WORLD FEDERATION OF EXCHANGES

Response:
IOSCO Consults on Recent Retail Investor Trends and Related Conduct Implications

May 2022

Background

The World Federation of Exchanges (WFE) is the global trade association for regulated exchanges and clearing houses. We represent over 250 market-infrastructures, spread across the Asia-Pacific region (~37%), EMEA (~43%) and the Americas (~20%). with everything from local entities in emerging markets to groups based in major financial centres. Collectively, member exchanges are home to nearly 53,000 listed companies, and the market capitalisation of these entities is over $95 trillion, while the 50 distinct CCP clearing services (both vertically integrated and stand-alone) collectively ensure that traders put up $1 trillion of resources to back their risk positions.

With extensive experience of developing and enforcing high standards of conduct, WFE members support an orderly, secure, fair and transparent environment for investors; for companies that raise capital; and for all who deal with financial risk. We seek outcomes that maximise financial stability, consumer confidence and economic growth. And we engage with policy makers and regulators in an open, collaborative way, reflecting the central, public role that exchanges and CCPs play in an internationally integrated financial system.

If you have any further questions, or wish to follow-up on our contribution, the WFE remains at your disposal. Please contact:

Nicolas Höck, Junior Analyst, Research: junior.analyst@world-exchanges.org

Richard Metcalfe, Head of Regulatory Affairs: rmetcalfe@world-exchanges.org

Nandini Sukumar, Chief Executive Officer: nsukumar@world-exchanges.org

Response to questions:

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

As a matter of principle, supervisors should be alert to any and all categories of investor that may have less experience or capacity in relation to the risks in question. Where investors are self-directed, it may be problematic for the supervisor to monitor or determine when a tipping point has been reached. This is why it is so important to supervise the way platforms and brokers interact with customers.

Furthermore, the WFE recognizes that younger demographics tend to use social media platforms on a regular basis, both to access information and communicate with others. Given the increasing role of these platforms, we believe that regulators should actively engage with them and social media to ensure that investors are protected from market manipulation and potentially fraudulent comments which could incite harmful behaviour. Particular attention should be paid to the presentation of risk; fees and charges; and performance, especially selective presentation of past performance (for instance by choosing favourable time windows).

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?

Recent market events have shown the increasing trend of retail investor participation in the markets. Broad retail participation in public markets is positive for the entire ecosystem. Investing is an important building block for wealth creation, and market quality is improved through broadening and diversifying participation. As retail investing increases, it is important to provide retail investors with equitable access to markets and strive for a level playing field with respect to information and market data. As such, developments which lower barriers to entry, make trading easier and more intuitive, and reduce the cost of investing can be argued to be beneficial for WFE's members by expanding equity ownership to a greater proportion of the population.

Specifically, new, or inexperienced investors should be provided with the resources to help them understand market infrastructure, the associated risks of trading on margin or using complex instruments with embedded leverage, their brokers' responsibilities, and discretionary authority, as well as the impact of capitalisation on a broker's level of service. In addition, with the emergence of new entrants and platforms in the broker dealer ecosystem, regulators should ensure that there is a minimum investor care and education standard which is being met. This should be in addition to a suitable and consistent due diligence applied across brokers for those investors who are accessing margin or complex instruments.

Moreover, as the use of social media becomes even more prevalent, regulators should build on their presence on these respective platforms, to protect investors from mis-selling, market manipulation and potentially fraudulent comments. Technology has transformed the manner through which information is disseminated and people interact. As such, regulators should take the steps needed to continue to have access to the data and tools necessary to protect investors and maintain fair and orderly markets.

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

When it comes to gamification, there are some elements that could be considered positive, while others rather negative for retail investor protection. When prompts, and other techniques designed to encourage activity amount to advice, there should at the very least be a way to check on whether these cross a line in terms communications no longer being fair, clear, or not misleading. The WFE supports the ability of regulators to monitor interactions with all clients, irrespective of whether those interactions are based on new technology or old.

The design of many trading applications with very easy handling is sometimes stated as an example of gamification. This sort of gamification should not be viewed as a problem. User-friendly designs can facilitate retail investors' access to capital markets and thus foster capital markets participation. However, other elements of gamification can pose serious risks. Those elements include bonuses like free stocks for new accounts, referral contests among investors, push notifications, and other graphical effects.

However, as gamification may drive more people into capital markets, regulators should not prohibit gamification practices per se. As an investor protection mechanism, regulators have frequently suggested limiting retail investors direct access to the market, pushing them towards funds and indirect investment vehicles. These are often more costly and can be equally misleading if there is a lack of financial education around their use. We would propose that any efforts to control gamification and supervise automated advice platforms do not discourage direct trading and access for retail investors to capital markets.

Hence, regulators should rather focus on providing clear guidance where to draw the line between those gamification practices that reduce the barriers for retail investors to participate in capital markets, and those practices of gamification that are detrimental to retail investor protection. IOSCO's proposed measure which notes that firms should be required to review their internal policies and processes on the use of targeting, behavioural techniques and gamification elements will help to address potential customer harm.

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

Whenever a crypto-asset amounts to a financial instrument, any platform or gateway to retail participation in crypto assets should be required to inform retail participants clearly (i.e., prominently, and unambiguously) as to the basis on which they are regulated. In addition, considering that anything which amounts to a financial instrument should be treated as such, it is vital for the purpose of level playing field and market integrity that a technology neutral approach is adopted. Comparisons to a 'stock exchange' or 'derivatives exchange' should not be permitted, unless strictly justified and evidenced.

Regarding regulatory arbitrage, the explosive growth of the crypto-assets market means that jurisdictions are moving fast to address the regulatory and supervisory concerns. This could result in regulatory arbitrage and could potentially cause implications for firms with a cross-border footprint. The WFE expects most local regulators and supervisors to embrace a risk-based approach to continue to encourage innovation. International organisations, such as FSB and IOSCO, could also issue guidance and standards to that effect. As cryptocurrencies will be used across local and national boundaries, it is important for policymakers to unite on a common set of standards.

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

As mentioned in the previous questions, IOSCO could in principle act as an information resource regarding cross-border issues and look to harmonise approaches to bilateral co-ordination between jurisdictions.

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?

Disclosure is necessary but far from sufficient as a tool. We support greater exploration of behavioural prompts, rather than relying purely on mass-education initiatives. In this regard, IOSCO can potentially play a useful role in tracking and promoting the use of behavioural 'nudges'. Nudge techniques indicate the importance of ensuring messaging and disclosures lead to positive and actionable outcomes. Many types of disclosures are currently designed in a way which discourage consumers from taking action rather than encouraging them into taking positive action. We recommend more consumer testing of retail disclosure standards to achieve a better balance between empowerment and protection than is currently the case.

Further improvement through educational engagement with retail investors should be another area of focus, to balance aspects of market access with their potential lack of investing experience and sophistication. Potential areas could include guidelines on financial literacy, identification of standard information and labelling of financial instruments, the role of various market participants involved in order execution (including any potential conflicts of interest), access to complaints/ clarification mechanisms, and so on.

As stated previously, the Federation believes retail participation in markets is positive for the entire ecosystem. However, clear, and consistent disclosure and education is necessary to better protect investors and give them the tools they need to make informed investment choices, particularly regarding complex exchange-traded products. As highlighted by our survey results, financial literacy has been key to attracting retail participation. The increasing adoption of self-directed investment underscores the need to improve financial literacy among retail investors, to encourage diversification and longer-term investment behaviours. This is something which the exchange community supports and has already been assisting IOSCO with, for example through IOSCO's C8 Committee on retail investors.

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

Several factors influence investors' use of leverage, including macro-economic factors like the prevailing monetary policy and/or industry-specific practices. As highlighted in the previous questions, both industry and regulation should aim for a high watermark of investor education and awareness about the risks involved in margin trading, standards in financial instruments labelling, and delivering an effective complaints/ clarification mechanism.

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

Digitalisation across investment services has helped to democratise access to financial markets, and increase competition amongst service providers, as well as reduce costs. In addition to that, social media networks and platforms provide an opportunity for the development of best practice and knowledge sharing for retail investors. However, our members agree that the growth in the use of social media and other digital platforms/products has led to a change in the way in which financial services are marketed and distributed. The WFE conducted an internal survey on retail investment in 2020 during the pandemic, which noted that enhanced educational material as well as new products were key contributors to the rise in retail investor participation in the global capital markets. Therefore, any conflicts arising from this should be identified and as necessary disclosed or managed by a broker or platform, to the satisfaction of the regulatory supervisor.

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)?

Overall, the above regulatory tools are appropriate to address the conduct implications from recent retail investor trends. However, when it comes to information on risks, performance, costs, and a description of the issuer for retail investment services, we believe that there is a gap in the format and presentation of this information rather than a lack of tools to address them. Therefore, regulatory tools should seek to limit the overload and instead bundle and make available the most important information in an easily comprehendible way. This would ensure that people with a lower level of financial literacy could also understand the information given to them. The current regulatory framework concerning warnings provides adequate protection for retail investors. If the investment service or product purchase is considered inappropriate for the client’s knowledge and experience, the client is made aware of this by an explicit warning. Such an unambiguous and clear warning is an adequate means of protecting retail investors from making the wrong decision.