

EUROPEAN SECURITIES AND MARKETS AUTHORITY DECISION (EU) 2018/795**of 22 May 2018****to temporarily prohibit the marketing, distribution or sale of binary options to retail clients in the Union in accordance with Article 40 of Regulation (EU) No 600/2014 of the European Parliament and of the Council**

THE EUROPEAN SECURITIES AND MARKETS AUTHORITY BOARD OF SUPERVISORS,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC ⁽¹⁾, and in particular Articles 9(5), 43(2) and 44(1) thereof,

Having regard to Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012 ⁽²⁾, and in particular Article 40 thereof,

Having regard to 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 ⁽³⁾, and in particular Article 19 thereof,

Whereas:

1. INTRODUCTION

- (1) In recent years, the European Securities and Markets Authority (ESMA) and several national competent authorities (NCAs) have observed a rapid increase in the marketing, distribution or sale of binary options to retail clients across the Union. Binary options are inherently risky and complex products and are often traded speculatively. ESMA and NCAs have also observed that their offer to retail clients has been increasingly featured by aggressive marketing techniques as well as a lack of transparent information that do not allow retail clients to understand the risks underlying these products. ESMA and NCAs have expressed widespread concerns on the increasing number of retail clients trading in these products and losing their money. These concerns are also supported by the numerous complaints received from retail clients across the EU who have suffered significant detriment when trading binary options.
- (2) These significant investor protection concerns have led ESMA to take a number of non-binding actions. As of June 2015, ESMA has been coordinating the work of a Joint Group established to tackle issues related to a number of Cyprus-based providers offering binary options, contracts for differences (CFDs) and other speculative products to retail clients on a cross-border basis across the Union ⁽⁴⁾. Furthermore, since July 2015, ESMA has been coordinating a task force composed of ESMA and NCAs whose work aims at monitoring the offer of binary options and CFDs to the retail mass market as well as to foster uniform supervisory approaches in this area across the Union. ESMA has also promoted supervisory convergence in the Union in respect of the offer

⁽¹⁾ OJ L 331, 15.12.2010, p. 84.

⁽²⁾ OJ L 173, 12.6.2014, p. 84.

⁽³⁾ OJ L 87, 31.3.2017, p. 90.

⁽⁴⁾ The Joint Group is composed of the representative of the Cypriot NCA 'Cyprus Securities and Exchange Commission (CY-CySEC)' as well as the representatives of eight NCAs whose jurisdictions have been affected by the services provided by the Cyprus-based providers. The work of the Joint Group resulted in an action plan to be implemented by CY-CySEC that included inter alia extended investigations into CFD providers as well as thematic reviews of a sample of CY-CySEC authorised firms.

of binary options to retail clients through the issuance of an opinion ⁽¹⁾ as well as a number of Questions and Answers (Q&As) ⁽²⁾ pursuant to Article 29 of Regulation (EU) No 1095/2010. Finally, ESMA has published warnings ⁽³⁾ in which it highlighted its concerns in respect of the risks posed by the uncontrolled offer of inter alia binary options to retail clients.

- (3) Although these actions had some positive effects ⁽⁴⁾, ESMA considers that the significant investor protection concerns persist.
- (4) On 18 January 2018, ESMA launched a call for evidence on its potential product intervention measures on the marketing, distribution or sale of binary options and CFDs to retail clients (the 'call for evidence') ⁽⁵⁾. The call for evidence was closed on 5 February 2018. ESMA received almost 18 500 ⁽⁶⁾ responses. Among those responses, 82 were from providers, trade organisations, stock exchanges and brokers involved in the binary options and/or CFD business, 10 were from consumer representatives and the remaining responses came from individuals. A vast majority of the responses from individuals were facilitated and channelled via binary option and/or CFD providers. The call for evidence disclosed a general concern from the first category of respondents and, in particular, product providers, that the proposed measure would adversely impact their business. A number of individuals also complained about the proposed measure and expressed their willingness to continue trading in binary options.
- (5) ESMA has duly considered such concerns. However, after balancing them against the significant investor protection concern identified, which was further confirmed by the responses received from nearly all consumer representatives and a number of individuals in strong support of the proposed measures, ESMA considers it necessary to impose a temporary prohibition on the marketing, distribution or sale of BOs to retail clients in accordance with Article 40 of Regulation (EU) No 600/2014.
- (6) A measure imposed under Article 40 of Regulation (EU) No 600/2014 must be reviewed at appropriate intervals and at least every 3 months. In reviewing this measure, ESMA will tackle any evasive practices that may emerge. If the measure is not renewed after 3 months, it will expire.
- (7) For the avoidance of doubt, terms used in this Decision have the same meaning as in Directive 2014/65/EU of the European Parliament and of the Council ⁽⁷⁾ and Regulation (EU) No 600/2014, including the definition of derivatives.
- (8) ESMA's temporary prohibition fulfils the conditions set out in Article 40 of Regulation (EU) No 600/2014 for the reasons explained below.

⁽¹⁾ Opinion on MiFID practices for firms selling complex financial products of 7 February 2014 (ESMA/2014/146)

⁽²⁾ Questions and Answers (Q&As) relating to the provision of CFDs and other speculative products to retail investors under MiFID (ESMA35-36-794). The Q&As were last updated on 31 March 2017.

⁽³⁾ ESMA's investor warning on 'risks in investing in complex products' of 7 February 2014 (https://www.esma.europa.eu/sites/default/files/library/2015/11/investor_warning_-_complex_products_20140207_-_en_0.pdf), and ESMA's investor warning on 'CFDs, binary options and other speculative products' of 25 July 2016 (available at: https://www.esma.europa.eu/sites/default/files/library/2016-1166_warning_on_cfds_binary_options_and_other_speculative_products_0.pdf).

⁽⁴⁾ For example, the work of the Joint Group has resulted in CY-CySEC adopting a number of enforcement measures aimed at increasing compliance by providers offering speculative products like binary options.

⁽⁵⁾ Call for evidence on potential product intervention measures on contracts for differences and binary options to retail clients of 18 January 2018 (ESMA35-43-904).

⁽⁶⁾ The number of respondents is lower than this figure since ESMA also received (i) multiple responses from the same respondents (for example a response on each of the proposed measures for CFDs in a separate email), and (ii) duplicative responses from the same respondents.

⁽⁷⁾ 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).

**2. DESCRIPTION OF THE BINARY OPTIONS RETAIL MARKET AND THE EXISTENCE OF
A SIGNIFICANT INVESTOR PROTECTION CONCERN (ARTICLE 40(2)(a) OF REGULATION (EU)
No 600/2014)**

- (9) A binary option is defined as any cash settled derivative in which the payment of a fixed monetary amount depends on whether one or more specified events in relation to the price, level or value of the underlying occurs at, or prior to, the derivative's expiry ⁽¹⁾ (for example the underlying has reached a specified price ('the strike price') at expiry).
- (10) Binary options give enable an investor to make a bet on the occurrence of a specified event in relation to the price, level or value of one or more underlying (for example a share, a currency, a commodity or an index). If the event does not occur, the investor loses their money (that is the option finishes 'out-of-the-money'). If the event occurs, the option pays out or the contract remains open with the opportunity to receive a pay out if a separate event occurs (the option finishes 'in-the-money'). In this sense, binary options can be regarded as 'yes/no propositions'. Often, the 'yes/no proposition' is whether the price of the underlying at expiry of the binary option is above or below a given price (the so-called 'strike price'). In some cases, the 'strike price' corresponds to the market price of the underlying at the time of entering into the binary option or at a future specified time. However, binary option providers offer a range of potential market outcomes for investors to bet on ⁽²⁾.
- (11) It is appropriate to clarify that all binary options, although marketed, distributed or sold under other names, fall within the scope of application of this Decision. Reference is made, for example, to all-or-nothing options, up-or-down options, trend options, digital options and one-touch options.
- (12) It is also appropriate to ensure that this Decision includes binary options that have several different predetermined conditions, which have to be met (or not met) before the payment is provided. Some respondents to the call for evidence indicated, for example, the case of a binary option that provides payment of (i) a predetermined amount if the underlying meets a certain predetermined condition (for example the value of the underlying rises on a specific date), as well as (ii) an additional predetermined amount (a 'bonus') if the underlying meets another predetermined condition (for example the value of the underlying rises above a certain percentage). In this and similar cases, the payment of the sum of the two predetermined amounts in points (i) and (ii) would amount to the payment of a predetermined fixed amount for the purposes of Article 1(2)(c) of this Decision.
- (13) Several NCAs have raised concerns about binary options not meeting any genuine investment needs for retail clients (unlike other types of options, which can serve a valuable role in hedging exposure to certain assets) ⁽³⁾. Furthermore, several NCAs have voiced concerns about the risks related to the inherent features of binary options as well as the in-built and unmanageable conflicts of interest related to the offer of these products to retail clients. These risks are often amplified by the aggressive marketing techniques used by binary option providers. Several NCAs have also indicated that these products attract compulsive gambling behaviour. A study from the UK-FCA demonstrated that some investors place many bets within the space of a few days or weeks, despite losing money on a cumulative basis. The study also found a close similarity in payoff structure and time horizon between binary options and gambling products ⁽⁴⁾. These concerns have materialised across several jurisdictions, with a vast majority of retail clients in those jurisdictions typically losing money as evidenced in this Decision ⁽⁵⁾.

⁽¹⁾ Typically, the lower of the two monetary payoffs is zero, but this need not be the case. Binary options are distinct from other speculative products sold to retail clients, such as CFDs, in that the payment is of a predetermined monetary amount not directly linked to the size of the change in the price, level or value of the underlying.

⁽²⁾ For example, investors can bet that the price of the underlying will be within a specified price range or whether the underlying will reach a specified price level at some point during the term of the binary option.

⁽³⁾ For example, FR-AMF, BE-FSMA, UK-FCA, IT-CONSOB.

⁽⁴⁾ For example, UK-FCA.

⁽⁵⁾ See recital 35.

- (14) As demonstrated in the IOSCO report on the IOSCO survey on retail OTC leveraged products ⁽¹⁾ (the 'IOSCO report'), this market sector has also been subject to significant regulatory scrutiny in a number of other non-EU jurisdictions because of the complex and risky nature of inter alia binary options and the frequently cross-border dimension of product providers which operate predominantly through the Internet ⁽²⁾. According to the IOSCO report, 'recent research reports in several national markets have shown that a large majority of investors in [binary options and other speculative products] very often lose money' ⁽³⁾.
- (15) The condition referred to in Article 40(2)(a) of Regulation (EU) No 600/2014 is that there must exist inter alia a significant investor protection concern. In determining whether there exists a significant investor protection concern, ESMA has assessed the relevance of the criteria and factors listed in Article 19(2) of the Delegated Regulation (EU) 2017/567. After taking the relevant criteria and factors into consideration, ESMA has concluded that there is a significant investor protection concern for the following reasons.

2.1. The degree of complexity and transparency of binary options

- (16) Binary options are complex financial instruments ⁽⁴⁾. The complexities of the pricing structure pose a risk of significant information asymmetries between providers and retail clients and hence raise significant investor protection concerns. Furthermore, there are a number of inherent features of binary options that make them complex and difficult for retail clients to understand.
- (17) Binary option providers typically price binary options based on the market-implied or otherwise modelled probability of a specified event occurring before applying a spread or other form of transaction fee to each option such that it yields a negative expected return for the client ⁽⁵⁾.
- (18) Most commonly binary options offer a comparatively large return for a statistically less likely event and vice-versa ⁽⁶⁾.
- (19) This pricing structure of binary options presents a number of challenges for retail clients. In particular, the pricing structure requires retail clients to accurately assess the value of the option in relation to the expected probability of the reference event occurring. Although retail clients may use common research and pricing tools, such as the Black-Scholes formula, to price binary options, retail clients face significant information asymmetries compared to providers. Providers have much greater access to information and systems to properly price and value these products. In particular, binary option providers have access to historical price data — for example, recorded price feeds from an exchange or commercial data provider in relation to a given underlying — which is not generally available to retail clients. Binary option providers also have much more experience in pricing

⁽¹⁾ IOSCO Report on the IOSCO Survey on Retail OTC Leveraged Products, December 2016 (available at: <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD550.pdf>).

⁽²⁾ For example, the Québec Autorité des Marchés Financiers and the Turkish Capital Markets Board (CMB) (page 2), the Financial Futures Association of Japan (page 6), the US Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) (page 55 of the IOSCO report). In Québec, binary options have not been authorised by the Québec competent authority to be sold to retail investors. The CMB has decided not to allow binary options to be sold to retail investors. In Israel a ban on the sale of binary options to investors has been approved. Available at: http://www.isa.gov.il/sites/ISAEng/1489/1511/Pages/eitonot25102017_1.aspx. The US CFTC's Office of Consumer Outreach and the SEC's Office of Investor Education and Advocacy have issued an investor alert to warn about fraudulent schemes involving binary options and their trading platforms. Available at: http://www.cftc.gov/ConsumerProtection/FraudAwarenessPrevention/CFTCFraudAdvisories/fraudadv_binaryoptions

⁽³⁾ IOSCO report, page iii.

⁽⁴⁾ For example, binary options do not meet the criteria to be regarded as non-complex financial instruments according to the combined reading of Article 25(4) of Directive 2014/65/EU and Article 57 of the Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (OJ L 87, 31.3.2017, p. 1).

⁽⁵⁾ In addition to estimating event probabilities based on the market pricing of relevant options, providers may use pricing models such as the Black-Scholes model, or models that include aspects of Black-Scholes pricing. In the Black-Scholes model, time to maturity, initial price of the underlying, and strike price are known variables. The drift of the stochastic process posited in the model is commonly estimated by either or both of the risk-free interest rate and the historical performance of the underlying.

⁽⁶⁾ For example, for a binary option offered at a distance from the strike price, the provider may offer the client the right to purchase the option at EUR 22 for a return of EUR 100 for an event that is likely to occur 20 % of the time (equating to a fair value of EUR 20).

contracts than retail clients typically do and are more likely to have developed sophisticated pricing methodologies. Furthermore, retail clients may not appreciate that if a trade has a very short term, or if a position is closed close to expiry, factors used to price options such as historic volatility have little impact on the option's value. This limits the ability of retail clients to properly value the option, even when using available pricing tools. Moreover, due to the application of spreads and other transaction fees, retail clients would need to outperform expected returns on investment significantly ('beat the odds') on a regular basis to achieve profits from trading. Therefore, in ESMA's view, it is difficult for retail clients to make an informed assessment of the risk-return profile of the product.

- (20) The combined effect of the pricing structure and the application of transaction fees to each trade is that a large majority of retail client accounts lose money in aggregate (even though they may make short-term profits) and providers, which are typically direct counterparties to the trade, make a profit from clients in the long term through their losses from trading and through transaction fees.
- (21) Some providers offer continual two-way pricing and the ability for clients to enter and exit the trade over the course of the term of a binary option. In such a case, a client can exit their position prior to the binary option's expiry by selling it back to the provider or otherwise forfeiting the conditional payment at expiry. In return, the client receives some payment from the provider, as per the continual price offered by the provider depending on the difference between the current market price and the fixed strike price of the underlying and the time to expiry.
- (22) Continual two-way pricing is an additional feature that may be offered by binary option providers. This feature adds a further layer of complexity, which makes it difficult for retail clients to value these products accurately or make a positive return on investment. This is because retail clients would need to continuously monitor the pricing and estimate the expected outcome. Furthermore, exiting a trade and entering a new one comes at an additional cost to the client due to the application of a spread to the offer price or through transaction fees ⁽¹⁾.
- (23) Furthermore, EU retail clients typically invest in binary options OTC. As such the pricing, performance and settlement of binary options is not standardised. This impairs retail clients' ability to understand the terms of the product. This, in addition to the differences in the type of 'yes/no propositions' that form the basis of a binary option, the complex pricing structure (sometimes including two-way pricing) and the existence of even more complex offerings (such as options that package together a set of binary options), add to the complexity of these products and further undermine retail clients' ability to understand that the specific features of one type of binary option do not necessarily feature in another.
- (24) In addition, binary option providers are typically the counterparty to their retail clients' trades, with the provider determining the price at execution and the payment at expiry. In addition, providers often require clients to acknowledge that the prices used to determine the value of the binary option may differ from the price available in the respective underlying market. This means that it may not always be possible for retail clients to check the accuracy of the prices received from the provider. These factors make it extremely complex for retail clients to value binary options objectively. The high level of complexity and poor degree of transparency associated with binary options therefore confirms that a significant investor protection concern exists.
- (25) In response to the call for evidence, a number of firms and trade organisations questioned whether ESMA should distinguish between binary options traded OTC and the ones that are traded on a trading venue. Some trade organisations asked for an explicit exclusion for securitised derivatives, touch-options and digital options, on the grounds that these products were used as an alternative for a stop-loss order or could serve as a hedge.

⁽¹⁾ If a binary option provider offers continual two-way pricing, a spread can be seen between the price at which clients can buy the binary option from the provider (the 'buy price') and the price at which clients can sell the option to the provider (the 'sell price'). These two prices in general differ from the 'zero-expected return price', namely the price at which purchasing the binary option would yield zero expected return for the purchaser, with the sell price typically lower and the buy price typically higher than the zero-expected return price. This spread around the zero-expected-return price illustrates that a retail client will on average make a loss both in entering into a binary option and in exiting it before expiry.

- (26) ESMA has duly considered these responses. However, the features and characteristics of binary options, which are the fundamental source of the identified detriment to retail clients, remain the same whether or not these products are traded on a trading venue or securitised. In other words, binary options on a trading venue would still present a negative expected return to investors, while offering a payoff structure which is not well-suited to hedging or to performing other economic functions that could form a compensating benefit. Notably, these properties hold true at any time prior to the expiry of the option. The existence of a secondary market in particular, therefore, does not change the fundamental characteristics that cause detriment to retail clients.

2.2. The particular features or components of binary options

- (27) Binary options are typically very short-term investments, in some cases expiring minutes after being entered into, which makes them extremely speculative in nature.
- (28) The binary outcome nature of binary options mean that they are primarily used for speculative purposes. The payment of a fixed monetary amount or zero limits the value of binary options as a hedging tool in contrast to traditional options, which allow the client to manage their risk by setting a 'ceiling' or 'floor' for a specific asset that they may have direct exposure to. This is exacerbated by the typical short term of binary options.
- (29) Furthermore, binary options are priced according to the probability of an event occurring, quoting payoffs in a similar manner as traditional fixed-odds bets (for example bets on sporting events or election outcomes). Trades are mostly of very short terms and investors stand either to make a very large return or to lose their entire investment. These fundamental features are also found in gambling products, which are linked with addictive behaviour and poor outcomes for consumers.
- (30) As mentioned above, binary option providers usually act as direct counterparty to the client's trade, hence taking the client's trade onto their own book. This business model places the provider's interests in direct conflict with those of its clients, which increases the risk that the provider may manipulate the price of the underlying at expiry of the binary option or extend the term of the binary option by seconds or milliseconds so as to avoid having to pay out on the option contract. The risk of conflict of interest is particularly acute for binary options, as the payment structure of these products is determined by whether the underlying has reached the specified strike price at expiry. NCAs have also identified practices whereby binary options providers apply an asymmetrical or inconsistent mark up to core spreads on the underlying, which results in the option being 'out of the money' where it otherwise would be 'in the money' at expiry. In addition, the distribution models observed by ESMA in this sector of the market bear certain and sometimes inherent conflicts of interest ⁽¹⁾ and the pressure to maintain a pipeline of new clients increase the potential for conflicts of interest to occur.
- (31) Given that binary options structurally have negative expected returns, the more positions an investor takes, the more likely they are to lose money on a cumulative basis ⁽²⁾.
- (32) The high risk of binary options being traded speculatively as well as of conflict of interests between binary option providers and their clients confirm the existence of a significant investor protection concern.

⁽¹⁾ Section 2 of ESMA's Questions and Answers (Q&As) relating to the provision of CFDs and other speculative products to retail investors under MiFID (ESMA35-36-794) as updated on 31 March 2017, discusses some of these conflicts of interest in more detail.

⁽²⁾ For instance, for a binary option with a 50 % win probability and a return of 80 % of the amount invested if at expiry the option is 'in-the-money', an investor faces around a 75 % probability of suffering a cumulative loss over 20 trades. See ESMA's *Product Intervention Analysis: Measure on Binary Options*, 2018.

2.3. The size of potential detrimental consequences and the degree of disparity between returns for investors and the risk of loss

- (33) Client numbers in relation to these products are fluid due to the relatively short life span of binary options client accounts and the cross-border nature of activities. Based on data gathered by ESMA from a number of NCAs ⁽¹⁾, ESMA estimates that the number of retail clients' trading accounts from EEA-based CFD and binary option providers increased from 1,5 million in 2015 ⁽²⁾ to approximately 2,2 million in 2017 ⁽³⁾.
- (34) In particular, the following information provided by NCAs to ESMA confirms that the market sector of binary options has grown across the Union:
- (i) the Cyprus Securities and Exchange Commission (CY-CySEC), the NCA in Cyprus, estimated the total number of active clients in Cyprus in binary options at the end of the second quarter 2017 to be 401 378 compared to 140 205 in 2015 ⁽⁴⁾;
 - (ii) the Bundesanstalt für Finanzdienstleistungsaufsicht (DE-BaFin), the NCA in Germany, estimates that there are up to 30 000 binary options clients in Germany, with the overall market in Germany growing at an annual rate of 4-5 % ⁽⁵⁾;
 - (iii) From sample client data from firms provided to the Financial Conduct Authority (UK-FCA), the NCA in the UK, it is estimated that the number of clients trading with UK binary option providers is around 40 000;
 - (iv) the Commissione Nazionale per le Società e la Borsa (IT-CONSOB), the NCA in Italy, found on the basis of a survey carried out in March 2017 at five branches of EU-based binary option providers that in 2016 there was a 2,4 % increase in the number of Italian retail clients trading in binary options;
 - (v) a number of NCAs reported that binary options are widely marketed and sold in their jurisdictions ⁽⁶⁾;
 - (vi) nearly all NCAs ⁽⁷⁾ reported that binary option providers passporting from other Member States are providing services in binary options in their jurisdictions. Some NCAs ⁽⁸⁾ also mentioned binary option providers using branches or tied agents to passport to host jurisdictions; and
 - (vii) NCAs have noted an increase in the number of requests for authorisation for investment firms offering the products in question ⁽⁹⁾.

⁽¹⁾ Data provided in 2015 by: BG-FSC, CY-CySEC, CZ-CNB, FR-AMF, IE-CBI, IS-FME, LU-CSSF, MT-MFSA, NL-AFM, PT-CMVM, RO-ASF, UK-FCA; data provided in 2017 by: CY-CySEC, CZ-CNB, ES-CNMV, FR-AMF, IE-CBI, LU-CSSF, NL-AFM, MT-MFSA, NO-Finanstilsynet, SK-NBS, UK-FCA.

⁽²⁾ Given the frequent cross-border dimension of the activity of product providers, this figure may include clients from non-EEA States. With particular regard to the UK, the number of CFD funded client accounts has risen from 657 000 in 2011 to 1 051 000 at end-2016. However, these figures do not exclude dormant client accounts or multiple accounts used by the same retail client. The figures provided by the CY-CySEC have been compiled on the basis of accounts opened in CY-CySEC authorised providers offering these products.

⁽³⁾ As far as the UK is concerned, this figure does not include non-UK clients of UK authorised firms which in 2016 was estimated at approximately 400 000. For the other Member States which provided the data to ESMA, the figure may include clients from non-EEA States.

⁽⁴⁾ CY-CySEC also noted that the figures provided included clients from non-EEA States.

⁽⁵⁾ Based on information provided by DE-BaFin in January 2017 covering 2016 data.

⁽⁶⁾ See IOSCO report. Although no overall statistics are available, a number of NCAs reported to ESMA that in 2016 the market grew in respect of the number of clients in their jurisdiction. For instance, Poland and Lithuania noted an increase in the value of transactions from binary option providers while Portugal noted a growth in the number of firms providing these services. In addition, two NCAs who had previously noted no real market for these instruments to retail clients in their jurisdiction specifically referred to a growing market in this area.

⁽⁷⁾ AT-FMA, BE-FSMA, CY-CySEC, CZ-CNB, DE-BaFin, DK-Finanstilsynet, EE-FSA, EL-HCMC, ES-CNMV, FI-FSA, FR-AMF, IE-CBI, IS-FME, IT-CONSOB, LI-FMA, LT-Lietuvos Bankas, MT-MFSA, NL-AFM, NO-Finanstilsynet, PT-CMVM, RO-ASF, SE-FI, SI-ATVP, UK-FCA.

⁽⁸⁾ CZ-CNB, IT-CONSOB.

⁽⁹⁾ In Cyprus, 42 applications were received in 2016 compared to 16 in 2015 and 28 in 2014. In the UK, the FCA has received a total of 27 applications from firms seeking to be authorised to offer binary options to retail clients (20 of these applications were from firms seeking variation of authorisations, and 7 were from new authorisation applicants). In this respect, it should be noted that binary options are within the UK-FCA's remit as of 3 January 2018. Before then, they were regulated by the UK Gambling Commission.

- (35) According to the IOSCO report, amongst the most common complaints across jurisdictions with regard to authorised providers are those related to product performance (investor losses incurred), clients not understanding the product or service provided (and its risks), difficulties in withdrawing funds, aggressive/misleading marketing, and price or trade manipulation ⁽¹⁾.
- (36) The aforementioned ESMA analysis on retail clients' expected negative returns ⁽²⁾ is also corroborated by data on losses suffered by retail clients reported to ESMA by certain NCAs:
- (i) CY-CySEC conducted analysis of a sample of binary option client accounts of 10 binary options providers for the period from 1 January 2017 to 31 August 2017. It found that on average, 87 % of client accounts made a loss over that period. On average, the loss per account was around EUR 480;
 - (ii) the Komisja Nadzoru Finansowego (PL-KNF), the NCA in Poland, based on data from a Polish investment firm, found that 86,3 % of the clients lost money in 2016 and 86,4 % lost money in 2017;
 - (iii) IT-CONSOB found on the basis of a survey carried out in March 2017 at five branches of EU-based investment firms active in binary options that Italian retail clients investing in binary options realised relevant losses in 2016 up to 74 % with an average loss of approximately EUR 590; and
 - (iv) UK-FCA found from a review of firm data reporting client account performance in 2016 that between 81 % and 85 % of client accounts lost money and that, on average, clients made a loss between GBP 400 and GBP 1 200. Reported figures indicate that clients made a profit from trading but made a loss when taking into account the impact of transaction fees. This indicates that clients may not understand the impact of transaction fees on the performance of their account.

2.4. The type of clients involved

- (37) Binary options are widely marketed, distributed or sold to the retail mass market. However, the complexity of binary options, as described in this Decision, makes it difficult for the majority of retail (unlike professional) clients to properly understand and assess the actual risk they incur when dealing with these products. The evidence of losses observed by ESMA in retail client accounts described in this Decision demonstrates that binary options are unsuited to retail clients.

2.5. Marketing and distribution activities in relation to binary options

- (38) Although binary options are complex products, they are offered to retail clients most commonly via electronic trading platforms, without the provision of investment advice or portfolio management. An assessment of appropriateness is required in such cases pursuant to Article 25(3) of Directive 2014/65/EU ⁽³⁾. However, this assessment does not prevent binary options providers or their clients or potential clients proceeding with a transaction, subject to a simple warning to the client. This can occur where the client has provided no or insufficient information to the provider as to their knowledge and experience in the investment field relevant to

⁽¹⁾ IOSCO report page 46.

⁽²⁾ See ESMA's *Product Intervention Analysis: Measure on Binary Options*, 2018.

⁽³⁾ Previously Article 19(5) of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (OJ L 145, 30.4.2004, p. 1).

the specific type of product as well as where the provider has concluded that the product is not appropriate for the client. This enables retail clients to access products, such as binary options, which, by their features, should not be distributed to them ⁽¹⁾.

- (39) Also in the light of ESMA's Questions and Answers (Q&As) ⁽²⁾, NCAs have observed aggressive marketing practices as well as misleading marketing communications in this sector of the market ⁽³⁾. They include, for example, the use of sponsorship arrangements or affiliations with major sports teams, which give the misleading impression that complex and speculative products such as binary options are suitable for the retail mass market by promoting general brand name awareness.
- (40) Furthermore, some NCAs have highlighted not only the regular use of misleading marketing materials, but also the extensive and intensive nature of the marketing activities undertaken:
- (i) the Autorité des Marchés Financiers (FR-AMF), the NCA in France, has reported that for 2016, the number of new advertisements (TV, radio, internet) for speculative trading (binary options, CFDs, forex) represented 36 % of all new advertisements in the financial domain, and 45 % of all new advertisements for financial instruments ⁽⁴⁾;
 - (ii) DE-BaFin has noted that investment firms based in another European Union jurisdiction, although small in size, may use up to 200 introducing brokers simultaneously ⁽⁵⁾; and
 - (iii) some NCAs have noted that the distribution of binary options can occur through electronic gaming or slot machines ⁽⁶⁾.
- (41) These developments are of particular concern given the increase in retail clients participating in this sector of the market.
- (42) Also in this context, some NCAs have also raised concerns about the 'churning' nature of the business models ⁽⁷⁾. Because the average life span of a client account can be relatively short, this can place a certain pressure on providers to maintain a steady stream of new clients, which could incentivise providers to adopt aggressive marketing and sales techniques that are not in the retail client's best interests.
- (43) A common feature of marketing and sales techniques adopted by the binary option industry is the offer of trading (monetary and non-monetary) benefits, such as bonuses to attract and encourage retail clients to invest in binary options, the offer of gifts (for example holidays, cars, electronic goods), trading tutorials or reduced costs (for example spread or fees) ⁽⁸⁾.

⁽¹⁾ This risk is possibly magnified by the overconfidence bias which has often been observed in recent behavioural studies. According to a recent study (Li, Mingsheng and Li, Qian and Li, Yan, The Danger of Investor Overconfidence (November 14, 2016) available at SSRN: <https://ssrn.com/abstract=2932961>) on the effects of investor sentiment on market efficiency around market crashes, investor overconfidence impedes price discovery, increases idiosyncratic risks and dampens responses to the market before market crashes because of the information biases (Peng, Lin, Wei Xiong, 2006. *Investor attention, overconfidence and category learning*. Journal of Financial Economics 80, 563-602), as well as investor attribution bias (Gervais, S., and T. Odean, 2001. *Learning to be Overconfident*. The Review of Financial Studies, 14, 1– 27.) and high risk of arbitrage (Benhabib, Jess, Xuewen Liu, and, Penfei Wang, 2016. *Sentiments, financial markets, and macro-economic fluctuations*. Journal of Financial Economics 120, 420-443. On the same topic, inter alia see also: Ricciardi, Victor, Chapter 26: *The Psychology of Speculation in the Financial Markets* (June 1, 2017). Financial Behavior: Players, Services, Products, and Markets. H. Kent Baker, Greg Filbeck, and Victor Ricciardi, editors, 481-498, New York, NY: Oxford University Press, 2017.; N. Barberis and R. H. Thaler (2003), *A Survey of Behavioral Finance*, in M. Harris, G.M. Constantinides and R. Stultz, 'Handbook of the Economics of Finance'; D. Dorn and G. Huberman (2005), *Talk and action: What individual investors say and what they do*; C.H. Pan and M. Statman (2010) *Beyond Risk Tolerance: Regret, Overconfidence, and Other Investor Propensities*, Working Paper; A. Nosis and M. Weber (2010), *How Risky do I invest: The Role of Risk Attitudes, Risk Perceptions and Overconfidence*; N. Linciano (2010), *How Cognitive Biases and Instability of Preferences in the Portfolio Choices of Retail Investors — Policy Implications of Behavioural Finance*, A. Lefevre, and M. Chapman (2017), 'Behavioural economics and financial consumer protection', OECD Working Papers on Finance, Insurance and Private Pensions, No 42 OECD Publishing.

⁽²⁾ Section 3 of ESMA's Questions and Answers (Q&As) relating to the provision of CFDs and other speculative products to retail investors under MiFID (ESMA35-36-794), as updated on 31 March 2017.

⁽³⁾ For example, BE-FSMA, ES-CNMV, FR-AMF and IT-CONSOB.

⁽⁴⁾ IOSCO report, page 5.

⁽⁵⁾ *Ibidem*.

⁽⁶⁾ As identified by DE-BaFin and PL-KNF.

⁽⁷⁾ For example, the UK-FCA and NO-Finanstilsynet.

⁽⁸⁾ Section 6 of ESMA's Q&As relating to the provision of CFDs and other speculative products to retail investors under MiFID (ESMA35-36-794), as updated on 31 March 2017, states that it is unlikely that a firm offering a bonus that is designed to incentivise retail clients to trade in complex speculative products such as CFDs, binary options and rolling spot forex could demonstrate that it is acting honestly, fairly and professionally and in the best interests of its retail clients.

- (44) Bonuses and other trading benefits can act as a distraction from the high-risk nature of the product. They are typically targeted to attract retail clients and incentivise trading. Retail clients can consider these promotions as a central product feature to the point they may fail to properly assess the level of risks associated with the product.
- (45) The practice of bonus systems is inspired by the online betting industry. Some providers marketing the relevant products offer 'welcome bonuses' (for any account opening) as well as bonuses based on the invested amounts (volume bonuses), for example, or as additional amounts of 'virtual cash' under certain conditions.
- (46) Supervisory work by several NCAs has discovered that the terms and conditions on promotional offers are often misleading and that many clients reported difficulties in withdrawing funds when trying to use such bonuses or are unaware that their access to the bonus offer or funds depends on a specified volume of trades. Given the feature of negative expected returns associated with trading in binary options, this often means that clients lose more money from trading more frequently than they otherwise would have without receiving a bonus offer.
- (47) In particular ⁽¹⁾:
- (i) FR-AMF has pointed out that one of the main issues about bonuses is that the client typically has to invest 20 or 30 times the amount of the bonus to have the right to withdraw the money;
 - (ii) the Financial Services and Markets Authority ('BE-FSMA'), the Belgian NCA, has noted that it has received many complaints from investors unable to recover their money due to the conditions applicable to bonuses;
 - (iii) PL-KNF has reported that providers offer gifts like tablets or phones to attract new clients, and that providers claim the gifts enhance the client's ability to contact the investment firm; and
 - (iv) DE-BaFin has stated that in the majority of cases involving bonuses observed so far, bonuses are offered by binary option providers acting on a cross-border basis to persuade inexperienced retail clients to speculate in the relevant products, which they may not fully understand.
- (48) Furthermore, NCAs have voiced concerns about the compliance of providers of binary options with their obligations to give clients fair, clear and not misleading information or act in the best interests of clients ⁽²⁾. NCAs are also concerned about the quality of information provided to retail clients (for example on providers' websites) about how binary options work, and in particular information presented about the risks involved ⁽³⁾. Some examples that are not compliant with the obligation for information to be fair, clear and not misleading and which use techniques drawing clients' attention but not necessarily reflecting the suitability or overall quality of the financial instrument or practice relate to:
- (i) website content or information presented in a language that is not a national language of the Member State where the services are to be provided, or presented in the official language but based on translations of insufficient quality, such that this is likely to hamper the comprehension of the information presented; and
 - (ii) presenting information that emphasises the possible benefits associated with investing in binary options without also giving a fair and prominent indication of the relevant risks, suggesting that these speculative products are suitable or appropriate for all investors or that making a return is a simple task. For example: 'Trading binary options is as easy as 1-2-3'; 'Trading has never been so easy', 'Start your career as a trader right now', 'Gain up to 85 % return every 60 seconds', '95 % return in a few minutes', and 'What can you do in 60 seconds? Trade binary options and double your money' ⁽⁴⁾.
- (49) The marketing and distribution practices associated with binary options described above confirms the existence of a significant investor protection concern.

⁽¹⁾ As described in the IOSCO report, page 32.

⁽²⁾ For example BE-FSMA, ES-CNMV, FR-AMF, IT-CONSOB.

⁽³⁾ Section 3 of ESMA's Q&As relating to the provision of CFDs, binary options and other speculative products to retail investors under MiFID (ESMA35-36-794), as updated on 31 March 2017, discusses the information that should be provided to clients and potential clients in more detail.

⁽⁴⁾ Section 3 of ESMA's Questions and Answers (Q&As) relating to the provision of CFDs and other speculative products to retail investors under MiFID (ESMA35-36-794), as updated on 31 March 2017.

2.6. The degree to which the financial instrument may threaten investors' confidence in the financial system

- (50) The combination of the degree of complexity and lack of transparency of binary options, the negative expected return of the product for investors, the lack of reasonable investment objectives; the misleading and aggressive nature of many marketing and distribution activities, conflicts of interest for providers as well as the size of potential detrimental consequences, all contribute to retail clients losing confidence in the financial system.
- (51) Given the high probability of clients suffering losses as evidenced in this Decision, investors who had no other experience of investing in financial instruments and had been attracted by the aggressive marketing conducted by binary option providers may conclude that these products are representative of all financial instruments. This concern is even more significant considering the high number of retail clients of binary option providers and the number of complaints in respect of these products.

3. APPLICABLE EXISTING REGULATORY REQUIREMENTS UNDER UNION LAW DO NOT ADDRESS THE SIGNIFICANT INVESTOR PROTECTION CONCERN IDENTIFIED (ARTICLE 40(2)(b) OF REGULATION (EU) No 600/2014)

- (52) As required under Article 40(2)(b) of Regulation (EU) No 600/2014, ESMA has considered whether existing regulatory requirements in the Union that are applicable to the relevant financial instrument or activity do not address the threat. The applicable existing regulatory requirements are set out in Directive 2014/65/EU, Regulation (EU) No 600/2014 and Regulation (EU) No 1286/2014 of the European Parliament and of the Council ⁽¹⁾. In particular, they include: (i) the requirement to provide appropriate information to clients in Article 24(3) and (4) of Directive 2014/65/EU ⁽²⁾; (ii) the suitability and appropriateness requirements in Article 25(2) and (3) of Directive 2014/65/EU ⁽³⁾; (iii) the best execution requirements in Article 27 of Directive 2014/65/EU ⁽⁴⁾; (iv) the product governance requirements in Articles 16(3) and 24(2) of Directive 2014/65/EU; and (v) the disclosure requirements in Articles 5 to 14 of Regulation (EU) No 1286/2014.
- (53) Some providers, brokers and trade organisations explicitly mentioned in their responses to the call for evidence that ESMA needs to consider the effects of new legislation before applying any product intervention measures, notably the recent introduction of MiFID II (in particular, the product governance rules) and PRIIPs.
- (54) It should be noted that the scope and content of several applicable regulatory requirements under Directive 2014/65/EU and Regulation (EU) No 600/2014 are similar to those existing under Directive 2004/39/EC ⁽⁵⁾. While the adoption of Directive 2014/65/EU and Regulation (EU) No 600/2014 aimed to improve several notable aspects of investment services and activities to strengthen investor protection (including through product intervention powers), the improvements in a number of relevant provisions do not address the specific concerns described in this Decision. From the perspective of the risks and the investor detriment addressed in this Decision, several provisions have therefore remained substantially unchanged.
- (55) The requirements to provide appropriate information to clients have been further detailed in Directive 2014/65/EU, with a significant improvement in the area of the disclosure of costs and charges, with investment firms required to provide clients with aggregated information on all costs and charges in connection with the investment services and the financial instruments. However, disclosure-based rules alone — including improved information on costs — are clearly insufficient to tackle the complex risk arising from the marketing, distribution or sale of binary option to retail clients.
- (56) In particular, Article 24(3) of Directive 2014/65/EU requires inter alia investment firms to ensure that all information, including marketing communications, addressed to clients or potential clients is fair, clear and not misleading. Article 24(4) of Directive 2014/65/EU further requires investment firms to give appropriate information in good time to clients and potential clients with regard to the firm and its services, the financial instruments and proposed strategies, execution venues and all costs and related charges, including notably guidance on and warnings of the risks associated with investing in those financial instruments and whether the financial instrument is intended for retail or professional clients. Based on the description of investor protection

⁽¹⁾ Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs) (OJ L 352, 9.12.2014, p. 1).

⁽²⁾ Previously Article 19(2) and (3) of Directive 2004/39/EC.

⁽³⁾ Previously Article 19(4) and (5) of Directive 2004/39/EC.

⁽⁴⁾ Previously Article 21 of Directive 2004/39/EC.

⁽⁵⁾ Directive 2004/39/EC. Annex IV to Directive 2014/65/EU provides a correlation table between the requirements of Directive 2004/39/EC and the requirements of Directive 2014/65/EU and Regulation (EU) No 600/2014.

concerns in relation to binary options (in particular their complexity, riskiness and expected negative return), it is clear that such investor detriment cannot be entirely and adequately controlled through the mere application of these rules. This type of disclosure does not sufficiently draw clients' attention to the concrete consequences (negative expected returns) of investing in these products and does not address concerns inherent to the product's features.

- (57) ESMA has also taken into consideration the relevance of the disclosure rules under Regulation (EU) No 1286/2014. Regulation (EU) No 1286/2014 lays down uniform rules on the format and content of the key information document to be provided by manufacturers of packaged retail and insurance based investment products ('PRIIPs') to retail investors in order to help them understand and compare the key features and risks of a PRIIP. In particular, Article 5 of Regulation (EU) No 1286/2014, as further implemented in the Commission Delegated Regulation (EU) 2017/653 ⁽¹⁾ sets out inter alia a methodology for the presentation of the summary risk indicator and accompanying explanations including whether the retail investor can lose all invested capital or incur additional financial commitments. However, this type of disclosure does not sufficiently draw retail clients' attention to the consequences of investing in binary options in particular. For example, the performance ratio only relates to the individual binary option product and does not provide the client with the overall percentage of retail client accounts that lose money.
- (58) More generally, a disclosure-based regulatory solution is inappropriate for these products, which are in themselves unsuitable for retail clients.
- (59) The requirements on suitability have also been strengthened in Directive 2014/65/EU by requiring the delivery of a suitability report to the client and refining the suitability assessment. In particular Article 25(2) of Directive 2014/65/EU requires binary option providers to obtain the necessary information regarding the client's or potential client's knowledge or experience in the investment field relevant inter alia to the specific type of product, the client's or potential client's financial situation including their ability to bear losses, and their investment objectives including their risk tolerance so as to enable the binary option provider to recommend the client or potential client financial products that are suitable for them and are in accordance with their risk tolerance and ability to bear losses. However, the suitability requirements are only applicable to the provision of investment advice and portfolio management and hence they are usually irrelevant in relation to the marketing, distribution or sale of binary options, which mostly occurs via electronic platforms, without the provision of investment advice or portfolio management.
- (60) Furthermore, the objectives of the suitability assessment (considering products against clients' knowledge and experience, financial situation and investment objectives) are substantially unchanged compared to the regime in Directive 2004/39/EC and, as evidenced in this Decision, have not been sufficient to avoid the investor detriment identified.
- (61) Similarly, the requirements on appropriateness have been strengthened under Directive 2014/65/EU, mainly by narrowing down the list of non-complex products and therefore restricting the scope of products for execution-only services. Article 25(3) of Directive 2014/65/EU requires binary option providers to ask their clients or potential clients to provide information regarding their knowledge and experience in the investment field relevant inter alia to the specific product offered or demanded so as to enable the provider to determine whether that product is appropriate for the client or potential client. If the provider considers the product to be inappropriate for the client or potential client, the provider shall warn them. Binary options qualify as complex financial products and therefore are subject to the appropriateness test pursuant to Article 25(3) of Directive 2014/65/EU.
- (62) However, that was already the case under Directive 2004/39/EC, which provided for substantially the same appropriateness test as the one set out in Directive 2014/65/EU. As evidenced in this Decision and as NCAs' supervisory experience has demonstrated ⁽²⁾, the appropriateness test has not been sufficient to address the investor protection concerns described in this Decision.

⁽¹⁾ Commission Delegated Regulation (EU) 2017/653 of 8 March 2017 supplementing Regulation (EU) No 1286/2014 of the European Parliament and of the Council on key information documents for packaged retail and insurance-based investment products (PRIIPs) by laying down regulatory technical standards with regard to the presentation, content, review and revision of key information documents and the conditions for fulfilling the requirement to provide such documents (OJ L 100, 12.4.2017, p. 1).

⁽²⁾ For example, IE-CBI expressed concerns on the criteria used to assess knowledge and experience for the purposes of the assessment following their themed inspection (available at: <https://www.centralbank.ie/news/article/inspection-finds-75-percent-of-cfd-clients-lost-money>). Furthermore, the UK-FCA has observed repeated failings by providers in relation to the adequacy of their appropriateness assessments and related policies and procedures (see above).

- (63) Both the suitability and appropriateness tests under the existing regulatory requirements therefore are unlikely to prevent retail clients from trading binary options in a way that ensures that the significant investor protection concern is addressed.
- (64) With regard to best execution, most of the best execution rules by themselves already existed under Directive 2004/39/EC. However, these rules have been strengthened under Directive 2014/65/EU. In particular, Article 27 of Directive 2014/65/EU provides that investment firms must take 'all sufficient steps' (and no longer 'all reasonable steps') to obtain the best possible result for their clients when executing orders. Furthermore, additional information has to be published by market participants and in particular investment firms are required to disclose the top five venues where they executed client orders and the outcomes achieved when executing those orders.
- (65) ESMA has considered whether the revised best execution rules could address at least some of the concerns identified in relation to the marketing, distribution or sale of binary options to retail clients. Increased transparency around order execution helps clients to better understand and to evaluate the quality of the firm's execution practices and thus to better assess the quality of the overall service provided to them. In addition, improved information on how firms execute clients' orders, assists clients when monitoring that the firm has taken all sufficient steps to achieve the best possible results for the client. The requirements in relation to best execution also strengthen the best execution standard in relation to OTC products by requiring firms to check the fairness of the price proposed to the client when executing orders or taking decisions to deal in OTC products, including bespoke products. The requirements in Directive 2014/65/EU imply gathering market data to use for the estimation of the price of such products and, where possible, by comparing with similar or comparable products. However, the best execution rules by themselves do not address the risks linked to the product's features, other than execution, and to the wide marketing, distribution or sale of these products to retail clients.
- (66) In respect of these substantially similar existing regulatory requirements, ESMA has repeatedly noted the risks described above in investor warnings ⁽¹⁾, Questions and Answers (Q&As) ⁽²⁾ and its opinion on 'MiFID practices for firms selling complex products' ⁽³⁾. ESMA has also carried out supervisory convergence work through, inter alia, the Joint Group. Despite ESMA's extensive use of its non-binding instruments to ensure a consistent and effective application of the applicable existing regulatory requirements, the investor protection concerns persists. This highlights that, for the reasons set out in this section, these requirements do not address the concern identified.
- (67) ESMA has indeed considered the potential impact of the product governance rules set out in Articles 16(3) and 24(2) of Directive 2014/65/EU. These rules require providers manufacturing financial instruments (including therefore binary options) for sale to clients to ensure that the products are designed to meet the needs of an identified target market of end clients within the relevant category of clients; that the strategy for distribution of the products is compatible with the identified target market; and that the providers take reasonable steps to ensure that the financial instruments are distributed to the identified target market and periodically review the identification of the target market and the performance of the product. Binary options providers shall understand the financial instruments they offer or recommend, assess the compatibility of the instrument with the needs of the client to whom it provides investment services, also taking into account the identified target market of end clients, and ensure that financial instruments are offered or recommended only when it is in the interest of the client. Furthermore, binary options providers that would distribute a financial instrument not manufactured by them shall have appropriate arrangements in place to obtain and understand the relevant information concerning the product approval process, including the identified target market and the characteristics of the product. Binary options providers distributing financial instruments manufactured by providers not subject to the product governance requirements in Directive 2014/65/EU or by third-country providers shall also have appropriate arrangements to obtain sufficient information about the financial instruments.

⁽¹⁾ ESMA's investor warning on 'risks in investing in complex products' of 7 February 2014 (https://www.esma.europa.eu/sites/default/files/library/2015/11/investor_warning_-_complex_products_20140207_-_en_0.pdf), and ESMA's investor warning on 'CFDs, binary options and other speculative products' of 25 July 2016 (available at: https://www.esma.europa.eu/sites/default/files/library/2016-1166_warning_on_cfds_binary_options_and_other_speculative_products_0.pdf).

⁽²⁾ Questions and Answers (Q&As) relating to the provision of CFDs and other speculative products to retail investors under MiFID (ESMA35-36-794) as updated on 31 March 2017.

⁽³⁾ Opinion on MIFID practices for firms selling complex financial products of 7 February 2014 (ESMA/2014/146).

- (68) ESMA notes that the product governance requirements are introduced for the first time in Union law under Directive 2014/65/EU. On 2 June 2017 ESMA published the 'Guidelines on MiFID II product governance requirements' ⁽¹⁾ in which guidance is provided to manufacturers and developers for the assessment of the target market.
- (69) The purpose of the product governance requirements is to narrow down the type of clients (that is, the target market) for which financial instruments would be appropriate and to which they should therefore be distributed. Considering the features of binary options (high degree of losses, negative expected return, short term of contracts, complexity of pricing structures, and in general the lack of reasonable investment objectives), NCAs and ESMA are of the view that no positive retail target market could be determined. Several firms, after implementation of Directive 2014/65/EU and the product governance requirements, still market binary options to the mass market.
- (70) Despite the existence of these regulatory requirements, evidence shows that retail clients continue and will continue to lose money on binary options. Therefore, this measure is necessary to address the threat.

4. COMPETENT AUTHORITIES HAVE NOT TAKEN ACTION TO ADDRESS THE THREAT OR THE ACTIONS TAKEN DO NOT ADEQUATELY ADDRESS THE THREAT (ARTICLE 40(2)(c) OF REGULATION (EU) No 600/2014)

- (71) One of the conditions for ESMA to adopt the restriction in this Decision is that 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.
- (72) The investor protection concerns described in this Decision have led some NCAs to consult on or take national actions aimed at restricting the marketing, distribution or sale of binary options to retail clients:
- (i) since August 2016, the Financial Services and Markets Authority ('BE-FSMA'), the Belgian NCA, has in place a ban on the commercialisation of certain OTC derivative contracts (including binary options) to retail clients. In addition, the FSMA has forbidden a number of aggressive or inappropriate distribution techniques such as cold calling via external call centres, inappropriate forms of remuneration and fictitious gifts or bonuses ⁽²⁾;
 - (ii) since December 2016, in France the legislation sets forth a ban on investment service providers' marketing communications to individuals regarding, inter alia, binary contracts ⁽³⁾;
 - (iii) in Spain since March 2017, the Comisión Nacional del Mercado de Valores (ES-CNMV), the Spanish NCA, requested entities which market, among retail clients established in Spain, CFDs or forex products, with leverage of over 10 times, or binary options, to expressly inform such clients that the ES-CNMV considers that, due to the complexity and the level of risk of these products, their acquisition is not suitable for retail clients. These entities have also been requested to ensure that clients are informed of the cost they would have to assume if they decided to close their position upon purchasing such products and, in the case of CFDs and forex products, that they are warned that, due to leverage, the losses could be greater than the amount initially paid to purchase the relevant product. In addition, they must obtain from the client a handwritten or recorded verbal statement that allows them to prove that the client is aware that the product they are going to acquire is particularly complex and that the ES-CNMV considers that it is not suitable for a retail client. Furthermore, the advertising material used by the entities subject to the CNMV's action to promote these products must always contain a warning about the difficulty of understanding the products and the fact that ES-CNMV considers that these products are not suitable for retail clients because of their complexity and the level of risk they carry. The ES-CNMV also requested CY-CySEC and the UK-FCA to inform binary options providers of these requirements, encouraging providers which provide services in Spain to display the same warning ⁽⁴⁾;

⁽¹⁾ ESMA Guidelines on MiFID II product governance requirements of 2 June 2017 (ESMA35-43-620).

⁽²⁾ Regulation of the Financial Services and Markets Authority governing the distribution of certain derivative financial instruments to the clients.

⁽³⁾ Article 72 de LOI n° 2016-1691 du 9 décembre 2016 relative à la transparence, à la lutte contre la corruption et à la modernisation de la vie économique.

⁽⁴⁾ The intended measures were announced by ES-CNMV's communication Measures on the Marketing of CFDs and Other Speculative Products to Retail Investors, dated 21 March 2017.

- (iv) in Italy in February 2017, IT-CONSOB issued a specific communication to warn Italian retail clients on the risks associated with binary options;
 - (v) in February 2018, the Comissão do Mercado de Valores Mobiliários ('PT-CMVM') the Portuguese NCA, issued a circular letter stating that investment firms shall refrain from providing trading services related to derivatives linked to cryptocurrencies if they are unable to ensure compliance with all the information obligations towards clients regarding the characteristics of the products;
 - (vi) on 10 May 2017 the Ελληνική Επιτροπή Κεφαλαιαγοράς ('EL-HCMC'), the Greek NCA, issued a circular on providing investment services in over-the-counter derivative financial instruments (including forex, CFDs and binary options) through electronic trading platforms ⁽¹⁾;
 - (vii) in the Czech Republic, the Central National Bank (CZ-CNB), the Czech NCA, issued a statement in October 2015 to warn retail investors about the risks associated with binary options;
 - (viii) in the Netherlands, in February 2017 the Autoriteit Financiële Markten (NL-AFM), the Dutch NCA, launched a consultation paper that proposes to make certain products, including binary options, subject to an advertising ban;
 - (ix) in Cyprus, in February 2017 CY-CySEC issued a consultation paper proposing to ban the distribution and trading of binary options in their current form, so as for the final product to take on the characteristics of an on-exchange derivative product ⁽²⁾;
 - (x) in December 2016 the UK-FCA anticipating that binary options would be brought within the scope of their regulation from 3 January 2018, consulted on early policy considerations for potential enhanced conduct of business rules for binary options, including potential use of product intervention powers to modify the particular product features of binary options or to place restrictions on the sale and marketing of these products to retail investors. The UK FCA also issued a consumer warning about the risks of investing in binary options on 14 November 2017 ⁽³⁾; and
 - (xi) in December 2016, the AT-FMA, the Austrian NCA, has issued a warning regarding the risks associated with CFDs, rolling spot forex and binary options.
- (73) In addition to this, the Finanstilsynet ('NO-Finanstilsynet'), the Norwegian NCA, published on 26 February 2018 a consultation paper in which they propose, inter alia, a ban on the marketing distribution or sale of binary options to retail clients, as proposed by ESMA in the call for evidence. The consultation period is from 26 February 2018 until 26 March 2018 ⁽⁴⁾.
- (74) These national measures may address certain concerns in isolation but are insufficient to address the significant investor protection concern described in this Decision on a cross-border level. As evidenced in this Decision, binary options are most commonly marketed, distributed or sold through online trading accounts and on a cross-border basis ⁽⁵⁾. A national ban would therefore be inadequate to protect retail clients in Member States other than the Member State in which the measure is taken when binary option providers operate in those other Member States as it often occurs ⁽⁶⁾.
- (75) In the light of the above, for national measures to be effective for retail clients across the Union, it would be necessary for NCAs in all Member States to take action aimed at introducing the common minimum level of investor protection set out in this Decision within a short period of time. Since this has not occurred and given the urgency to address the investor protection concerns identified, ESMA finds it necessary to exercise its temporary product intervention powers. The current fragmented framework provides retail clients with no or a different level of protection across the Union when investing in the same complex products, sometimes from the same providers.

⁽¹⁾ HCMC Circular No 56/10.5.2017.

⁽²⁾ Available at: <https://www.cysec.gov.cy/CMSPages/GetFile.aspx?guid=ebf53e28-2bb7-4494-bb3a-4cced2e3c8ba>

⁽³⁾ UK-FCA, 'Consumer warning on the risks of investing in binary options,' 14 November 2017. Available at: <https://www.fca.org.uk/news/news-stories/consumer-warning-about-risks-investing-binary-options>

⁽⁴⁾ Available at: <https://www.finanstilsynet.no/contentassets/455795d40fe4445f88a3b71b35079c94/horningsnotat—produktintervensjon.pdf>

⁽⁵⁾ For example, UK-FCA, IT-CONSOB, ES-CNMV, BE-FSMA, FR-AMF, DE- BaFin, DK- Finanstilsynet, LU-CSSF, NL-AFM.

⁽⁶⁾ See recital 34(vi).

- (76) In light of the significance and persistence of investor protection concerns, the cross-border nature of these activities, the fact that they affect more than one country and of the evidence of the spread of the distribution of binary options in new jurisdictions leading to the increasing amount of various national measures to address similar investor protection concerns, EU-wide measures are necessary to ensure a minimum common level of protection across the EU.
- (77) Lastly, the use of supervisory powers by NCAs under Article 69 of Directive 2014/65/EU for example under paragraph (2)(f) (temporary prohibition of professional activity) and (t) (suspension of the marketing or sale for a lack of compliance with the product approval process requirements) would also not address the significant investor protection concerns. A product intervention measure applies to a product, or to an activity relating to that product, and therefore applies to all investment firms providing that product or activity, rather than one particular non-compliance by an individual investment firm.
- (78) By addressing on a Union basis the risks arising from the offer of binary options to retail clients, the intervention measure is more effective than NCAs trying to take action against each firm individually. As noted above, evidence shows that this is a market wide issue as the problem is not limited to the specificities of particular providers and that the key risks are inherent to the product and providers' business model. There are real concerns that the distribution of binary options to retail clients does not allow the provider to act in the best interests of clients or to allow the provision of information that is fair, clear and not misleading. As such, varied individual supervisory actions would not immediately ensure that further harm to retail clients is prevented and would not provide an adequate alternative to the use of ESMA's intervention powers. The cross-border nature of the distribution of binary options, the fact that they affect more than one Member State, the spread of the distribution of binary options in new jurisdictions, and the proliferation of different national measures to address similar investor protection concerns (which, in turn, may contribute to the risk of regulatory arbitrage) lead to the conclusion that Union-wide measures to ensure a common level of protection across the Union are considered necessary.

5. ESMA'S MEASURE ADDRESSES THE SIGNIFICANT INVESTOR PROTECTION CONCERN IDENTIFIED AND DOES NOT HAVE A DETRIMENTAL EFFECT ON THE EFFICIENCY OF FINANCIAL MARKETS OR ON INVESTORS THAT IS DISPROPORTIONATE TO ITS BENEFITS (ARTICLE 40(2)(a) AND (3)(a) OF REGULATION (EU) No 600/2014)

- (79) Taking into account the size and nature of the significant investor protection concern identified, ESMA considers it necessary and proportionate to temporarily prohibit the marketing, distribution or sale of binary options to retail clients. This prohibition addresses the concern by affording an appropriate and uniform level of protection to retail clients trading binary options in the Union. It does not have a detrimental effect on the efficiency of financial markets or on investors that is disproportionate to its benefits.
- (80) In order to assess how and the degree to which binary options pose a risk to investor protection, ESMA has analysed the distribution of investor returns ⁽¹⁾. This analysis identified two important features ⁽²⁾. The first important feature is the high level of risk involved in binary options: a general feature of binary options is that the investor stands to lose the entire amount invested.
- (81) The second feature, the negative expected return of the product, is an important source of detriment in this context and applies to all binary options. Unlike financial investments, the contracts are typically very short term and do not offer participation in the growth in value of the underlying. Unlike traditional options, which are often used for hedging purposes, binary options provide a fixed payoff if a specified event occurs. In contrast, the payoff of a typical option is contingent on the change in the price of the underlying once the option is in the money (that is the payoff is variable). This inherent feature of the products limits the value of the product as a hedging tool, whereas other kinds of option have been used to smooth out or limit the price of an asset that a firm or an investor has direct exposure to.
- (82) Furthermore, the typically short term of binary options enables an investor to place many trades sequentially. This combined with the negative expected return results in an increasing likelihood of an investor losing on a cumulative basis the more trades placed. This is a statistical property of repeated negative expected return trading.

⁽¹⁾ See ESMA's *Product Intervention Analysis: Measure on Binary Options*, 2018.

⁽²⁾ *Ibidem*.

- (83) Importantly, the negative-expected return is generally integral to the business model of a provider, as it is generally the source of their expected profits. A binary option obliges the binary option provider to pay the investor a fixed amount if a specified event happens, so for the provider to make an expected profit, the investor must make an expected loss. In addition, it is also possible that providers will impose additional charges.
- (84) Specifically for binary options offered with continual two-way pricing, as the provider will need to offer pricing allowing them to make an expected profit, the provision of this pricing cannot improve expected returns for the investor. Indeed, to the extent investors exit positions before expiry, their expected return is lower than if they hold the position to expiry. The magnitude of this incremental expected loss will vary from provider to provider and case to case, but the expected value to an investor implied by the two-way pricing must typically be negative, just as a product's initial price will imply a negative expected return for the investor.
- (85) The combined effect illustrates an essential element of binary options due to their negative expected returns: if the retail client makes a very large number of investments, or if a very large number of investors each make a single investment, the probability of making a profit overall is very low.
- (86) The analysis of the return distribution of binary options correlates with data from NCAs in highlighting the degree of high risks for retail clients to lose a substantial portion (often all) of their investment and the negative expected return. These features are also combined with a general complexity and lack of transparency related to the product features of binary options, poor marketing and distribution practices and inherent conflicts of interest. There is no compensation by any corresponding benefit. Together these features constitute a major source of detriment to current and potential retail clients.
- (87) A principal reason why the financial sector is highly regulated is that it serves important overarching interests and objectives. Special attention in this context is devoted to the protection of retail clients. The marketing, distribution or sale of an investment product assumes that a product is able, at least potentially, to serve these overarching interests and objectives and does not put at risk in a disproportionate way the need to ensure a minimum level of investor protection.
- (88) ESMA has reached the limit of the effectiveness of its non-binding tools in this area. In this context, specifically with regard to product governance, ESMA also acknowledges that product governance principles already form part of the financial services supervisory culture in the Union. In November 2013, the European Supervisory Authorities ('ESAs') issued a Joint Position on 'Manufacturers' Product Oversight and Governance Processes' setting out high-level principles applicable to the oversight and governance processes of financial instruments ⁽¹⁾. In February 2014, ESMA issued an opinion on 'MiFID practices for firms selling complex products' ⁽²⁾ and, in March 2014, it issued an opinion on 'Structured Retail Products — Good practices for product governance arrangements' ⁽³⁾. Furthermore, as of March 2007, guidance setting out product governance principles is in place in the UK ⁽⁴⁾.
- (89) Despite these supervisory principles and the regulatory requirements described in this Decision, the detriment in relation to the marketing, distribution or sale of binary options to retail clients had continued to develop over the past years.
- (90) ESMA therefore considers that the intervention measures to prohibit the marketing, distribution or sale to retail clients of all types of binary options (whether traded on a trading venue or not) to be appropriate to address risks to investor protection. It should be mentioned that retail clients will be able to acquire similar products in the gambling sphere, when these products are allowed in accordance with the applicable relevant legislation.

⁽¹⁾ Joint Position on 'Manufacturers' Product Oversight and Governance Processes' (JC-2013-77).

⁽²⁾ Opinion on MiFID practices for firms selling complex products of 7 February 2014 (ESMA/2014/146). This opinion specifically included references to CFDs and binary options.

⁽³⁾ Opinion on Structured Retail Products — Good practices for product governance arrangements of 27 March 2014 (ESMA/2014/332).

⁽⁴⁾ 'The Responsibilities of Providers and Distributors for the Fair Treatment of Customers'. Available at: https://www.handbook.fca.org.uk/handbook/document/RPPD_FCA_20130401.pdf. The guidance is linked to the UK's Principles for Businesses (PRIN). Available at: https://www.handbook.fca.org.uk/handbook/document/rppd/RPPD_Full_20180103.pdf

- (91) Less restrictive measures have been considered, such as the obligation to sell and distribute these products through advisory services. However, due to their features, these products are unsuitable for retail clients. Therefore, such a measure would impose a case-by-case assessment, burdensome for providers and NCAs, the result of which, due to the features of these products, should not actually be significantly different from the measures proposed in this Decision. Another measure considered is to set a minimum term of the binary options. However, the key concerns in relation to this product will not change due to such a measure. In particular, the pricing structure of the product means that, on average, investors will experience negative expected returns without receiving any clear compensating benefits (for example the hedging function served by traditional options).
- (92) ESMA has also considered the merits of stricter measures, notably the extension of the prohibition to the marketing, distribution or sale of binary options to non-retail clients as well. At this stage, there is no evidence that non-retail clients are targeted by investment firms dealing in these products. Therefore, binary options will remain available to clients classified as professional clients and eligible counterparties who, in any case, are better able to assess the technical features of financial products. This group of clients also includes those retail clients which have sufficient knowledge and experience to request to be classified as professional clients on request.
- (93) ESMA is aware that providers will face potential financial consequences and costs arising from focusing their business and orienting their clients towards other financial instruments and products.
- (94) ESMA considers however that the following benefits gained from addressing the investor protection concern identified outweigh the potential negative impact of the measures:
- (i) reduction of the mis-selling risk and its related financial consequences, which is a major benefit for retail clients and for the financial markets as whole;
 - (ii) reduction of risks linked to regulatory or supervisory arbitrage across different entities and jurisdictions; and
 - (iii) restoring retail clients' confidence in financial markets.
- (95) ESMA's measure will apply from 1 month after publication of this Decision in the *Official Journal of the European Union* (OJEU). This implies a notice period of 1 month after official publication which aims at balancing retail clients' interest to an immediate reduction of the detriment arising from the current trading of binary options and the need to allow sufficient time to relevant market participants to organise and change their business models in an orderly manner.

6. THE MEASURES DO NOT CREATE A RISK OF REGULATORY ARBITRAGE (ARTICLE 40(3)(b) OF REGULATION (EU) No 600/2014)

- (96) In light of the nature of the risks identified and the number and type of investors affected and the national measures being proposed by a number of Member States, ESMA's measure will ensure a common minimum approach across the Union. ESMA has also considered the risk that providers currently offering binary options could try to offer products with comparable features. ESMA and NCAs will also closely monitor whether such new distribution trends develop raising similar detrimental consequences for retail clients and whether there are any such efforts by binary options providers to circumvent these intervention measures and will act as necessary.
- (97) In addition, ESMA's temporary intervention measures apply to all providers of binary options and any other persons knowingly and intentionally contributing to a breach of the measures that fall under the scope of Regulation (EU) No 600/2014. While the scope of the entities falling under Article 40 of this Regulation in respect of fund management companies ultimately needs to be addressed at a legislative level to improve legal certainty⁽¹⁾, ESMA has considered the scope for regulatory arbitrage. ESMA has determined that, in light of the investor detriment evidenced above, the measures proposed have a sufficiently wide scope of application and are therefore able to address the significant investor protection concern arising from the marketing, distribution or sale of binary options.

⁽¹⁾ ESMA has emphasised the risk of regulatory arbitrage in its opinion on Impact of the exclusion of fund management companies from the scope of the MiFIR Intervention Powers of 12 January 2017 (ESMA50-1215332076-23), in which it has expressed concerns for the risk of regulatory arbitrage and the potential reduction in effectiveness of future intervention measures arising from the exclusion of certain entities from the scope of the relevant measures (UCITS management companies and Alternative investment fund managers). The Commission has proposed amendments to enhance legal certainty in this respect by amending Regulation (EU) No 600/2014 (COM (2017)536/948972).

7. CONSULTATION AND NOTICE (ARTICLE 40(3)(c) AND (4) OF REGULATION (EU) No 600/2014)

- (98) As the proposed measures may, to a limited extent, relate to agricultural commodities derivatives, ESMA has consulted the public bodies competent for the oversight, administration and regulation of physical agricultural markets under Council Regulation (EC) No 1234/2007⁽¹⁾. ESMA received responses from the Bundesministerium für Ernährung und Landwirtschaft (Germany), the Ministry of Agriculture (Latvia) and the Ministry of Agriculture and Forestry (Finland). These respondents have not raised any objections to the adoption of the proposed measures.
- (99) ESMA has notified NCAs of this proposed Decision,

HAS ADOPTED THIS DECISION:

*Article 1***Temporary prohibition on binary options in respect of retail clients**

1. The marketing, distribution or sale to retail clients of binary options is prohibited.
2. For the purposes of paragraph 1, irrespective of whether it is traded on a trading venue, a binary option 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 or zero if the underlying of the derivative meets one or more predetermined conditions; and
 - (ii) a predetermined fixed amount or zero if the underlying of the derivative does not meet one or more predetermined conditions.

*Article 2***Prohibition of participating in circumvention activities**

It shall be prohibited to participate, knowingly and intentionally, in activities the object or effect of which is to circumvent the requirements in Article 1, including by acting as a substitute for the binary option provider.

*Article 3***Entry into force and application**

1. This Decision enters into force on the day following that of its publication in the *Official Journal of the European Union*.
2. This Decision shall apply from 2 July 2018 for a period of 3 months.

Done at Paris, 22 May 2018.

For the Board of Supervisors
Steven MAIJOOR
The Chair

⁽¹⁾ Council Regulation (EC) No 1234/2007 of 22 October 2007 establishing a common organisation of agricultural markets and on specific provisions for certain agricultural products (Single CMO Regulation) (OJ L 299, 16.11.2007, p. 1).