

Over the past decade, online trading has become increasingly accessible for regular consumers. The European market is now full of platforms offering a wide array of products and investment options. While these platforms initially positioned themselves as gateways between clients (consumers) and the traditional financial markets, new technologies have paved the road for different (innovative) business models. This is the case for so-called 'prop trading firms', which have gained the attention of both consumers and regulators in Europe. But is this newly garnered attention justified and is any of this regulated? As with most legal questions, it depends.

PROP TRADING

—
JUST PLAYING WITH DATA OR ACTUAL INVESTMENT SERVICES?

WHAT ARE PROP TRADING FIRMS?

Prop trading firms, short for 'proprietary trading firms', are companies that trade financial instruments (or any type of financial assets) using their own funds (instead of using clients' money) to make a profit for themselves. Their business model is based on receiving full profit of the investment instead of commissions for trades made on behalf of clients or other investment services. In this context, these companies do not act on behalf of any investor. This last feature sets them aside from various regulated investment firms who are providing services to clients by executing client orders, providing investment advice or discretionary managing clients' portfolios.

While the core business of all prop trading firms essentially boils down to the same model, they can in practice operate in very different ways to achieve their objective.

In a traditional set-up, the firm entrusts its own assets to professional traders, being internal employees or independent traders with whom the firms have a collaboration agreement.

But the evolution of technologies made another model emerge whereby such prop trading firms make use of the data generated by (external) traders, who most of the time never access the firm's funds (nor their own). In such a set-up, the prop trading firm uses the data generated by virtual trades executed by external traders in a virtual market mirroring live market conditions.

The data generated by those (virtual) trades are fed into the prop trading firm's systems, which decide whether to replicate them in live conditions with the firm's actual funds. In such a scenario, any external trader that has proven their skills in a 'demo account' for a certain period of time can become a so-called 'prop trader' and make virtual trades whereby the data generated by such traders is afterwards used by the prop trading firms.

Besides offering access to their platform to interested external traders, prop trading firms often propose (paying) trading courses and study material to prop trader candidates; in certain cases, passing these courses is even mandatory to access the platform. There is however no guarantee that paying for and completing these courses will lead to a potential partnership with the prop trading firm.

Once accepted the prop traders (in case of successful virtual trades) are often paid a commission or fixed fee by the prop trading firms based on the actual benefits generated on the “real” markets.

WHAT IS THE STATUS OF PROP TRADING FROM A REGULATORY STANDPOINT?

In March 2023, the European Securities and Market Authorities ([ESMA](#)) looked into the practice of ‘copy trading’, defined as “a service that involves trading of a client’s assets based on the trades of another trader”. ESMA confirmed that copy trading can include regulated services (MiFID services, such as portfolio management, investment advice, reception and transmission of orders or executions of orders) – depending on how the service is structured.

While the set-up where a prop trading firm replicates virtual trades presents very similar elements to copy trading, prop trading firms do not, in principle, provide regulated services to clients since they only trade on their own account. It is established under the European investment service regulation (called ‘MiFID’) that dealing on own account does not constitute a regulated investment service activity in so far no actual investment services to clients are offered. This becomes of course a different story as soon as the dealing on own account is in reality part of a back-to-back trading set-up for the benefit of clients or simply comes down to executing client orders. Therefore a concrete analysis per use case is advised, especially in complex setups.

The question also arises whether the trading individuals (the prop traders) themselves do not offer regulated (MiFID) services to the prop trading firms. While there is no general answer which applies to all use cases, it seems that in many cases they simply provide data generated in a virtual environment to the prop trading firms. Therefore and under the current regulatory framework there are good arguments to say that such prop traders should not be considered as offering any investment services (such as portfolio management) to the prop trading firms. Depending on the circumstances however and in certain specific cases it could be debated whether they are not providing (regulated) investment advice.

CONCERN OF THE REGULATORS

Regulators all over Europe are staring to look into this phenomenon as more and more individuals are drawn to the attractive propositions of prop trading firms. Very often they are invited to participate only after having made certain contributions themselves (by ordering online courses, paying a community fee etc.) which obviously raises the attention of consumer protection instances.

Just last month, the Financial Services and Markets Authority (FSMA) in Belgium issued a [warning](#) for consumers that partake in the challenges and courses of prop trading firms.



In its warning, the FSMA highlights different risks related to prop trading. First, it reminds that prop trading firms operate in principle without a licence, so that they (and their marketing materials) are not supervised by any national authority. Second, it draws the attention of the public to the fact that the products being traded – albeit in a simulation – are often complex financial instruments such as CDFs and forex-products. It also emphasises that the ‘gaming element’ in prop trading can give overconfidence to the prop traders and has an addictive nature, which may drive them to adopt reckless behaviour (when trading with their own funds). Finally, the FSMA observes that prop traders have usually no guarantee to get paid, as their commissions can be very opaque and are unilaterally decided by the prop trading firm (which could be an issue from a general consumer law perspective).

OUTLOOK

Currently, the FSMA and other regulators seem to focus on this type of warnings rather than arguing that any regulated activities would be performed. As this activity is getting more traction in the future it is however likely that both national and European regulatory bodies will take an even closer look at these initiatives.

At Simont Braun we are at the forefront of all developments in the Digital Finance space and specialise in European and Belgian regulatory and legal assistance for the Financial Services industry.

Should you have any questions on prop trading or other FinTech related matters, do not hesitate to reach out to digitalfinance@simontbraun.eu

This newsletter is not a legal advice or a legal opinion. You should seek advice from a legal counsel of your choice before acting upon any of the information in this newsletter.

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