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Client Alert

Financial Regulatory

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ESMA consults on product intervention measures for retail CFDs

At a Glance…

On 18 January 2018, the European Securities and Markets Authority (ESMA) published a call for evidence on potential product intervention measures relating to the sale, distribution and marketing of contracts for differences (CFDs) and binary options to retail investors. ESMA has asked for comments by 5 February, just 12 working days following publication. ESMA has not said when it will publish follow-up proposals, but the narrow deadline suggests that measures may be imposed sooner rather than later.

In a statement published on 15 December 2017, ESMA expressed its concern about the threat to retail investors' protection provisions that the proliferation of CFDs poses. ESMA explained in the statement that it was considering the possible use of its product intervention powers under article 40 of MiFIR[1] to address the concerns posed by the marketing, distribution and sale of CFDs to retail investors. It expresses the same sentiment in the call for evidence.

In ESMA's view, CFDs:

i. expose retail investors to significant risk of loss from trading and transaction fees, which is exacerbated by high leverage;

ii. lack transparent information at point of sale, limiting retail investors' ability to understand the risks involved in inherently complex products; and

iii. are subject to incentives and other aggressive marketing techniques.

ESMA believes that the objective of investor protection can be achieved by restriction rather than prohibition.

History

ESMA has observed a rapid increase in the marketing, distribution and sale of CFDs to retail investors across the EU. The inherent risk and complexity of these products, combined with their wide-reaching marketing, distribution and sale through online platforms, have led ESMA to express significant investor protection concerns. As a result, local regulators have taken steps to enhance consumer protection, with leverage limits being imposed in a number of countries. At one extreme, the Belgian Financial Services and Markets Authority, for example, banned the sale to retail clients of leveraged CFDs and binary options in the summer of 2016. (See the information at the end of this article for a more detailed review of the approaches to date in the UK, Germany and France.)

Call for evidence

ESMA has stated that it is considering restricting the marketing, distribution or sale of CFDs to retail investors by implementing the following restrictions:

a. Leverage limits

The limits would range from 30:1 to 5:1, depending on the historical price behaviour of the underlying asset. A limit of 20:1, for example, implies that the retail customer must post an initial margin of 5 per cent of the initial total exposure of the CFD.

By contrast, the FCA put forward less stringent limits in its consultation paper, proposing CFD leverage limits of 25:1 for new customers and 50:1 for experienced customers.

ESMA is also reviewing its position in relation to CFDs on cryptocurrencies. ESMA is currently discussing whether an initial 5:1 leverage would provide enough investor protection, or whether the unique volatility of cryptocurrencies might demand stricter measures (such as an outright prohibition).

b. A margin close-out rule on a position-by-position basis

This rule would standardise the percentage of margin at which providers would be required to close out a retail client's open CFD. It would mean that the position must be closed out on terms most favourable to the client at the time when the available sum remaining in the trading account falls below 50 per cent of the amount of the initial margin posted.

For example, a CFD with a leverage limit of 5:1, which requires a minimum initial margin of 20 per cent of initial total exposure, must be automatically closed out if the overall margin allocated to the CFD falls below 10 per cent of the initial total exposure.

c. Negative balance protection on a per account basis

ESMA proposes a negative balance protection on a per account basis rather than per position.

d. A restriction on incentivisation of trading

This restriction is intended to reduce the use of incentives to entice retail clients to use CFDs. It is proposed that providers will be banned from providing retail clients with a payment (other than a realised profit on any CFD) or a non-monetary benefit, to induce trading.

e. A standardised risk warning

ESMA is considering requiring CFD providers to provide a standardised warning in any communication to, or published information accessible by, a retail client relating to the marketing, distribution or sale of a CFD. One option is to mandate CFD providers to indicate the percentage of retail client accounts that posted losses in the previous quarter, which may provide a more tangible risk warning.

What happens next?

ESMA has asked stakeholders to outline the likely impact that the above proposals would have on their business. In submitting responses, stakeholders are invited to submit qualitative and quantitative data, to inform ESMA's decisions.

While an outright pan-European ban is unlikely, ESMA may turn to the product intervention powers under article 40 of MiFIR if it appears that the risks to investor protection are not sufficiently controlled. The regulation provides ESMA with the power to require temporary prohibitions concerning financial instruments when the proposed action addresses a "significant investor protection concern in the Union".

We now await ESMA's decisions. While it appears that investor protection concerns can be addressed without banning CFDs (unlike ESMA's considerations in relation to binary options), the resultant proposals – depending on their severity – may, of course, cause some providers to cease to offer CFDs to retail clients.

Some market participants have started to re-classify certain clients as professional clients rather than retail clients in a bid to avoid the restrictions proposed by ESMA. There is also a possibility that some clients will move their accounts to brokers in less restricted jurisdictions.

There has been a great deal of regulatory concern about these products in recent years but no strong European framework to act as a foundation (as evidenced by the patchwork approach taken by National Competent Authorities across the EU to date). ESMA's proposals may serve to influence a uniform approach across member states.

Read David Calligan's article "FCA proposes tougher rules for retail CFD, FX and spread betting providers" to learn more about this topic.

	The UK and the FCA	Germany and BaFin	France and the AMF
History	In the UK, the FCA published a consultation paper on 6 December 2016 which contained proposals to enhance the conduct of business rules for firms providing CFDs to retail clients. It proposed a three-pronged approach to deal with leverage limits, disclosures and promotions. Please see our article on this topic for further details. The FCA was due to publish its proposals in the summer of 2017. However, in June 2017 it announced that it would delay the finalisation of its proposals following ESMA's announcement that it was reviewing the leveraged trading sector itself and planned to implement its own pan-European rules for CFD trading.	BaFin[2] issued a general administrative act regarding CFDs on 8 May 2017 (the **Administrative Act**). The Administrative Act limits the marketing, distribution and sale of financial CFDs. CFDs with an additional payments obligation (*mit Nachschusspflicht*) cannot be offered to retail clients. BaFin therefore used the option of product intervention for the first time to safeguard the interests of retail clients.[3] BaFin has significant investor protection concerns in relation to unquantified losses that may occur following the purchase of CFDs. BaFin has said that an additional payments obligation applies if the client is obliged to compensate losses it has suffered on its trading account in an amount larger than the moneys that the client has deposited to its trading account (see BaFin's guidance note for more information).[4] Pursuant to the Administrative Act, providers of CFDs with an additional payments obligation had three months from the date of publication of the Act (i.e., until 10 August 2017) to adjust their business models.	The AMF issued a warning on CFDs and binary options on 3 October 2016. The concerns were clearly focused on retail investors' protection and highlighted, in particular, the risk of losing even more than the initial investment. Later that year, Law No. 2016-1691 of 9 December 2016 was introduced, coming into force in early 2017. The law amended some provisions of the French Monetary and Financial Code (MFC) and paved the way for a prohibition on the marketing of both CFDs and binary options. According to article L. 533-12-7 of the MFC,[5] investment firms are forbidden to address, directly or indirectly, by electronic means, marketing communications to any persons who: may qualify as retail clients; are not admitted to trading on a regulated market or multilateral trading facility; fulfil one of the criteria referred to in this article; and, cumulatively, belong to one of the three categories defined by article 314-7 of the AMF General Regulation (AMFGR).[6] In other words, the prohibition becomes effective if, cumulatively, one or more of the criteria set forth in article L. 533-12-7 of the MFC and one or more of the categories defined by article 314-7 of the AMFGR are met. The three alternative criteria in article L. 533-12-7 of the MFC are: "(i)The maximum risk is unknown at the time the contract is entered into; (ii) the risk of loss is greater than the amount initially invested; [and] (iii) the risk of loss compared to the potential advantages is not reasonably understood with regard to the particular nature of the derivative". Article 314-7 of the AMFGR defines three categories of financial contracts, the second of which describes the characteristics of CFDs, namely: "they give rise to the payment of a positive or negative differential between the price of an underlying asset or basket of assets at the time the contract has been entered into and the price at which the position is closed out, and can oblige the client to pay an amount greater than the amount invested at the time the contract has been entered into".

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Current positon	More recently,the FCA published a 'Dear CEO' letter on 10 January 2018 which detailed their findings of a review undertaken into the CFD market. The letter suggested CFD providers and marketers may be failing to conduct their activities in accordance with FCA principles or the client's best interests rule at COBS 2.1.1R. On 29th January 2018,[7] the FCA also asked the public to be vigilant to the threat of online investment fraud in relation to CFDs and binary options.	BaFin is currently scrutinising the general terms and conditions of the respective market participants to ensure that the requirements are implemented. Access to CFDs is therefore not completely blocked for retail clients. CFDs without an additional payments obligation may continue to be marketed, distributed and sold to retail investors.	As certain CFDs belong to the second category and some binary options to the first category, the electronic marketing of both these financial instruments is forbidden for retail investors. Of course, a CFD with a stop-loss guarantee can fall outside the restriction.

[4] 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.

[5] The Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht).

[6] Pursuant to section 4b of the German Securities Trading Act (Wertpapierhandelsgesetz – WpHG).

[7] https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Merkblatt/WA/mb_171113_CFD_en.html;jsessionid=C7188D5DD0E8AD164FB6F01055B84D6C.1_cid381?nn=9866146

[8] As amended by article 72 of Law No. 2016-1691.

[9] Règlement Général de l'AMF.

[10] https://www.fca.org.uk/news/press-releases/fca-warns-increased-risk-online-investment-fraud-investors-scamsmart