BETTER FINANCE
The European Federation of Investors and Financial Services Users
Fédération Européenne des Épargnants et Usagers des Services Financiers

PRESS RELEASE

GameStop Case Highlights Discrimination of "Retail" Investors in Stock Markets

4 March 2021– In January, the market value of American video game and electronics retailer GameStop, driven by an "army" of "retail" investors[1], shot up from $1.4 billion to $33.7 billion. This dramatic increase in stock price caused hedge funds that were *shorting*[2] GameStop to "suffer" significant losses and accuse retail investors of market manipulation. This standoff between "retail"[3] and professional investors revealed the challenges faced by "retail" investors in equity trading: discrimination and conflicts of interest.

Once the extent of the GameStop stock surge became clear, hedge funds themselves started to buy GameStop stock in order to limit their losses, thereby redoubling the pressure on the stock (this is known as a *short squeeze)*.[4] Considering that the main "retail" platform on which most of the "retail" trading activity was taking place, was channelling all its retail orders to third parties, and that this platform suspended its services at the same time as the short squeeze, taking out the retail investors betting against short sellers, it is quite ironic that those same short sellers shouted "market manipulation"!

Yet, alarmed by the volatile situation and under pressure from hedge funds, regulators across the globe soon reacted. In Europe, the European Securities and Markets Authority (ESMA) issued a statement on 17 February urging "*retail investors to be careful when taking investment decisions based exclusively on information from social media and other unregulated online platforms*", followed by a thinly veiled warning stating that "*organising or executing coordinated strategies to trade or place orders at certain conditions and times to move a share's price could constitute market manipulation*".[5]

Whereas it is important for retail investors to be aware of the risks involved in such activities, BETTER FINANCE had hoped the EU Supervisor would rather denounce the detrimental practice known as "Payments For Order Flow" or PFOF, which is at the core of the GameStop saga.

The main price surge was driven by a new wave of internet-savvy retail investors using online brokerage platforms such as RobinHood (US-based) or Trade Republic (Germany-based) that provide commission-free securities via mobile applications. Whereas, at first sight, these platforms seem to provide very cheap brokerage services, their business model could be based on the *Payment for Order flows* (PFOF) mechanism and constitute a conflict of interest between their duties to their clients and to third parties (i.e., clearing houses).[6] Since brokerage platforms benefit from third-party companies that execute the

[1] https://www.reuters.com/article/us-retail-trading-gamestop-capitalraise/exclusive-how-gamestop-missed-out-on-capitalizing-on-the-reddit-rally-idUKKBN2AB14F
[2] Shorting, or short-selling, is a technique by which an investor sells a security (usually borrowed) at a certain price, hoping that the price will decrease in the future; when the price falls, the investor buys back the security for much cheaper than it sold (usually in order to return it to the lender), and earns the difference between the initial selling price and the lower price at which it was bought.
[3] "retail" is the name given by EU Law (MiFID) to consumers acting as individual non-professional investors.
[4] https://sven-giegold.de/en/gamestop-frenzy/
[5] https://www.esma.europa.eu/sites/default/files/library/esma70-155-11809_episodes_of_very_high_volatility_in_trading_of_certain_stocks_0.pdf
[6] https://www.cnbc.com/2021/02/18/payment-for-order-flow-the-controversial-wall-street-practice-to-draw-scrutiny-at-robinhood-hearing.html

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trades, they may have little incentive to respect the spirit of their best-execution obligation to obtain the best-price execution from other market makers or trading venues for their clients.[7] In many instances, orders are routed to platforms or dark pools, where there is no transparency and the "market maker" can use this pre- retail trade info to trade on its own account and/or to derive a profit from the spread, and share it in one way or another with the broker. This not only leads to consumer detriment, to poorer execution prices or, sometimes, to orders not being executed at all,[8] [9] but it also affects the price discovery and formation process, which can be very detrimental in the long-term for EU equity trading. As such, this business model inevitably places the interest of the parties involved in these order flows before the needs of their end-users.[10]

Fortunately, in his address at the European Parliament's hearing on the GameStop case on 23 February, the Chair of EMSA, Steven Maijoor, clearly took a different stance and stated that "***Payments For Order Flow from third parties such as market makers may substitute commissions that are otherwise paid by clients. These create conflicts of interest** […] and need to be carefully assessed against the MIFID II requirements on conflicts of interests, best execution and inducement.*"[11] Ugo Bassi, Director of Financial Markets at the European Commission, went one step further, mentioning that "*some of the fee models that these commission-free brokers like Robinhood use, such as the payment for money flows, [...] **when interpreting MiFID II correctly, the provisions on inducements and best execution combined, would make it impossible or illegal**."*[12]

Guillaume Prache, Managing Director of BETTER FINANCE, stresses that "*capital market authorities should put "retail" investor protection first in any response to the recent events*" and calls on ESMA "*to take into consideration potential issues of insider trading, market manipulation and conflict of interests associated to these online brokerage apps and Payments For Order Flows*".

Even though European markets saw no increase in overall share short-selling activities in January 2021 and experienced lower volatility as a result of GameStop trading compared to the US[13], MEP Sven Giegold launched the discussion on whether stricter rules are needed to avoid the negative effects short squeezing could engender. [14]

Mr Prache points out that "*whichever way you look at the GameStop saga, the fact that online brokerage apps such as Robinhood and Trade Republic[15] were able to simply block retail investors (but not hedge funds) from trading in the midst of the GameStop chaos without any regulatory intervention is very worrying.*[16] *If there was any market manipulation, who started it?"* Whereas MIFID II further

[7] https://www.cfainstitute.org/-/media/documents/issue-brief/payment-for-order-flow.ashx

[8] According to F2iC (a BETTER FINANCE member), "*individual investors often complain on forums of seeing other investors' orders being executed on the central order book of exchanges at their quotes, whilst their own orders are pending execution or not executed at all, as those were routed to alternative platforms*" (translated from French, courtesy of BETTER FINANCE) - see Aldo Sicurani, 'Bourse: Zero commission ne veut pas dire zero couts' (December 2020) Inform@ctions – Magazine de la F2iC, p. 4, available at: https://www.f2ic.fr/ffci-portal/custom/module/cms/content/file/Informactions/informactions-n67-12-2020.pdf

[9] For a detailed explanation on payments for order flows, see for example Aldo Sicurani, ibid

[10] https://www.forbes.com/sites/ronshevlin/2021/02/08/the-rise-of-the-anti-robinhood/?sh=56342d21d3d6

[11] EP Hearing on GameStop Case: https://multimedia.europarl.europa.eu/en/committee-on-economic-and-monetary-affairs_20210223-1345-COMMITTEE-ECON_vd

[12] ibid

[13] ibid

[14] https://sven-giegold.de/en/gamestop-frenzy/

[15] https://www.reuters.com/article/retail-trading-germany-idUSL1N2K323K

[16] https://www.cnbc.com/2021/02/17/robinhood-faces-lawsuits-after-gamestop-trading-halt.html

restricts third party profits from the execution of trade orders on behalf of end-users and professionals[17], the regulatory framework does not explicitly forbid the "payment for order flows" practice.

Therefore, BETTER FINANCE asks EU capital market supervisors to investigate PFOF practices and their impact on non-professional investors and to consider banning this practice as part of the upcoming MiFID II review.

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[17] https://www.engage.hoganlovells.com/knowledgeservices/news/mifid-ii-fca-publishes-dear-ceo-letter-on-payment-for-order-flow