

ADVICE TO ESMA

Call for evidence – Effects of product intervention measures regarding CFD’s and binary options on market participants and clients

I. Executive summary

1. *Introduction.* The SMSG fully supports this ESMA call for evidence, which will result in an improved picture of the effects of its product intervention measures. However the SMSG (i) requests more information on a number of important statements in the call; (ii) advises ESMA to resolve a number of interpretation issues; and (iii) takes position on a number of issues which should be taken into account in the MiFID/MiFIR and PRIIPs Review.
2. *Information request.* The SMSG would like to receive more information in respect of a number of statements made in the call for evidence, and more in particular on (i) the impact of leverage limits on different types of CFDs in the different Member States; and (ii) the reported increase in the number of clients treated as professional clients on request.
3. *Interpretation issues.* The SMSG further believes that ESMA should resolve a number of interpretation issues and:
 - (i) Clarify that NCAs should, in view of article 40(7) MiFIR, not deviate from an ESMA product intervention measure, as long as the ESMA measure exists;
 - (ii) Clarify that national pre-MiFIR product intervention measures should be brought into the scope of MiFIR if Member States want to maintain them (no ‘grandfathering’), since national pre-MiFIR measures which are not brought into the scope of MiFIR result in (a) ESMA giving an incomplete and therefore misleading picture of NPIMs and (b) hampering of the internal market;
 - (iii) Ensure that there is no room for interpretation on what products are in the scope of ESMA’s product intervention measures and that the scope of those measures is directly connected to the investor threat assessment;
 - (iv) Clarify that the MiFIR product intervention measures do apply to all market participants selling products in scope of ESMA or NCA product intervention measures, not only to credit institutions or investment firms.
 - (v) Closely cooperate with the other ESAs to avoid regulatory arbitrage.

- (vi) Recognize that the question whether there are examples of circumvention of product intervention measures can be interpreted in many different manners, recognize that they are all relevant, and look into all those sources of circumvention.

4. *Need for legislative changes.* With a view to the MiFID/MiFIR and PRIIPs Review, the SMSG is in favour of a number of legislative changes, including: (i) the possibility for both NCAs and ESMA to take permanent measures, the necessity of which should in both cases, however, be reviewed on a yearly basis (the current solution where all NCAs need to transpose the temporary ESMA measures into permanent national measures is inefficient and potentially undermines the internal market); (ii) the extension of ESMA scrutiny to NCAs voluntary agreements with market participants, which have the same effect as product intervention measures but cannot be scrutinized by ESMA even when they have a disruptive effect on the internal market; and (iii) a further alignment of the MiFIR and PRIIPs provisions on product intervention, ideally by putting them all in the PRIIPs Regulation.

II. Background

1. Legal Background

5. The Markets in Financial Instruments Regulation (EU) N° 600/2014 (MiFIR) has attributed product intervention competences to ESMA:

- (i) The MiFIR explicitly allows Member States' competent authorities, upon certain conditions, to prohibit or restrict the marketing, distribution or sale of certain financial instruments or financial instruments with certain specified features; or a type of financial activity or practice in or from their Member State (art. 42 MiFIR). *ESMA should in such circumstances perform a facilitation and coordination role and ensure that action taken by a competent authority is justified and proportionate and that, where appropriate, a consistent approach is taken by competent authorities* (art. 43 MiFIR). The "comply or explain" approach applies in this matter: ESMA can give an opinion on whether it deems action by the competent authority appropriate; if the competent authority does not comply with such opinion, it should immediately publish on its website a notice fully explaining its reasons (art. 43 MiFIR).
- (ii) Moreover, *ESMA itself can temporarily prohibit or restrict in the Union the marketing, distribution or sale of certain financial instruments or financial instruments with certain specified features; or a type of financial activity or practice* (art. 40 (1)). ESMA can however only do so if the following conditions are met:
 - (a) the proposed action addresses a significant investor protection concern or a threat to the orderly functioning and integrity of financial markets or commodity markets or to the stability of the whole or part of the financial system in the Union;
 - (b) regulatory requirements under Union law that are applicable to the relevant financial instrument or activity do not address the threat;
 - (c) a competent authority or competent authorities have not taken action to address the threat or the actions that have been taken do not adequately address the threat.

Where a competent authority or competent authorities have taken a measure under Article 42, ESMA may take any of the measures referred to in paragraph 1 without issuing the opinion provided for in Article 43.

A Commission Regulation further details the “criteria and factors to be taken into account in applying product intervention powers” (Commission Delegated Regulation (EU) 2017/567 of 18 May 2016 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council with regard to definitions, transparency, portfolio compression and supervisory measures on product intervention and positions (OJ L 87, 31.3.2017)).

2. SMSG Own Initiative Report and ESMA action

6. On June 16th 2017, the SMSG delivered an Own Initiative Report to ESMA in order to (1) give the SMSG’s opinion on two important legal questions relating to MiFIR product intervention (scope of application and grandfathering of pre-MiFIR national product intervention measures); (2) summarize national measures already taken before entry into force of MiFIR; and (3) indicate issues where intervention by ESMA was considered useful.

The SMSG concluded that ESMA needed to consider the effect and effectiveness of (i) new MiFID II investor protection measures, such as product governance, and (ii) Member States product intervention measures, before taking more intrusive EU product intervention initiatives, but it expressed a specific concern in relation to CFDs and binary options.

The SMSG is therefore pleased to see that ESMA has indeed been cautious in using its product intervention powers under MiFIR, and that the actions taken by ESMA have been in the field of CFDs and binary options.

3. ESMA Call for Evidence

7. The SMSG welcomes the current call for evidence, which will without doubt further refine ESMA’s views on the effects of its product intervention measures.

Even though a number of questions ask for experience of market participants, and cannot be answered by the SMSG, other questions are of a broader nature and do allow for an SMSG opinion. Moreover the SMSG also has a number of general comments relating to the Call for Evidence.

III. General comments relating to the Call for Evidence

8. In respect of the text of the Call for Evidence, the SMSG would like to raise the following comments.

9. In para 22, ESMA mentions that NCAs reported an overall decrease in the number of CFD retail client accounts, trading volume and total retail client equity when comparing the reporting period with the same period a year earlier. Since the ESMA measures do not prohibit the sale of CFDs as such, but only limit the leverage level, it would be very useful to receive more detailed information on the impact of those leverage limits on different types of CFDs in the different Member States.

10. Para 23 mentions that NCAs reported that for both binary options and CFDs there has been an increase in the number of clients treated as professional clients on request. Again, it would be

very informative to receive more information / data on this remarkable evolution including: in which Member States was this evolution noted?; what is the background?; and have the strict MiFID II – rules for client recategorisation been complied with?

11. Para 29 mentions that ESMA concluded in its opinions that it was necessary for the NCAs to take product intervention measures that are at least as stringent as ESMA's measures. Para 30, moreover, mentions that some NCAs took NPIMs that diverge from ESMA's ones.

However, art. 40(7) MiFIR states that ESMA measures take precedence over Member States measures. Therefore, NCAs should in any event not deviate from the ESMA measure, as long as the ESMA measure exists. The SMSG is of the opinion that this also means that NCAs should not be stricter than the ESMA measures. If ESMA measures could be made permanent (see advice in response to question E), then deviating NCA measures could be permanently dealt with under the rule that ESMA measures take precedence, which would improve the current situation where NPIMs can deviate from the original ESMA measure, once the temporary ESMA measure ceases to have effect.

12. Para 32 states that no NIPMs deal with products other than binary options and CFDs. However, many Member States have pre-MiFID measures (see the annex to the 2017 Own Initiative Report SMSG report on product intervention), which, if they were taken today would qualify as MiFIR product intervention measures.

In its 2017 Own Initiative Report, the SMSG argued that those pre-MiFIR measures should not be grandfathered and that Member States which wanted to keep those pre-MiFIR measures in force should comply with the MiFIR procedure (including a proportionality test and notification to ESMA and other NCAs). From the statement in para 32 that no NIPMs deal with products other than binary options and CFDs, the SMSG concludes that its advice on this point has not been followed.

The SMSG is of the opinion that ESMA should investigate the need and proportionality of all national pre-MiFIR measures and require NCAs to follow the MiFIR procedure (i.e. proportionality test and notification to all other NCAs and to ESMA) if they want to keep those measures in force.

The current situation results in ESMA giving an incomplete and therefore misleading overview of Member States product intervention measures. Moreover such national pre-MiFIR measures, which are not brought under the scope of the MiFIR procedure, undermine the internal market.

IV. Questions

A-B. Even though individual members of the group or their associations may respond separately, the SMSG as a group cannot respond to questions A-B.

C-D. The SMSG is of the opinion that the current practice, where all NCAs need to transpose the ESMA product intervention measure into a permanent measure at national level is highly inefficient, and, even worse, undermines the internal market. The recent experiences with the transposition of the ESMA product intervention measures into national measures indeed show

that (i) certain NCAs have not transposed the ESMA measures, and (ii) certain NCAs have modified the ESMA measures. Both deviations result in an unlevel playing field and potential investor detriment from within the EU.

This problem is closely linked to the temporary nature of the ESMA product intervention measures, which is discussed under E.

E. The SMSG supports the principle that product intervention measures, which have a very crude impact on the market they target, should be reviewed on a regular basis. However, the intervals for review should be sufficiently long. The SMSG therefore supports the longer duration of the ESMA product intervention measures in the ESA Review.

On the other hand, as mentioned under C-D, the current practice where all NCAs need to transpose the ESMA product intervention measure into a permanent measure at national level is highly inefficient and undermines the internal market.

A better alternative would be that ESMA can, for instance after two renewals, take a permanent measure, but is required to submit the necessity of this measure to a yearly review.

In respect of national measures, which can be, and typically are, of a permanent nature, art. 42 (6) MiFIR currently provides that *'The competent authority shall revoke a prohibition or restriction if the conditions in paragraph 2 no longer apply.'* However, the MiFIR does not provide for an obligation for NCAs to submit the necessity of a product intervention measure to a yearly review.

The SMSG is of the opinion that both the NCAs and ESMA should be able to take permanent measures (for instance after a number of renewals of temporary measures). The NCAs should be able to do so in respect of national vulnerabilities or problems; ESMA in respect of EU-wide problems. Both the NCAs and ESMA should, however, review the necessity of their measures on a yearly basis. The SMSG is of the opinion that the MiFIR should be changed in this respect.

F. The question whether there are examples of circumvention of product intervention measures can be interpreted in different manners.

- a. It can mean that *product providers repackage* their products as something else, which falls outside the scope of the product intervention measure. The SMSG is not aware of such measures.
- b. It can also mean that *NCAs could take measures which formally do not qualify as product intervention measures*, even though they have the same effect. Before the entry into force of MiFIR, for instance, the Belgian NCA introduced a voluntary moratorium on particularly complex products¹ and the German NCA facilitated a voluntary commitment in respect of Credit Linked Notes². Since both measures date back from before the introduction of the MiFIR, this was perfectly possible at the time.

¹ Moratorium on the distribution of particularly complex structured products (FSMA/2011_02, 20 June 2011) <http://www.fsma.be/en/Article/nipic/nipic.aspx>.

² Voluntary commitment not to issue credit-linked notes (CLN) with a denomination of less than 10.000 € and further not to distribute to retail investors credit-linked notes with complex structures. Features seen as giving rise to

Today, however, similar agreements could be made by NCAs to circumvent the MiFIR product intervention rules. Such voluntary agreements would in the SMSG's opinion not qualify as product intervention measures, since they are not imposed as binding measures on market participants (see 2017 SMSG own initiative report). Such voluntary agreements could even be defended under the proportionality principle, since no binding measures are needed if the market is prepared to concede to certain measures voluntarily.

However, since such agreements are voluntary, and fall outside the scope of MiFIR, they do not have to be reported to other NCAs or to ESMA, and ESMA cannot take up a coordinating role in this respect. Nevertheless those voluntary measures do have a strong effect on the markets of these Member States, which is an important impediment to the internal market.

Even though it can be argued that such voluntary agreements are beneficial from an investor protection perspective, the SMSG is of the opinion that it would be better if such measures would fall within the MiFIR framework, which would allow ESMA to 'supervise the national supervisors' and ensure an appropriate framework for the adoption of measures which such a heavy an impact on the national market.

- c. Circumvention could, finally, also mean, that *distributors unduly requalify retail investors to professionals* in order to be able to sell them CFDs or binary options, in respect of which the product intervention measures only prohibit the sale to retail clients (see also comment in para 10 above).

G. The SMSG sees the following points for improving the (application of the) regulatory framework in regard of product intervention measures:

- a. Consistency in the product scope of the measure with the investor threat assessment.

In its Q&A of March 2017, ESMA reported the abusive practices that accompanied the distribution of CFDs, binary options and rolling spot forex, and noted that these speculative bilateral contracts "*are typically sold on an over-the-counter (OTC) basis and not through a regulated market or multilateral trading facility (MTF)*". Despite the identification of abusive practices in the bilateral market, ESMA's measures extended the scope of application to products that were listed on regulated markets. This extension of scope was not accompanied by supporting evidence of a threat assessment concerning listed products. Such Exchange products typically benefit from the following protective features:

- i. A capital risk that is capped to the limited invested amount (no-recourse products);
- ii. A regulated product issuance framework, involving *inter alia*: an approved issuance prospectus; a fair, liquid and transparent secondary market; a fair business model thanks to hedged positions, limiting conflicts of interests; and established industry codes of conduct.

concerns included complexity, pricing and naming. See https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Pressemitteilung/2016/pm_161216_bonitaetsanleihen_branche.html

b. Spill-over effect: Uncertain scope of concerned products

The definition provided by ESMA of binary options created uncertainty with respect to the scope of application. As a result, several manufacturers and distributors received questions in several jurisdictions about a number of widely distributed long-term structured notes, despite such products being outside the initially-defined intended scope of the measure. This uncertainty was ultimately resolved after extensive discussions between industry participants, trade associations and certain NCAs.

To limit uncertainty and possible disruption in the future, the SMSG recommends that ESMA carefully assesses such unintended spill-over risks. Where possible, it would be useful to provide examples of products that are explicitly outside of the scope of the measure.

- c. No grandfathering of pre-MiFIR product intervention measures (see para 12 above).
- d. Voluntary agreements should come under ESMA scrutiny, whether via MiFIR or via supervisory convergence work (see answer to question F).
- e. ESMA should take a stance maintaining that product intervention measures do apply to all market participants who sell products the focus of ESMA or NCA product intervention measures, and not only to credit institutions or investment firms. Awaiting a clarification in the MiFIR text, this interpretation would already make perfect sense.³
- f. ESMA should closely coordinate with the other ESAs in order to ensure that regulatory arbitrage is avoided.
- g. Ideally, the MiFIR and PRIIPs provisions on product intervention should be further aligned. In the context of the MiFID / MiFIR and PRIIPs Review, it would be a good idea to move the rules in regard of product intervention powers to the PRIIPs Regulation.⁴

³ See for an in-depth argumentation: V. Colaert, 'Product Intervention: Keystone of the EU Investor Protection Regime' (KU Leuven Working Paper, July 2019) p. 14-16.

⁴ See for further arguments: V. Colaert, 'Product Intervention: a Cross-sectoral Analysis' in V. Colaert, D. Busch and T. Incalza (eds), *European Financial Regulation: Levelling the Cross-sectoral Playing Field* (Hart Publishing, 2019).

This advice will be published on the Securities and Markets Stakeholder Group section of ESMA's website.

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[signed]

Veerle Colaert

Chair

Securities and Markets Stakeholder Group