



European Securities and
Markets Authority

Call for evidence

Potential product intervention measures on contracts for differences and binary options to retail clients.



Responding to this paper

ESMA invites comments on this paper and in particular on the specific questions summarised in **Chapter 4**.

ESMA will consider all comments received by **5 February 2018**.

All contributions should be submitted online at www.esma.europa.eu under the heading 'Your input - Consultations'.

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading [Legal Notice](#).

Who should read this paper

This Consultation Paper may be of particular interest to investment firms involved in the sale, distribution or marketing of contracts for difference and/or binary options, and to consumer groups and investors.



Table of Contents

1	Investor protection concerns arising from the sale, distribution or marketing of contracts for differences and binary options	4
2	ESMA work on potential intervention measures	6
3	Impact of the measures	9
4	Questions.....	9

1 Investor protection concerns arising from the sale, distribution or marketing of contracts for differences and binary options

1. In recent years ESMA and several national competent authorities (NCAs) have observed a rapid increase in the marketing, distribution and sale of contracts for differences, including rolling spot forex (CFDs) and binary options (BOs) to retail investors across the EU.
2. The inherent risk and complexity of these products, the marketing, distribution and sale through on-line channels and the associated aggressive marketing techniques used by a number of firms have led to significant investor protection concerns. Several NCAs have also conducted analyses or studies showing that between 74 and 89% of clients trading in these products lose money.

Features of CFDs that have required increased attention by supervisors

3. A CFD is a derivative other than an option, future, swap or forward rate agreement, the purpose of which is to give the holder a long or short exposure to fluctuations in the price, level or value of an underlying, irrespective of whether it is traded on a trading venue, and that must be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event.
4. The following main features of CFDs and the way in which they have been distributed, marketed or sold across the EU have required increased attention by supervisors:
 - Retail investors are exposed to a significant risk of loss (both from trading and from transaction fees), which is magnified by the effect of high leverage.
 - The complexity of these products and a lack of transparent information at point of sale, which limits the ability of retail investors to understand the risks underlying these products.
 - The use of aggressive marketing techniques, including the offer of incentives to clients to encourage trading in these products.

Features of BOs that have required increased attention by supervisors

5. A BO is a derivative that meets the following conditions:
 - (a) it must be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event;
 - (b) it only provides for payment at its close-out or expiry;
 - (c) its payment is limited to:
 - (i) a predetermined fixed amount if the underlying of the derivative meets one or more predetermined conditions; and
 - (ii) zero or another predetermined fixed amount if the underlying of the derivative does not meet one or more predetermined conditions.
6. The following main features of BOs and the way in which they have been distributed, marketed or sold across the EU have required increased attention by supervisors:

- Retail investors are exposed to very high levels of risk and intrinsic negative expected returns, in the absence of compensating benefits (in contrast with, for example, vanilla options that are often suited to provide hedging functions). These features are intrinsic to the product.
- The short duration of trades in combination with the extreme pay-off distribution increases the exposure to losses and raises the risk of addictive behaviour. Indeed, retail investors in BOs often place many repeated trades, making it increasingly likely that they will lose on a cumulative basis. This holds for BOs of any variety.
- The complexity of these products and a lack of transparent information at point of sale, which limits the ability of retail investors to understand the risks underlying these products.
- The use of aggressive marketing techniques, including the offer of incentives to clients to encourage trading in these products.

Actions taken to date

7. Since 2013, ESMA has taken a number of actions and initiatives, including specific warnings in 2013 and 2016, dedicated Q&As and the coordination of a joint group of NCAs to tackle issues related to a number of providers offering CFDs and other speculative products to retail clients on a cross-border basis across the Union.
8. Several NCAs have also taken actions to address risks to investor protection arising from these products. The type of actions include: increased supervision of firms providing these products; banning the distribution of certain derivative contracts to retail clients, banning providers from marketing communications to individuals; imposing leverage limits on CFDs provided to retail clients; limiting clients' payment obligations; introducing specific risk warnings; and requiring clients to acknowledge risk via a handwritten statement.
9. ESMA remains concerned that the risks to investor protection are not sufficiently controlled or reduced by the above actions. In June 2017, an ESMA statement¹ indicated that it would be considering the possible use of its product intervention powers under Article 40 of Regulation (EU) 600/2014² (MiFIR), which have become applicable with the implementation date of MiFIR on 3rd January 2018. The law provides ESMA, in compliance with relevant regulatory requirements, with the power to require temporary prohibitions or restrictions concerning certain financial instruments, financial activities or practices when, among other conditions, the proposed action addresses a significant investor protection concern in the Union.
10. As indicated in its Statement published on 15 December 2017³, ESMA is considering measures to:
 - restrict the marketing, distribution or sale to retail clients of CFDs; and
 - prohibit the marketing, distribution or sale to retail clients of BOs.
11. The purpose of this document is to seek additional evidence from firms and investors on the expected impact of the measures under consideration.

¹ <https://www.esma.europa.eu/document/product-intervention-general-statement>

² OJ L173 of 12.6.2014

³ <https://www.esma.europa.eu/press-news/esma-news/esma-issues-updated-statement-preparatory-work-in-relation-cfds-binary-options>

2 ESMA work on potential intervention measures

12. Regulation (EU) n. 600/2014 (MiFIR) has provided ESMA, in compliance with relevant regulatory requirements, with the power to require temporary prohibitions or restrictions concerning certain financial instruments, financial activities or practices when, among other conditions, the proposed action addresses a significant investor protection concern in the Union (Article 40 MiFIR).
13. Against this background, ESMA published a Statement on 15 December 2017 providing an update on its work in relation to CFDs (including rolling spot forex) and BOs. In particular, ESMA is working on the possible use of its temporary product intervention powers under Article 40 of MiFIR to address investor protection concerns in relation to these products.
14. **In relation to CFDs**, ESMA is considering restricting the marketing, distribution or sale to retail clients of CFDs, including rolling spot forex.
15. ESMA has analysed various options. For example, ESMA considered whether to prohibit the marketing, distribution or sale of CFDs. While this option would have been expected to minimise consumer detriment, ESMA currently believes the objective of investor protection can be adequately achieved by restrictions on the provision of CFDs to retail clients, rather than a prohibition.
16. The restrictions currently under review in order to address the investor protection risks set out in paragraph 4 are as follows. Please note that, in each case, the restrictions contemplated would only apply in respect of retail clients. The option of applying the restrictions to professional clients is not under consideration due to the lack of evidence of harm to this type of client.
 - i. **Leverage limits** on the opening of a position by a retail client. The contemplated leverage limits would apply to any payment made to a product provider for the purpose of entering into a CFD, excluding commission and transaction fees. They would range from 30:1 to 5:1 to reflect the historical price behaviour of different classes of underlying assets. In particular:
 - a. for CFDs in major currency pairs,⁴ which have relatively low historical volatility, a limit of 30:1 is being considered;
 - b. for CFDs in non-major currency pairs and major equity indices⁵, a limit of 20:1 is being considered;
 - c. for CFDs in gold, a relatively stable commodity, a limit of 20:1 is being considered;

⁴Any currency pair comprising any two of the following currencies: US Dollar, Euro, Japanese Yen, Pound Sterling, Canadian Dollar or Swiss Franc.

⁵ Any of the following equity indices: Financial Times Stock Exchange 100 (FTSE 100); Cotation Assistée en Continu 40 (CAC 40); Deutsche Bourse AG German Stock Index 30 (DAX30); Dow Jones Industrial Average (DJIA); Standard & Poors 500 (S&P 500); NASDAQ Composite Index (NASDAQ); Nikkei Index (Nikkei 225); Standard & Poors / Australian Securities Exchange 200 (ASX 200).

- d. for CFDs in commodities other than gold, and for CFDs in minor equity indices, a limit of 10:1 is being considered; and
- e. for individual equities, which tend to be relatively volatile, and for any underlying not otherwise listed above, a limit of 5:1 is being considered.

A leverage limit of 5:1 on the opening of a CFD implies that the client must post initial margin of at least 20% of the initial total exposure of the CFD. Similarly, a leverage limit of 20:1 on the opening of a CFD implies that the client must post initial margin of at least 5% of the initial total exposure of the CFD.

ESMA is currently considering how CFDs on cryptocurrencies fit within the MiFID regulatory framework as financial instruments. ESMA will be considering this issue further and welcomes views on the matter. In this context ESMA is currently discussing whether CFDs on cryptocurrencies, whose underlying assets have displayed very high price variation, should be addressed in the measures and whether a 5:1 initial leverage would provide investors with sufficient protection. Alternatively, a lower leverage limit (2:1 or 1:1) or stricter measures (such as a prohibition on the marketing, distribution or sale of CFDs in cryptocurrencies to retail clients) could be considered.

- ii. A **margin close-out rule** on a position-by-position basis. This would standardise the percentage of margin at which providers are required to close out a retail client's open CFD. The aim is that, consistently across providers, clients are routinely protected from losing more than what they have invested. The intention is to make the resulting rule as clear and straightforward to understand as possible for investors. This rule would be implemented on a position-by-position basis, such that a retail client's open CFD must be closed out on terms most favourable to the client⁶ at the point in time at which the available sum remaining in the CFD trading account of the initial margin and variation margin⁷ relating to that CFD falls below 50% of the amount of the initial margin posted. For instance, for a CFD with a leverage limit of 5:1, minimum initial margin is 20% of initial total exposure, so if the overall margin allocated to the CFD falls below 10% of initial total exposure, the CFD must be closed out. The alternative approach of a margin close-out rule on an account-wide basis appears to make it harder for investors to understand how the rule operates and to understand their exposure to each individual CFD position (especially as this may involve comparing profitable CFDs versus loss-making ones). Additionally, implementing a margin close-out rule on an account-wide basis would make leverage limits less able to standardise levels of risk across different investments, in contrast to a per-position basis. For these reasons, at present ESMA's preferred option is to implement the rule on a position-by-position basis rather than on an account-wide basis.
- iii. **Negative balance protection** on a per-account basis, to provide an overall guaranteed limit on retail client losses. ESMA has discussed whether such a limit should apply on a "per position" or a "per account" basis. Implementing this rule on a "per position" basis would ensure a stronger protection to clients but it would likely increase the impact on firms and therefore on the ongoing prices offered to clients. The implementation of this

⁶ In accordance with Articles 24 and 27 of Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (OJ L 173, 12.6.2014, p. 349–496).

⁷ Any other payment made for the purpose of trading the CFD, excluding commission and transaction fees.

rule on an account basis would reduce this impact whilst still achieving the objective to protect clients from unexpectedly owing money to firms in rare cases of extreme market conditions. For this reason, at present ESMA's preferred option is to implement the rule on an account basis. Specifically, ESMA is considering a restriction that would require a CFD provider to limit the retail client's aggregate liability for all CFDs connected to that client's CFD trading account with that provider to the sum of (i) available funds in the account from initial margin and variation margin; (ii) any profits in respect of open CFDs; and (iii) any realised profits in respect of closed CFDs remaining in the CFD trading account.

- iv. A **restriction on incentivisation of trading** provided directly or indirectly by a CFD provider, such as providing retail clients with a payment (other than a realised profit on any CFD provided) or a non-monetary benefit⁸ in relation to the marketing, sale or distribution of a CFD. This measure is intended to reduce the risk that such incentives are used to entice retail clients to these often unsuitable as well as complex products.
- v. A **standardised risk warning**. ESMA is considering requiring CFD providers to provide a standardised warning in any communication to, or published information accessible by, a retail client relating to the marketing, distribution or sale of a CFD. At present, ESMA's preferred option is that this standardised warning would indicate the percentage range of retail investor accounts having losses, as emerging from studies and analyses conducted by NCAs (previous paragraph 2). ESMA is also considering to require a more abbreviated version of the risk warning when the relevant communication or published information to a retail client is made other than through a durable medium or a webpage.

An alternative option would be to require firms to disclose the percentage of client accounts that were loss-making and profit-making based on each firm's client data from previous quarters. Applying a standardised risk warning on this basis would ensure that the information is up to date and would reflect consumer outcomes at the firm in question.

17. **In relation to BOs**, ESMA is considering a prohibition on the marketing, distribution or sale of binary options to retail clients. ESMA is currently minded to adopt this measure as the significant investor protection concerns relating to this product are due to inherent features of the product that are unlikely to be sufficiently addressed through certain restrictions on the product (e.g. minimum duration contract periods). In particular, the pricing structure of the product means that, on average, investors will experience negative expected returns without providing any clear compensating benefits to retail investors (e.g. the hedging function served by vanilla options). The alternative option of a total ban that would include professional clients is not under consideration due to the lack of evidence of harm to this type of client.

⁸ Other than information and research tools relating to CFDs.

3 Impact of the measures

18. As part of its analysis of the possible intervention measures currently under review, ESMA is studying in detail the likely impacts of the measures.
19. To this end, ESMA would welcome responses from all stakeholders to the questions below. Firms that are involved in the sale, distribution or marketing of CFDs and/or BOs may be especially well-placed to provide responses to questions A to H below. Respondents are invited to provide any qualitative information and especially any quantitative information they may have.
20. As regards impacts on investors, ESMA has undertaken quantitative simulations and analysis of investor returns of the products in question. It has also taken into account detailed information provided by many NCAs in relation to investor detriment. While ESMA has already gathered extensive evidence in this respect, any responses from investors and from firms to question I and J below, will be considered by ESMA.

4 Questions

A: Do you think that ESMA has adequately identified the instruments in the scope of its possible measures (paragraphs 3 and 5 above)?

B: What impact do you consider that the introduction of leverage limits on the basis described above (applying to retail clients only) would have on your business? Please describe and explain any one-off or ongoing costs or benefits.

C: What impact do you consider that the introduction of a margin close-out rule on a per-position basis (applying to retail clients only) would have on your business? Please describe and explain any one-off or ongoing costs or benefits.

D: What impact do you consider that the introduction of negative balance protection on a per-account basis (applying to retail clients only) would have on your business? Please describe and explain any one-off or ongoing costs or benefits.

E: What impact do you consider that a restriction on incentivisation of trading (applying to retail clients only) would have on your business? Please describe and explain any one-off or ongoing costs or benefits.

F: What impact do you consider that a standardised risk warning (applying to retail clients only) would have on your business? Please describe and explain any one-off or ongoing costs or benefits.

G: Please provide evidence on the proportion of retail clients that use these products for hedging purposes and how the suggested measures will affect them.

H: What impact do you consider that a prohibition on providing binary options to retail clients would have on your business? Please describe and explain any one-off or ongoing costs or benefits.

I: What impact do you consider that the envisaged measures would have on retail investors?

J. Do you believe that specific restrictions concerning CFDs in cryptocurrencies should be introduced? In particular, what impact do you consider that assigning a leverage limit of 5:1 to such CFDs would have on firms' business and / or any expected additional benefits for retail clients? How would such an impact compare to that from the possible alternatives of lower leverage limits such as 2:1 or 1:1, or a prohibition on the sale, marketing and distribution of such CFDs? Please describe and explain any one-off or ongoing costs or benefits.