

**EUROPEAN SECURITIES AND MARKETS AUTHORITY DECISION (EU) 2018/796****of 22 May 2018****to temporarily restrict contracts for differences 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 <sup>(1)</sup>, 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 <sup>(2)</sup>, 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 <sup>(3)</sup>, 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 contracts for differences (CFDs) to retail clients across the Union. CFDs 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 CFDs.
- (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 CFDs, binary options and other speculative products to retail clients on a cross-border basis across the Union <sup>(4)</sup>. Furthermore, since July 2015, ESMA has been coordinating a task force composed of ESMA and NCAs whose work aims at monitoring the offer of CFDs and binary options 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 of CFDs to retail clients through the issuance of an opinion <sup>(5)</sup> as well as a number of Questions and Answers (Q&As) <sup>(6)</sup> pursuant to Article 29 of

<sup>(1)</sup> OJ L 331, 15.12.2010, p. 84.

<sup>(2)</sup> OJ L 173, 12.6.2014, p. 84.

<sup>(3)</sup> OJ L 87, 31.3.2017, p. 90.

<sup>(4)</sup> The Joint Group is composed of the representative of the Cyprus Securities and Exchange Commission (CY-CySEC), the Cypriot NCA, 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.

<sup>(5)</sup> Opinion on MiFID practices for firms selling complex financial products (ESMA/2014/146).

<sup>(6)</sup> Questions and Answers (Q&As) relating to the provision of CFDs and other speculative products to retail clients under MiFID (ESMA-35-36-794). The Q&As were last updated on 31 March 2017.

Regulation (EU) No 1095/2010. Finally, ESMA has published warnings <sup>(1)</sup> in which it highlighted its concerns in respect of the risks posed by the uncontrolled offer of inter alia CFDs and binary options to retail clients. Although these actions had some positive effects <sup>(2)</sup>, ESMA considers that the significant investor protection concerns persist.

- (3) On 18 January 2018, ESMA launched a call for evidence on its potential product intervention measures on the marketing, distribution or sale of CFDs and binary options to retail clients <sup>(3)</sup> (the 'call for evidence'). The call for evidence was closed on 5 February 2018. ESMA received almost 18 500 <sup>(4)</sup> responses. Among those responses, 82 were from providers, trade organisations, stock exchanges and brokers involved in the CFD and/or binary option 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 CFD and/or binary option providers. The call for evidence disclosed a general concern from the first category of respondents and, in particular product providers, as to the decrease of revenues which the proposed measures may cause as well as the costs related to their implementation. Furthermore, concerns were also expressed by a large number of individual respondents mainly about proposed leverage limits being too low.
- (4) 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 consumer representatives and individuals in support of the proposed measures and calling for more stringent measures, ESMA considers it necessary to impose a temporary restriction on the marketing, distribution or sale of CFDs to retail clients in accordance with Article 40 of Regulation (EU) No 600/2014.
- (5) 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.
- (6) 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 <sup>(5)</sup> and Regulation (EU) No 600/2014, including the definition of derivatives.
- (7) ESMA's temporary restriction fulfils the conditions set out in Article 40 of Regulation (EU) No 600/2014 for the reasons explained below.

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

- (8) This Decision relates to CFDs that are cash settled derivative contracts, the purpose of which is to give the holder an exposure, which can be long or short, to fluctuations in the price, level or value of an underlying. These CFDs include, inter alia, rolling spot forex products and financial spread bets. This Decision does not relate to options, futures, swaps, and forward-rate agreements.
- (9) Some respondents to the call for evidence asked for further clarification on the scope of the measure. Some of the respondents suggested that ESMA's definition of CFDs in the call for evidence explicitly excluded securitised derivatives from the scope of the measure whereas others flagged the similarities between CFDs and other investment products and asked to apply the same measures.

<sup>(1)</sup> ESMA and EBA's investor warning on 'contracts for difference (CFDs)' of 28 February 2013 (available at: <https://www.esma.europa.eu/sites/default/files/library/2015/11/2013-267.pdf>); ESMA's investor warning on 'risks in investing in complex products' of 7 February 2014 (available at: [https://www.esma.europa.eu/sites/default/files/library/2015/11/investor\\_warning\\_-\\_complex\\_products\\_20140207\\_-\\_en\\_0.pdf](https://www.esma.europa.eu/sites/default/files/library/2015/11/investor_warning_-_complex_products_20140207_-_en_0.pdf)); 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](https://www.esma.europa.eu/sites/default/files/library/2016-1166_warning_on_cfds_binary_options_and_other_speculative_products_0.pdf)).

<sup>(2)</sup> For example, the work of the Joint Group has resulted in CY-CySEC adopting a number of enforcement measures aimed at increasing compliance by investment firms offering speculative products like CFDs.

<sup>(3)</sup> Call for evidence on potential product intervention measures on contracts for differences and binary options to retail clients (ESMA35-43-904).

<sup>(4)</sup> 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 restrictions for CFDs in a separate email), and (ii) duplicative responses from the same respondents.

<sup>(5)</sup> 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).

- (10) ESMA confirms that only CFDs are in scope of this Decision. Warrants and turbo certificates are not in scope. ESMA acknowledges that there are similarities between CFDs and warrants and turbo certificates but the products also differ in various respects. ESMA will closely monitor whether similar detrimental consequences for retail clients develop on a pan-European basis and will act as necessary. Securitised derivatives that are CFDs are not explicitly excluded from the definition of CFDs. Although ESMA is not aware of securitised CFDs at this stage, the wrapper of a security and the tradability on a trading venue do not change the key characteristics of a CFD. In case such products were to be launched, these products would be in scope of this Decision.
- (11) CFDs that offer leveraged exposure to price, level or value changes in underlying asset classes have existed as a speculative short-term investment product provided to a *niche* client base in some jurisdictions for several years. However, in recent years, a large number of NCAs have raised concerns about the widening distribution of CFDs to a mass retail market, despite these products being complex and inappropriate for the large majority of retail clients. On the basis of information provided by a number of NCAs, ESMA has also observed an increase in the levels of leverage being offered in such products to retail clients and in the levels of client losses arising from investing in these products <sup>(1)</sup>. These concerns are amplified by often aggressive marketing techniques and inappropriate practices from providers marketing, distributing or selling CFDs, such as the offering of payments, monetary or non-monetary benefits or through inappropriate disclosures of risks.
- (12) These concerns have materialised across several jurisdictions, with a majority of retail clients in those jurisdictions typically losing money as evidenced by a number of NCAs <sup>(2)</sup>. In an attempt to address these concerns, some NCAs took measures in this area <sup>(3)</sup>. However, in light *inter alia* of the cross-border nature of these activities, ESMA's temporary restriction is the most appropriate and efficient tool to address the significant investor protection concerns and to ensure a common minimum level of investor protection throughout the Union, in compliance with the conditions in Article 40 of Regulation (EU) No 600/2014.
- (13) 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 CFDs

- (14) CFDs are complex products <sup>(4)</sup>, typically not traded on a trading venue. The pricing, trading terms, and settlement of such products is not standardised, impairing retail clients' ability to understand the terms of the product. In addition, CFD providers often require clients to acknowledge that the reference prices used to determine the value of a CFD may differ from the price available in the respective market where the underlying is traded, making it difficult for retail clients to check and verify the accuracy of the prices received from the provider.
- (15) The costs and charges applicable to trading in CFDs are complex and lack transparency for retail clients. In particular, retail clients typically find it difficult to understand and assess the expected performance of a CFD, also taking into account the complexity arising from the impact of transaction fees on such performance. Transaction fees in CFDs are normally applied to the full notional value of the trade and investors consequently incur higher transaction fees relative to their invested funds at higher levels of leverage. Transaction fees are usually deducted

<sup>(1)</sup> See recital 35.

<sup>(2)</sup> See recital 35.

<sup>(3)</sup> See recitals 73 and 75.

<sup>(4)</sup> CFDs 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).

from the initial margin deposited by a client and high leverage can lead to a situation where the client, at the moment of opening a CFD, observes a significant loss on their trading account, caused by the application of high transaction fees. Since transaction fees at higher leverage will erode more of the client's initial margin, clients will be required to earn more money from the trade itself to realise a profit. This lowers the client's chances of realising a profit net of transaction fees, exposing clients to a greater risk of loss.

- (16) In addition to transaction fees, spreads and various other financing costs and charges may be applied <sup>(1)</sup>. These include commissions (a general commission or a commission on each trade, or on opening and closing a CFD account) and/or account management fees. Financing charges are also usually applied to keep a CFD open, such as daily or overnight charges, to which a mark-up can also be added. The number and complexity of the various costs and charges and their impact on clients' trading performance contribute to the lack of sufficient transparency in relation to CFDs in order to enable a retail client to make an informed investment decision.
- (17) Another complexity arises from the use of stop loss orders. This product feature may give retail clients the misleading impression that a stop loss order guarantees execution at the price which they have set (the level of the stop loss). However, stop loss orders do not guarantee a protection level but the triggering of a 'market order' when the CFD price reaches the price set by the client. Accordingly, the price received by the client (execution price) can be different from the price at which the stop loss was set <sup>(2)</sup>. While stop losses are not unique to CFDs, leverage increases the sensitivity of an investor's margin to price movements of the underlying increasing the risk of sudden losses and means that traditional trading controls such as stop-losses are insufficient to manage investor protection concern.
- (18) Another key complexity associated with CFDs may arise from the relevant underlying market. For instance, with FX trading, clients speculate on one currency against another. If neither of these currencies is the currency used by the client to open a CFD position, any return received by the client will be dependent on the measures taken by the client to assess the movement of these three currencies. This suggests that a high level of knowledge of all the currencies involved is required to successfully navigate the complexities of such currency trading. Retail clients do not normally have such knowledge.
- (19) CFDs with cryptocurrencies as an underlying raise separate and significant concerns. Cryptocurrencies are a relatively immature asset class that pose major risks for investors. ESMA and other regulators have repeatedly warned <sup>(3)</sup> of the risks involved with investing in cryptocurrencies. For CFDs on cryptocurrencies many of these concerns remain present. This is because retail clients typically do not understand the risks involved when speculating on an extremely volatile and relatively immature asset class, which are exacerbated by trading on margin, as it requires clients to react in a very short time period. Due to the specific characteristics of cryptocurrencies as an asset class the measures in this Decision will be closely monitored and reviewed if deemed necessary.
- (20) The high level of complexity, poor degree of transparency, nature of risks and type of underlying confirm that a significant investor protection concern exists in respect of these CFDs.

<sup>(1)</sup> A spread quoted by a CFD provider to retail clients may include a mark-up to the market prices the provider faces from an external source, such as a liquidity provider.

<sup>(2)</sup> See also Article 19(2)(d) of Delegated Regulation (EU) 2017/567 and, in particular, the last sub-factor listed therein, that is the use of inter alia terminology that implies a greater level of security than that which is actually possible or likely.

<sup>(3)</sup> See for example the joint warning by ESMA, EBA and EIOPA on virtual currencies. Available at: [https://www.esma.europa.eu/sites/default/files/library/esma50-164-1284\\_joint\\_esas\\_warning\\_on\\_virtual\\_currenciesl.pdf](https://www.esma.europa.eu/sites/default/files/library/esma50-164-1284_joint_esas_warning_on_virtual_currenciesl.pdf), the EBA warning from 2013. Available at: <https://www.eba.europa.eu/documents/10180/598344/EBA+Warning+on+Virtual+Currencies.pdf>, and see IOSCO's webpage for an overview of regulator's warnings on virtual currencies and initial coin offerings. Available at: <http://www.iosco.org/publications/?subsection=ico-statements>

## 2.2. The particular features or components of CFDs

- (21) The main feature of CFDs is their ability to operate on leverage. In general, whilst leverage can increase the possible profit for clients, it can also increase the possible losses. NCAs have noted that leverage levels applied to CFDs across the Union range from 3:1 to 500:1 <sup>(1)</sup>. As far as retail clients are concerned, the application of leverage may increase the probability of a larger loss to a greater extent than the probability of a larger gain for the reasons set out below.
- (22) Leverage affects an investment's performance by increasing the impact of transaction fees incurred by retail clients <sup>(2)</sup>.
- (23) Another risk related to trading in leveraged products is linked to the interaction of high leverage and the practice of automatic margin close-out. Under commonly applied contractual terms, CFD providers are granted the discretion to close-out a client's account once the client's net equity reaches a specified percentage of the initial margin that the client is required to pay in order to open a CFD position(s) <sup>(3)</sup>.
- (24) The interaction between high leverage and automatic margin close-out is that it increases the probability that a client's position will be closed automatically by the CFD provider in a short timeframe or a client has to post additional margin in the hope of turning around a losing position. High leverage increases the probability that the client has insufficient margin to support their open CFDs by making the client's position(s) sensitive to small fluctuations in the price of the underlying to the client's disadvantage.
- (25) ESMA observes that in market practice margin close-out appears to have been introduced by CFD providers mainly to allow them to more easily manage client exposures and the provider's credit risk by closing out a client's position before the client had insufficient funds to cover their current exposure. Automatic margin close-out also provides a degree of protection for clients as it reduces, but does not eliminate, the risk that the client (particularly at high levels of leverage) loses all or more than their initial margin.
- (26) Some NCAs reported to ESMA <sup>(4)</sup> that the level at which automatic margin close-out is applied is inconsistent across CFD providers <sup>(5)</sup>. CFD providers with clients who typically trade at lower value order sizes, and who typically act as direct counterparty to the clients' trades, have previously set the margin close-out rule between 0 and 30 % of initial margin required. By eroding the client's funds close to 0, the provider is placing the client at increased risk of losing more money than they had invested. Some NCAs also observe that it is standard market practice to apply margin close-out on a per account basis <sup>(6)</sup>. This means that minimum margin requirements are applied based on the combined margin required for all a client's open positions connected to the CFD account, including across different asset classes. This allows profitable positions to offset losing positions across the client's account.

<sup>(1)</sup> The Financial Conduct Authority (UK-FCA), the NCA in the UK, has noted leverage levels of 200:1 for smaller position sizes. Furthermore, the UK-FCA has also observed that 200:1 is the typical leverage in 'major' currencies, but 500:1 and occasionally higher is available from providers targeting smaller retail clients. L'Autorité des marchés financiers (FR-AMF), the French NCA, has observed leverage of up to 400:1 for the most liquid currency pairs. The Central Bank of Ireland (IE-CBI), the Irish NCA, has observed leverage of up to 400:1. The Bundesanstalt für Finanzdienstleistungsaufsicht (DE-BaFin), the German NCA, highlighted one particular case in Germany of a firm offering a leverage of 400:1 with no margin call. The Commissione Nazionale per le Società e la Borsa (IT-CONSOB), the Italian NCA, and the Комисията за финансов надзор (BG-FSC) the Bulgarian NCA, have observed leverage of up to 500:1.

<sup>(2)</sup> See recital 15.

<sup>(3)</sup> However, it is also market practice for CFD providers to set a margin call level which is higher than the margin close-out level and which gives the client the opportunity to post more margin to support their trade. The client can choose to do so at the risk of losing more money. For example, if a provider sets the margin call level at 70 % of an initial margin of 100, the client would be requested to place more money in the trading account once the balance falls to 70 or lower.

<sup>(4)</sup> ESMA and NCAs have shared information, including through discussion, on an ongoing basis in relation to the offering of CFDs across the Union.

<sup>(5)</sup> The Česká národní banka (CZ-CBN), the Czech NCA, has observed that Czech CFD providers usually close-out positions when margin drops under 15 %. DE-BaFin and BG-FSC have observed that clients' positions would be closed when funds in a client's account fall between 30-50 % of the minimum margin. The Commission de Surveillance du Secteur Financier (LU-CSSF), the Luxembourgish NCA, and l'Autorité des marchés financiers (FR-AMF), the French NCA, have noted that automatic close-outs set by providers are typically between 120-150 % of the initial margin.

<sup>(6)</sup> The CY-CySEC and the UK-FCA.

- (27) A related risk of leverage is that it places clients at risk of losing more money than they have invested. This is a key risk which retail clients may not understand, even despite written warnings. The margin posted by a client is posted as collateral to support the client's position. If the price of the underlying, for example, moves against the client's position in excess of the initial margin posted <sup>(1)</sup>, the client can be liable for losses in excess of the funds in their CFD trading account, even after the closure of all their other open CFD positions. Some NCAs have reported to ESMA that a number of retail clients lost significant sums of money during the de-pegging of the Swiss Franc in January 2015 <sup>(2)</sup>. Many retail clients were unaware that they could lose more money than they had invested <sup>(3)</sup>.
- (28) Trading at high leverage levels also increases the impact of 'gapping' during periods of significant market volatility (for example the Sterling flash crash and Swiss franc de-pegging). Gapping occurs when there is a sudden movement in the price of the underlying. Gapping is not unique to CFDs, but the risks related to such events are exacerbated by high leverage. If gapping occurs, the client on the losing side may be unable to close an open CFD at their preferred price and can result in significant client losses <sup>(4)</sup> when trading at high leverage. In the case of the Swiss franc shock in 2015 for example, this has led to retail clients losing significantly more than the sum initially invested <sup>(5)</sup>.
- (29) The often high levels of leverage offered to retail clients, the volatility of certain underlying assets, together with the application of transaction costs which impact the investment's performance, can result in rapid changes to a client's investment position. This results in the client having to take swift action to manage the risk exposure by posting additional margin to avoid the position being automatically closed out. In such instances, high leverage can lead to large losses for retail clients over a very short time span and exacerbates the risk that clients will lose more than the funds paid to trade CFDs.
- (30) The above factors confirm that a significant investor protection concern exists in respect of these CFDs.

### 2.3. The size of potential detrimental consequences and the degree of disparity between the expected return or profit for investors and the risk of loss

- (31) The following information provided by NCAs to ESMA indicates that the number of retail clients investing in CFDs as well as the number of providers offering these products across the Union has grown:
- (i) most NCAs reported to ESMA that they have observed providers offering CFDs to retail clients that are authorised in their jurisdiction <sup>(6)</sup>. Nearly all NCAs reported to ESMA that CFD providers passporting from other Member States offer CFDs in their jurisdiction <sup>(7)</sup>. Some NCAs also mentioned CFD providers using branches or tied agents to passport to host jurisdictions <sup>(8)</sup>;
- (ii) the Cyprus Securities and Exchange Commission ('CY-CySEC'), the Cypriot NCA, and the Financial Conduct Authority ('UK-FCA'), the UK NCA, have reported an increase in the number of CFD providers specialising in the sale of these products to retail clients on a cross border basis from 103 to 138 providers in Cyprus and from 117 to 143 providers in the UK between 2016 and 2017;

<sup>(1)</sup> For example, at a leverage of 50:1 a price change in excess of 2 %.

<sup>(2)</sup> For example, the FR-AMF, the DE-BaFin and the UK-FCA.

<sup>(3)</sup> According to the DE-BaFin, 'such products (CFDs) came to the public's attention primarily as a result of the 'Swiss franc shock' at the beginning of 2015, when the Swiss National Bank abandoned the cap on the Swiss franc's value against the euro and many CFD investors suffered major losses as a result of having to subsequently make additional payments.' Available at: [https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Pressemitteilung/2016/pm\\_161208\\_allgvfg\\_cfd\\_en.html](https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Pressemitteilung/2016/pm_161208_allgvfg_cfd_en.html)

<sup>(4)</sup> Some respondents to the call for evidence signalled that they lost more than EUR 100 000 while trading CFDs.

<sup>(5)</sup> See an example where an investor lost EUR 280 000 with only EUR 2 800 invested. Available at: [https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Pressemitteilung/2016/pm\\_161208\\_allgvfg\\_cfd\\_en.html](https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Pressemitteilung/2016/pm_161208_allgvfg_cfd_en.html).

<sup>(6)</sup> Austria, Belgium, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Lithuania, Malta, Netherlands, Romania, Spain, Slovenia and the United Kingdom, as well as Norway, Liechtenstein and Iceland.

<sup>(7)</sup> AT-FMA, BE-FSMA (with national measures introduced to restrict these products), CY-CySEC, CZ-CNB, DE-BaFin, DK-Finanstilsynet, EE-FSA, EL-HCMC, ES-CNMF, 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.

<sup>(8)</sup> IT-CONSOB, IE-CBI, FR-AFM and CZ-CNB.

- (iii) the UK-FCA, has also noted an increase in the number of requests for authorisation for investment firms offering CFDs. Newer markets such as Greece, Hungary, Portugal and Slovakia have also noted an increase in applications for authorisation for investment firms offering CFDs <sup>(1)</sup>.
- (32) Active client numbers in relation to these products are fluid due to the relatively short life span of CFD client accounts and the cross-border nature of activities. Based on data gathered by ESMA from a number of NCAs <sup>(2)</sup>, 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 <sup>(3)</sup> to approximately 2,2 million in 2017 <sup>(4)</sup>.
- (33) retail clients complaints data also indicates ongoing consumer concerns in this area <sup>(5)</sup>.
- (34) NCAs <sup>(6)</sup> have reported to ESMA the concern that as some national markets become restricted due to national measures (for example Belgium <sup>(7)</sup> and France <sup>(8)</sup>) CFD providers will seek out clients in other Member States.
- (35) Specific studies carried out by the following NCAs into investor outcomes for retail clients investing in CFDs show that a majority of retail clients in these Member States investing in these products lose money from trading:
- (i) CY-CySEC conducted analysis of a sample of retail client accounts (approximately 290 000 client accounts) of 18 major CFD providers for the period from 1 January 2017 to 31 August 2017. It was found that on average, 76 % of client accounts made a loss overall over that particular period, with around 24 % of client accounts in profit. On average, the loss per account was around EUR 1 600;
- (ii) the Comisión Nacional del Mercado de Valores ('ES-CNMV'), the Spanish NCA, found that approximately 82 % of retail clients <sup>(9)</sup> have lost money overall in a 21-month period between early 2015 and late 2016. The average loss per retail client was EUR 4 700 <sup>(10)</sup>;
- (iii) the Autorité des marchés financiers ('FR-AMF'), the French NCA, found that more than 89 % of retail investors lost money overall over a 4-year period from 2009 to 2013, and that the average loss per retail client was EUR 10 887 <sup>(11)</sup>. In addition, data provided by the FR-AMF from the office of the Ombudsman identified that the average overall loss per annum for complainants of CFDs was EUR 15 207 in 2016. Furthermore, the Ombudsman noted that particularly in 2016 and 2017, the practices of regulated providers became even more aggressive and increasingly targeted investors likely to make significant payments. Several complaints regarding incidents of harassment and manipulation were from applicants with substantial savings. Figures for 2016 mediations before the French Ombudsman appear to support

<sup>(1)</sup> In 2017, the Ελληνική Επιτροπή Κεφαλαιαγοράς (EL-HCMC), the Greek NCA, the Magyar Nemzeti Bank (HU-MNB), the Hungarian NCA, and the Národná Banka Slovenska (SK-NBS), the Slovakian NCA, reported to ESMA that they have observed a growth in the number of applications for authorisation of CFD providers.

<sup>(2)</sup> Data provided in 2015 by: BG-FSMA, CY-CySEC, CZ-CNB, FR-AMF, IE-CBI, IS-FME, LU-CSSF, NL-AFM, MT-MFSA, 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.

<sup>(3)</sup> 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 CY-CySEC have been compiled on the basis of accounts opened in CY-CySEC authorised providers offering these products.

<sup>(4)</sup> As far as the UK is concerned, this figure does not include non-UK clients of UK authorised providers 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.

<sup>(5)</sup> Complaints relating to CFDs have been received by the AT-FMA, the BE-FSMA, the BG-FSC, the HR- HANFA, the CZ-CNB, the CY-CySEC, the DE-Bain, the DK-Finanstilsynet, the EE-Finantsinspektsoon, the EL-HCMC, the ES-CNMV, the FI-Finanssivalvonta, the FR-AMF, the IE-CBI, IT-CONSOB, the LT-Lietuvos Bankas, the MT-MFSA, the NL-AFM, the PL-KNF, the PT-CMVM, the RO-ASF, the SE-Finansinspektionen, the SI-ATVP, the UK-FCA and the NO-Finanstilsynet.

<sup>(6)</sup> For example, the Czech National Bank, the Polish KNF and the Spanish CNMV.

<sup>(7)</sup> Available at: <https://www.fsma.be/en/news/fsma-regulation-establishes-framework-distribution-otc-derivatives-binary-options-cfds>

<sup>(8)</sup> Available at: [http://www.amf-france.org/en\\_US/Actualites/Communiqués-de-presse/AMF/annee-2016.html?docId=workspace%3A%2F%2FSpacesStore%2Fad42eccc-9720-49da-82a8-2ddcb72fbf1d](http://www.amf-france.org/en_US/Actualites/Communiqués-de-presse/AMF/annee-2016.html?docId=workspace%3A%2F%2FSpacesStore%2Fad42eccc-9720-49da-82a8-2ddcb72fbf1d)

<sup>(9)</sup> Across a study of 30 000 clients representing approximately 100 % of retail clients of CFD providers authorised by CNMV.

<sup>(10)</sup> Published in Spanish: <http://www.cnmv.es/Portal/verDoc.axd?t=%7bf1a92bb1-5f1b-420b-b58c-122d64a1ed9a%7d>

<sup>(11)</sup> Available at: <http://www.amf-france.org/technique/multimedia%3FdocId%3Dworkspace%253A%252F%252FSpacesStore%252F9bf2caa8-1ce4-4832-85f4-4dfface8644%26>

this, with the average amount recovered increasing to EUR 11 938 and half of all cases concerning an amount above EUR 5 000. The losses incurred by some investors topped EUR 90 000, and the cumulative losses in cases handled on the merits, that is involving authorised companies, exceeded EUR 1 million. The FR-AMF also found that retail investors who trade the most (by number of trades, average trade size or cumulative volume) lose the most. The same applies to those who continue over time, indicating there is no learning curve;

- (iv) the Hrvatska agencija za nadzor financijskih usluga ('HR-HANFA'), the Croatian NCA, carried out a loss-per-client study for one Croatian investment firm offering CFDs to its clients. The study assessed 267 retail clients' losses or gains for the trading period from January to September 2016. HR-HANFA found that total client losses for the period was approximately EUR 1 017 900, while total retail client gains were approximately EUR 420 000;
- (v) the Central Bank of Ireland ('IE-CBI'), the Irish NCA, carried out a thematic review in 2015 which showed that 75 % of retail clients trading CFDs during 2013 and 2014 suffered losses with the average loss amongst those clients being EUR 6 900. A follow-up review of a sample of the largest CFD providers in Ireland found that in the 2-year period from 2015 to 2016, 74 % of retail clients lost money with an average loss of EUR 2 700 <sup>(1)</sup>;
- (vi) the work of the Commissione Nazionale per le Società e la Borsa ('IT-CONSOB'), the Italian NCA, conducted during 2016 has shown that in 2014-2015 78 % of the Italian retail clients of a specific CFD provider lost money investing in CFDs and 75 % lost money investing in rolling spot forex, with the average loss being EUR 2 800. It was also found that there is a positive correlation between the number of trades carried out by retail clients and the amount of losses suffered. A subsequent survey conducted for IT-CONSOB in March 2017 on five Italian branches of providers operating in CFDs found that in 2016 retail client losses were up to 83 % with the average loss per client of approximately EUR 7 000;
- (vii) the Komisja Nadzoru Finansowego ('PL-KNF'), the Polish NCA, conducted in Q1 2017 a study <sup>(2)</sup> based on the data provided by 10 investment firms offering CFDs (based on 130 399 client accounts of which 38 691 active accounts) and concluded that 79,28 % of the clients lost money in 2016. The average result was a loss per client of PLN 10 060. Moreover, a similar study conducted by PL-KNF in Q1 2018 based on the data provided by seven investment firms offering CFDs in Poland in 2017 (177 883 client accounts, of which 40 209 active accounts) showed that 79,69 % of the clients lost money in 2017. The average result was a loss per client of PLN 12 156 in 2017. The percentage of active clients <sup>(3)</sup> losing money amounted to 81 % (2012), 81 % (2013), 80 % (2014), 82 % (2015), 79 % (2016) and 80 % (2017);
- (viii) a study carried out by the Commission de Surveillance du Secteur Financier ('LU-CSSF'), the Luxembourgish NCA, stated in September 2017 that from two LU-CSSF authorised providers providing CFDs the average losses per retail client are EUR 4 500 and approximately EUR 1 700;
- (ix) an analysis carried out by the UK-FCA in 2014 on a sample of non-advised retail client accounts from 8 CFD providers, suggested that 82 % of retail clients lost money on these products and that the average outcome was a loss of GBP 2 200 per retail client over a year. Information received during the UK-FCA's December 2016 consultation process also found a correlation between higher leverage levels, and increased probability and size of losses <sup>(4)</sup>. A further study by the UK-FCA in 2016/2017 in relation to advisory and discretionary services provided for CFDs over a 12-month period found further evidence of poor outcomes for retail clients. The review found that within the population of firms offering CFDs on an advisory and discretionary services, 76 % of retail clients lost money, experiencing an average loss of GBP 9 000. Even when the profitable retail clients were taken into consideration, on average, a typical retail client investing under an advisory and discretionary managed account lost around GBP 4 100 <sup>(5)</sup>;
- (x) the Comissão Mercado de Valores Mobiliários (PT-CMVM), the Portuguese NCA, found that on a notional value of investors' position of EUR 44 700 million in 2016 and EUR 44 200 million in 2017, the associated losses for retail investors were EUR 66,8 million and EUR 47,7 million for the years 2016 and 2017 respectively.

<sup>(1)</sup> Available at: <https://www.centralbank.ie/docs/default-source/publications/Consultation-Papers/cp107/consultation-paper-107.pdf?sfvrsn=4>. See page 1 and 2.

<sup>(2)</sup> Available at: [https://www.knf.gov.pl/o\\_nas/komunikaty?articleId=50315&p\\_id=18](https://www.knf.gov.pl/o_nas/komunikaty?articleId=50315&p_id=18) (only available in Polish).

<sup>(3)</sup> Those clients invested mainly in CFDs. These data also include investors investing in binary options who constituted less than 4 % of active clients in 2017.

<sup>(4)</sup> Available at: <https://www.fca.org.uk/publication/consultation/cp16-40.pdf>. See page 23 and 35.

<sup>(5)</sup> Available at: <https://www.fca.org.uk/publication/correspondence/dear-ceo-letter-cfd-review-findings.pdf>

- (36) In addition, a study carried out by the Finanstilsynet ('NO-Finanstilsynet'), the Norwegian NCA, on the trading results of 6 CFD providers' clients in 2016. The study included approximately 1 000 retail clients <sup>(1)</sup> trading in CFDs over 1 to 2 years with January 2014 as the start date and the end date ranging between December 2014 and December 2015 (on average a trading period of 1,5 years). It showed that 82 % of those clients lost money with an average loss per client of EUR 29 000. The average transaction costs relative to a client's equity was 37 % (due to high leverage and frequent trading) <sup>(2)</sup>.
- (37) Notably, the consistent pattern of average losses for retail clients in CFDs over time and across countries comes despite positive returns for retail clients in other financial products in many of the years in question. The percentage of retail clients losing money in the AMF study referred to in recital 35(iii) in each year from 2009 to 2013 is remarkably consistent, despite varying annual returns in stock market and commodity indices over the same period, for example <sup>(3)</sup>. The persistence of the pattern of losses for retail clients in CFDs indicates a structural feature of the return profile, in contrast to positive historical returns on (long term) investments in other financial products such as equity investment funds.
- (38) These studies paint a stark picture of the significant investor protection concern raised by the offer of these CFDs to retail clients.

#### 2.4. The type of clients involved

- (39) CFDs are *marketed*, distributed or sold to both retail and professional clients. However, retail (unlike professional) clients do not normally possess the experience, knowledge and expertise to make investment decisions which properly assess the risks they incur with regard to the complex CFDs that are restricted by this Decision.
- (40) Indeed, one study in a Member State has indicated that the highest maximum leverage levels were often offered to retail clients, whilst professional clients and eligible counterparties were offered lower maximum leverage levels <sup>(4)</sup>. Given the evidence of losses observed by ESMA in retail client accounts described in this Decision, it is clear that a significant investor protection concern exists in respect of the unrestricted marketing, distribution or sale of CFDs to this category of client.

#### 2.5. Marketing and distribution activities in relation to CFDs

- (41) Although CFDs 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 <sup>(5)</sup>. However, this assessment does not prevent CFD providers or their clients or potential clients proceeding with a transaction, subject to

<sup>(1)</sup> Representing approximately 33 % to 50 % of all CFD retail clients active in Norway.

<sup>(2)</sup> Published in Norwegian: <https://www.finanstilsynet.no/nyhetsarkiv/nyheter/2017/finanstilsynet-advarer-mot-handel-i-cfd/>

<sup>(3)</sup> For example, based on Thomson Reuters Lipper data on retail share classes of the EU-domiciled UCITS fund universe, ESMA estimates that the average annual investor return, weighted by assets, net of charges and front and back loads, was around 3 % over the period 2008-2017, with more than 5 % return on average for equity fund investments. Further details on performance and costs relating to EU UCITS may be found in the ESMA Report on Trends, Risks and Vulnerabilities No 2 2017, pages 36-44, available at [https://www.esma.europa.eu/sites/default/files/library/esma50-165-416\\_trends\\_risks\\_and\\_vulnerabilities\\_no.2\\_2017.pdf](https://www.esma.europa.eu/sites/default/files/library/esma50-165-416_trends_risks_and_vulnerabilities_no.2_2017.pdf).

<sup>(4)</sup> A study on the offer of CFDs and rolling spot forex to retail clients was conducted by the MT-MFSA.

<sup>(5)</sup> 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). 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.

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 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 CFDs, which, by their features, should not be distributed to them <sup>(1)</sup>.

- (42) The UK-FCA observed repeated failings by the approach of CFD providers to completing the appropriateness assessment, including inadequacies in the assessment itself, inadequate risk warnings to retail clients who failed the appropriateness assessments and lack of establishment of a process to assess whether clients who fail the appropriateness assessment, but who nonetheless wish to trade CFDs, should be allowed to proceed with CFD transactions <sup>(2)</sup>. Revisiting this issue in late 2016, the UK-FCA found that a significant number of firms had failed to address these failings following the previous feedback provided to them <sup>(3)</sup>.
- (43) Furthermore, NCAs have voiced concerns about CFD providers' compliance with their obligations to give clients clear and not misleading information, or act in the best interests of clients <sup>(4)</sup>. NCAs have also voiced concerns regarding the inadequate performance of appropriateness tests <sup>(5)</sup> in practice and inadequate warnings to clients when they fail the appropriateness test <sup>(6)</sup>. Examples of these bad practices are described in and gave rise to ESMA's Questions and Answers relating to the provision of CFDs and other speculative products to retail clients under MiFID <sup>(7)</sup>
- (44) NCAs have also observed aggressive marketing practices as well as misleading marketing communications in this sector of the market <sup>(8)</sup>. 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 CFDs are suitable for the retail mass market by promoting general brand name awareness. Furthermore, they also include the use of misleading statements such as 'Trading has never been so easy', 'Start your career as a trader right now', 'Earn GBP 13 000 in 24 Hours! Get started' <sup>(9)</sup>.

<sup>(1)</sup> This risk is possibly magnified by the overconfidence bias which has often been observed in recent behavioural studies. A recent study focussing on forex markets demonstrates that leverage is a significant indicator of overconfidence: Forman, John H. and Horton, Joanne, Is Leverage Use a Better Indication for Overconfidence? Evidence from the Forex Market (August 30, 2017). Available at SSRN: <https://ssrn.com/abstract=2860103>. 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 macroeconomic 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. Nasic 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.

<sup>(2)</sup> UK-FCA, Dear CEO Letter, 'Client take-on review in firms offering contract for difference (CFD) products,' 2 February 2016. See: <https://www.fca.org.uk/publication/correspondence/dear-ceo-letter-cfd.pdf>

<sup>(3)</sup> UK-FCA, 'CFD firms fail to meet our expectations on appropriateness assessments,' 29 June 2017. See: <https://www.fca.org.uk/publications/multi-firm-reviews/cfd-firms-fail-expectations-appropriateness-assessments>

<sup>(4)</sup> For example, DE - BaFin, DK- Finanstilsynet, ES-CNMV, IE-CBI, FR-AMF, LU-CSSF NL-AFM.

<sup>(5)</sup> For example, IE-CBI.

<sup>(6)</sup> For example, the UK-FCA.

<sup>(7)</sup> Questions and Answers (Q&As) relating to the provision of CFDs and other speculative products to retail investors under MiFID (ESMA-35-36-794) as updated on 31 March 2017.

<sup>(8)</sup> For example, BE-FSMA, ES-CNMV, FR-AMF and IT-CONSOB.

<sup>(9)</sup> Section 3 of Questions and Answers (Q&As) relating to the provision of CFDs and other speculative products to retail investors under MiFID (ESMA-35-36-794) as updated on 31 March 2017 and one example from UK-FCA.

- (45) In the context of the development of the CFD Q&As, some NCAs have reported to ESMA that CFD providers often fail to adequately disclose the risks of these products <sup>(1)</sup>. In particular, some NCAs <sup>(2)</sup> found that CFD providers did not adequately describe the potential for rapid losses that could exceed their invested funds.
- (46) Also in this context, some NCAs have also raised concerns about the ‘churning’ nature of some CFD providers’ business models <sup>(3)</sup>. 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.
- (47) A common feature of marketing and sales techniques adopted by the CFD industry has been the offer of trading (monetary and non-monetary) benefits, such as bonuses to attract and encourage retail clients to invest in CFDs, the offer of gifts (for example holidays, cars, electronic goods), trading tutorials or reduced costs (for example spread or fees) <sup>(4)</sup>.
- (48) 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.
- (49) Furthermore, such trading benefits to open CFD trading accounts often require clients to pay funds to the provider and conduct a specified number of trades over a specified period of time. Given that the evidence demonstrates that the majority of retail clients lose money trading CFDs, this often means that clients lose more money from trading CFDs more frequently than they otherwise would have without receiving a bonus offer.
- (50) Supervisory work by several NCAs has discovered that the terms and conditions on promotional offers are often misleading and that many clients were unaware of the conditions to access the benefits/bonuses offered. Finally, a number of clients reported difficulties in withdrawing funds when trying to use such bonuses <sup>(5)</sup>.
- (51) In addition to the factors outlined above, many NCAs <sup>(6)</sup> observe that distribution models observed in this sector of the market bear certain conflicts of interest <sup>(7)</sup>. The pressure to maintain a pipeline of new clients increases the potential for conflicts of interest to occur. Conflicts of interest have and may arise from the fact that some CFD providers are counterparties to clients’ trades without hedging their exposure, therefore placing their interests in direct conflict with that of their clients. For these providers there is a greater risk and incentive to manipulate or use less transparent reference prices, or to pursue other questionable practices such as cancelling profitable trades on spurious pretexts. There is also a risk that providers may seek to exploit asymmetric slippage (for example pass on any loss as a result of slippage to the client, while retaining any profit obtained as a result of slippage). Providers may purposefully delay the time between quotes and execution of CFD trades to further exploit this practice. NCAs have also identified practices whereby CFD providers apply an asymmetrical or inconsistent mark up to core spreads.
- (52) The marketing and distribution practices associated with CFDs described above confirms the existence of a significant investor protection concern in respect of these CFDs.

<sup>(1)</sup> For example, ES-CNMV, UK-FCA, CY-CySEC and DE-BaFin.

<sup>(2)</sup> In particular the UK-FCA. In Germany legislation was introduced to protect clients from losses (DE-BaFin General Administrative Act published on 8 May 2017. It bans the marketing, distribution or sale of CFDs to retail clients that do not exclude additional payment obligations).

<sup>(3)</sup> ES-CNMV for example found that clients usually operate for a short time given the negative results obtained.

<sup>(4)</sup> Section 6 of the Questions and Answers (Q&As) relating to the provision of CFDs and other speculative products to retail investors under MiFID (ESMA-35-36-794) 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, CFDs and rolling spot forex could demonstrate that it is acting honestly, fairly and professionally and in the best interests of its retail clients.

<sup>(5)</sup> For example, FR-AMF, UK-FCA and ES-CNMV.

<sup>(6)</sup> For example, CZ-CNB, FR-AMF, HU-MNB, LU-CSSF and UK-FCA.

<sup>(7)</sup> Section 2 of 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.

**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)**

- (53) As required under Article 40(2)(b) of Regulation (EU) 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 <sup>(1)</sup>. In particular, they include: (i) the requirement to provide appropriate information to clients in Article 24(3) and (4) of Directive 2014/65/EU <sup>(2)</sup>; (ii) the suitability and appropriateness requirements in Article 25(2) and (3) of Directive 2014/65/EU <sup>(3)</sup>; (iii) the best execution requirements in Article 27 of Directive 2014/65/EU <sup>(4)</sup>; (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.
- (54) 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.
- (55) 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 <sup>(5)</sup>. 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.
- (56) 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 CFDs to retail clients.
- (57) 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.
- (58) 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

<sup>(1)</sup> 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).

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

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

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

<sup>(5)</sup> 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.

Delegated Regulation (EU) 2017/653 <sup>(1)</sup> 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 CFDs in particular. For example, the performance ratio only relates to the individual CFD product and this does not provide the client with the overall percentage of retail client accounts that lose money when trading CFDs. Furthermore, the summary risk indicator does not include direct information on the past performance of the product and this information may not be provided in the accompanying narrative explanations as some discretion is left to the PRIIPS manufacturer on the extent to which certain narratives should be included.

- (59) ESMA has considered whether those requirements could address some or all of the concerns in relation to the marketing, distribution or sale of CFDs to retail clients or at least remove the need to introduce the risk warnings in this Decision. However, these requirements do not ensure that retail clients across the Union are provided with uniform and effective information on the risks related to trading in CFDs. In particular, the guidance and warnings referred to in Article 24(4) of Directive 2014/65/EU do not appear to address these concerns given the divergence in the information that may be provided to clients which may not sufficiently draw clients' attention to the concrete consequences arising from trading CFDs. The risk warnings introduced in this Decision would provide retail clients with important information, namely the percentage of retail accounts losing money when trading CFDs with each particular firm. Furthermore, it would harmonise practices in the cross-border business, hence ensuring an equal level of information to investors across the Union.
- (60) 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 CFD 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 CFD 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 CFD trading which mostly occurs via electronic platforms, without the provision of investment advice or portfolio management.
- (61) 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.
- (62) 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 CFD 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. CFDs qualify as complex financial products and therefore are subject to the appropriateness test pursuant to Article 25(3) of Directive 2014/65/EU.

<sup>(1)</sup> 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).

- (63) 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 <sup>(1)</sup>, the appropriateness test has not been sufficient to address the investor protection concern described in this Decision.
- (64) Both the suitability and appropriateness tests under the existing regulatory requirements therefore are unlikely to prevent retail clients from trading CFDs in a way that ensures that the significant investor protection concern is addressed.
- (65) 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.
- (66) 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 CFDs 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.
- (67) In respect of these substantially similar existing regulatory requirements, ESMA has repeatedly noted the risks described above in investor warnings, the Questions and Answers (Q&As) <sup>(2)</sup> and the opinion on 'MiFID practices for firms selling complex products'. ESMA has also carried out supervisory convergence work through, inter alia, the Joint Group and the CFD task force. 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 concern persists. This highlights that, for the reasons set out in this section, these requirements do not address the concern identified.
- (68) 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 CFDs) 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 takes reasonable steps to ensure that the financial instruments are distributed to the identified target market and periodically review the identification of the target market of and the performance of the product. CFD 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, CFD 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

<sup>(1)</sup> For example, the IE-CBI expressed concerns on the criteria used to assess knowledge and experience for the purposes of the assessment following their themed inspection (<https://www.centralbank.ie/news/article/inspection-finds-75-percent-of-cfd-clients-lost-money>). Furthermore, firm data received by the UK-FCA in Q1 2017 from CFD providers shows that, at some of the largest retail CFD providers in the UK (representing approximately 70 % of the relevant UK market), approximately 50 % of clients had failed the appropriateness test but continued to trade after receiving an enhanced risk warning. Furthermore, the UK-FCA has observed repeated failings by firms in relation to the adequacy of their appropriateness assessments and related policies and procedures (see above).

<sup>(2)</sup> 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.

approval process, including the identified target market and the characteristics of the product. CFD 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.

- (69) 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' <sup>(1)</sup> in which guidance is provided to manufacturers and developers for the assessment of the target market.
- (70) Whilst these requirements could narrow down the type of clients (the target market) for which CFDs would be appropriate and to which they should therefore be distributed, they do not address the key risks described in this Decision linked to the product's features (for example high leverage) or associated practices (for example, allowing additional payment obligations or the offer of bonuses). They also do not restrict specifically the distribution of products with the above features to the mass market. Instead, the detriment occurred to clients shows that the marketing, distribution or sale of CFDs is not appropriate for the retail mass market, unless accompanied by certain restrictions which the product governance requirements do not detail. Where respondents to the call for evidence fairly state that the product governance requirements are important aspects in determining the target market and aligning the distribution strategy with this target market, it is also clear from the call for evidence that certain providers indicated in their response that they consider that CFDs with high leverage limits (for example, 100:1 <sup>(2)</sup>) are, even where the product governance requirements are applicable, an appropriate product for retail clients (they conclude that the target market for CFDs with this particular leverage is a mass market). Several firms, after implementation of Directive 2014/65/EU and its product governance requirements, still market CFDs with such high leverages to the mass market (assessing only the appropriateness). ESMA and the NCAs disagree with such an approach. This demonstrates that product governance requirements still give a certain margin of discretion to individual providers to identify the features of products they intend to offer to their clients. There is still, therefore, a lack of a common minimum level of investor protection across the Union.
- (71) Despite the existence of these regulatory requirements, evidence shows that retail clients continue and will continue to lose money on CFDs. 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)**

- (72) 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.
- (73) The investor protection concern described in this Decision have led some NCAs to consult on or take national actions aimed at restricting the marketing, distribution or sale of CFDs 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 CFDs) 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 <sup>(3)</sup>;
  - (ii) since November 2016, CY-CySEC requires CFD providers to establish a leverage policy and apply leverage limits not exceeding 50:1 for retail clients, unless a client, with the relevant knowledge and experience, requires a higher level of leverage <sup>(4)</sup>. CY-CySEC also requires providers to have a negative balance protection per CFD account. Furthermore, since mid-March 2017 there is in place a bonus promotion prohibition <sup>(5)</sup>;

<sup>(1)</sup> ESMA 'Guidelines on MiFID II product governance requirements' of 2 June 2017 (ESMA 35-43-620).

<sup>(2)</sup> For example London Capital Group Ltd, Dom Maklerski TMS Brokers S.A., GKFX Financial Services Limited, AxiCorp Financial Services Pty Ltd, Swissquote and also some confidential responses explicitly referred to a 100:1 leverage.

<sup>(3)</sup> Regulation of the BE-FSMA governing the distribution of certain derivative financial instruments to the clients.

<sup>(4)</sup> CY-CySEC Circular No C168, dated 30 November 2016.

<sup>(5)</sup> CY-CySEC Circular No C168, dated 30 November 2016.

- (iii) since December 2016, in France the legislation sets forth a ban on investment service providers' marketing communications to individuals regarding CFDs not limiting the client's loss per position <sup>(1)</sup>;
- (iv) since July 2015, the PL-KNF requires CFD providers to have leverage limits for CFDs to retail clients not higher than 100:1 <sup>(2)</sup>. In July 2017, the Polish Ministry of Finance released a project of change in the Act on Trading in Financial Instruments in order to set maximum leverage of 25:1 across all asset classes and financial instruments traded by retail clients without CCP settlement <sup>(3)</sup>. Following its wide public consultation between July and November 2017, on 13 December 2017, the Polish Ministry of Finance announced an update to the project with a public consultation open from 13 to 22 December 2017. The new project will introduce two different maximum leverage limits: 100:1 for experienced retail clients (those who concluded at least 40 transactions in the 24 months prior to entering into a new transaction for which a leverage limit is being established) and 50:1 for inexperienced retail clients <sup>(4)</sup>;
- (v) since October 2017, the Malta Financial Services Authority ('MT-MFSA'), the NCA in Malta, has in place an Online Forex Policy requiring providers of CFDs, rolling spot forex and other complex, speculative products to set the following leverage limits: 50:1 for retail clients and 100:1 for retail clients which elect to be treated as professional clients <sup>(5)</sup>;
- (vi) in May 2017, the Bundesanstalt für Finanzdienstleistungsaufsicht ('DE-BaFin'), the German NCA, banned the marketing, distribution or sale of CFDs to retail clients that do not exclude additional payment obligations <sup>(6)</sup>;
- (vii) in March 2017, the ES-CNMV requested entities which market to 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 ES-CNMV's action to promote these products must always contain a warning about the difficulty of understanding the products and the fact that the 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 CFD providers of these requirements, encouraging providers that provide services in Spain to display the same warning <sup>(7)</sup>;
- (viii) on 6 March 2017, the IE-CBI issued a consultation paper which sought views on two main options: (i) the prohibition of the sale or distribution of CFDs to retail clients, or (ii) the implementation of enhanced investor protection measures, including a limitation on leverage and a requirement that retail clients cannot lose more than the amount they had deposited on a per-position basis <sup>(8)</sup>;

<sup>(1)</sup> 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.

<sup>(2)</sup> Available at: <http://prawo.sejm.gov.pl/isap.nsf/DocDetails.xsp?id=WDU20150000073>

<sup>(3)</sup> Available at: <http://legislacja.gov.pl/docs//2/12300403/12445426/12445427/dokument298571.pdf>

<sup>(4)</sup> Available at: <https://legislacja.rcl.gov.pl/docs//2/12300403/12445438/12445439/dokument321489.pdf>

<sup>(5)</sup> MT-MFSA: Requirements for Category 2 or Category 3 Investment Services Firms distributing or intending to distribute CFDs and/or rolling spot forex contracts under the MiFID regime, 3 April 2017; available at: [https://www.mfsa.com.mt/pages/readfile.aspx?f=/files/Announcements/Consultation/2017/20170403\\_Revised%20online%20forex%20policy\\_clean.pdf](https://www.mfsa.com.mt/pages/readfile.aspx?f=/files/Announcements/Consultation/2017/20170403_Revised%20online%20forex%20policy_clean.pdf)

<sup>(6)</sup> The DE-BaFin General Administrative Act was published on 8 May 2017 and CFD providers had to implement the relevant measures by 10 August 2017, the Act is available at: [https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Aufsichtsrecht/Verfuegung/vf\\_170508\\_allgvfg\\_cfd\\_wa.html;jsessionid=BEF7FF8ADA6FF31D076D4DE32FBF8025.2\\_cid290?nn=7846960](https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Aufsichtsrecht/Verfuegung/vf_170508_allgvfg_cfd_wa.html;jsessionid=BEF7FF8ADA6FF31D076D4DE32FBF8025.2_cid290?nn=7846960)

<sup>(7)</sup> 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.

<sup>(8)</sup> Consultation Paper 107 on the Protection of Retail Investors in relation to the Distribution of CFDs.

- (ix) 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 <sup>(1)</sup>; and
- (x) in February 2018, the PT-CMVM 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.
- (74) 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 similar measures in relation to CFDs as proposed by ESMA in the call for evidence. The consultation period is from 26 February 2018 until 26 March 2018 <sup>(2)</sup>.
- (75) Other NCAs have warned retail clients in relation to CFDs. In particular:
- (i) in December 2016, the AT-FMA issued a warning regarding the risks associated with CFDs, rolling spot forex and binary options;
- (ii) in February 2017, IT-CONSOB issued a specific communication to warn Italian retail clients on the risks associated with CFDs <sup>(3)</sup>; and
- (iii) in November 2017, the UK-FCA issued a warning regarding the risks associated with CFDs on cryptocurrencies <sup>(4)</sup>.
- (76) Furthermore, the NO- Finanstilsynet has revoked the authorisation of a CFD provider after an on-site inspection.
- (77) As evidenced above, some actions to tackle investor protection concern arising from the marketing, distribution or sale of CFDs to retail clients have been taken or considered by NCAs in 13 out of 28 Member States. These measures vary significantly and include, inter alia, a ban on the commercialisation of CFDs to retail clients, the introduction of certain leverage limits, marketing restrictions and a requirement to ensure negative balance protection. However, even though these measures have had some effects, the significant investor protection concern persist.
- (78) For example, in France, where one of the strongest measures in the Union was adopted, the FR-AMF confirms that it still has concerns linked to the features of these products and to the continuing offer of these products to retail clients. By way of example, while the FR-AMF has recorded a reduction in the number of complaints in 2017, it still observes a significant number (33 %) <sup>(5)</sup> of complaints in relation to these products, compared to the overall number of complaints it receives in relation to other investment products and services. In Poland, the adoption of measures in July 2015 has not been sufficient to address investor protection concern. As previously mentioned, a study conducted by the PL-KNF in the first quarter of 2018 showed that 79,69 % of clients lost money in 2017 and the average loss per client increased.
- (79) In contrast, in Belgium, the BE-FSMA is satisfied with the result of its action; however, BE-FSMA introduced a ban of the commercialisation of CFDs to retail clients and therefore these products cannot be legally offered to retail clients in Belgium anymore.
- (80) ESMA does not have evidence that a prohibition of, as opposed to restrictions on, the marketing, distribution or sale of CFDs to retail clients at Union level is necessary at this stage. However, given that the individual restrictions applied in the national measures taken so far which featured only some of the elements included in this measure (for example specific leverage limits or marketing restrictions) proved to be insufficient to solve the investor protection concern identified, ESMA considers it necessary to impose each of the requirements in this Decision as a package to achieve a minimum level of protection of retail clients across the Union.

<sup>(1)</sup> HCMC Circular No 56/10.5.2017.

<sup>(2)</sup> Available at: <https://www.finanstilsynet.no/contentassets/455795d40fe4445f88a3b71b35079c94/horningsnotat—produktintervensjon.pdf>

<sup>(3)</sup> The CONSOB Communication was published on 13 February 2017 in the CONSOB newsletter, available at: (Italian version) <http://www.consob.it/web/area-pubblica/avvisi-ai-risparmiatori/documenti/tutela/cns/2017/ct20170207.html>; (English version) [http://www.consob.it/web/consob-and-its-activities/newsletter/documenti/english/en\\_newsletter/2017/year\\_23\\_n-05\\_13\\_february\\_2017.html#news2](http://www.consob.it/web/consob-and-its-activities/newsletter/documenti/english/en_newsletter/2017/year_23_n-05_13_february_2017.html#news2)

<sup>(4)</sup> Available at: <https://www.fca.org.uk/news/news-stories/consumer-warning-about-risks-investing-cryptocurrency-cfds>

<sup>(5)</sup> 33 % of all complaints received by the AMF in 2017 relate to CFDs and binary options.

- (81) Furthermore, CFDs are commonly marketed, distributed or sold through online trading accounts. Therefore, a national ban or restriction is inadequate to protect retail clients in Member States other than the Member State in which the measure is taken when CFD providers operate in other Member States. As evidenced by data gathered by the UK-FCA and the CY-CySEC <sup>(1)</sup>, CFD providers have been able to reach out to new clients across the Union easily and quickly by operating online. As a further example confirming the persisting EU dimension of business in this area, IT-CONSOB reported to ESMA that all complaints it received on CFDs and binary options in the time period from September 2017 to February 2018 entirely concerned CFD providers operating in Italy from five different Member States by virtue of the freedom to provide investment services or activities or the right to establish a branch in other Member States <sup>(2)</sup>.
- (82) 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 concern 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.
- (83) 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 concern. 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. By addressing on a Union basis the risks arising from the offer of CFDs 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 to the providers' business model. 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 CFDs, the fact that they affect more than one Member State, the spread of the distribution of CFDs in new jurisdictions, and the proliferation of different national measures to address similar investor protection concern (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)**

- (84) Taking into account the size and nature of the significant investor protection concern identified, ESMA considers it necessary and proportionate to temporarily restrict the marketing, distribution or sale of CFDs to retail clients to circumstances where a number of conditions are met.
- (85) ESMA's restriction addresses the significant investor protection concern identified by affording an appropriate and uniform level of minimum protection to retail clients trading CFDs in the Union. Furthermore, it does not have a detrimental effect on the efficiency of financial markets or on investors that is disproportionate to its benefits.
- (86) The main benefits linked to ESMA's temporary intervention measures are the following:
- (i) reduction of the mis-selling risk of CFDs and its related financial consequences. This is a major benefit for retail clients and for the financial markets as a whole;

<sup>(1)</sup> In the UK and Cyprus, where most CFD providers are established, the CY-CySEC and the UK-FCA have reported an increase in the number of providers specialising in the sale of CFDs to retail clients on a cross-border basis from 103 to 138 providers and from 117 to 143 providers respectively between 2016 and 2017.

<sup>(2)</sup> Articles 34 and 35 of Directive 2014/65/EU.

- (ii) reduction of risks linked to regulatory or supervisory arbitrage across different entities and jurisdictions;
  - (iii) restoring investors' confidence in financial markets including confidence in providers active in this sector which may have suffered from reputational damage arising from problems encountered by investors.
- (87) ESMA believes that potential financial consequences and costs that providers will face when implementing the intervention measures in this Decision are likely to be of both a one-off and ongoing nature linked, inter alia, to:
- (i) initial and ongoing IT costs;
  - (ii) the update/review of the existing procedural and organisational arrangements;
  - (iii) relevant HR costs linked to the implementation of ESMA's intervention measures (including compliance function staff and staff providing relevant investment services or information about the products);
  - (iv) the potential review and update of existing contracts (repapering); and
  - (v) reduced sales volumes of products covered by ESMA's intervention measures.
- (88) It is possible that some of these costs will be passed on to investors.
- (89) Further reference to the expected impact of the intervention measures is set out below.

#### 5.1. Initial margin protection

- (90) ESMA considers it necessary to restrict the marketing, distribution or sale of CFDs to retail clients by the application of certain specific leverage limits depending on the nature of the underlying.
- (91) The introduction of these leverage limits will protect clients by requiring them to pay a minimum initial margin in order to enter into a CFD. This requirement is known as 'initial margin protection'. This will limit the client's notional investment exposure in relation to the amount of money invested. As the costs a client faces are increasing in notional investment exposure, initial margin protection will reduce the probability of client losses compared to those that would be expected if the client were to trade at higher leverage <sup>(1)</sup>. As further explained below, empirical academic research corroborates this analysis and establishes that leverage limits improve average outcomes for investors <sup>(2)</sup>.
- (92) In coming to its conclusion, ESMA has taken into account the responses from its call for evidence. The responses from providers, trade organisations and other interested entities to the call for evidence were, with some exceptions, generally negative on the proposed leverage limits. The main impact on providers of imposing leverage limits as proposed was an expected decrease of revenues. However, many of them indicated that they — in general — did not oppose leverage limits as an intervention measure, but disagreed with the specific limits proposed.
- (93) The consumer representatives were generally positive towards the proposed measures on CFDs, including the leverage limits proposed by ESMA. In almost half of the responses from consumer representatives, however, it was proposed to go beyond the measures proposed by ESMA, by adopting stricter measures such as stricter leverage limits or a full ban on the marketing, distribution or sale of CFDs to retail clients.
- (94) The large majority of responses from individuals expressed a generic, often very short, approval or disapproval of the proposed measures and only a very limited number qualified their comments in a more substantial way. A vast majority of these individuals were negative towards the proposed leverage limits. Among the few individuals supporting ESMA's proposed measures on CFDs, some mentioned that they believe retail clients require a further layer of protection when trading these instruments. Some of them referred to the amount of losses arising from CFDs trading or complained about the aggressive behaviour carried out by some firms. In some instances, the investors claimed that they have been victims of fraud.

<sup>(1)</sup> The higher the leverage, the more likely client losses are because spreads and fees make up a larger proportion of the initial margin. Higher leverage also makes it more likely that a client will lose a given percentage of the margin, increasing the risk of material detriment to the investor.

<sup>(2)</sup> *Should Retail Investors' Leverage Be Limited?* Rawley Z. Heimer and Alp Simsek. NBER Working Paper No 24176, issued in December 2017 and available at: [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2150980](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2150980)

- (95) Some respondents to the call for evidence indicated that they would appreciate further fine-tuning of the categories used for the initial margin protection. One respondent indicated several specific underlyings for reclassification due to its volatility. Following further quantitative analysis, ESMA has reassigned the EuroSTOXX50 to the asset class of major indices. Also the NASDAQ-100 is added to the asset class of major indices.
- (96) Existing research indicates that lower leverage is associated with improved client outcomes, including lower losses per trade and lower total transaction fees as a function of lower volumes of trading <sup>(1)</sup>.
- (97) In particular, detailed research by Rawley Z. Heimer and Alp Simsek, comparing client outcomes before and after the application of leverage limits in the US market concludes that leverage limits improved outcomes for the highest-leveraged clients by 18 percentage points per month and alleviated their losses by 40 % <sup>(2)</sup>. This in-depth academic study demonstrates a positive relationship between lower leverage and lower trading volumes, which contributed to improved outcomes for consumers.
- (98) ESMA has not received during the call for evidence any quantitative data evidencing that introducing initial margin protection results in lower returns on investment for retail clients.
- (99) In addition, requiring minimum initial margin will address some of the distribution risks relating to CFDs by ensuring that only retail clients who are capable of posting sufficiently high margin can trade in these products <sup>(3)</sup>.
- (100) Relatedly, the initial margin protection is also expected to lower the likelihood that CFD providers target a mass retail client through smaller account sizes, supported by higher leverage. It will likely encourage firms to focus on sophisticated retail clients and professional clients, rather than 'churning' less sophisticated retail clients. The proposed initial margin protection will therefore help ensure that CFD providers act on terms that are in the best interests of their clients instead of seeking to attract new clients or to expand market share through higher levels of leverage.
- (101) The initial margin protection will also help address the risk of potential conflicts of interest particularly when CFD providers do not hedge their clients' trades and so benefit directly from client losses, by reducing the risk of firms profiting from losing client trades and expected profits from trading. It reflects a common investor protection approach taken by a number of other international jurisdictions <sup>(4)</sup>.
- (102) The initial margin protection for each underlying has been set according to the volatility of that underlying using a simulation model to assess the likelihood of a client losing 50 % of their initial investment over an appropriate holding period <sup>(5)</sup>. Specifically, ESMA undertook a quantitative simulation of the distribution of returns an investor in a single CFD might expect to receive at different leverage levels. The starting point of the simulation was approximately 10 years of daily market price data (in most cases) for various underlying types commonly used in CFDs sold to retail clients <sup>(6)</sup>. For the purpose of the analysis, ESMA considered a CFD that is automatically closed out if the margin reaches 50 % of its initial value. The simulated probability with which close-out occurs depends on (and is increasing in) the given leverage. A metric examined was the probability of (automatic) close-out as a function of leverage. This metric allows for leverage limits to be set according to a model that is expected to address detriment on a consistent basis across different underlying types.

<sup>(1)</sup> See, Heimer, Rawley, and Simsek, Alp, *Should Retail Investors' Leverage Be Limited?* NBER Working Paper No 24176, issued in December 2017 and available at: [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2150980](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2150980)

<sup>(2)</sup> *Should Retail Investors' Leverage Be Limited?* Rawley Z. Heimer and Alp Simsek. NBER Working Paper No 24176, issued in December 2017 and available at: [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2150980](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2150980)

<sup>(3)</sup> As such, initial margin protection should also reduce the extent to which these products are distributed to particularly vulnerable investors, such as low income groups of clients.

<sup>(4)</sup> Leverage limits are for instance in force in the US, Japan, Hong Kong and Singapore. Leverage limits and minimum margin requirements are also included in IOSCO's Consultation Paper dated February 2018 available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD592.pdf>

<sup>(5)</sup> A similar analytical framework was used by the FCA in its consultation published in December 2016. Available at: <https://www.fca.org.uk/publication/consultation/cp16-40.pdf>

<sup>(6)</sup> In most cases, approximately 10 years of data were used. The exception was for some equities, for which price data was only available for the period starting at the relevant initial public offering and cryptocurrencies.

- (103) ESMA considered that, given the retail nature of investors and statistics on the distributions of CFD holding periods (using data collected by NCAs) it was appropriate to set initial margin protection by assuming retail clients hold an asset for at least 1 day. To provide a consistent reference point, ESMA then simulated what leverage would lead to margin close-out with a 5 % probability, for different underlying assets. The range of results within each asset class then informed the selection of leverage limits. In most cases, the limits were set conservatively towards the lower end of the range. Consideration was given to how widely traded different assets are. For example, among CFDs on commodities, oil and gold are both commonly traded by retail clients, but simulations indicate that the leverage implying a 5 % probability of margin close-out for CFDs in gold is around twice that of CFDs in oil. The leverage limit for CFDs in gold is accordingly different to that for those in oil and other commodities. Determining initial margin protection in this way, in particular through simulated positions lasting at least 1 day, provides a consistent and necessary level of protection for retail clients who may not actively monitor their position over the course of a trading day or may not be able to assess the need for quick reactions in light of the volatility of the underlying market. In the case of CFDs on equities, data suggest that holdings are typically longer than for other assets, and consideration was given to holding periods of up to 5 days.
- (104) ESMA considered alternative approaches to the calibration of the initial margin protection. For example, an alternative would be to set a single leverage limit for all CFDs irrespective of their underlying. However, ESMA considered it appropriate to distinguish between different underlying types given differences in historic price volatility between different classes of underlying, in addition to differences in typical fee structures within the current CFD firm population <sup>(1)</sup> and typical client behaviour.
- (105) While implementing the initial margin protection will imply certain costs for those CFD providers that would need to adjust the leverage limits currently made available to retail clients, ESMA expects these costs will not be disproportionate to the benefits of introducing such a protection. ESMA also notes that it is already standard practice for CFD providers routinely to modify the leverage offered to their clients based on the changing risk profile of certain assets.

## 5.2. Margin close-out protection

- (106) Another measure to protect retail clients is the margin close-out protection. This measure complements the introduction of initial margin protection and mitigates the risk of retail clients losing significant funds in excess of the funds they have invested in a CFD, under normal market circumstances.
- (107) The provision of a margin close-out protection and the standardisation of the percentage at which CFD providers are required to close-out a client's open CFD (at 50 % of the initial required margin) is also designed to address the inconsistent application of margin close-out practices by CFD providers. Some NCAs have observed that CFD providers allow their clients' funds to fall to 0 – 30 % of the initial margin required to open a CFD <sup>(2)</sup>. By allowing clients to erode their margin close to zero, providers are placing clients at risk of losing more than their deposited funds particularly during a gapping event. Conversely, a too high level of margin close-out would expose clients to be frequently closed out which might not be in their interest. The 50 % threshold set out in ESMA's measure mitigates the risk of substantial loss by retail clients and is therefore proportionate.

<sup>(1)</sup> The cost assumptions used were based on cost data from CFD providers. The cost assumptions were varied as part of robustness checks, which did not lead to material changes in the results. This does not indicate that spreads, fees and charges are not a source of material detriment in general, especially at high leverage. Indeed, these costs are a key reason that a majority of retail clients lose money and a source of substantial losses for clients who trade many positions frequently. Rather, the robustness checks simply indicate that typical spreads, fees and charges do not make close-out substantially more likely under the assumptions used. In the modelling exercise a single CFD position was simulated in all cases.

<sup>(2)</sup> See recital 26.

- (108) In the call for evidence, ESMA described a margin close-out protection per individual position. Such approach was intended to address a number of concerns about the application of this measure on an CFD trading account basis in the current market. In particular, as initial margin protection is being applied based on the underlying of the CFD, applying a margin close-out rule on a per position basis would ensure the effective application of the initial margin protection for each underlying class and ensure a hard cap on leverage available per underlying class. Another reason for such an approach was the intention to help ensure that retail clients are aware and understand their exposure to each individual underlying. ESMA originally proposed the application of a margin close-out rule at 50 % of initial margin on a per position basis to provide an effective protection for retail clients while also reducing the complexity of the product, and with improving retail clients' understanding of their exposure.
- (109) ESMA has taken into account the responses provided to its call for evidence. A vast majority of the providers, brokers and trade organisations that responded to the call for evidence listed their concerns about a margin close-out rule on a per position basis. Regarding impacts on firms, key points raised were the prospect of significant IT implementation costs and ongoing monitoring costs. Many responses from firms also flagged concerns in relation to existing clients who are familiar with close-out per account. Additionally, respondents highlighted that investors that apply specific trading strategies would no longer be able to use these strategies effectively, as individual positions could be closed at a certain moment if clients do not top up their margins for the specific position, therefore resulting in unanticipated market exposure on the remaining positions. Another argument identifying potential negative consequences of margin close-out on a per position basis was that due to the closure of positions, clients would be required to re-open positions which could lead to higher costs of trading.
- (110) Similar concerns with regard to negative consequences for investors of margin close-out on a per position basis were mentioned by a substantial part of the responses from individual investors to the call for evidence. The most frequent arguments were that a per position rule would inhibit the use of certain trading strategies, and would require investors to continuously monitor their positions as they could no longer rely on certain hedges they placed.
- (111) Most consumer representatives were in favour of the proposed measures or even proposed considerably more restrictive measures in relation to CFDs (such as a full ban of the marketing, distribution or sale of these financial instruments to retail clients).
- (112) There were also responses from firms in the call for evidence that were in favour of the per position margin close-out rule proposed in the call for evidence. These firms indicated that they already apply such an approach and are content with the outcomes of it.
- (113) ESMA conducted analysis on expected investor outcomes according to whether a margin close-out rule was applied per position (a CFD will be closed out when its value falls below 50 % of the value of the initial margin) or per CFD trading account (a CFD will be closed out when the value of all open CFDs connected with the trading account together with all funds in that account falls below 50 % of the value of the total initial margin for all those open CFDs). In particular, it assessed the frequency of close-out and the impact of crystallising clients losses for a simulated portfolio of CFD positions under each scenario. This analysis did not estimate precise numerical outcomes, reflecting that there is an extremely large range of different potential portfolios that an investor could hold. Instead, the analysis considered whether either of the two bases would be expected in general to lead to better outcomes for investors. The general conclusion was that the better investor outcome for a position or account basis of margin close-out depends on the price movements of the underlyings of the CFDs in investment portfolios. The reason for this is that following a close-out which would happen on one basis but not the other, the price of an underlying may recover or may deteriorate.
- (114) In general, close-out would be expected to happen slightly more frequently under a position basis, assuming an investor's portfolio were the same in each case. However, close-out is expected to be rare under either basis, due to the initial margin protection. For clients with one single position in their CFD trading account, there would not be any difference between the account basis and the position basis. From the call for evidence, it is clear that there are many retail CFD trading accounts that include just one position.

- (115) While the difference in outcomes resulting from the per position basis versus the per account basis is expected to be small for many investors (but cannot be precisely quantified in the absence of a representative portfolio), the call for evidence responses highlighted additional reasons why an account basis may be better for some investors. Firstly, in allowing gains from one position to offset losses from another, an account basis supports a diverse portfolio of investments. Secondly, to the extent close-out happens less frequently on an account basis, it reduces the scope for investors to bear costs arising from re-entering positions.
- (116) Taking into consideration the above analysis and the responses from the call for evidence, ESMA considers a standardised margin close-out rule per account basis at 50 % of the total initial margin protection, as an individual measure to take in addition to the other measures described in this Decision, is more proportionate as a minimum protection to be applied. In particular, this rule should provide for close-out of one or more CFDs on terms most favourable to the retail client to ensure that the value of the account does not fall lower than 50 % of the total initial margin protection that was paid to enter into all currently open CFDs at any point in time. The value of the account for these purposes should be determined by the funds in that account together with any unrealised net profits from open CFDs connected to that account.
- (117) The margin close-out protection proposed by ESMA does not prevent a provider from applying a per position close-out rule at 50 % of the initial margin requirement of the specific position instead of a per account close-out rule; indeed this could reduce the complexity for retail clients. Furthermore, by applying a per position close-out rule at 50 %, the provider inherently fulfils the close-out requirement on a per account basis as all the single positions will be closed in accordance with the 50 % close-out rule.

### 5.3. Negative balance protection

- (118) The negative balance protection aims at protecting retail clients in exceptional circumstances where there is a price change in the underlying that is sufficiently large and sudden to prevent the CFD provider from closing out the position as required by the margin close-out protection, such that the client has a negative account value. In other words, large market events can cause gapping, preventing the automatic margin close-out protection from being effective. A number of NCAs <sup>(1)</sup> have observed that, following such events, clients have owed considerably more than they invested, ending up with a negative balance on their CFD trading account.
- (119) The purpose of a negative balance protection is to ensure that an investor's maximum losses from trading CFDs, including all related costs, are limited to the total funds related to trading CFDs that are in the investor's CFD trading account. This should include any funds yet to be paid into that account due to net profits from the closure of open CFDs connected to that account. An investor should not incur any additional liability connected with its trading of CFDs. Other accounts should not be part of the investor's capital at risk. In case a trading account also includes other financial instruments (for example, UCITS or shares), only the funds explicitly dedicated to CFD trading, and not those dedicated to other financial instruments, are at risk.
- (120) The purpose of the negative balance protection is also to provide a 'backstop' in case of extreme market conditions. ESMA conducted analysis of the Swiss franc event in January 2015 to consider its direct impact on investors across a number of scenarios <sup>(2)</sup>. These scenarios were the following:
- (i) protection against any negative balance on a CFD trading account held by a retail client;
  - (ii) protection against any negative balance on each CFD position held by a retail client; and
  - (iii) no negative balance protection.

<sup>(1)</sup> For example, DE-BaFin stated that some investors lost more money than they invested due to the decision of the Swiss National Bank to no longer peg the Swiss Franc to the Euro. Available at: [https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Aufsichtsrecht/Verfuegung/vf\\_170508\\_allgvgf\\_cfd\\_wa\\_en.html](https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Aufsichtsrecht/Verfuegung/vf_170508_allgvgf_cfd_wa_en.html)

<sup>(2)</sup> 'Swiss franc event' refers to the sudden appreciation in the Swiss franc against the euro, of the order of 15 %, on the morning of Thursday, 15 January 2015.

- (121) In assessing these options, ESMA noted that the direct impact on investors resulting from the different options in the case of extreme market events needed to be weighed against the resulting ongoing costs of providing this protection. In particular, CFD providers would face ongoing costs attributable to additional capital or hedging, as part of their risk management. Some portion of these costs could in turn be passed through to investors themselves in the form of higher spreads or other charges.
- (122) On the other hand, an important risk of major consumer detriment that arises in the absence of negative balance protection is the potential for an investor to owe money to a firm as a result of extreme market conditions. Such a situation is especially detrimental for investors without considerable liquid wealth<sup>(1)</sup>. ESMA decided to adopt negative balance protection per CFD trading account as the way to address this source of potential major detriment while minimising associated costs to firms and investors. In particular, ESMA considered that the imposition of a negative balance protection per each CFD would have risked imposing disproportionate costs on investors and firms. If a negative balance protection per position were introduced, firms would be required to forgive any losses by the client in excess of the funds dedicated to that position, including initial margin and any additional margin paid by the client. As negative balance protection would not enable the netting of a significant loss with other positions in a client's portfolio, a per position rule would increase the market risk assumed by firms. This would likely result in an increase of the capital requirements for firms, the costs of which would likely be passed on to retail clients.
- (123) Regarding the proposal on negative balance protection, a majority of the providers, brokers and trade organisations expressed a positive view. Some providers asked for further clarification of this rule. The concerns flagged were related to the impact of the measures on firms' capital requirements and the possibility that clients could use this to speculate against the providers by entering two opposite positions with the same broker on different accounts. The consumer representatives were positive towards the proposed measures, including negative balance protection. In general, the individuals that responded to the call for evidence and explicitly referred in their response to the proposals on a negative balance protection were positive on these proposals.
- (124) ESMA has considered the effects on CFD providers for providing negative balance protection as well as the substantial detriment to retail clients, which can arise without this protection. ESMA considers that, on balance, negative balance protection on an account basis addresses the investor protection concern identified and is proportionate.

#### 5.4. Risk warnings

- (125) Another measure to address risks to retail clients in relation to CFDs is to require the provision of standardised and effective firm specific risk warnings including information on the percentage of retail client accounts' losses. As previously noted, several NCAs have noted the low quality of risk warnings provided to clients and have reported on CFD providers often failing to clearly set out the high-risk and complex nature of the products. In particular, risk warnings often do not clearly explain the potential for rapid losses that could exceed the money invested by clients, or the messages are diluted by the way warnings are presented or by statements about potential profits.
- (126) In their responses to the call for evidence, only a minority of the providers and brokers opposed introducing a standardised risk warning. Some firms flagged that they appreciate a firm-specific loss percentage instead of a more standardised warning. The consumer representatives were mixed as almost half of the responses indicated that they were in favour of more strict measures on CFDs (for example a ban). The consumer representatives that explicitly mentioned the risk warning in their response were positive on the proposal, as long it is considered in combination with the other proposed measures.

<sup>(1)</sup> The detriment caused in such a situation was evident in relation to the Swiss franc crash, where some investors unwittingly became liable for tens of thousands of euros, sums they were unable to pay.

- (127) The firm specific risk warnings introduced in this Decision would provide retail clients with essential information about these particular products, namely the percentage of retail accounts losing money when trading CFDs. A study found that a standardised risk warning significantly improved a retail client's understanding of the product, including the possibility of losing more money than they invested and the likelihood of making a profit <sup>(1)</sup>.
- (128) A requirement for CFD providers to state the percentage of retail client accounts that are at a loss is designed to offset the tendency of CFD providers to highlight the potential profits over losses.
- (129) Furthermore, the warnings are expected to support retail clients in making an informed decision about whether they wish to proceed with a high risk product that is more likely to result in a loss than a gain.
- (130) In order to warn investors of the risk of losses related to investing in CFDs, ESMA considers that each CFD provider should inform their clients of the percentage of its CFD trading accounts of retail clients that lost money over the last 12 month period. To ensure the figure is kept up-to-date, this calculation should be updated on a quarterly basis. The percentage shown should be presented in a simple and clear manner as part of a risk warning in every communication of the provider.
- (131) In order to determine whether an account lost money, both the realised and unrealised profits or losses have to be taken into account. Realised profits and losses relate to the CFD positions that were closed during the calculation period. Unrealised profits and losses relate to the value of open positions at the end of the calculation period. In order to provide a complete picture of the percentage of accounts that resulted in a profit or loss all costs in relation to the trading of CFDs should be taken into account in the calculation.
- (132) For newly established CFD providers and CFD providers that have not had any open CFD positions in the past 12 months, it is not possible to calculate such a percentage over the last 12 months. This Decision prescribes for these firms a standardised risk warning in which reference is made to the percentages found by NCAs in their existing studies.
- (133) As mentioned above, almost all providers that responded to the call for evidence supported or were neutral towards a standardised risk warning. The respondents who were negative either questioned the effectiveness of a risk warning or disagreed with the percentages found by NCA studies. A frequently made comment is that firms requested a more condensed version of the risk warning which could be used for digital marketing by the firms.
- (134) ESMA has considered the possibility of requiring a generic risk warning stating only the risk that retail clients may lose money rapidly due to the leverage of CFDs or a more specific risk warning based on average losses for retail clients based on the studies of NCAs. The former option has been discarded because it did not effectively draw retail clients' attention to the actual risk, specific to CFDs trading. The latter option has been discarded because these studies do not reflect any specificities (for example a firm offering only certain types of CFDs). Although firm specific calculations may be more burdensome for providers than a generic risk warning, in line with feedback from the call for evidence, ESMA believes they are necessary to properly warn investors of the risk of losses.
- (135) One risk ESMA and NCAs acknowledge of the firm-specific loss percentages is that these percentages will be used for marketing instead of the original purpose, being the risk warning. For these reasons NCAs should monitor that investment firms will not use the firm-specific percentages in an inappropriate manner and will review the application of this measure.

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<sup>(1)</sup> In particular, prior to being presented with the standardised risk warning, 66 % of participants in the study accurately stated that CFDs are riskier than savings accounts, bonds, and tracker funds, 50 % accurately stated that could lose more money than you invested in CFDs, and 54 % accurately said that most clients lose money using these products. After being presented with the standardised risk warning on the firm's webpage, the study found that 90 % of participants accurately described the risk profile of CFDs (that is that they are risky than the above described assets). For clients who inaccurately said that all investors make money, the probability of a client responding accurately (by stating that most investors lose money) was 91,5 %. This indicates that standardised risk warnings, including the disclosure of client account performance, can significantly improve a client's understanding of the product. From Mullett, T.L. & Stewart, N. (2017) The effect of risk warning content for contract for difference products. *Working Paper*. This work was funded by a public research grant but was developed in consultation with the UK-FCA.

- (136) In line with feedback from the call for evidence, ESMA considers a more proportionate approach would also adapt the risk warning to the type of communication channels used. For this reason, an abbreviated risk warning for communications through a non-durable medium, such as mobile applications or social media posts, is prescribed in this Decision.

#### 5.5. The prohibition of monetary and non-monetary benefits

- (137) A final measure to address risks relating to the distribution of CFDs to retail clients is a ban on monetary (for example so called 'trading bonuses') and certain types of non-monetary benefits. Financial promotions offering bonuses or other incentives to trade CFDs often distract retail clients from the high-risk nature of CFD products. They draw in retail clients who may not otherwise choose to invest in these products. Such benefits are often contingent on clients depositing money on the account or on executing a certain volume of trades.
- (138) ESMA's prohibition of benefits however does not capture information and research tools provided to retail clients insofar as they relate to CFDs (excluded non-monetary benefits), as these would help clients' decision-making.
- (139) A majority of the responses from providers, trade organisations and brokers were in favour of the measures in relation to incentivisation of clients. Also the consumer representatives that explicitly referred to these measures were positive. Considering the risks posed to retail clients of these benefits, ESMA considers it is necessary and proportionate to restrict them.

#### 5.6. Overall proportionality

- (140) 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<sup>(1)</sup>. In February 2014, ESMA issued an opinion on 'MiFID practices for firms selling complex products'<sup>(2)</sup> and, in March 2014, it issued an opinion on 'Structured Retail Products — Good practices for product governance arrangements'<sup>(3)</sup>. Furthermore, as of March 2007, guidance setting out product governance principles is in place in the UK<sup>(4)</sup>.
- (141) Despite these supervisory principles and the regulatory requirements described in this Decision, the detriment in relation to the marketing, distribution or sale of CFDs to retail clients had continued to develop over the past years.
- (142) ESMA's overall measure is necessary and proportionate to address the investor protection concern identified. In general, it is expected that it will reduce abnormal and significant losses experienced by retail clients on CFDs as well as enhance retail clients' awareness of the risks related to these products. The benefits gained from addressing the investor protection concern identified in the way proposed outweigh the potential consequences for CFD providers, including through implementation costs associated with complying with these requirements and a potential reduction in CFD providers' revenues (through lower volumes of trading, lower total transaction fees paid by clients and lower client losses).
- (143) Additionally, ESMA's measure will apply from 2 months after publication of this Decision in the *Official Journal of the European Union* (OJEU). This implies a notice period of 2 months after official publication which aims at balancing retail clients' interest to an immediate reduction of the detriment arising from the current trading of CFDs and the need to allow sufficient time to relevant market participants to organise and change their business models in an orderly manner.

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

<sup>(2)</sup> Opinion on 'MiFID practices for firms selling complex products' (ESMA/2014/146. This opinion specifically included references to CFDs and binary options.

<sup>(3)</sup> Opinion on 'Structured Retail Products — Good practices for product governance arrangements' (ESMA/2014/332).

<sup>(4)</sup> 'The Responsibilities of Providers and Distributors for the Fair Treatment of Customers' [https://www.handbook.fca.org.uk/handbook/document/RPPD\\_FCA\\_20130401.pdf](https://www.handbook.fca.org.uk/handbook/document/RPPD_FCA_20130401.pdf). The guidance is linked to the UK's Principles for Businesses (PRIN) [https://www.handbook.fca.org.uk/handbook/document/rppd/RPPD\\_Full\\_20180103.pdf](https://www.handbook.fca.org.uk/handbook/document/rppd/RPPD_Full_20180103.pdf)

- (144) This Decision lays down common requirements which aim to provide a necessary minimum level of protection to retail clients across the Union, in addition to existing requirements. It is not intended to prevent NCAs or CFD providers from ensuring a greater level of investor protection, for example, by applying higher initial margins requirements.

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

- (145) 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 CFDs could try to offer products with comparable features such as options, futures, swaps and forward rate agreements. Respondents to the call for evidence confirmed that there are similarities between CFDs and these products. Therefore, while ESMA's evidence primarily relates to trading in CFDs, 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 CFD providers to circumvent these intervention measures and will act as necessary.
- (146) In addition, ESMA's temporary intervention measures apply to all providers of CFDs 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 <sup>(1)</sup>, 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 CFDs.

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

- (147) 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 <sup>(2)</sup>. 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.
- (148) ESMA has notified NCAs of this proposed Decision,

HAS ADOPTED THIS DECISION:

#### *Article 1*

#### **Definitions**

For the purposes of this Decision:

- (a) 'contract for differences' or 'CFD' means 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;

<sup>(1)</sup> 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).

<sup>(2)</sup> 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).

- (b) 'excluded non-monetary benefit' means any non-monetary benefit other than, insofar as they relate to CFDs, information and research tools;
- (c) 'initial margin' means any payment for the purpose of entering into a CFD, excluding commission, transaction fees and any other related costs;
- (d) 'initial margin protection' means the initial margin determined by Annex I;
- (e) 'margin close-out protection' means the closure of one or more of a retail client's open CFDs on terms most favourable to the client in accordance with Articles 24 and 27 of Directive 2014/65/EU when the sum of funds in the CFD trading account and the unrealised net profits of all open CFDs connected to that account falls to less than half of the total initial margin protection for all those open CFDs;
- (f) 'negative balance protection' means the limit of a retail client's aggregate liability for all CFDs connected to a CFD trading account with a CFD provider to the funds in that CFD trading account.

#### Article 2

##### **Temporary restriction on CFDs in respect of retail clients**

The marketing, distribution or sale to retail clients of CFDs is restricted to circumstances where at least all of the following conditions are met:

- (a) the CFD provider requires the retail client to pay the initial margin protection;
- (b) the CFD provider provides the retail client with the margin close-out protection;
- (c) the CFD provider provides the retail client with the negative balance protection;
- (d) the CFD provider does not directly or indirectly provide the retail client with a payment, monetary or excluded non-monetary benefit in relation to the marketing, distribution or sale of a CFD, other than the realised profits on any CFD provided; and
- (e) the CFD provider does not send directly or indirectly a communication to or publish information accessible by a retail client relating to the marketing, distribution or sale of a CFD unless it includes the appropriate risk warning specified by and complying with the conditions in Annex II.

#### Article 3

##### **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 2, including by acting as a substitute for the CFD provider.

#### Article 4

##### **Entry into force and application**

This Decision enters into force on the day following that of its publication in the *Official Journal of the European Union*.

This Decision shall apply from 1 August, 2018 for a period of 3 months.

Done at Paris, 22 May 2018.

*For the Board of Supervisors*

Steven MAIJOOR

*The Chair*

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## ANNEX I

## INITIAL MARGIN PERCENTAGES BY TYPE OF UNDERLYING

- (a) 3,33 % of the notional value of the *CFD* when the underlying currency pair is composed of any two of the following currencies: US dollar, Euro, Japanese yen, Pound sterling, Canadian dollar or Swiss franc;
  - (b) 5 % of the notional value of the *CFD* when the underlying index, currency pair or commodity is:
    - (i) 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), NASDAQ 100 Index (NASDAQ 100); Nikkei Index (Nikkei 225); Standard & Poors / Australian Securities Exchange 200 (ASX 200); EURO STOXX 50 Index (EURO STOXX 50);
    - (ii) a currency pair composed of at least one currency that is not listed in point (a) above; or
    - (iii) gold;
  - (c) 10 % of the notional value of the *CFD* when the underlying commodity or equity index is a commodity or any equity index other than those listed in point (b) above;
  - (d) 50 % of the notional value of the *CFD* when the underlying is a cryptocurrency; or
  - (e) 20 % of the notional value of the *CFD* when the underlying is:
    - (i) a share; or
    - (ii) not otherwise listed in this Annex.
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## ANNEX II

## RISK WARNINGS

## SECTION A

**Risk warning conditions**

1. The risk warning shall be in a layout ensuring its prominence, in a font size at least equal to the predominant font size and in the same language as that used in the communication or published information.
2. If the communication or published information is in a durable medium or a webpage, the risk warning shall be in the format specified in Section B.
3. If the communication or information is in a medium other than a durable medium or a webpage, the risk warning shall be in the format specified in Section C.
4. The risk warning shall include an up-to-date provider-specific loss percentage based on a calculation of the percentage of *CFD* trading accounts provided to retail clients by the *CFD* provider that lost money. The calculation shall be performed every 3 months and cover the 12-month period preceding the date on which it is performed ('12-month calculation period'). For the purposes of the calculation:
  - (a) an individual retail client *CFD* trading account shall be considered to have lost money if the sum of all realised and unrealised net profits on *CFDs* connected to the *CFD* trading account during the 12-month calculation period is negative;
  - (b) any costs relating to the *CFDs* connected to the *CFD* trading account shall be included in the calculation, including all charges, fees and commissions;
  - (c) the following items shall be excluded from the calculation:
    - (i) any *CFD* trading account that did not have an open *CFD* connected to it within the calculation period;
    - (ii) any profits or losses from products other than *CFDs* connected to the *CFD* trading account;
    - (iii) any deposits or withdrawals of funds from the *CFD* trading account.
5. By way of derogation from paragraphs 2 to 4, if in the last 12-month calculation period a *CFD* provider has not provided an open *CFD* connected to a retail client *CFD* trading account, that *CFD* provider shall use the standard risk warning specified in Sections D and E, as appropriate.

## SECTION B

**Durable medium and webpage provider-specific risk warning**

*CFDs* are complex instruments and come with a high risk of losing money rapidly due to leverage.

**[insert percentage per provider] % of retail investor accounts lose money when trading *CFDs* with this provider.**

You should consider whether you understand how *CFDs* work and whether you can afford to take the high risk of losing your money.

## SECTION C

**Abbreviated provider-specific risk warning**

**[insert percentage per provider] % of retail investor accounts lose money when trading *CFDs* with this provider.**

You should consider whether you can afford to take the high risk of losing your money.

## SECTION D

**Durable medium and webpage standard risk warning**

CFDs are complex instruments and come with a high risk of losing money rapidly due to leverage.

**Between 74-89 % of retail investor accounts lose money when trading CFDs.**

You should consider whether you understand how CFDs work and whether you can afford to take the high risk of losing your money.

## SECTION E

**Abbreviated standard risk warning**

**Between 74-89 % of retail investor accounts lose money when trading CFDs.**

You should consider whether you can afford to take the high risk of losing your money.