retail investors do not invest in any of the underlying securities. Worse, CFD issuers control the trading platform on which these instruments are being traded, and price as well as product characteristics. CFD investors are known to lose significant amounts of money in an overwhelming number of cases, fueled by incentives to trade often and with leverage.

Unlike warrants and sprinters, turbos and speeders, CFDs are not traded on exchanges. Pricing is fully controlled by the CFD issuer and its platform, and the 'asset' is nothing more than a contract against the same issuer, without any clearing, carrying full counterparty and liquidity risk. FIA EPTA members are deeply concerned that, particularly given the aggressive marketing efforts and gamification of trading, retail investors are completely unaware of these characteristics – and that they do not 'trade' or 'invest in' shares, commodities or any asset 'on an exchange' at all. We urge regulators to take immediate and thorough action to protect investors as these products and platforms deteriorate trust in financial markets and investing, particularly with a younger generation of retail investors, while at the same time driving retail investment away from public capital markets and, ultimately, the European economy.

Conclusion

FIA EPTA considers that regulatory measures should be taken to encourage and highlight the benefits of exchange-listed products. Retail investors should be protected against any product or market structure that is not transparent, overly complex or clearly jeopardising retail investor interests via corrosive conflicts of interest. Products that meet requirements of simplicity and are traded on a trading venue should be accessible, paired with sufficient and simple communication on risks and characteristics. Any other products should be measured against a test of 1) transparency of the market and 2) transparency of the product itself, addressing inherent conflicts of interest with the issuer of any product.

Q9: On the topic of disclosures on sustainability risks and factors, do you see any critical issue emerging from the overlap of MiFID II with the Sustainable Finance Disclosure Regulation (SFDR)14 and other legislation covering ESG matters?

FIA EPTA members welcome the implementation of disclosure requirements. We observe an increasing awareness with retail investors of the impact arising from climate change and that they are becoming conscious of the potential contribution they might make towards mitigating those risks by making more sustainable choices.

FIA EPTA members would like to note that it is difficult to verify for retail investors if the investments that they do are truly sustainable. We believe that all regulations focused on disclosure requirements on sustainability risks and factors should be transparent and it should be clear what the requirements entail and are compatible and standardised.

FIA EPTA members observe a large variety of ESG ratings in the market and would like to express their concerns on the comparability of the data. Due to the absence of standardisation of ESG indicators, research has found there to be an average correlation of .61.[2] Standardisation and transparency of financial products are key for retail investors to make informed decisions.

[2] 'Aggregate confusion: the divergence of ESG ratings', Berg, Koelbel and Rigobon, 2020: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3438533

As FIA EPTA members as market makers do not take directional positions in the market and therefore the direct impact of sustainability disclosures is more limited for our members' activity as liquidity providers compared to buy-and-hold investors However, FIA EPTA members are actively providing liquidity in ESG linked listed products as market makers, and this is expected to increase further.[3] In this regard, we note the ESG disclosures drive investor behaviour and market dynamics (e.g., via changes to ESG exclusions), and it is relevant for market makers to understand the ESG disclosures at a granular level as well so as to be able to price the related instruments correctly. Inconsistencies and opacity are very unhelpful in this regard and can ultimately impact on the efficient price formation process for ESG linked listed instruments, the more so as end-investors are increasingly preferencing such products.

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.

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.

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.

<u>FIA EPTA's combined response to Questions 28-30 follows below:</u>

Executive summary

FIA EPTA members are familiar with the practice of PFOF both in the EU and the US and would like to emphasize that these are not directly comparable. We understand the current drafting of the proposed PFOF ban under the MiFIR Review to be geared towards the U.S. PFOF model. However, we would caution that PFOF practices in the EU do *not* mirror those in the US and include unique attributes, not seen in the U.S. model, which negatively impact end-investors and should in our view be specifically addressed in the MiFIR Review legislation. Consequently, FIA EPTA's views of PFOF as practiced in the EU are not reflective of any view on PFOF practices in the US.

Our main concerns with the EU PFOF model are that it is insufficiently transparent and objective, undermining best execution and disadvantaging end-investors while creating an unlevel playing field between firms and Member States and undermining open competition between liquidity providers.

We consider that the key policy objective for EU authorities should be to ensure a harmonised approach and a level playing field around EU PFOF practices. To this end, FIA EPTA supports a PFOF ban in the EU, if properly targeted and scoped (which we note is not the case with the current EC proposal). In our comments below, FIA EPTA suggests, therefore, concrete amendments to improve the legal text. In particular, it will be important to ensure an EU PFOF ban encompasses both (a) all types of non-monetary inducements and (b) <u>all</u> possible execution and routing scenarios. Specifically, on the latter aspect, we consider that the ban should encompass the PFOF practices prevalent in one

[3] https://www.fia.org/marketvoice/articles/two-thirds-european-market-makers-plan-expand-esg-liquidity-provision

Member State where some trading venues operate a single market maker model whereby retail order flow is directed to these specific venues, based on the market maker paying retail brokers for routing their order flow to that venue so that the market maker will be the exclusive counterparty to the retail trades.

Further, we consider that to address these unlevel playing field issues additional measures (outside PFOF) would need to be taken as well – to address i.a., the problematic aspects of the single market maker model and the associated last-look practices.

While an effective EU PFOF ban would be the preferred option for FIA EPTA, as an alternative policy approach, a well-designed and harmonised regulatory regime to enable PFOF in a responsible manner could also be envisioned. However, this would in our view only be feasible if implemented together with other key regulatory reforms such as a well-designed post-trade/real-time Consolidated Tape, upgraded best execution requirements based on (price improvement to) the EBBO, significantly upgraded best execution reporting obligations and supervision by ESMA to ensure a level playing field.

PFOF: Key differences between U.S. and EU market structure

In the context of the PFOF discussion, key market structure differences exist between the US and the EU, namely:

U.S. Market Structure

1. **Scope and supervision** – the U.S. practices set out below relate to securities and are consistently regulated and supervised by the SEC and FINRA.
2. **National Best Bid and Offer (NBBO)** – the U.S. Regulation NMS requires brokers to trade at or within the NBBO which is the best available (lowest) ask price and best available (highest) bid price available to customers from multiple exchanges.
3. **Consolidated Tape** – this, combined with the NBBO, provides a benchmark which allows the retail investor to ensure they are getting a fair price on their execution.
4. **Transparent disclosure of order execution information** – Under Regulation 605 NMS wholesale brokers are obliged to make available certain order execution information, facilitating the uniform public disclosure of order execution information by all market centres. This generally allows retail brokers to determine which market maker is providing the best execution price on orders they receive.
5. **PFOF** – Under the U.S. model, PFOF is disclosed, transparent and based upon an open model allowing for competition between liquidity providers. Brokers set a single payment rate and multiple wholesalers (e.g., market makers) compete to win order flow based on their ability to offer best execution quality based on transparent and quantifiable criteria. The brokers then enter into agreement with a number of these wholesalers to route order flow to them, with regular periodic reviews to re-prioritize wholesalers based on ongoing performance. Brokers typically concurrently route to many execution partners and exchanges mitigating single-point-of-failure risk.

EU Market Structure

1. **Scope and supervision** – In relation to the EU we observe practices across different types of financial instruments (equities and non-equities) as well as structured products. The current unlevel playing field between Member States is in consequence of inconsistent and conflicting

interpretations of the EU Single Rulebook between NCAs and an associated absence of supervisory convergence on these matters.

2. **Best execution** – Article 27(1) of MiFIR requires an investment firm to take all sufficient steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature and any other consideration relevant to the execution of that order. Nevertheless, where there is a specific instruction from the client the investment firm shall execute the order following the specific instruction.
3. **Consolidated Tape** – not currently in place.
4. **Disclosure of order execution information** – the current format of the execution quality reporting (RTS 27 & 28) has been deemed not fit for purpose and is under review.
5. **PFOF** – in contrast to the US, in the EU PFOF is used in a non-transparent manner with discriminatory practices and no open price discovery. In this regard, FIA EPTA members are aware of two distinct forms of PFOF that occur in the EU:

   (i) **Broker-to-retail exchange/SI PFOF**: We are aware of PFOF in Germany where trading firms pay the retail order flow providers. The trading firms make these payments either as single market makers on a trading venue or in their OTC SI capacity. Under this PFOF model, a retail broker enters into an agreement to receive PFOF when it routes orders to a specific trading venue (or in some cases an SI). The trading venue has a single market maker per trading segment who has an obligation to execute at a local reference market price or better. Orders are sent as quote requests, with the market maker having the ability not only to opt not to respond but even to withdraw from the trade after the client has accepted the quote (i.e., a last look facility). This is a 'closed' trading venue model where no other market maker is permitted to provide liquidity in the same trading segment. Alongside this, FIA EPTA members are aware that the retail brokers release themselves from best execution obligations by stating e.g., in the customer agreement that:

   > *The customer must instruct [*the broker*] at which of the execution venues offered its order is to be executed. This is true due to the restricted selection of execution venues described above, even if only one Execution venue is offered. ……As a result, [*the broker*] is not obliged to comply with this Execution Policy to achieve the best possible result (best execution).*

   (ii) **Broker-to-investment bank PFOF:** This is where a broker enters into an agreement with an investment bank offering execution and clearing services, to route its client orders to the investment bank in exchange for lower (or zero) custody and exchange fees. This is primarily seen in the listed derivatives (ETD) space where trades are pre-arranged and internalized to the maximum extent permitted by exchange rules.

Conflicts of Interest & Best Execution Concerns

The current MiFID II legislation (Article 24(9)) sets out that if an investment firm pays or receives any fee or commission or provides or is provided with any non-monetary benefit in connection with the provision of an investment service, to or by any third party this is in violation of an investment firm's obligations with regards to acting in the best interest of its clients and preventing conflicts of interest.

In FIA EPTA's opinion the two EU PFOF practices set out under 5(i) and 5 (ii) above may result in detriment to the broker's clients. In both cases, the broker has created a scenario whereby trading flow is

prioritized to be sent to a particular location creating in effect a single point of failure risk and jeopardizing best execution as the flow not being entered into an openly competitive marketplace. Should the market maker, that the broker routes the order flow to either directly or on a particular venue, choose not to provide liquidity for whatever reason the clients will be negatively impacted. Reliance on this single point of failure is detrimental to end investors and not in the spirit of best execution.

With regards to practice (i), although an exemption is set out in the legislation that an investment firm is permitted to receive payment of a fee, commission or non-monetary benefit where it is designed to enhance the quality of the relevant service to the client, FIA EPTA would very much question, given the factors outlined above with respect to EU market structure, whether this condition is achievable i.e., that this does not impair compliance with the investment firm's duty to act honestly, fairly and professionally in accordance with the best interest of its clients. In addition, our members believe this model is not in line with MiFID II requirements for multilateral systems and non-discriminatory access to trading venues.

- FIA EPTA members are aware that in Germany a significant number of smaller retail focused ("regional") exchanges (RMs and MTFs) operate these single-market maker trading models, whereby only one market maker per product segment is responsible for the entire order book. While order execution ostensibly takes place within a multilateral system, in practice retail orders are matched bilaterally against only the one market maker who the exclusive counterparty to the retail orders. The retail broker, in exchange for steering its clients' order flow to a specific system, receives a monetary inducement from the relevant single market maker on that system who will be the exclusive counterparty to the retail investors' orders.
- We have likewise observed market practices in Germany where retail brokers ostensibly offer their customers a choice of execution venue, but in their marketing/client-facing interfaces actual preference is given to one particular execution venue – normally one that operates a single market maker model as described above, so that the customers' orders in practice are directed to the single market maker making the PFOF payment.
- Also, under practice (i), retail client orders are being executed via reference price trading where the aim is to provide the client with as good a price as the client would get at that time on the relevant local lit market. This means that the client may receive an execution price at the NBBO (in Germany) but this may not be equivalent to the EBBO available at a trading venue in a different Member State. In our members' opinion, an open transparent environment where all market participants can contribute to the price formation process is in the best interest of end investors as market participants reacting to the increased trading interest may provide a price improvement to the client over and above the current top of book.

With regards to practice (ii), our members understanding is that a number of investment banks providing clearing and custody services are relying on an exemption within MiFID II, Article 24(9) which states that a payment or benefit which enables or is necessary for the provision of investment services, such as custody costs, settlement and exchange fees, regulatory levies or legal fees, and which by its nature cannot give rise to conflicts (with the investment firm's duties to act honestly, fairly and professionally in accordance with the best interests of its clients) and, therefore, is acceptable. As best execution has a wider definition in the EU than in the US where it is simply the achievement of the best price, these brokers maintain that they are meeting their best execution obligation as the execution price is taken in conjunction with the clearing and settlement costs. Receipt of these benefits has the effect of reducing operational costs for the brokers as they would otherwise have to pay these fees. This results in a conflict of interest between the broker's interests (the desire to lower operating costs) and those of their clients (the need to obtain the best possible execution result). In addition, this creates a

situation where only those willing to provide this indirect PFOF can win the order flow. Our members would, therefore, call for this exemption to be tightened or removed from the MiFID II legislation.

Draft MiFIR legislation

Currently, there is an unlevel playing field across Europe as the majority (but not all) NCAs have an outright ban of PFOF in place. Although direct PFOF is only a widely accepted practice in one Member State (when certain conditions are met), the prevalence of PFOF in retail trading is expected to impact an increasing number of EU retail clients as brokers from this Member State use the MiFID II passporting regime to reach additional clients across the EU.

FIA EPTA members do not believe this unlevel playing field should be allowed to continue and would call on ESMA to recommend to the Commission to take steps to ensure a harmonized approach to PFOF across the EU.

However, in regard to the recent MiFIR Review proposal for an EU PFOF ban, FIA EPTA was highly surprised and concerned by the statement in the Explanatory Memorandum, which suggests that the reason for the proposed ban is to "end the controversial practice that certain high-frequency traders, organised as SIs on account of their large transaction volumes, pay retail brokers in exchange for the latter channelling their retail orders to the high-frequency trader for execution".[4] We assume that this is a reference to SIs operated by Electronic Liquidity Providers (ELPs), including some of FIA EPTA's members. However, our members are unaware of *any* ELP SIs that have PFOF arrangements in the EU.

The suggestion that ELP SIs are driving PFOF in the EU is, in other words, factually incorrect and a distraction from the real issue: As set out above, current EU PFOF practices mainly involve the routing of order flow to a single market maker platform (in Germany)[5] or otherwise to a third party for execution which will cross pre-arranged listed derivative trades on-venue. These are the practices which should be in scope for the proposed EU PFOF ban, but we are concerned that the current draft legal text will not achieve this aim. To ensure the effectiveness of the proposed EU PFOF ban, we would therefore call for the proposed Article 39(a) to be amended, as follows (proposed amendment in bold, underlined):

Article 39a

Ban on payment for client order flow ~~forwarding client orders for execution~~

> *Investment firms acting on behalf of clients shall not receive any fee or commission or non-monetary benefits from any third party for forwarding **or routing** client orders to such third party**, either directly or via a particular trading venue,** for their execution **or executing client orders with such third party.***

This will prohibit any SIs from engaging in PFOF and clamp down on the practice currently observed in one Member State with regard to PFOF practices between brokers and retail-oriented trading venues, described above. We note that strict supervisory convergence measures would be needed to ensure

[4] MiFIR Review Proposal (COM(2021) 727 final), Explanatory Memorandum, p 16.
[5] Typically to German regional trading venues, but also in some cases to German (non-ELP) SIs.

harmonized application of such new obligations across the Union and to safeguard the level playing field between firms. To that end, it is essential in our view that a clear oversight role for ESMA be mandated at Level 1.

We also suggest that Article 24(9) of MiFID be amended to remove the apparent blanket exemption from the above prohibition clearing and exchange fees (proposed amendment in bold, underlined):

Article 24(9) of Directive 2014/65/EU

> *9. Member States shall ensure that investment firms are regarded as not fulfilling their obligations under Article 23 or under paragraph 1 of this Article where they pay or are paid any fee or commission, or provide or are provided with any non-monetary benefit in connection with the provision of an investment service or an ancillary service, to or by any party except the client or a person on behalf of the client, other than where the payment or benefit:*
>
> *(a) is designed to enhance the quality of the relevant service to the client; and*
>
> *(b) does not impair compliance with the investment firm's duty to act honestly, fairly and professionally in accordance with the best interest of its clients.*
>
> *The existence, nature and amount of the payment or benefit referred to in the first subparagraph, or, where the amount cannot be ascertained, the method of calculating that amount, must be clearly disclosed to the client, in a manner that is comprehensive, accurate and understandable, prior to the provision of the relevant investment or ancillary service. Where applicable, the investment firm shall also inform the client on mechanisms for transferring to the client the fee, commission, monetary or non-monetary benefit received in relation to the provision of the investment or ancillary service.*
>
> *The payment or benefit which enables or is necessary for the provision of investment services, such as custody costs, settlement and exchange fees, regulatory levies or legal fees, and which by its nature cannot give rise to conflicts with the investment firm's duties to act honestly, fairly and professionally in accordance with the best interests of its clients, is not subject to the requirements set out in the first subparagraph.* ***<u>This does not permit an investment firm to receive a benefit from a third party such as the reduction in or elimination of safe custody fees or exchange fees which would normally be incurred by them in the provision of a service to their clients in return for routing their orders to that third party.</u>***

Additional unlevel playing field concerns and need for regulatory intervention

In addition, FIA EPTA would reiterate that the unlevel playing field concerns with retail-focused trading venues applying a single market maker model go beyond the inducement practices applied by these venues. We would, therefore, also call for the following additional measures as only addressing PFOF will not fully mitigate the issues observed:

- Trading venues should be prohibited from operating single market maker trading models/segments that do not allow for the entrance of additional liquidity providers in the same market segment.
- Trading venues should also be prohibited from operating market models offering a de-facto last-look facility to market makers or liquidity providers on that venue.

- Retail brokers should be prohibited from releasing themselves from their best execution obligation by including a blanket mandatory requirement for their clients to instruct the execution venue for all orders.

Considerations and prerequisites for alternative policy approach

FIA EPTA's proposals above are rooted in our concerns that PFOF as it is currently practised in the EU is falling short of appropriate investor protection, and is resulting in poor outcomes, specifically regarding competition, conflicts of interest management, and best execution. For this reason, we support, as detailed above, a modified PFOF ban in MiFID II that addresses the concretely observed PFOF practices and non-competitive market structure features in the EU.

As mentioned, we consider it critical that a harmonized EU approach be adopted to ensure a level playing field and fair competition across Member States. Apart from an explicit and correctly scoped ban of current EU PFOF practices, the only other policy approach that we could envision to achieve such an outcome would be to appropriately and consistently regulate PFOF activity in a harmonized manner across the EU.

Such an alternative policy approach would then be in recognition of the fact that, *subject to robust and effectively and consistently supervised requirements to ensure investor protection and fair and open competition*, PFOF can in fact be a useful mechanism to both retail investors and the wider the market. I.e., via reducing barriers to entry for small retail brokers and thus increasing competition between different brokers; and by making more cost-efficient financial services provision available for retail investors (low cost trading) as implicit execution costs are reduced for retail investors with more of the cost borne by the wholesale broker via competition. However, this is predicated on brokers appropriately managing the potential conflicts of interest and seeking to achieve the best possible outcome for clients in a competitive market structure and against an objective, transparent, and appropriately disclosed benchmark. We reiterate that none of this can currently be found among the existing PFOF practices in the EU.

As fundamental red-lines, such an alternative approach would require core market structure features that achieve comparable outcomes as those in the US, i.e. a transparent and competitive system where optimal execution outcomes for retail investors can be objectively evidenced against a market-wide benchmark (i.e., the EBBO) and which is coherently and consistently supervised in the same way across the Union by ESMA.

- A necessary prerequisite for such an approach would, therefore, be a well-designed and well-functioning Consolidated Tape (at least offering post-trade, real-time price information for each financial instrument for which PFOF were to be allowed under such a system). If properly utilised, such a Consolidated Tape could address the best execution concerns referenced in our comments above, by providing transparency as to the actual quality of the execution received compared against the best prices across the Union, regardless of the structure of the market where the trade was executed. Secondly, it could open up the avenue to require brokers to trade at the EBBO or better to ensure best execution for retail customers in scenarios such as PFOF.
- Additionally, it would require the availability of a significantly improved best execution disclosure regime, including explicit, prominent, unambiguous and easy-to-understand disclosures to all clients of retail brokers which are in receipt of PFOF. ESMA's ongoing 'Review of the MiFID II framework on best execution reports' (ESMA35-43-2836) offers some promise of enhancing the EU best execution regime and addressing the widely accepted shortcomings of the current regime. However, to be fit-for-purpose in a potential EU market

structure allowing well-managed, transparently disclosed, and competitive PFOF, significant further improvements to mandated best execution reporting would urgently be required.

Unless the European market structure can provide unambivalent safeguards to ensure a level playing field and the aforementioned enhanced investor protection measures, FIA EPTA members would continue to advocate for a straightforward ban of current EU PFOF practices, based on our suggestions regarding the current EC proposal outlined above.

Q32: Do you have any information on "zero-commission brokers" business models, e.g., their main sources of revenue and the incidence of PFOF on their revenue? If so, please provide a description.

Please see our response below to Q33

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.

FIA EPTA observes that while brokers may advertise 'zero commission,' often other fees may not be adequately disclosed or explained to retail investors, such as:

- High margin rates (e.g., 6.99%) – as popularity of highly leveraged strategies grows
- 'Zero Order' type – which does not provide immediacy of execution but rather executes at the end of the trading day at closing price, or if placed after 16h00 (CET), will be executed only the following day
- FX fees – a broker offers zero commission on trading US shares, but in small print may apply an FX markup of 0.25% on the EUR/USD FX spot rate; another broker charges 0.45% FX fees
- Annual custody fees – e.g., 0.01% / 12 of the market value of assets charged at the end of each month for custody
- Zero commission on market orders, but fees on limit orders
- Free trading in CFDs only – incentivizes trading in unregulated, high-risk products (see also our comments below)
- Inactivity fees if the retail investor does not log in and trade in a given period (examples: 3 months; 1 year) – such practices discourage buy & hold investing in favour of more active "day trading", increasing the likelihood of losses for the retail investor
- High costs for paying out dividends or transferring positions or cash balances to other accounts

We also observe other revenue models related to PFOF that may embed conflicts of interest:

- Income from partnerships with providers of financial products (issuers) – issuers pay commissions to brokers in order to advertise their own products in a targeted manner. The platform receives commissions, but the partners often also (partially) assume the

trading fees, i.e. the platform continues to receive a fee per transaction, but the customer does not have to pay this (in full)

- Income from partnerships with exchanges that pay for traffic – specific exchanges (e.g., German regional markets) can offer brokers reimbursements if the broker directs trading volume to this exchange. Trading is then only via these alternative platforms and with only one market maker per instrument, and the prices are not determined by a free market.

Generally, we observe that PFOF and “zero commission” trading encourages the use of more risky and economically less useful products, especially CFDs but also warrants and other structured products. Retail investors are generally not aware that CFDs are not centrally cleared and that the instruments are not standardized. This means that there is a more credit risk and product price risk involved than the case with e.g., listed futures. Additionally, most CFDs are privately issued derivatives and a position can only be closed against the issuer, adding to liquidity risk. Therefore, we find it peculiar that in many EU countries the barriers to trade exchange-listed derivatives are much higher than for trading CFDs.

For the sake of investor protection, we would welcome for ESMA to continue to take a critical look at these offerings and consider following the U.S. example to direct these riskier trading flows to exchange-listed instruments. In our view, regulators should not aim to prevent retail investors from doing risky trades per se, but they do need to ensure that investors know what they trade, what the risk is so that they don’t harm themselves or others in the process, for example by using instruments that almost guarantee a loss. Additionally, ensuring these retail order flows can reach multilateral venues, market supervision will be much more efficient, while ensuring a greater diversity of pricing signals in the public markets, which enhances the resilience and quality of the price formation process.

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.

FIA EPTA agrees that the increased digitalisation of investment services brings about the possibility to provide investment services across other Member States with little extra effort. In and of itself, we view this is a positive development. However, to the extent that regulatory divergence exists between one or more European NCAs regarding the application of prevailing regulatory requirements, or interpretations thereof, the ability to passport digital services on a freedom of services basis facilitates the most permissive interpretation of regulatory requirements prevailing across the Union, so called "regulatory arbitrage". The provision of regulated services through digital means exacerbates the scale of regulatory arbitrage and stifles competition by rewarding geographic footprint rather than innovation.

With reference to the German single market maker trading model referred to in our response to Questions 28-30 above, the ability for German retail brokers to distribute their services across the Union digitally, exposes retail clients across the Union to this single market maker trading model, which essentially constitutes PFOF, despite the fact that other Member States have banned PFOF outright. We consider this creates a significant unlevel playing field which is to the detriment of effective capital markets development in the Union and hence requires regulatory intervention to ensure a

harmonized approach across Member States to ensure appropriate investor protection and fair competition. We further refer to our comments on these matters above.