Retail Revolution

How retail brokers in Europe are planning to counter CFD restrictions and what that means for institutional markets

IN ASSOCIATION WITH

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Introduction

Retail trading of listed derivatives in Europe has been muted at best in recent years. The situation stands in stark contrast to the US, where the astonishing growth of options volumes over the past five years has largely been down to the growth of retail trading, which today totals between 20% and 40% of daily volumes.

Europe's listed derivatives markets, however, may be on the cusp of significant growth in retail volumes in the wake of regulatory crack downs on CFDs and other leveraged retail products such as turbos and warrants.

Retail products have flourished in Europe over the past 20 years owing both their relative simplicity and also the favourable tax treatment they received in several European countries, including the UK.

However, last year CNMV, the Spanish regulator, banned the promotion and distribution of CFDs to retail clients, citing aggressive marketing strategies and significant losses incurred by investors.

The move strengthened measures that the CNMV had taken in 2019 and followed crackdowns on the promotion and offering of retail products in other EU states.

In the words of one retail broker that was interviewed for this study, "regulators in Europe are only going one way with regards to retail trading of CFDs".

The potential impact on retail brokers from restrictions in their ability to offer CFDs and other products is stark. Currently, most retail brokers effectively operate as OTC venues in their offering to retail clients. Restricting the range of products they offer will have major implications for their business models.

The question for European retail brokers is how to respond. Institutional markets and other regions offer opportunities. As European regulators look set to allow retail trading in futures and options (albeit probably with leverage restrictions) these markets look like becoming an essential part of retail brokers' offerings.

For incumbent institutional brokers, the potential of retail flows into listed markets offers an opportunity to expand their offerings. However, that will be countered by the growing ambitions of nimble, technologically-savvy retail brokers shifting their attentions to institutional markets. Ultimately, regulatory actions may well force institutional and retail markets closer together, with listed derivatives markets in Europe set for a significant boost.

Listed derivatives markets in the US have shown how they can cater to retail with the launch of smaller sized contracts and 0DTE products – the two fastest growing segments across global markets. Similar products have been launched in Europe and are gaining in popularity.

To understand how retail brokers were thinking about the challenges posed by regulatory restrictions, their strategies to respond and how the institutional sell-side viewed both the threat and opportunity of that response, ION commissioned Acuiti to conduct a study of both the institutional and retail markets.

This report is based on a survey of 72 firms in the European market, covering retail and institutional brokerage as well as interviews with retail traders aimed at understanding the challenges that they see in trading listed derivatives in place of CFDs and other retail products.

The key findings are:

- Concern is high among European retail brokers about the impact of restrictions on offering CFDs and other retail instruments
- Retail brokers are planning to respond to any such restrictions by expanding into institutional markets, other regions and growing their offerings of futures and options
- Expansion into institutional markets and growth of the futures and options offering will require investment and a change of approach for retail brokers
- The incumbent sell-side is largely sanguine over the potential increase in competition, but does see opportunity from retail traders coming in to listed markets
- Retail traders are open to trading in listed markets instead of CFDs but voiced concerns over lack of understanding of the products and higher costs – in particular with regards to market data

The problem with CFDs

The reason for the relative absence of retail traders from European listed derivatives markets when compared to the US is predominantly down to the availability of alternative retail instruments. Among these, CFDs are the most common alternative.

According to data aggregator Global Market Estimates, the total market size for CFDs in Europe was $3.2bn in 2023. CFDs, however, are only one part of the picture when it comes to retail trading in Europe.

Mainly because of historical regulatory preferences and tax treatment, different instruments have evolved as dominant retail trading products in different countries. Turbos, for example, are popular among retail investors in Germany but are banned in the UK.

Concerns among financial regulators across Europe over the rising risks of retail trading have grown over the past decade. ESMA has intervened with two major legislative frameworks. The Package Retail and Insurance-Based Products Regulation (PRIIPs), which came into force in 2018, increased transparency for offerings to retail investors.

This built on MiFiD II, which granted new powers to local regulators to impose restrictions on products offered to retail investors. In 2018, ESMA implemented temporary restrictions on the marketing, distribution and sale of binary options to retail investors. Binary options have also been banned permanently by regulators in several European countries including the UK, France and Belgium.

In 2021, the Dutch AFM announced restrictions on leverage when offering turbos to retail traders, citing significant losses incurred by traders in the product.

These losses are not insignificant. A 2020 study by the AFM found that the average retail investor lost €2680 between June 2017 and June 2018. Retail brokers in Europe are now required to state what percentage of their clients lost money trading CFDs or other retail trading products over the past 12 months – this typically ranges between 70% and 80% of customers.

However, it is not simply the fact that retail investors are losing money that is attracting concern from regulators. In the UK, the FCA is said to be taking a keen interest in the size of the positions that retail brokers are carrying and the risk of default. Trading in CFDs and other retail products that are not centrally cleared exposes the customer to counterparty risk against the broker.

To date, the risk management of retail brokers has been sufficient to withstand significant market shifts. However, concerns are rising over the size of retail brokers and the risks of wider market impact from a collapse of a key player. A bank with similar OTC exposures as the larger providers in the European retail market would be subject to significant capital requirements.

Regulators are therefore seeking to get ahead of the risk and fully understand the exposures that firms operating in their jurisdictions, but often head-quartered elsewhere, pose to both their clients and the wider market.

Spanish action

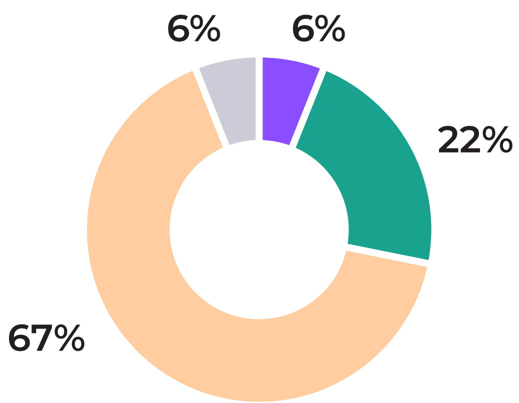
The most significant recent regulatory action came from Spain. In July 2023, Spain announced the ban of marketing CFDs to investors in the country as well as restrictions on the leverage that retail clients can be offered in futures and options markets.

While Spain is not the biggest retail market in Europe, the actions by Spanish regulators are a key indicator of the direction of travel across the EU. A recent Acuiti survey of proprietary trading firms in Europe found that 69% of firms thought that other EU countries would follow Spain by imposing greater restrictions on CFD trading and other leveraged products.

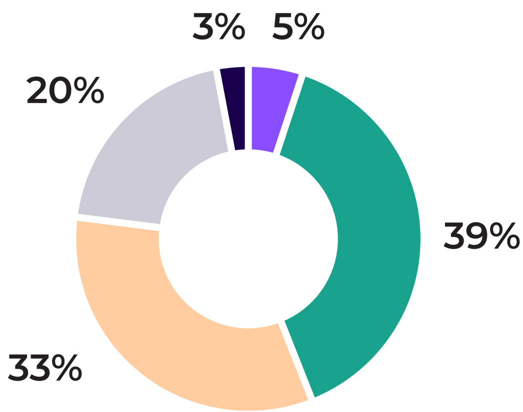
Participants in this study were split on the move. Proprietary trading firms and the institutional sell-side were in favour, while retail brokers were - understandably - strongly opposed.

Do you agree with the move by Spanish regulators to restrict the promotion of certain trading products such as CFDs to retail investors?

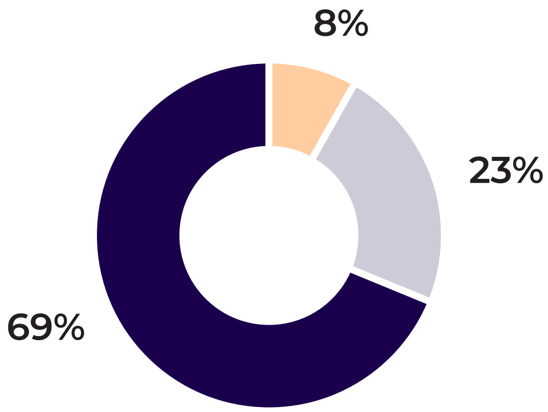
Institutional sell-side



Proprietary trading firms



Retail brokers

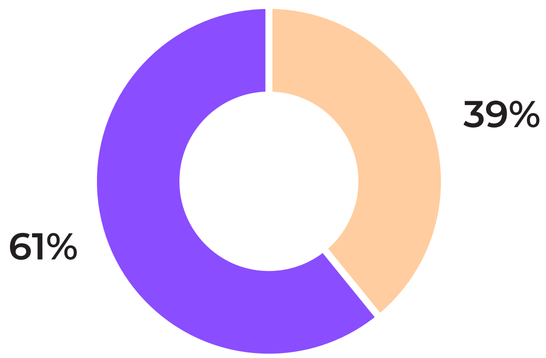


- Strongly agree
- Somewhat agree
- Neither agree nor disagree
- Somewhat disagree
- Strongly disagree

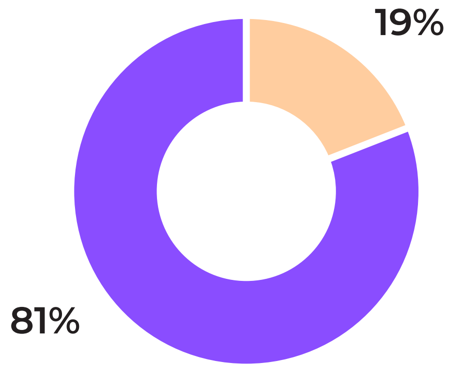
As with any regulatory response, however, there is a risk of over-reach. One such area is in moves to curb retail trading in futures and options in Europe. On this the market was agreed that futures and options should be out of scope. Just 15% of retail brokers argued for their inclusion and no institutional sell-side firms or proprietary trading firms did so.

Do you think that listed futures and options should be included in any moves to restrict promotion of products to retail traders in the EU or Europe?

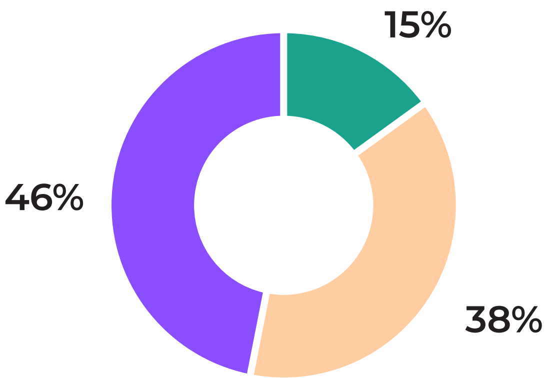
Institutional sell-side



Proprietary trading firms



Retail brokers



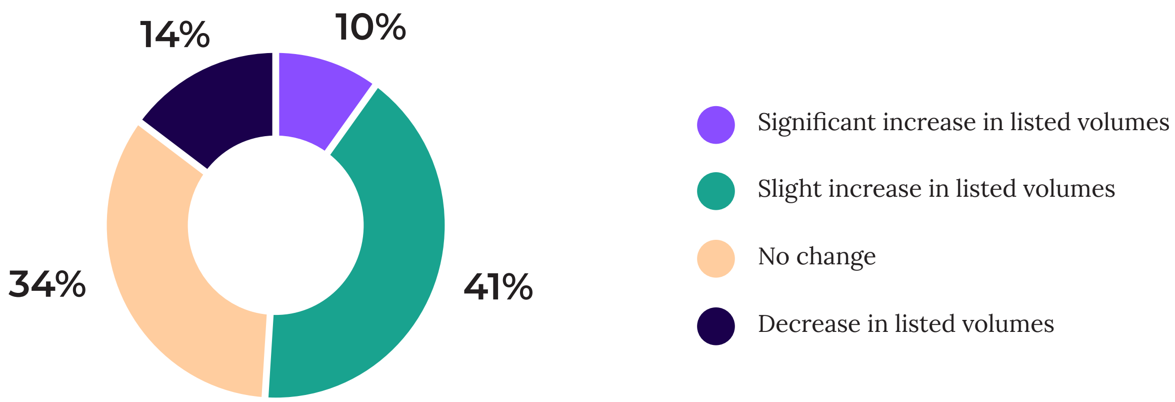
Yes
Potentially
No

Those in favour of restricting retail access to listed futures and options pointed to the similar levels of leverage and risk of loss in those markets when compared with other retail products. Others argued that futures and, in particular options, were complex financial instruments that may not be fully understood by retail investors.

Those against including futures and options cited the relative lack of counterparty risk in a centrally cleared market structure and the fact that retail investors should be allowed some instruments to trade. Others also pointed to the impact that growing retail participation in Europe would have on the overall strength and diversity of institutional derivatives markets.

Indeed, greater retail participation in Europe's listed derivatives markets has long been seen as a key initiative that could restore the fortunes of the market. Over half of respondents to this survey thought that restrictions on retail products would have a positive impact on listed markets. However, some cautioned that retail flow could go outside European or to FX and crypto products and that listed markets would lose the hedges that are often channeled through them by retail brokers.

What impact do you think regulatory restrictions on retail products such as warrants, CFDs and certificates would have on listed markets in the EU and UK?



There are certain structural changes to European listed markets that would be required for Europe to fully capitalise on the potential that retail trading offers. Retail investors that Acuiti spoke with for this report said that education was required to encourage the market to shift to listed products. In addition, there are concerns about the higher costs of trading in listed markets, particularly with regards to market data charges.

However, should retail flow to listed markets increase, there will be significant benefits. Proprietary trading firms that took part in this study predicted that significant retail flows into listed derivatives markets would improve liquidity, provide greater opportunities for institutional firms and boost revenues for institutional trading firms. Less than 10% thought that it would increase volatility.

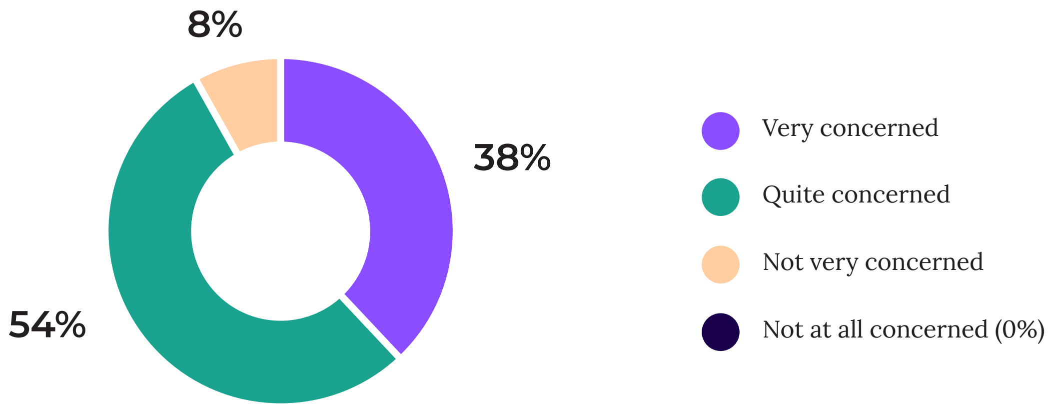
What impact do you think that significant retail flows into listed derivatives in Europe would have on the market?

Measuring the impact and the response

For retail brokers, however, the impact of restrictions across Europe would be significant. Of the retail-focused brokers that took part in this study, over two thirds said that between 76% and 100% of their revenues came from retail trading.

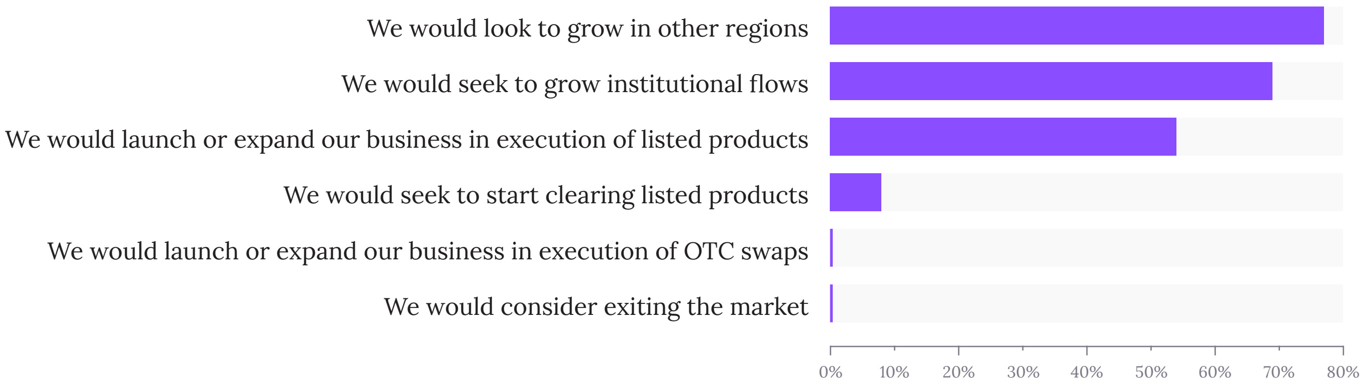
Unsurprisingly, there are high levels of concern over potential restrictions. Over a third of retail broker respondents to this study said that they were very concerned over the impact that restrictions on retail trading would have on their business.

How concerned are you about the impact that potential restrictions on retail trading of CFDs, warrants and other retail products in Europe will have on your business?



Respondents were most concerned about any restrictions on CFD trading, reflecting the importance of these instruments to these firms' revenues. However, retail brokers are preparing plans to mitigate lost revenues. Most retail brokers said that they would look to other regions to grow and replace revenue lost in Europe. Significantly, just over two thirds said that they would target institutional flows, while over half said that they would expand their business in the execution of listed products.

Were further restrictions on retail trading in CFDs, warrants and other retail products to come into force in the EU or UK, how do you expect you would change your business model?



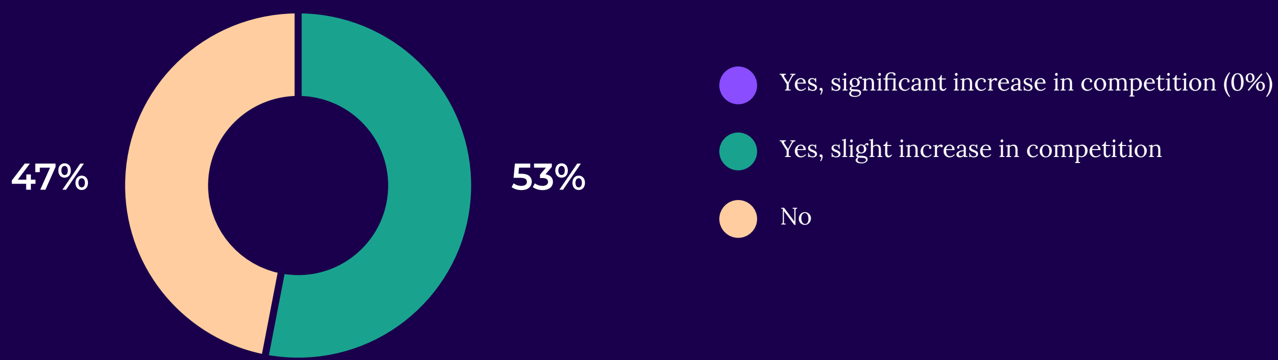
Opportunities and threats for the incumbents

If retail brokers are targeting expansion into the institutional world and retail traders will increasingly turn to futures and options trading, what will be the impact on incumbent institutional firms?

Acuiti asked our networks of senior sell-side execution and clearing executives how they viewed the possible increase in competition from retail brokers and if they saw an opportunity in retail markets.

Currently the institutional sell-side appears relatively sanguine on both the threat of competition and the opportunities that retail traders present their business.

Do you think such a ban would increase competition in your institutional markets as retail brokers seek to replace retail revenues with institutional flows?

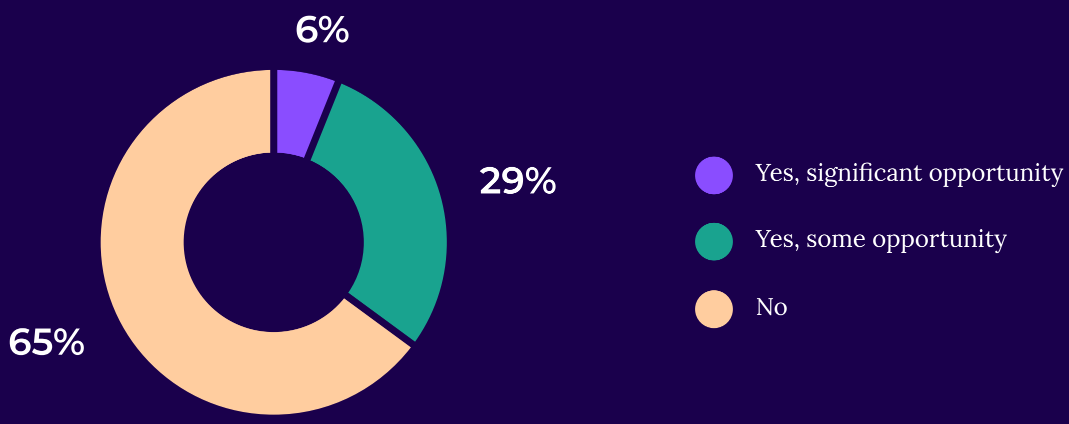


While over half of respondents expected an increase in competition, none expected that to be significant.

This potentially reflects an under-appreciation of the challenge and ambitions of retail brokers that this report has found. Several brokers in the US that began life focused exclusively on retail have made significant strides into the institutional market. While clearing firms are likely to see benefits from retail brokers moving into futures and options, execution-focused brokers will inevitably face greater competition.

However, the blurring of the boundaries between retail and institutional enabled by a shift of retail trading in listed markets will create opportunities for institutional brokers to expand their client bases. This was reflected in the fact that a third of institutional sell-side firms saw an opportunity to expand their business if CFD bans came into force across Europe. Interestingly, this included almost half of multinational banks that took part in this study.

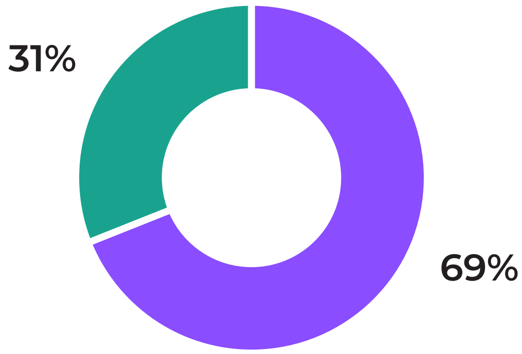
Do you think a ban on CFD and other retails products would create an opportunity for your business to target retail investors if they were trading on listed markets?



Building for the future

Most retail brokers that took part in this survey said that the pivot in their business model would require investment in technology.

Would you be likely to invest in software in order to realise those changes?



Investment will therefore be a key theme for retail brokers as they seek to launch into institutional markets and expand their listed execution offerings.

Already many of the retail brokers that contributed to this study traded in futures and options markets to hedge exposures, generally in end of day blocks. Several also offered listed products to clients already, although they reported that flows were low – those that offered futures and options to retail client reported that typically less than 10% of orders received from clients were in listed markets.

However, the expansion required will result in a change of approach to listed markets. If flows increase significantly, brokers that currently trade on listed markets via an institutional broker will likely seek to gain memberships and take more responsibility for their order flows.

This will require investment across the trade workflow from pre-trade risk management to reconciliations and settlement. Of those that were planning on investing, all envisaged investment in the front office while half were looking to invest in risk management software to meet the demands of the new business model.

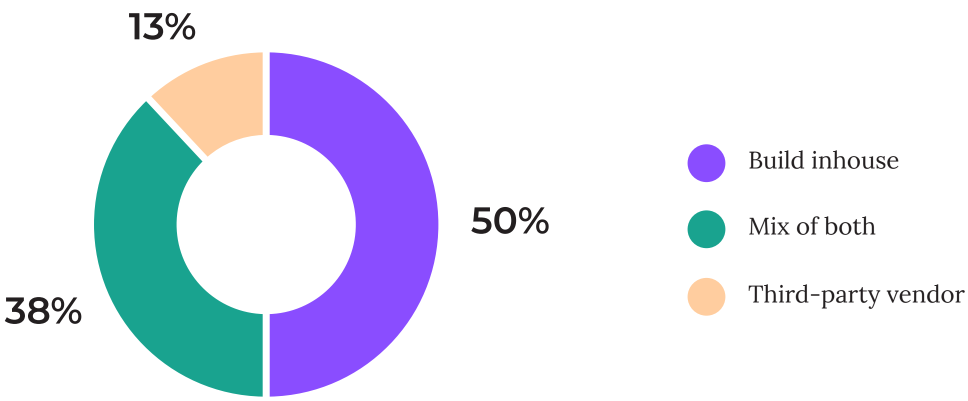
Other areas of investment included reconciliation software and processing. Around a third of firms that envisaged the need to invest were targeting investment in front to back straight-through-processing to increase the efficiency of their operations.

WHERE ARE FIRMS PLANNING TO INVEST?

1. Front office
2. Risk management
3. Reconciliations
4. Front-to-back STP
5. Trade processing

Currently half of the firms that anticipated a requirement to invest were planning on building inhouse, while over a third were planning a mix of outsourcing and inhouse builds.

Would you be likely to work with a third-party vendor or build inhouse?



The tendency to build inhouse is higher than in institutional markets. Many retail brokers are recent entrants to the market and have been built with technology as a foundation of their offering. At the same time, the relative lack of off-the-shelf software for retail brokers when compared to the institutional market has encouraged inhouse development. However, it is likely that firms will turn to third-parties as they look to institutional and listed markets, where there is a wide breadth of products available on the market today and the benefits both in terms of time and complexity in building institutional listed and clearing

Conclusion

Regulators across Europe are increasing their attention on the retail trading market. The Spanish ban on CFD promotions and distribution, which came into force last year, is the latest in a growing trend towards curtailing retail trading in OTC-based products such as CFDs.

This regulatory attention was historically driven by concerns over losses that retail traders are exposed to. That concern has not gone away. However, regulators are also increasingly focusing on the total exposures that retail brokers hold and the counterparty risks they pose — both to their clients and the wider market.

Listed futures and options have long been seen by regulators as safer markets than OTC markets, as evidenced by the post-crisis reforms to centrally clear and "futurise" significant swathes of the OTC markets. As such, any regulatory restrictions are likely to open the path to retail trading in listed markets.

For retail brokers, this presents a major threat to their current business models. Futures and options trading will be less lucrative than CFDs. As a result, firms will need to expand their offerings to compete. This study finds that retail brokers see institutional markets as a key opportunity to diversifying their business models.

The divisions between retail and institutional are already blurring across much of Europe driven by the increased sophistication of so call "protail" investors. In another indication of this blurring of the traditional boundaries, a UK broker recently announced it would allow retail investors to buy government bonds in the primary market through retail investment platforms.

Regulatory change in Europe will shake up the market and create winners and losers. There will likely be an acceleration of the consolidation among smaller providers as the current business model of some is rendered unsustainable without the revenue streams from retail traders in CFDs.

However, there will also be opportunities. The US has shown that a vibrant market for retail trading in futures and options creates scope for retail firms to also become meaningful players in the institutional markets. Exchanges have developed retail-focused products such as micro contracts and zero day options and seen significant volume growth as a result.

The growth of retail investing has also added depth and improved liquidity in US derivatives markets and been a key factor in the significant growth that US listed markets have seen since 2019. According to SIFMA, notional open interest in US listed markets has more than doubled over the past four years.

This growth could follow in Europe as well. Admittedly, there are market structure elements to address to fully realise the potential of the listed markets in Europe. In addition, the US retail investment boom has been fuelled by an extensive education programme conducted by the OCC.

However, European exchanges have launched similar retail-focused products, such as smaller contracts and zero day options to cater to retail demand and listed markets today provide a viable alternative for retail investors if CFDs are restricted.

Retail brokers that think big in the current climate will be the ultimate winners. They typically have the advantage of being technology-led, relatively new entrants to the market. That technology will stand them in good stead as they approach listed and institutional markets.

However, third-party technology is more dominant in institutional markets than in retail and firms that outsource or adopt a buy-and-build strategy will reduce time to market, costs and regulatory risk.

As well as expanding into listed and institutional markets, this study found that retail brokers were planning to grow their offerings in other regions. This creates the potential for regional players today to become global, offering both retail and institutional clients access to global markets around the clock.

These are challenging times for Europe's retail brokers. However, with challenges come opportunities and the potential for reinvention.

0203 998 9190
acuiti.io
info@acuiti.io