

Consultation Paper

CP16/40**

Enhancing conduct of business rules for firms providing contract for difference products to retail clients



December 2016

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We are asking for comments on this Consultation Paper by 7 March 2017

You can send them to us using the form on our website at:
www.fca.org.uk/cp16-40-response-form.

Or in writing to:

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We have developed the policy in this consultation paper in the context of the existing UK and EU regulatory framework. We will keep the proposals under review to assess whether any amendments will be required due to changes in the UK regulatory framework, including as a result of any negotiations following the UK's vote to leave the EU.

We make all responses to formal consultation available for public inspection unless the respondent requests otherwise. We will not regard a standard confidentiality statement in an email message as a request for non-disclosure.

Despite this, we may be asked to disclose a confidential response under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Rights Tribunal.

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Abbreviations used in this paper

AML	Anti-Money Laundering
CBA	Cost Benefit Analysis
CFDs	Contracts for Differences
COBS	Conduct of Business Sourcebook
CP	Consultation Paper
EEA	European Economic Area
ESMA	European Securities and Markets Authority
EU	European Union
FCA	Financial Conduct Authority
FX	Foreign Exchange
IOSCO	International Organisation of Securities Commissions
MiFID	Markets in Financial Instruments Directive
MiFID II	Markets in Financial Instruments Directive II
MiFIR	Markets in Financial Instruments Regulation
NCA	National Competent Authorities
PRIIPs	Regulation of Packaged Retail and Insurance-based Investment Products
RAO	Regulated Activities Order

1. Overview

Introduction

- 1.1** Retail contracts for differences (CFDs)¹ are complex, leveraged derivative financial instruments that investment firms commonly offer to retail clients through online trading platforms.² This Consultation Paper (CP) outlines our concerns about increasing evidence of poor conduct and risks to investor protection from retail CFDs and proposes a package of policy measures designed to address those risks.
- 1.2** This CP also discusses our early policy considerations for the sale and distribution of binary bets (commonly known as binary options) to retail clients.³ It is anticipated binary bets will be brought in to scope of FCA regulation following the expected amendment to the Regulated Activities Order (RAO).⁴

Context

- 1.3** The longest established UK providers of retail CFDs date back to the 1970s and 80s. Historically, CFD products were typically marketed to more financially sophisticated retail investors.
- 1.4** Since 2009/10, our supervisory work and thematic reviews have found increasing instances of poor conduct and risks of consumer detriment across the CFD sector. In our most recent review of retail CFD providers in 2015, we found shortcomings in the appropriateness test, including risk warnings, and anti-money laundering (AML) checks across all firms in our sample.
- 1.5** Based on a sample of client account data collected as part of this work, we also found over 80% of clients lost money on these products over a year. The average result per client was a loss of £2,200. Other European Union (EU) jurisdictions have seen similar figures.⁵

¹ Contracts for differences include actual contracts for differences, spread bets, and rolling spot FX contracts.

² Retail CFD products allow retail investors to gain indirect exposure to the price movements in an underlying index, single stock equity, commodity, or foreign exchange pair, by trading with an investment firm on an over-the-counter basis.

³ Binary options will be defined in our Handbook Glossary as binary bets as has been outlined in FCA, CP16/29: Markets in Financial Instruments Directive II Implementation – Consultation Paper III, September 2016, pp. 124.
See: www.fca.org.uk/sites/default/files/cp16-29.pdf.

⁴ HM Treasury, Transposition of the Markets in Financial Instruments Directive II, March 2015. See: www.gov.uk/government/uploads/system/uploads/attachment_data/file/418281/PU_1750_MiFID_II_26.03.15.pdf; also FCA, CP16/29: Markets in Financial Instruments Directive II Implementation – Consultation Paper III.

⁵ France's Autorité des Marchés Financiers (AMF) found 89% of consumers lost money on these products and investors lost on average €10,887 and with a median investor loss of €1,843. Autorité des Marchés Financiers (AMF), Study of investment performance of individuals trading in CFDs and forex in France, 13 October 2014. The Central Bank of Ireland (CBI) found 75% of consumers lost money at an average loss of €6,900. CBI, Central Bank inspection finds 75% of CFD clients lose money, 23 November 2015. See: www.amf-france.org/technique/multimedia%3FdocId%3Dworkspace%253A%252F%252Fspace%252F9bf2caa8-1ce4-4832-85f4-4dffca8644%26. Also see: www.centralbank.ie/press-area/press-releases/Pages/CentralBankinspectionfinds75percentofCFDclientslostmoney.aspx.

- 1.6** These recent concerns have coincided with an increasing number of firms entering this market in the past 5 years, including firms operating on a cross-border basis from other European Economic Area (EEA) member states under a Markets in Financial Instruments Directive (MiFID) services passport. While new entrants and expansion by firms can indicate effective competition in a market, the CFD sector has seen firms extending the target market for these products to retail clients for whom the products are unlikely to be appropriate and offering them on terms that significantly increase the risks and probability of losses. This has created significant conduct concerns. In particular:
- Retail clients are being offered smaller minimum account sizes and order sizes combined with higher leverage, with some firms offering in excess of 200:1. At 200:1, clients are only required to post 0.5% of their total notional exposure (this is commonly known as initial margin).
 - High levels of leverage, combined with firms' use of automatic margin close out (whereby trading positions are closed if a client's available margin falls below a certain level), can result in a high probability of trades being closed at a loss due to ordinary intra-day market volatility. This means the riskiest CFDs are being sold to retail clients who may be least able to bear losses.
 - Retail clients' attention is increasingly being drawn towards gambling-style promotions, such as the ability to win bonuses through trading or the offer of account opening bonuses or gifts. These promotions can become a focal point for clients to the point that they do not properly assess the level of risk associated with the investment product.
- 1.7** As a result, we see a significant risk that more retail clients are opening accounts and trading CFD products they do not adequately understand. This is a particular concern given the risk of rapid, large and unexpected losses. To ensure an appropriate degree of consumer protection, we believe there is a need to enhance our conduct of business requirements. These will improve and reinforce conduct standards in the sector and limit the risks of these products for retail investors, reducing the potential for consumer detriment.
- 1.8** This CP also provides a discussion of our policy considerations and possible policy approaches for the regulation of binary bets once these products are brought in scope, following the expected amendment to the RAO as part of the Government's transposition of MiFID II.⁶
- 1.9** Binary bets are often marketed in a similar way to CFD products, and allow a client to 'bet' on whether the price of a financial instrument will be higher or lower than a fixed threshold at a future point in time.⁷
- 1.10** Binary bet firms use complex probability methodologies and internal models to calculate payoffs. Furthermore, the short duration of binary bet – some as low as 30 seconds – can lead to potentially addictive 'trading' behaviours more associated with gambling and do not appear to meet a genuine investment need.
- 1.11** Binary bets present significant information asymmetries (where the firm has greater information than the consumer) making it extremely difficult for most retail clients to make an informed investment decision or understand their fair value.

⁶ HM Treasury, Transposition of the Markets in Financial Instruments Directive II.

⁷ If at expiry a price is not above or below the threshold and position taken by the client, they lose their entire stake, but if a price has moved beyond the threshold in the direction predicted by the client, they receive a fixed pay-out. The pay-out is calculated when the client takes out the binary option, and does not fluctuate according to how far beyond a threshold the price has moved.

- 1.12** Based on our assessment of the risks of these products and potential investor protection concerns, we set out a discussion on possible policy measures. Any policy measure(s) would be contingent on the Government's final legislative changes to bring binary bets inside our regulatory perimeter. We would consult on any formal proposals after the final legislation has been confirmed and following responses to this paper. We welcome feedback on this discussion.

EU initiatives

- 1.13** Retail CFDs and other speculative products have also been a focus of discussion at the European Securities and Markets Authority (ESMA). Supervisory convergence work at ESMA has produced a range of material to improve the harmonised application of MiFID standards to the CFD sector over the past 18 months (see Chapter 2). ESMA also re-issued a warning about retail CFDs in July 2016, highlighting investor protection and conduct concerns.⁸
- 1.14** In parallel, several EU member states have already introduced or announced an intention to introduce financial promotion bans on CFD retail products in 2016, including Belgium, France and the Netherlands. These actions indicate a number of other EU regulators have significant consumer protection concerns; although these are partly driven by unauthorised businesses offering unregulated services or operating scams.
- 1.15** In light of European-wide concerns about CFD products, ESMA has stated that it "will also consider the need for any further work on this topic, in the medium term, in light of new aspects of the MiFID II framework, such as in relation to the application of product governance requirements and product intervention powers".⁹ This further reinforces our view that we must take action to address poor conduct by firms in the UK, particularly as UK firms serve clients based across the EU and other international jurisdictions. This CP and our analysis will help inform our ongoing engagement with ESMA on the risks of these products and the appropriate conduct standards needed to ensure an adequate degree of investor protection.

Summary of our proposals

- 1.16** We are proposing a package of policy measures that are intended to improve investor protection by limiting the risks of CFD products for retail investors. They will also raise conduct standards across the industry by ensuring CFD products are targeted at, and sold to, retail clients who understand the products and the risks involved. The package of reforms includes the following measures:
- Enhanced disclosure requirements – we are proposing that all retail CFD firms must provide a standardised risk warning and mandatory profit-loss disclosures to better illustrate the risks of CFD products.
 - Leverage limits (minimum margin requirements) – we will require firms to apply:

⁸ ESMA, Warning about CFDs, binary options and other speculative products, 25 July 2015. See: www.esma.europa.eu/sites/default/files/library/2016-1166_warning_on_cfds_binary_options_and_other_speculative_products.pdf.

⁹ ESMA, Questions and Answers: Relating to the provision of CFDs and other speculative products to retail investors under MiFID, 11 October 2016. See: https://www.esma.europa.eu/sites/default/files/library/2016-1165_qa_relating_to_the_provision_of_cfds_and_other_speculative_products_to_retail_investors_under_mifid.pdf

- Lower leverage limits for inexperienced retail clients that have less than 12 months of active trading experience¹⁰ in CFD products or other relevant margined products (with a maximum of 25:1), and
 - Higher leverage limits for experienced retail clients, which are set according to the volatility of the underlying asset, to prevent plainly excessive levels being offered by firms (with a maximum of 50:1).
 - Prohibition on bonus promotions – we will prevent firms from using any form of trading or account opening ‘bonuses’ or benefits to promote their retail CFD products and platforms.
- 1.17** To ensure that UK consumers are afforded a consistent level of protection we are proposing a restriction on financial promotions for incoming EEA firms that do not adopt comparable measures when offering retail CFD products to UK clients.
- 1.18** In line with other recent policy proposals, we have developed the policy in this CP in the context of the existing UK and EU regulatory framework. Following the result of the UK’s referendum on its membership of the EU, firms must continue to abide by their obligations under UK law, including those derived from EU law, and continue with their implementation plans for MiFID II and other pieces of EU financial services legislation that are due to come into effect in the UK.
- 1.19** These proposals are designed to advance our objective of securing an appropriate degree of investor protection. Whether firms are based in the UK or overseas, we are keen to ensure that they make investors fully aware of the risks of these products and do not expose retail clients to excessive risk of losses through increased levels of leverage. Since our supervisory work has raised concerns about the quality of appropriateness testing by firms, the proposals are intended to reduce the risks to retail clients when deciding to invest in retail CFDs and ensure that the terms of trading CFD products are appropriate to these clients’ relative experience. We are keen to ensure UK firms compete in the interests of clients and not by lowering conduct standards and/or offering inappropriate products or services to retail clients who may suffer detriment as a result.

Who does this consultation affect?

- 1.20** Our proposals will most directly affect:
- Retail clients and potential clients in CFDs, spread betting and rolling spot foreign exchange (FX) products
 - providers and distributors of retail CFD products
 - providers and distributors of binary bets
- 1.21** Our proposals may also be of interest to:
- trade bodies representing retail CFD product providers
 - consumer bodies

¹⁰ Our draft Handbook rules define inexperienced clients as clients who have less than four quarters of trading experience in CFDs or similar investment products (i.e. options and futures) in the last three years (12 quarters). Clients must have executed at least forty trades over those four quarters and at least two trades per quarter.

Is this of interest to consumers?

- 1.22** This paper will be of interest to consumers, particularly to the existing and potential retail customers of firms offering CFDs and binary bet products.

Equality and diversity considerations

- 1.23** We have considered the equality and diversity issues that may arise from the proposals in this CP. We do not believe that the proposals in this CP raise concerns with regards to equality and diversity issues.
- 1.24** We do not consider that the proposals in this consultation adversely impact any of the groups with protected characteristics i.e. age, disability, sex, marriage or civil partnership, pregnancy and maternity, race, religion and belief, sexual orientation and gender reassignment.
- 1.25** We recognise that the impact of our proposed introduction of leverage limits for retail clients will increase the cost for individuals who want to gain exposure to a range of financial assets through CFDs due to higher initial margin requirements. We know that this will disproportionately affect those on lower incomes. We are introducing these policy measures because we have observed that firms have expanded their target market to include investors for whom these products are inappropriate, including those who are less able to bear losses. As such, we believe that the increased cost of retail CFDs, and the potential for those on lower incomes to have less access to these products, is appropriate given the risk of investor detriment.
- 1.26** We will continue to consider the equality and diversity implications of the proposals during the consultation period, and will revisit them when publishing the final rules. In the interim, we welcome any input to this consultation on such matters.

EU Considerations

- 1.27** The package of policy measures we have proposed are compatible with our requirements under MiFID I and future requirements due to be introduced under MiFID II. In particular:
- Our proposed risk warning and enhanced disclosure requirements are compatible with our MiFID requirements under Article 31 of MiFID and under MiFID II recital 64, which grants Member States the discretion to specify the precise terms, contents or description of risks.
 - Our proposal to introduce leverage limits is compatible with our EU legal obligations under MiFID. MiFID does not set rules on leverage offered for products such as CFDs. On that basis, we believe there is scope to introduce leverage limits at national level. Our proposal does not directly apply to firms offering CFDs on a cross-border services passport from another EU member state.
 - Our proposal to ban bonus promotions and other incentives to open accounts or trade can be justified as an area that is not addressed directly by MiFID I or MiFID II. MiFID I and MiFID II do not directly set rules relating to financial promotions. On that basis, we consider there is scope to implement this measure without infringing our obligations under EU law.
 - As noted above, we are proposing a restriction on financial promotions for incoming EEA

firms that do not adopt similar conduct of business standards to ensure UK retail clients receive a consistent level of protection. This approach is consistent with our obligation to ensure our policies do not discriminate unfairly between UK and incoming EEA firms.

Next steps

What do you need to do next?

- 1.28** We are asking for feedback on the proposals set out in this CP. Please send us your comments by 7 March 2017.

How?

- 1.29** Use the online response form on our website: www.fca.org.uk/cp16-40-response-form. Alternatively, you can write to us at the address on page 2.

What will we do?

- 1.30** We will consider your feedback on our policy proposals for retail CFDs and aim to publish a Policy Statement confirming final FCA Handbook rules in spring 2017, with a view to these rules coming in to force shortly afterwards.
- 1.31** We will also consider your feedback in relation to our discussion of binary bets. Based on these responses and the Government's final legislation we will assess whether further policy measures are necessary. If so, we will aim to publish a CP in spring 2017.

2. The UK retail CFD market and international initiatives

- 2.1** This Chapter describes the UK market for retail CFD products. We also summarise the findings of supervisory work in recent years and evidence of conduct issues in this sector. It then discusses EU and international initiatives relating to retail CFDs, which have served to inform our policy proposals as set out in Chapter 3.

Retail CFD products

- 2.2** Retail CFD products are typically offered through online trading platforms. They include actual contracts for differences, spread bets and rolling spot FX contracts. They allow retail investors to gain indirect exposure to the price movements in an underlying index, single stock equity, commodities or FX pairs. Retail CFD products are traded on an over-the-counter (OTC) basis. The investment firm typically takes the other side of the transaction to that of the client (trading as principal). Some firms hedge their market exposure through external liquidity providers according to their agreed market risk appetite, or on a trade by trade basis, while others assume the full market risk against the client's position.
- Retail CFD products are typically offered on margin, like options and futures, which allow clients to deposit a small percentage of the overall notional amount they place on a trade (i.e. a smaller commitment of capital is 'leveraged' to achieve a larger investment exposure). Trading with leverage means profits or losses, as well as the costs of trading, are multiplied. Losses can exceed the client's deposited funds.
 - Retail CFDs are generally used for shorter-term investments to take advantage of price movements, although in some cases they may be used for hedging purposes. They are predominantly offered on a non-advised basis.
 - CFDs are deemed complex products under MiFID when provided on a non-advised basis because they use leverage, are derivatives and are traded OTC. As a result, CFD products are unlikely to be appropriate for many retail clients. Since retail clients can take 'short' positions in these products, they can also be exposed to potentially unlimited losses.

The UK retail CFD market

- 2.3** The longest established providers of retail CFDs date back to the 1970s and 80s. Historically, these products were typically marketed to more financially sophisticated retail investors and involved telephone-based broking.

- 2.4** The relative popularity of retail CFD products in the UK can be ascribed to several factors, including features such as:
- the ability to trade on margin and trade short as well as long
 - tax efficiency – traditionally there is no stamp duty for a CFD on equities (whereas this would apply to direct investment in equities) and spread betting attracts no capital gains tax
 - the ability to gain exposure to assets such as commodities or an index that may otherwise be more expensive or difficult for retail clients to access
 - the fact there is no commission on spread betting, and
 - the accessibility of online platforms and range of trading controls and order types available directly to the consumer
- 2.5** The number of active clients in retail CFD products in the UK is estimated at around 125,000 in 2016. There are currently 97 FCA-authorised firms whose primary activity is selling and distributing CFD products to retail clients.¹¹
- 2.6** There has been considerable growth in the number of retail CFD providers since 2010, when there were around half this number. Despite this, the largest UK provider has around 40% of the market, with a further half dozen firms making up another 30%, and a long tail of smaller firms make up the remaining 30%. We estimate UK retail CFD providers hold around £3.5bn in client money.¹²
- 2.7** In addition to firms with a physical presence in the UK, there are around 130 firms registered to provide cross-border services into the UK under a MiFID passport. The majority of these firms are based in Cyprus and are subject to oversight by the Cyprus Securities and Exchange Commission (CySec), based on the common EU regulatory standards in MiFID that apply to investment services and activities.
- 2.8** The UK is both a recipient and provider of these products. A large number of incoming-EEA firms offer CFDs to UK retail clients operating under a MiFID cross-border services passport, while most UK retail CFD providers operate branches or provide services across many EU member states. We conservatively estimate that UK firms serve around 400,000 individual active retail clients based outside the UK.
- 2.9** CFD firms typically trade as principal and are thus the counterparty to the client's trade. Most firms accept some level of market risk exposure and so do not always execute a hedge trade before filling the client's order. However, some firms trade as 'matched principal'. This means they cannot fill a client order unless they have a matching hedge trade with counterparty. There are also many smaller firms in this sector who act as introducers, brokers or tied agents to a core provider.
- 2.10** The growth in both smaller UK-based firms and services offered into the UK on a cross-border basis has been largely driven by the use of online trading platforms in the CFD market as technology has improved. New internet technology platforms have lowered the costs for new firms to set up and manage their business. By bringing the business online and using computer-based trading tools, CFD providers have been able to introduce automated 'margin close outs'.

¹¹ This excludes a significant number of firms who may have permissions to provide services related to CFDs to retail clients, but do not provide CFDs as a primary activity, for example asset managers.

¹² This figure was obtained using information submitted by firms to the FCA as part of the regulatory reporting obligations.

This is a common feature where, if a client account falls below a required level of margin to support their open trades and does not meet a margin call (which the client position is also automated) the CFD platform can automatically close out the client's position(s). This allows the firm to more easily manage client exposures and the firm's credit risk, and has resulted in some firms offering clients higher leverage alongside lower minimum account sizes.

- 2.11** The online nature of these providers is also reflected in their marketing approach. This focuses strongly on search engine optimisation and the use of online banner adverts and social media to generate interest or leads for prospective clients by drawing clients to the providers' websites. However, CFD providers are increasingly using brand advertising with the aim of generating mass-market awareness by sponsoring sports teams, placing adverts on social media platforms and advertising in traditional media such as on public transport and free newspapers.

Supervisory findings and conduct concerns in the CFD sector

- 2.12** The growth of the number of firms active in the CFD market in recent years has intensified competition between existing firms and new entrants. There is evidence that this competition is not necessarily working in the best interests of clients. Anecdotally, we have seen examples of firms seeking to gain market share by offering smaller account sizes and using marketing ploys such as bonuses or benefits for opening accounts or trading. It appears that newer firms are adopting a business model that relies on a high volume of inexperienced retail customers that have a high probability of losing money and a high turnover of customers.
- 2.13** To maintain this flow of new customers and to make it as easy as possible for new clients to trade, we noted the risk that firms may fail to undertake sufficiently robust processes before allowing a new client to join a platform, both in respect to appropriateness tests and AML checks. These concerns led to our thematic supervisory review of client on-boarding practices in 2015.
- 2.14** The approach of new entrants in the market, and the corresponding competitive pressure this applies to existing providers, has led to efforts to expand the market for CFD products. This may go beyond the limited target market we would expect for these products given their risk and complexity. Increased competition in the sector also appears to have driven retail CFD firms to offer increasing levels of leverage – in FX and indices in particular – especially on the smallest account sizes. While the FCA actively supports competition when it acts in the interests of consumers, these developments are at odds with our operational objectives to protect consumers and ensure effective competition in their interests.

Trading with leverage

Trading with leverage means that investors are only required to deposit a small percentage (margin) of the total value of the investment when opening a position. The remainder is funded by the firm a client is trading with at a specified rate of interest. This effectively amounts to a loan by the firm to the client. However, the client's profits or losses are based on changes in value of the total investment. This means leverage magnifies a client's profit or loss on a position compared to the funds deposited as margin, and losses can exceed their deposit.

As an example, if the total value of a client's initial position in a CFD trade is £10,000 and the leverage ratio offered by a firm is 100:1, the initial margin requirement for the client would be set at 1% of £10,000, so they would need to deposit £100. A market movement of 0.5% against the client's position, originally valued at £10,000, would result in a 50% (£50) loss against the client's deposited margin.

2.15 These issues have been reflected in our ongoing supervisory work which, since 2009, has detected repeated instances of poor conduct across this sector. This has included:

- Post-implementation findings on appropriateness testing in January 2009 following the introduction of MiFID in 2007, which focused on retail CFD products. Our supervisory work found poor practices of firms asking clients with no experience to self-certify that they understood the nature of the product and the risks involved.
- A thematic review of spread betting financial promotions later in 2009, which highlighted concerns around the prominence of risk warnings, the balance in describing the benefits and risks of the products and use of language that was inappropriate for the target audience.¹³
- The failure of Worldspreads in 2012 which caused consumer detriment and was caused by shortcomings in the firm's accounting and safeguarding of client assets. This contributed to the FCA's initiative to further strengthen the UK client assets regime.
- Enforcement action against FXCM in 2014 for asymmetric slippage¹⁴ and other best execution failings. FXCM were fined £4 million and made to pay client redress of £6 million.¹⁵
- A thematic review on best execution (TR 14/13), which included six retail CFD firms, showed specific concerns about CFDs inappropriately claiming an exemption from best execution obligations. They claimed that exemption on the basis that they were executing client orders against their own books. A number of CFD retail product providers could not give us adequate information on their best execution policies.¹⁶
- The failure of Alpari and significant losses incurred by a number of other retail CFD firms and clients following the Swiss National Bank's decision to remove a fixed exchange rate floor of Swiss Francs to Euros in January 2015. In response to this event, FCA Supervision conducted visits to review client assets controls in 24 firms, finding concerns in over a third of them.
- A supervisory thematic review on client on-boarding in 2015, with subsequent feedback published in a Dear CEO letter in February 2016, which again found shortcomings across all firms in how they took on new clients, including the quality of appropriateness tests and performing adequate AML checks.¹⁷
- Complaints about these products to the Financial Ombudsman Service have risen over the past five years, from 126 complaints in 2011/2012 to 434 in 2015/2016.

2.16 We also conducted analysis of a sample of client accounts from eight major providers as part of the thematic review on client on-boarding in 2015. We found that more than 80% of client accounts made a loss over a year, with less than 20% of client accounts in profit. Across all

¹³ Financial Services Authority (FSA), Thematic communication on spread betting, 2009. See: www.fsa.gov.uk/pages/doing/regulated/promo/thematic/spread_betting2.shtml.

¹⁴ Asymmetric slippage refers to practices whereby, if a firm's initial quoted price differs from the final execution price, the firm passes on negative price movements to the client, but captures any positive benefit from a price movement itself by giving the client the original quoted price.

¹⁵ FCA, The Financial Conduct Authority Fines FXCM UK £4 million for making 'unfair profits' and not being open with the FCA, 26 February 2014. See: www.fca.org.uk/news/press-releases/financial-conduct-authority-fines-fxcm-uk-%C2%A34-million-making-%E2%80%98unfair-profits%E2%80%99-and.

¹⁶ Chapter 11.2 of COBS and FCA, TR 14/13: Best execution and payment for order flow, July 2014. See: www.fca.org.uk/publication/thematic-reviews/tr14-13.pdf.

¹⁷ See: www.fca.org.uk/publication/correspondence/dear-ceo-letter-cfd.pdf.

FCA, Dear CEO letter – client take-on review in firms offering contract for difference (CFD) products, 2 December 2016.

eight firms, the average result per client account was a loss of £2,200. Although there were small differences in the average level of client losses by firm, the proportion of profitable to loss-making clients was very similar. When combined with the fact that clients may invest in these products based on firms' unclear disclosures and inadequate risk warnings and with inadequate testing of knowledge and experience, there is a strong likelihood that some clients should not have entered into these products at all.

- 2.17** The growth of new entrants in this sector has also raised other conduct and prudential concerns. New entrants into the market have generally been smaller firms, which often rely on outsourced control and compliance functions and 'off the shelf' IT platforms. We have also seen growth in firms seeking to operate a 'matched principal model', where hedging is, in practice, carried out with intragroup or affiliated entities. This practice raises questions about whether the risk is really being hedged or whether it has simply been moved to another jurisdiction with lower prudential requirements or lower tax burdens. If a firm only uses a single hedging counterparty to provide execution prices, and the firm does not properly assess whether this consistently provides the best price for their clients, it is also doubtful that they are meeting their best execution obligations.
- 2.18** We have also detected concerns with the conduct standards of some intermediary firms who are offering advisory or discretionary-managed account services solely in relation to retail CFDs. We have concerns around the level of client losses and potential conflicts of interest related to these business models due to high commissions charged to clients.¹⁸ The suitability of advice or portfolios offered by these 'advisory' firms also appears highly questionable. We are currently carrying out further supervisory work in this area to address these issues.

Unauthorised business

- 2.19** In addition to issues relating to authorised CFD firms, we have seen a rise in the number of unauthorised firms and investment scams targeting clients by purporting to offer authorised forms of retail CFD products or binary bets.
- 2.20** Between 1 September 2015 and 31 August 2016, the FCA published 16 alerts regarding unauthorised rolling spot FX and CFD providers. Furthermore, the FCA has published 22 alerts regarding clone firms purporting to offer rolling spot FX/CFD investment services.
- 2.21** We recognise that this issue poses a serious risk of consumer detriment and we will continue to monitor this issue and take enforcement action where necessary.

EU Supervisory Concerns

- 2.22** EU member states have observed a similar set of issues relating to CFD products and their providers. These include a similar increase in the marketing and sale of these products and services to retail clients and higher than usual investor losses. A number of those jurisdictions have also reported a disproportionately high number of investor complaints, particularly against unauthorised entities purporting to offer retail CFD and binary bets. These include:
- In 2014, the French AMF highlighted findings showing that nearly 90% of French investors in retail CFD products lose money, with average client losses over 4 years of nearly €11,000, although median losses are lower at €1,800.¹⁹ The AMF has reported significant levels of consumer complaints, many of which are about unauthorised activity.

¹⁸ A recent sample of client accounts shows that average client losses appear to be higher for clients that are sold CFDs on an advised rather than a non-advised basis.

¹⁹ AMF, Study of investment performance of individuals trading in CFDs and forex in France.

- The Dutch AFM carried out a review of the CFD sector between 2013 and 2014. Their review identified investors being given unclear and misleading information, a failure to indicate the target market for CFDs, poor client joining processes, and aggressive marketing and promotion activities.²⁰
- In 2015, the Central Bank of Ireland examined client profitability among a sample of firms and found that 75% of investors lost €6,900 on average.²¹ The CBI also found shortcomings in firms' marketing disclosures and appropriateness tests.
- CySec has undertaken supervisory and enforcement actions with several firms. It announced a series of fines in 2015 for five firms operating CFD, rolling spot FX or binary bet trading platforms. In January 2016, CySec fined Banc de Binary and Rodeler Limited, which operates 24option.com and other websites, for conduct failings.²²

2.23 In response to the supervisory concerns raised by its members, ESMA is examining ways to improve supervisory convergence based on the common standards established by MiFID.

2.24 ESMA established a CFD taskforce in Q3 2015. It has subsequently examined issues with retail CFD products across all member states and developed and published a series of questions and answers (Q&A).²³ These Q&As are intended to foster better supervisory convergence, and clarify and strengthen how firms offering investment services for retail CFD products apply existing MiFID standards.

2.25 ESMA took earlier steps to promote awareness among retail consumers of the risks of CFDs and leverage FX trading, with consumer warnings published in 2011 and 2013 respectively.²⁴ ESMA issued an updated warning in July 2016.²⁵

2.26 Despite these steps, a handful of European National Competent Authorities (NCAs) have taken more aggressive measures, including a proposed ban on the distribution or marketing of CFD products to retail investors. For instance:

- France's AMF have taken steps to ban several websites for unauthorised business and have run a campaign with AMF pop-ups appearing on other websites to tell people of the risks that they will lose money. The AMF also announced its intention to ban the advertising of binary bets, and CFDs and FX products with leverage greater than 5:1, by any electronic means such as e-mail and website banners in August 2016.²⁶ The AMF completed its consultation period and the French Parliament is currently considering legislation to give effect to this measure.

20 Autoriteit Financiële Markten, *Contracts for Difference product review: findings and recommendations*, 13 February 2015. See: www.afm.nl/en/professionals/nieuws/2015/feb/rapport-cfds.

21 Central Bank of Ireland, Central Bank inspection finds 75% of CFD clients lose money.

22 Cyprus Securities and Exchange Commission, Board Decisions. See: www.cysec.gov.cy/en-GB/public-info/decisions.

23 ESMA, Investor Warning – Trading in Foreign Exchange (Forex), 5 December 2011. See: www.esma.europa.eu/system/files_force/library/2015/11/2011-412_1.pdf?download=1. ESMA, Investor Warning – Contracts for Difference (CFDs), 28 February 2013. See: www.esma.europa.eu/sites/default/files/library/2015/11/2013-267.pdf.

24 ESMA, Warning about CFDs, binary options and other speculative products, 25 July 2016. See: https://www.esma.europa.eu/sites/default/files/library/2016-1166_warning_on_cfds_binary_options_and_other_speculative_products_0.pdf.

25 ESMA, Warning about CFDs, binary options and other speculative products.

26 AMF news release, Ban on the advertising of Forex products, binary options and some CFDs: AMF launches consultation on changes to its General Regulation, 1 August 2016. See: www.amf-france.org/en_US/Actualites/Communiqués-de-presse/AMF/annee-2016.html?docId=workspace%3A%2F%2FspacesStore%2Fad42eccc-9720-49da-82a8-2ddcb72fbf1d.

- In Belgium, on 21 July 2016, the Financial Services and Markets Authority (FSMA) introduced a ban on the distribution of binary bets, CFDs and rolling spot FX contracts via electronic trading platforms and a ban on aggressive or inappropriate distribution techniques including cold calling and bonus promotions.²⁷

2.27 The Polish regulator, the Komisja Nadzoru Finansowego (KNF), has also taken specific measures relating to retail CFD products, introducing a maximum leverage limit of 100:1 in July 2015.

International and European Regulatory Developments

2.28 It is clear that retail CFD products pose significant conduct risks and give rise to investor protection concerns with a cross-border footprint, and will continue to receive heightened international regulatory scrutiny. We are keen to ensure that UK firms apply adequate conduct standards and protections for investors both in the UK and abroad, including when operating on a services-only passport within the EU and when operating in international markets.

2.29 In developing the measures set out in the next Chapter, we have carefully considered the implications of forthcoming EU regulation under MiFID II, which will strengthen the current regulatory framework, and the supporting supervisory guidance for these products based on MiFID which ESMA has recently produced.

2.30 However, given the heightened risks associated with trading these products, we believe it is necessary to develop an additional set of targeted measures to limit their risks and ensure that clients are fully aware of the risks involved.

2.31 In designing these measures, we have tried to balance the need to ensure robust protections for retail investors while ensuring firms are able to compete on reasonable terms to meet the evident consumer demand for these products. In doing so, we have carefully considered the measures adopted in other international jurisdictions and their effectiveness to ensure a calibrated and proportionate approach.

Forthcoming EU Regulation

2.32 Forthcoming EU regulation will introduce product governance requirements and enhanced conduct requirements that will go some way to address the risks of CFDs, our supervisory concerns and those of other EU jurisdictions.

2.33 In addition to existing powers under MiFID, retail CFD firms will be subject to enhanced regulatory requirements under forthcoming EU regulation. This includes:

- The Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation, which requires new key investor information document to be produced for retail CFD products. This should help enhance disclosure to clients, by standardising in a comparable and accessible way the costs, charges and risks of CFD products. PRIIPs is expected to take effect in late-December 2017 following a recent European Commission statement.

²⁷ Financial Services and Markets Authority (FSMA), *FSMA Regulation establishes a framework for the distribution of OTC Derivatives (Binary options, CFDs...)*, 8 August 2016. See: www.fsma.be/en/Site/Repository/press/div/2016/08-08_banning.aspx.

- MiFID II, which will enhance conduct and organisation and requirements that apply to investment firms offering retail CFD products. Conduct standards for best execution and costs and charges disclosures will be enhanced under the reforms in addition to new product governance requirements. The latter will place requirements on product manufacturers and distributors to assess a target market for their products and take steps to ensure products are distributed appropriately, reviewing distribution and product performance to ensure it remains appropriate.

2.34 Mass marketing by MiFID investment firms of retail CFD products appears unlikely to meet these new requirements, as they are only likely to be appropriate for a small sub-set of retail clients with sufficient knowledge and experience in these or other related products.

2.35 MiFID II also includes new product or service intervention powers in the Markets in Financial Instruments Regulation (MiFIR). It gives ESMA temporary product intervention powers and member states permanent powers to prohibit or restrict the marketing, distribution or sale of certain financial instruments, or financial instruments with certain specified features, or a type of financial activity or practice, subject to conditions.²⁸

International approaches to the sector

2.36 Many jurisdictions have taken steps to impose specific conduct requirements to ensure clients better understand the product features or to limit the risks, particularly from leverage, to retail clients.

2.37 We believe there are several useful measures adopted by other international regulators, which have informed our proposed policy measures. To briefly summarise some of the main international approaches, the table below sets out some key measures and approaches used:

²⁸ These provisions are set out in Articles 40 and 42 of MiFIR. See: www.eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0600&from=EN

Table 1: Summary of international regulation of retail CFD products

Country	Leverage limits		Key features
	FX	CFDs	
US (CFTC / NFA)	50:1 (major) / 20:1 (minor)	N/a	<p>Effective ban on retail clients investing in OTC CFDs related to securities</p> <p>Rolling spot FX permitted subject to leverage limits.</p> <p>NFA has also increased minimum margin for certain currencies: JPY and AUD (3%); Russian Ruble (20%); Brazilian Real (9%); Mexican Peso (6%)</p> <p>CFTC net capital requirements for Forex Dealer Members of no less than \$20m</p> <p>Firms must disclose to clients a profit / loss ratio across all client accounts for the last four calendar quarters</p> <p>Risk disclosure must be signed and dated by the client</p>
Japan (FSA / FFAJ)	25:1	50:1	<p>Minimum margin of 4% on FX, with minimum margin levels for CFDs of 2-20% based on underlying, e.g. indices subject to 10% (10:1)</p> <p>Limits on financial promotions on OTC FX</p> <p>Rolling spot FX providers required to agree 'loss limits' with individual investors</p> <p>The Financial Futures Association of Japan requires binary options to be subject to a 2 hour minimum transaction period</p>
Hong Kong (SFC)	20:1	-	<p>HK SFC sets a 5% initial margin minimum (20:1), and a 3% maintenance margin on leverage FX trading</p> <p>Capital requirements on leveraged FX trading firms of HK\$30m (€3.5m) and liquid resources of HK\$25m (€3m) or 1/60 of gross value of FX exposures</p> <p>Requires firms to set limits on size of individual positions clients can take</p>
Singapore (MAS)	50:1	50:1	<p>Minimum margin requirement of 2%, but lower for certain underlyings – e.g. 10% for CFDs included in an index, 20% for equities not in liquid index</p> <p>Consulting on increasing FX margin requirement to 5% (20:1)</p>
Poland (KNF)	100:1	100:1	<p>Minimum margin requirement of 1% for retail clients to invest in OTC derivatives</p>
Israel	100:1-20:1	100:1-20:1	<p>100:1 for low-risk currencies and commodities (gold), 40:1 for indices, 20:1 for all other assets.</p> <p>Capital requirements starting from \$200,000 (€180,000)</p>

- 2.38** Other international regulators are taking similar approaches; though some have chosen to ban binary bets altogether. For example, the Capital Markets Board of Turkey has adopted a maximum cap on leverage of 100:1 for rolling spot FX trading and CFDs, while banning binary bets completely. The Quebec Autorité des Marchés Financiers has also recently announced it will not authorise binary bets in its jurisdiction, and will require rolling spot FX providers to disclose a percentage figure of profitable versus loss making accounts. Other jurisdictions have adopted additional requirements, including requiring specific risk warnings or disclosures, trade reporting obligations and/or client asset protections, among others.
- 2.39** The International Organization of Securities Commissions (IOSCO) has undertaken some work in this area and is expected to publish a report shortly.

Q1: What investment need(s) do CFDs fulfil for retail clients and would they be disadvantaged if they no longer had access to these products?

3. CFD policy proposals

- 3.1** This Chapter outlines our proposed package of conduct of business reforms for firms providing retail CFDs. We set out our policy reasoning for adopting these measures in light of our supervisory findings, and ask a number of questions on our proposals, to which we seek responses. The proposed Handbook rules that will apply these policy measures are outlined in Appendix 1 of this CP.

Overview

- 3.2** We have seen a persistent range of issues with existing retail CFD providers in the UK in the last few years. We have also highlighted that the types of business models being pursued and the targeting of these complex, high risk products at retail clients with insufficient knowledge or experience raises a significant risk of consumer detriment. The growth of marketing strategies and services that try to downplay the risks of retail CFDs, exacerbated by the leverage offered on these products, provides a clear case for FCA policy interventions to ensure we continue to meet our consumer protection objective.
- 3.3** We propose a set of policy measures that will address our concerns with firms' conduct in this area. The proposed measures for retail CFD products are:
- Enhanced disclosure requirements – we are proposing that all retail CFD firms must provide a standardised risk warning and mandatory profit-loss disclosures to better illustrate the risks of CFD products.
 - Leverage limits (minimum margin requirements) – we will require firms to apply:
 - Lower leverage limits for inexperienced retail clients that have less than 12 months of active trading experience²⁹ in CFD products or other relevant margined products (with a maximum of 25:1), and
 - Higher leverage limits for experienced retail clients, which are set according to the volatility of the underlying asset, to prevent plainly excessive levels being offered by firms (with a maximum of 50:1).
 - Prohibition on bonus promotions – we will prevent firms from using any form of trading or account opening 'bonuses' or benefits to promote their retail CFD products and platforms.

²⁹ Our draft Handbook rules define inexperienced clients as clients who have less than four quarters of trading experience in CFDs or similar investment products (i.e. options and futures) in the last three years (12 quarters). Clients must have executed at least forty trades over those four quarters and at least two trades per quarter.

3.4 These measures in combination are designed to:

- Secure an adequate degree of consumer protection for retail clients, whether based in the UK or overseas, so that firms offering CFDs do not expose retail clients to excessive risk of losses and do not encourage investment where clients do not understand the product's features and risks, and
- Ensure UK firms compete in the best interests of clients and not by lowering conduct standards.

Detailed policy proposals

Enhanced disclosures

- 3.5** A key failing found in our thematic supervisory work was the quality of risk warnings provided to retail clients by firms taking on new clients.
- 3.6** Firms often failed to clearly set out the high-risk, leveraged and OTC nature of these products. In particular, risk disclosures and warnings often did not clearly explain the potential for rapid losses that could exceed deposited funds, or these messages were diluted by the way warnings were presented or countered by statements about potential profits.
- 3.7** In light of these concerns, we propose a requirement for firms to provide a standardised risk warning which discloses sufficient and more effective information to retail clients. The proposed standardised risk warnings must also meet the general requirements to ensure prominence and appropriate presentation to the client.
- 3.8** This policy measure is intended to change the behaviour of clients seeking to open CFD accounts by ensuring that the most important risks are more simply and clearly set out in the warning, and key messages are given in a more understandable way. This will ensure that retail clients are better informed of the risks associated with retail CFD products, and help them make an informed decision when deciding to invest.
- 3.9** Firms will be also be required to provide a standard risk disclosure stating the percentage of client accounts that made a net profit or loss, both in the previous calendar quarter of trading activity and over the last 12 months. This disclosure must include actual profits or losses and the current level of profit or loss from equity in open trading positions.³⁰ Firms will need to present this disclosure on any other website page or mobile application that contains a reference to the benefits of retail CFD products.
- 3.10** This measure is designed to offset the tendency of firms and clients to focus on the potential for profits rather than losses. A focus on the proportion of accounts that show a net profit or

³⁰ The US CFTC have requirements on retail foreign exchange dealers, futures commission merchants and introducing brokers offering retail FX accounts for off-exchange currency transactions to provide a standardised risk disclosure statement which includes a figure on the percentage of profitable and not profitable accounts for each quarter. This is out in Section 5.5 and 5.18(i) of Part 5, Chapter 1, Title 17 of the Commodity and Security Exchanges Act 1936.

loss also avoids the potential distortion created by disclosing profit or losses per trade.³¹ On the basis that a majority of clients lose money on these products – with our own figures suggesting an approximate ratio of 82% of clients losing against 18% making a profit – this will provide a simple, firm-specific figure highlighting actual client trading outcomes. This measure has been used in other international jurisdictions and was suggested as good practice in the 2016 ESMA Q&A publication. This will further support clients in making an informed decision about whether they wish to proceed with a high risk product that, proportionately, is more likely to result in a loss than a gain.

- 3.11** This policy measure would not directly apply to firms offering CFDs into the UK on a cross-border services passport from another EU member state. This is because, under EU law, investment firms operating on a services-only passport into another member state remain the sole responsibility of their home state NCA in terms of ensuring they meet the regulatory obligations in MiFID. However, we are proposing a restriction on financial promotions for firms that do not adopt our proposed enhanced disclosure requirement.
- 3.12** These requirements will form a rule and accompanying provisions in a new section in COBS 22. We believe these requirements are compatible with our existing MiFID requirements and will also be consistent with the disclosure requirements and provisions for providing information to clients under MiFID II Article 24(4)(b). The restriction on financial promotions for incoming EEA firms that do not adopt comparable enhanced risk disclosures is designed to ensure that UK investors enjoy a consistent level of consumer protection and firms are competing on similar terms and conduct standards. This is consistent with our obligation to ensure our policies do not discriminate between UK and incoming EEA firms.

Q2: Do you agree with our proposal to require enhanced disclosures for CFD products?

Q3: Do you agree with our proposal to require CFD firms to disclose the percentage of client accounts that are in profit or loss over the previous calendar quarter and over the last 12 months?

Leverage Limits

- 3.13** Leverage alters the exposure of clients to the underlying financial asset. In particular, it increases a client's notional investment exposure, exposes them to potential losses that can exceed their initial deposited funds, and increases the likelihood that 'normal' market volatility will cause investors to make actual losses through firms' use of automatic margin close outs.
- 3.14** Current levels of leverage which firms offer to retail CFD clients (of up to 500:1) pose substantial risks to investors. This is particularly relevant for investors who often lack the experience, expertise or knowledge of these products to be able to understand the extent of their exposure to losses. In the current CFD market, firms offer investors smaller margins for lower client order sizes (as little as 0.2% to cover exposures, or 500:1 leverage). Disregarding fees, a client depositing £100 could take a position worth £50,000 in a CFD. It is highly unlikely many retail clients would be able or willing to assume a £50,000 exposure in a single trade on a single asset class if they viewed CFDs in these terms.
- 3.15** The excessive leverage offered in the current market make these instruments particularly price-sensitive. With automatic margin close-outs often set at 50% of the initial margin posted,

³¹ Since there is a behavioural tendency for clients to run losses (although they may be closed out in some cases) while taking smaller profits, per trades figure may not reveal the overall client experience when trading over a period of time.

at 500:1 a 0.1% change in the price of a specified instrument, without the client posting an additional deposit, would trigger the automatic close-out, crystallising their losses.

- 3.16** Our internal analysis of USD-GBP daily price volatility shows that, at 500:1 and a 50% automatic margin-close out, retail clients who do not make an additional investment over a two hour span, will be automatically closed out and on the losing side of the trade 81% of the time and either lose all of, or more than, their initial margin 44% of the time.³²
- 3.17** Leverage also exacerbates the impact of costs and charges, given they are based on the notional investment. This benefits the firm at the expense of the client, especially when considered against the significantly smaller amount of actual deposited funds. Apart from the trading costs to enter and exit positions, other charges such as overnight financing costs will mean the client's break-even point is skewed further above zero increasing the likelihood of a net loss over a period of trading.
- 3.18** Since leverage increases the probability and value of client losses, there is an increased risk of conflicts of interest particularly when firms do not hedge the client's trades and so benefits directly from client losses. This incentivises firms to offer higher rates of leverage even when this may not be in the client's best interests.
- 3.19** We are particularly concerned that under current market practice, firms commonly vary the level of leverage offered to clients according to the credit risk to the firm, rather than setting a level that is appropriate for the client. Often firms offer higher levels of leverage to investors that have small deposits and positions in the market, while imposing lower levels for clients taking larger trading positions. This market practice targets lower value and less experienced clients by offering the prospect of higher rates of return at lower margin requirements. It may result in the churning of retail investors due to the high probability that their trades will be closed out at a loss before they can post additional margin when trading with high leverage, even in ordinary market conditions, which is not in the best interests of the client.
- 3.20** We are also concerned that the high levels of leverage offered by the firm could pose a credit risk to the firms themselves. It is possible that, when offering high levels of leverage, the firm may experience a significant negative movement across its aggregate client positions in a given asset class. The firm may face immediate calls from its wholesale liquidity providers to post additional margin, meaning the firm has to request extra margin from many underlying clients. If some of those clients cannot immediately provide margin, thus the firm faces a cash-flow shortfall. In an extreme scenario this may make the firm insolvent. This happened to Alpari UK following the Swiss Franc unpegging. The higher the leverage the firm offers to its clients, the higher the risk for the firm. The proposed leverage limits will help mitigate these risks.
- 3.21** Given the nature of CFD products and the risks to retail investors of extensive losses, we believe it is necessary to impose a leverage limit for all retail clients. Firms will continue to have the discretion to set their own margin requirements for professional clients.

Leverage Limits for Inexperienced Retail Clients

- 3.22** We are proposing a lower set of leverage limits for inexperienced retail clients. Firms will be required to designate their client as 'inexperienced' or 'experienced' based on the client's experience of trading CFDs or similar products. Clients will be required to evidence they have forty trades conducted at least over four quarters in the previous three years to be designated

³² This analysis was conducted using 11 months of historical trading data. A full description of the statistical methods and data used to establish these probabilities are described in footnote 42 on page 42 in Annex 2: Cost benefit analysis.

as an experienced client with at least two trades per quarter – otherwise, they should be treated as an ‘inexperienced’ retail client.

- 3.23** To evidence experience, the firm must receive and record evidence of previous accounts and trading from the client. The firm cannot rely on a self-certification by a retail client. Experience of demonstration or trading accounts would not be acceptable for this purpose.
- 3.24** We propose that inexperienced clients will be subject to lower leverage limits (higher margin requirements) before they can enter into CFD trades. Specially, we are proposing that firms will have to require inexperienced retail clients to post initial margin of at least:
- 4% for major FX pairs (equal to a leverage limit of 25:1)
 - 5% for major stock market indices and gold (equal to a leverage limit of 20:1)
 - 10% for minor indices and other commodities (equal to a leverage limit of 10:1)
 - 20% for single stock equities and all other assets (equal to a leverage limit of 5:1)
- 3.25** As well as leverage limits or initial margin requirements, we also propose a 50% margin close-out requirement for inexperienced retail clients. The firm may allow the client to maintain their open position(s) until the client’s net equity (‘maintenance margin’), defined as the sum of the client’s net profit and loss on an open position(s) and the client’s deposited funds, falls below 50% of the initial margin required to establish the open position(s). Once the client’s maintenance margin falls below 50% of the initial margin required, the firm must close out the client’s position(s) as soon as market conditions allow. The margin close-out requirement, when combined with the proposed leverage limits, will mitigate the exposure of clients to potentially limitless losses. However, the proposed margin close-out requirement does not impose a guaranteed stop-loss on firms. It is possible that during periods of excessive market volatility, a firm is unable to immediately close out a client and, as a result, clients could lose their entire deposited funds or sustain losses exceeding their deposited funds.
- 3.26** Introducing leverage limits for inexperienced clients will reduce the risk of significant losses where a new retail client trades retail CFD products without fully realising the impact of leverage on their trading results. It reduces the likelihood that these clients will make substantial losses in a short period of time before they decide either to cease trading, or gain sufficient familiarity with the product that they can better understand and assess the risks of trading on leverage.
- 3.27** In the current market, the lowest margin requirements are offered for the lowest order size. This practice has attracted a growing number of inexperienced clients who are often unaware of the effects of leverage on market risk. The main risk to retail clients is that at high levels of leverage, even low levels of market volatility can result in a very high likelihood that a client will be automatically closed out by the firm in a losing position. This may result in the client losing most or all of their initial margin. In some cases, clients may lose more than their despotised margin.
- 3.28** This measure seeks to reverse the current market practice of firms offering the highest leverage to small accounts. It also tackles the practice of limiting leverage for larger accounts or trades, which only reflects the firm’s own credit risk and does not consider the best interests of clients.
- 3.29** This measure is also intended to address the limitations of appropriateness tests. We have seen repeat instances of firms not requesting sufficient information to reasonably establish the client’s knowledge and experience. This information is necessary to properly establish if these

products are appropriate. Alternatively, firms have extensively relied on clients' self-certifying that they understand the risks, or relied on weak assessments of 'knowledge' to deem CFD products appropriate for a client. Firms have also often used demonstration accounts to provide 'training' to retail clients in an effort to improve their knowledge and experience of CFDs for the purposes of passing the appropriateness test. By setting leverage limits on the basis of actual, evidenced client experience of trading leveraged instruments, the policy measure addresses the risk of weak appropriateness testing and should ensure that the level of risk created by leverage offered on retail CFD products is better moderated for retail clients.

- 3.30** If an inexperienced client persists with trading such that they can then meet the threshold for an experienced client, e.g. they have at least four quarters active trading experience, a firm can re-classify them and offer access to higher levels of leverage, up to the limits proposed below for experienced clients. In such cases, we would expect a firm to clearly inform the client before offering higher leverage limits, and explain how this may alter the risk of losses and costs and charges on trades.

Leverage caps for Experienced Retail Clients

- 3.31** In addition to leverage limits for inexperienced clients, we are proposing leverage limits for experienced retail clients trading in CFD products according to the underlying asset.
- 3.32** We propose that for experienced retail clients, firms must require initial margin based on the value of a trade of at least:
- 2% for major FX pairs (equal to a leverage limit of 50:1)
 - 2.5% for major stock market indices and gold (equal to a leverage limit of 40:1)
 - 5% for minor indices and other commodities (equal to a leverage limit of 20:1)
 - 10% for single stock equities and all other assets (equal to a leverage limit of 10:1)
- 3.33** The proposed leverage limits have been set to reflect the risk and relative volatility of each of the underlying assets and are in line with international practices. We are keen to ensure we provide adequate protections for consumers while also ensuring that UK CFD providers remain competitive. We believe that the leverage limits we have proposed achieve this balance.
- 3.34** These limits will reduce the risks to investors from the plainly excessive levels of leverage currently offered to them.
- 3.35** The proposed leverage caps have also been introduced to ensure that firms compete on terms that are in the best interests of their clients. In recent years we have seen a trend towards higher levels of leverage being offered to clients, as new firms enter the market place. By seeking to attract new clients or to expand market share through higher levels of leverage, the current marketplace is exposing retail investors to greater risk. By introducing leverage caps across asset classes, we want to ensure that CFD providers compete for business through product features that work in the interests of consumers, rather than those that are harmful to them.
- 3.36** These measures will also limit the credit risks to retail CFD firms since they act as principal and counterparty to trades with their clients. The high levels of leverage that most CFD retail product providers offer exposes firms to significant credit risk if sudden market movements lead to significant client trading losses that exceed margin deposits, and mean the client owes money to the firm. The introduction of leverage limits will help reduce these risks, supporting financial stability.

- 3.37** As well as leverage limits or initial margin requirements, we are proposing the same 50% margin close-out requirement for experienced retail clients. Similarly, this measure is intended to improve protections against sudden loss of their deposited funds.
- 3.38** This policy measure would not directly apply to firms offering CFDs on a cross-border services passport from another EU member state. However, we are proposing a restriction on financial promotions for firms that do not seek to limit leverage on similar terms to the final reforms we propose for UK-based firms.
- 3.39** Our proposal is compatible with our EU legal obligations under MiFID, which does not directly set rules on leverage offered for trading products such as CFDs. On that basis, there is scope to implement a measure at national level. The restriction on financial promotions for incoming EEA firms that do not adopt comparable leverage limits for UK clients is designed to ensure UK investors enjoy a consistent level of protection. This is consistent with our obligation to ensure our policies do not discriminate between UK and incoming EEA firms.

Q4: Do you agree with the proposal to limit the risks of CFDs by taking steps to limit leverage for retail clients?

Q5: Do you agree with the proposal to adopt different leverage limits for inexperienced and experienced retail clients and how we propose to classify 'experience'?

Q6: Do you agree with the proposed margin limits for inexperienced clients and experienced retail clients?

Q7: Do you agree with the proposal to set a margin close out limit of 50% of initial margin required? In particular, we welcome feedback on the detailed drafting of this rule and whether it is compatible with standard market practices.

Ban on financial promotions offering bonuses and other incentives to open accounts or trade

- 3.40** We propose a ban on all financial promotions offering bonuses and other incentives to open accounts or trade.
- 3.41** Financial promotions offering bonuses and or other incentives to open accounts or trade often distract clients from the high-risk nature of CFD products. They draw in inexperienced retail clients who may not otherwise choose to invest in these products.
- 3.42** In recent years, offering bonuses to open trading accounts has become a common feature and focal point of advertising by some firms. Bonus promotions and introductory offers have been used to target new and inexperienced clients who are unfamiliar with the product and its associated risks. These clients are more likely to be lured into trading retail CFD products by the prospect of 'free money'. However, trading bonuses and other incentives to open accounts require the investment of the client's own funds and are often contingent on reaching a certain total volume of trades. Because bonus funds are also applied to the trade's initial margin, bonus promotions can expose clients to greater losses than if they entered in to trades using just their own funds.
- 3.43** Our supervisory work has also discovered that the terms and conditions on promotional offers are often misleading. Many clients reported that they were unaware that their access to bonus

funds depended on a specified volume of trades or of a requirement to invest additional funds in order to have the right to withdraw. A number of investors have reported difficulties in withdrawing funds when trying to use bonus promotions.

- 3.44** Even if the terms and conditions were presented to clients in a clear manner and clients were capable of withdrawing their funds with ease, we are still of the view that offering bonuses and other inducements to trade is inappropriate.
- 3.45** We do not believe that banning these financial promotions restricts the ability of either new entrants or existing firms to compete. This is because there are other product features and/or services that CFD firms offer to new and existing clients that enable them to compete in the market that act in the best interests of consumers. Importantly, market research suggests that the primary reasons why investors chose particular CFD providers are how easy it is to use trading platforms, supporting features of the platform, the cost of trading in terms of commission and spreads and the reputation of the firm, including its financial strength. Very few clients said introductory offers were the main reason they chose a platform or switched from one platform to another.
- 3.46** A ban on financial promotions offering bonuses and other incentives would provide much needed protection for retail investors.
- 3.47** Our proposal is consistent with our legal obligations under MiFID I and will be consistent with our obligations under MiFID II. MiFID I and MiFID II do not directly set rules relating to financial promotions. On that basis, we believe there is scope to implement this measure at national level.

Q8: Do you agree with our proposal to ban bonus promotions or other incentives to open accounts or trade?

4. Binary bet considerations

- 4.1** In this Chapter, we summarise our views on some of the conduct risks and investor protection concerns related to binary bets. We also outline potential policy approaches we could consider with regard to the sale of these products to retail clients, once binary bets are inside the FCA's perimeter. We seek views in response to this discussion.

Binary bets activity

- 4.2** Binary bets are often marketed in a similar way to CFD products, and allow a client to 'bet' on whether the price of a financial instrument will be higher or lower than a fixed threshold at a future point in time.³³
- 4.3** At present, binary bets are currently treated as gambling products in the UK and providers are currently licensed under the Gambling Commission, rather than being regulated by the FCA. Based on Gambling Commission figures, we estimate that the current volume of activity in binary bets in the UK is relatively small.
- 4.4** However, the Treasury has consulted on bringing binary bets in to scope of FCA regulation as part of the transposition of MiFID II,³⁴ after a European Commission opinion concluded that they should be considered as MiFID financial instruments. We recently indicated our intention to create a new permission category of binary bets as part of our third consultation paper on Markets in Financial Instruments Directive II Implementation (CP16/29). In light of these developments, we are considering appropriate policy measures to regulate these products.
- 4.5** We have significant concerns over the conduct of firms from other EEA jurisdictions and elsewhere and the nature of the products offered in the current market, which have negatively affected UK consumers.³⁵ A number of inward EEA passporting binary bet providers have been fined by their home NCAs. The reasons for this include, failing to apply appropriateness tests or give effective risk warnings when a client failed an appropriateness test, failing to comply with the requirement that communications with clients are fair, clear and not misleading, providing investment advice without authorisation and failure to act in the best interests of the client.³⁶

³³ If at expiry a price is not above or below the threshold and position taken by the client, they lose their entire stake, but if a price has move beyond the threshold in the direction predicted by the client, they receive a fixed pay-out. The pay-out is calculated when the client takes out the binary option, and does not fluctuate according to how far beyond a threshold the price has moved.

³⁴ HM Treasury, Transposition of the Markets in Financial Instruments Directive II.

³⁵ CySec fined Banc de Binary for a third time earlier this year. See CYSEC, *Board Decisions*. Binary bet firms have also been the subject of a number of media articles by UK press highlighting consumer complaints about the firm. For instance, multiple articles have been written by Tony Hetherington in This is Money. See: www.thisismoney.co.uk/money/index.html.

³⁶ See footnotes 4, 5 and 6 in ESMA, Warning about CFDs, binary options and other speculative products. .

- 4.6** We have also seen a significant rise in alleged scams linked to binary bets reported to our Unauthorised Business Unit. A recent warning by Action Fraud cited 305 reports about binary bets between June 2015 and May 2016.
- 4.7** Although we are concerned about the risks of the conduct of incoming EEA firms and the rise in scams linked to binary bets, we also consider that the inherent features of binary bets make them inappropriate for many retail investors. At present, these products are insufficiently transparent to allow a retail client to judge the value of a binary bet because of the complex probability methodology or other internal models binary bet firms use to calculate pay-outs.
- 4.8** This feature, which is common to all binary bet products, makes it difficult, if not impossible, for clients to fairly value these investment products and assess the potential rate of return relative to the risk of loss.
- 4.9** These products present similar challenges to our ability to ensure that firms are complying with their best execution obligation. These products have an inherent conflict of interest for firms because of how they calculate prices at expiry. There is a significant incentive for firms to favour their own interests over their clients, which may not be manageable when dealing with retail clients.
- 4.10** Recent binary bet products have included '30 second countdown' binaries which encourage investors to take positions on the movement of prices over a very short timeframe. The short duration of these binary bets suggest that they are more akin to gambling products – and have similar addiction-type risks for consumers – than to investment products that meet a genuine investment need.
- 4.11** Our initial information indicates that existing binary bet consumers typically lose money on these products on average, and these losses can be significant.
- 4.12** Overall, we believe binary bets as they are offered in the current market:
- Do not allow retail investors to make informed decisions. This is because it is nearly impossible to predict outcomes in such short periods, and can also lead to addictive behaviour akin to gambling.
 - Pose significant information asymmetries for clients. Pay-outs are linked to probability theory rather than directly correlated to a public reference price, and
 - Lead to significant conflicts of interest for the firm which takes the other side of the client's bet. There is potentially a strong commercial incentive for a specific expiry reference price to be manipulated to avoid pay-outs to clients.

Possible policy approaches for discussion

- 4.13** Given these consumer protection risks and questions over whether binary bets can meet a genuine investment need for retail clients, we are considering possible policy measures that could supplement existing MiFID-derived conduct of business rules. These could include:
- A restriction on marketing these products to certain retail clients
 - The future use of product intervention powers under MiFID II to address specific product

features of binary bets, or the nature of certain marketing, distribution or sales techniques relating to them, or

- Other approaches to ensure that binary bets are designed in a manner that meets the needs of an identified target market, allow investors to understand their fair value, and are capable of being appropriately distributed to retail clients.

4.14 Any potential measure(s) will be subject to the Government's final legislative changes to bring binary bets within the scope of our regulatory powers. We would only consult on any formal proposals once the legislation has been finalised and following responses to this publication. In order to further inform our considerations, we welcome feedback from retail investors, binary bet providers and any other interested stakeholders on the following questions:

Q9: What investment need(s) do binary bets fulfil for retail clients, and do you agree with the risks we have identified?

Q10: What are your views on a limiting the marketing of binary bets to some retail clients?

Q11: What are your views on the potential use of product intervention powers under MiFID II to restrict specific features of binary bets or place limits on the distribution or sale of these products for retail clients?

Q12: Are there any alternative policy measures that we should consider to address our investor protection concerns in relation to binary bets and enable retail clients to effectively value these products?

5. Next steps

Retail CFD policy proposals

- 5.1** We welcome feedback on the policy measures we have proposed by 7 March 2017. Subject to these responses, we will seek to publish a final policy statement and final Handbook rules by late spring 2017.
- 5.2** In the interim, we expect all CFD providers to ensure they are complying with our existing rules for the provisions of services involving retail CFD products. In particular, as we outlined in a Dear CEO letter in February 2016, we expect all firms in this sector to assess whether they have adequate standards in relation to appropriateness assessments, AML controls and client categorisation.³⁷
- 5.3** We also expect firms to ensure they comply with current disclosure requirements. In particular, risk warnings should be clear and not diminished by other statements or their overall positioning and prominence.³⁸ Risk warnings ensure clients make informed decisions on whether or not to proceed with an investment. This is particularly important for retail CFD products given the high risk of losses and the need to carefully monitor investments.
- 5.4** In response to our previous findings, we are also conducting further supervisory work and are also applying increased scrutiny during the authorisation process to all new applicants seeking to offer retail CFDs.³⁹

Binary bets

- 5.5** We have indicated our current policy considerations in relation to binary bets, ahead of these products being brought inside the FCA's perimeter. We welcome views on these products and the range of possible policy measures discussed in this CP by 7 March 2017 alongside responses to our proposals on retail CFDs.
- 5.6** We would consult on any formal proposals and draft Handbook rules in relation to binary bets in spring 2017.

³⁷ FCA, Dear CEO Letter – Client take-on review in firms offering contract for difference (CFD) products.

³⁸ In accordance with COBS 4.2.1R and COBS 10.3.1R.

³⁹ Firms should continue to review authorisation applications and ensure that firms using compliance consultants to fill control functions and provision of generic policy documents meet our expectations. We have seen applications that raise questions as to the extent of presence planned by firms seeking UK authorisation and issues such as outsourcing and intragroup arrangements, which bring into question whether the mind and management of an applicant firm is genuinely in the UK and would remain here post-authorisation.

Annex 1

List of questions

We seek responses to the following consultation questions:

- Q1:** What investment need(s) do CFDs fulfil for retail clients and would they be disadvantaged if they no longer had access to these products?
- Q2:** Do you agree with our proposal to require enhanced disclosure requirements for CFD products?
- Q3:** Do you agree with our proposal to require CFD firms to disclose the percentage of client accounts that are in profit or loss over the previous calendar quarter and over the last 12 months?
- Q4:** Do you agree with the proposal to limit the risks of CFDs by taking steps to limit leverage for retail clients?
- Q5:** Do you agree with the proposal to adopt different leverage limits for inexperienced and experienced retail clients?
- Q6:** Do you agree with the proposed margin limits for inexperienced clients and experienced retail clients?
- Q7:** Do you agree with the proposal to set a margin close out limit of 50% of initial margin required? In particular, we welcome feedback on the detailed drafting of this rule and whether it is compatible with standard market practices.
- Q8:** Do you agree with our proposal to ban bonus promotions or other incentives to open accounts or trade?

We seek responses to the following discussion questions:

- Q9:** What investment need(s) do binary bets fulfil for retail clients, and do you agree with the risks we have identified?
- Q10:** What are your views on limiting the marketing of binary bets to some retail clients?

Q11: What are your views on the potential use of product intervention powers under MiFID II to restrict specific features of binary bets or place limits on the distribution or sale of these products for retail clients?

Q12: Are there any alternative policy measures that we should consider to address our investor protection concerns in relation to binary bets?

Annex 2

Cost benefit analysis

The Market

CFD Firms

1. We have identified 97 FCA-authorized firms⁴⁰ whose primary activity is selling and distributing CFD products to retail clients. These firms currently hold around £3.5bn in client money.
2. There are 74 'full-scope' and 'matched principal' firms⁴¹ that act as the principal to the client, which will be affected by all of the policy proposals.
3. There are 23 firms that provide advisory, arranging, or portfolio management services. These firms will only be affected by the requirement to introduce standardised risk warnings and enhanced disclosure requirements, and the proposed ban on bonus promotions.
4. In assessing the costs of our proposed policy measures, we consider the one-off and ongoing compliance costs incurred by firms to comply with our proposals.

Investors

5. Our internal data show that retail CFD firms have 1,050,000 funded retail client accounts. Those figures include dormant accounts and potentially multiple accounts owned by the same investor. Our cost benefit analysis assumes that total active client numbers are approximately 50% of the number of reported client accounts, equating to 525,000 clients. Based on market intelligence there are approximately 125,000 active UK clients and around 400,000 overseas-based clients.
6. Due to our concerns about the quality of firms' use of appropriateness tests, we believe we would be unable to obtain reliable data on the number of clients that would be classified as experienced or inexperienced. However, based on our observations of the sector we estimate that at least 40% of the current population of retail clients would be classified as inexperienced retail clients and 60% of would be designated as experienced retail clients under our proposed rules. Based on the current population of retail clients, these figures correspond to a total figure of 210,000 active inexperienced clients and 315,000 active experienced clients.
7. From a random sample of client accounts from eight CFD firms, our internal analysis suggests that 82% of clients lose money on these products. The average outcome was a loss of £2,200 per client. Our research suggests that inexperienced retail clients lose less money than experienced clients due to the lower number and volume of trades.

⁴⁰ In addition to the 97 firms that are specialist CFD firms, 1,657 firms and individuals are authorised to sell and distribute CFD products to retail clients. However, we reasonably believe that the overwhelming majority of these firms do not sell CFD products to retail clients. We reasonably believe that, although these firms would be subject to the provisions outlined in this paper, they would unlikely be affected by these provisions for the purposes of this CBA. It is common practice for firms to apply for multiple authorisations to cover a multitude of investment products that they never sell or distribute these products to their clients.

⁴¹ 'Full scope' refers to MiFID investment firms who are not limited licence or limited activity firms, and are subject to initial minimum capital requirements of €730,000. 'Matched-principal' firms refer to those meeting the matched principal exemption conditions as defined in the FCA Glossary, and are subject to initial minimum capital requirements of €125,000.

8. Investors in retail CFD products have historically had higher than average incomes in a professional occupation. However, there is evidence that CFD firms are increasingly targeting retail clients who have less experience in these products and that these clients are becoming an important source of revenue and profit for some CFD firms. The poor quality of appropriateness tests conducted by firms also makes it difficult for us to get accurate information on the experience of retail CFD firms' clients.
9. We are concerned that the market has expanded to target investors who are less familiar with CFD products, or other comparable products such as options and futures, through the mass marketing of these products and by offering lower minimum account sizes. Our supervisory work has found that some CFD firms appear to increasingly rely on a high turnover of new clients who lose most, if not all, of their initial deposited funds in a short period of time. Some firms offer higher rates of leverage to retail clients who make smaller orders and trade sizes. This increases the probability that these clients will be automatically closed-out in a short period of time and lose their deposited funds after just a few trades.
10. We are also concerned that the losses borne by of inexperienced retail clients are a greater proportion of their total deposited funds and represent a greater proportion of their total investible savings in comparison to experienced retail clients.

Market Failure Analysis

11. When considering possible involvement in the CFD market by retail investors, the principal market failure is the information asymmetry between firms and retail investors.
12. At present, a large number of firms fail to provide clear and effective information to retail clients to allow them to understand the complexity of these products and their risks while all firms fail to provide clear information on the historical performance of these products that would enable the client to make a informed investment decision. This presents a clear information asymmetry between retail clients and the firm, particularly as it relates to the relative probability of clients making a profit or a loss from these products.
13. A clear information asymmetry also exists between most retail clients and the firm when it comes to understanding and assessing the appropriateness of taking a leveraged position on a specified financial asset. Firms have increasingly emphasized the benefits of higher levels of leverage, in terms of potentially higher profits, without giving sufficient prominence to the risks. In particular, through lower margin requirements or higher leverage limits, the firm increases the probability that it will automatically close out an investor and that investors will lose a proportion of their initial deposited margin. Clients without experience in these products, or comparable products such as options or futures, are less able to assess the risks of higher rates of leverage. The proposed leverage limits for inexperienced and experienced retail clients are designed to ensure that margin requirements are set at levels that match the client's experience with leveraged financial products and the volatility of the underlying financial asset.

Cost Benefit Analysis

14. The Financial Services and Markets Act 2000 (FSMA), as amended by the Financial Services Act (2012), requires us to publish a cost benefit analysis (CBA) of our proposed rules. Specifically, section 138I requires us to publish a CBA of proposed rules, defined as 'an analysis of the costs,

together with an analysis of the benefits' that will arise if the proposed rules are made. It also requires us to include estimates of those costs and those benefits, unless these cannot be reasonably estimated or it is not reasonably practicable to produce an estimate.

15. In summary, the proposals we are consulting on are:
- enhanced disclosure requirements and a standardised risk warning
 - leverage limits for inexperienced and experienced retail clients
 - prohibitions on bonus promotions
16. Our cost benefit analysis examines the direct compliance costs of the proposed reforms for firms, potential costs to investors and the expected benefits to investors.

Compliance Costs to Firms

17. We expect that the proposed policy measures will create one-off and ongoing costs for firms to comply. Overall we expect the main compliance costs on CFD firms to be:
- the costs of gathering information on client accounts to produce the profit and loss disclosure,
 - gathering information from clients to appropriately categorise retail clients as experienced or inexperienced clients, and
 - configuring internal systems to ensure that the prescribed leverage limits for inexperienced and experienced retail clients are consistent with clients' designation
18. We expect that the costs of complying with the enhanced disclosure requirement and standardised risk warning and prohibitions on bonus promotions will be incurred by all 97 authorised CFD firms.
19. We expect that the costs of compliance for applying leverage limits to inexperienced and experienced retail clients will only be incurred by the 74 'full-service' firms.
20. We outline the initial and ongoing costs of compliance with the proposed policy measures in the table below:

Table 2: Summary of one-off and ongoing costs to firms from our CFD reform proposals

Measure	One-off Cost '000	Ongoing Costs
Standardised risk warning and enhanced disclosure requirement	£251	Minimal
Leverage limits for experienced and inexperienced retail clients	£285 – £363	Minimal
Ban on Bonus Promotions	Minimal	Minimal

Standardised risk warning and enhanced disclosure requirement

21. The standardised risk warning requirement will incur one-off and ongoing costs for retail CFD product providers. The profit or loss disclosure will incur a one-off cost to revise client data management and IT systems to capture the requisite client data to calculate and disclose the percentage of client accounts that were in profit or loss over the previous quarter and the last 12 months. Firms will also incur a one-off cost to redesign their website to include the standardised risk warning and comply with the related prominence requirements.
22. We estimate that it will take five days (of seven hours per day) of an IT specialist for all firms to update client data management and IT systems to calculate average client account profit/loss across all client accounts at a cost of £70 per hour. This leads to an initial cost of £2,450 per firm.
23. We estimate that it will take 2 hours of an IT specialist to revise and update the webpage and or mobile application of the firm's platform to include the standardised risk warning on the relevant landing pages and at the point of sale at a cost of £70 per hour. This leads to an initial cost of £140 per firm.
24. Based on this assessment, this policy measure will incur an initial one-off cost of £251,230 for the industry as a whole.
25. In terms of ongoing costs, firms will be required to recalculate average profit/loss client account figures each quarter and include those figures in the standardised risk warning on the firm's website or mobile application. This will require firms to automate their internal systems to ensure that figures are kept up to date. We expect only minimal ongoing costs for the firm.

Leverage limits for inexperienced and experienced retail clients

26. We expect firms will incur one-off and ongoing costs to implement the requirement to assess client experience with CFD products or other related leveraged product and setting the relevant margin requirements.
27. The requirement to assess client experience will incur a one-off cost for the firm to establish internal compliance measures to ensure that the firm gets the required information from the client and checks it. This is to ensure that the client is appropriately categorised and leverage limits are accurately applied.
28. We estimate that it will take five days (of seven hours per day) of the compliance manager or compliance consultant to develop appropriate policies and procedures to ensure these measures are implemented effectively. Assuming a cost of £40 – £70 per hour for compliance managers or external consultants, we expect a cost of between £1,400 and £2,450 per firm. Based on the current population of firms, we estimate a one-off cost of between £103,600 and £181,300 for the industry as a whole.
29. We expect that firms will be required to modify their internal systems and trading platforms to ensure that the leverage they make available to clients is consistent with their 'experienced' or 'inexperienced' designation. We estimate that this will take five days (of seven hours per day) of an IT specialist for all firms to update client data management and IT systems at a cost of £70 per hour. This leads to a cost of £2,450 per firm. Based on the current population of firms, we estimate a one-off of £181,300 for the industry as a whole.
30. We also expect that firms will incur a one-off and ongoing cost to implement leverage limits for inexperienced and experienced retail clients by modifying the leverage they make available to their clients through their internal systems and trading platforms. Firms already routinely

modify the leverage offered to clients based on the changing risk profile of certain assets. Therefore, we conclude that modifying available leverage levels will incur minimal one-off and ongoing costs to the firm.

31. Firms will incur ongoing costs to ensure compliance with the requirement to assess client experience. However, we expect that the ongoing costs for firms will be minimal once standard procedures have been put in place.
32. We estimate the total one-off costs experienced by firms will be between £284,900 and £362,600 for the industry as a whole.

Ban on financial promotions offering bonuses and other incentives to open accounts or trade

33. We expect that firms will incur a minimal one-off cost to amend or remove existing marketing literature through their website, mobile applications, and social media platforms, to ensure they comply with this rule. This measure will provide cost savings to firms on an ongoing basis as they will no longer incur the costs of providing such bonuses. Overall, we expect a minimal one-off cost to firms.

Indirect Costs to Firms

34. We expect that our package of policy measures will have a wider impact on the industry as a whole. We expect that these measures will reduce the overall number of clients, the total volume and value of trades and total firm revenues. These measures could consequently affect the profitability of firms across the sector. This is, in part, because the standardised risk warning and enhanced disclosure requirement will reduce the total number of retail clients who choose to invest in these products. It also reflects the lower likelihood of clients losing money and the expected decline in total client losses (as outlined in Investor Benefits). These changes will likely require firms to reassess the suitability of their business models.
35. The impact of these measures on firms will be very different across firms because of differences in their business models. Firms that have relied on more experienced retail clients, or have diversified their product offerings to include other investment products, will be less impacted by our policies. Firms that have relied on a higher proportion of client accounts losing money to the firm by targeting less experienced clients, and/or offering higher levels of leverage, will be more impacted by our policies.
36. We believe some firms may choose to exit the market and expect there will be a degree of market consolidation. However, given the number of firms active in the market we do not think that this additional consolidation will significantly reduce competition.

Costs to Investors

37. We expect few costs to investors. Our proposed leverage limits will require retail clients to post additional margin to maintain the same level of notional exposure. We expect that most investors will choose to lower their notional exposure rather than post additional margin. This will limit the potential returns on each trade. However, given that we observe that only 18% of client accounts were in profit, we believe that this will only have a minimal impact on investors. For retail clients who choose to post additional margin, the opportunity cost of holding more cash is zero. This is because CFD firms charge their clients interest on the leverage offered by the firm.
38. There is a risk that inexperienced retail clients will no longer be offered these products by CFD firms because these clients are no longer as profitable or attractive to them. Higher margin requirements may also increase the minimum account sizes offered by firms. However, given

that these products are not appropriate for many retail clients, and that retail clients who are unable to post higher initial margin may correspond with investors who are less able to bear losses, a reduction in consumer choice is not necessarily a cost to investors.

Benefits to Investors

39. The benefits we estimate occur as a result of the transfer of money from firms to investors. This is because investors are expected to incur fewer losses as they will have greater knowledge about the risks of CFDs and the reduced levels of leverage they will have available.
40. To estimate the benefits to investors, we estimate that there are 525,000 retail clients. Within the total population of investors, we estimate that 210,000 would be designated as inexperienced clients and 315,000 as experienced clients. However, while the classification between experienced and inexperienced investors matters for the overall estimate of benefits, the proposals provide net benefits under all circumstances.
41. Based on a sample of retail CFD client accounts, we assume 82% of investors lost money on these products at an average rate of £2,200 per client. We have calculated benefits to investors based on expected differences in losses between experienced and inexperienced clients. Using the same sample of retail CFD client accounts, we estimate that the average loss per inexperienced retail client is £400 and average loss per experienced retail client is £3,500. This is based on average losses for clients conducting less than 100 trades and average losses for clients conducting 100 trades or more.
42. Our analysis expects welfare gains for investors from:
- fewer inexperienced clients trading in retail CFD products as a result of the standardised risk warning and enhanced disclosure requirement and the ban on bonus promotions and other incentives to open accounts or trade, and
 - lower losses per client account through the introduction of leverage limits for inexperienced and experienced retail clients
43. Our analysis reasonably estimates the welfare gains associated with each of the proposed policy measures. The total value of client benefits is outlined in the table below:

Table 3: Summary of benefits to retail CFD investors

	Inexperienced retail clients £m	Experienced retail clients £m	All retail clients £m
Standardised risk warning and a ban on bonus promotions	£1.6	Minimal	£1.6
Leverage limits for inexperienced and experienced retail clients	£9.7 – £19.3	£136.5 – £273	£146.1 – £292.3

44. We expect the standardised risk warning and enhanced disclosure requirements, and the ban on financial promotions offering bonuses and other incentives to trade, will reduce the number of clients who choose to trade in CFD products.

- 45.** It is very difficult to estimate the impact of a standardised risk warning and the ban on bonus promotions. However, we expect these measures will have no impact on experienced clients. We base our estimate on a conservative assumption that they will reduce the total number of inexperienced retail clients who trade in CFD products by 2%, which equates to 4,100 fewer inexperienced retail clients.
- 46.** On that basis, the combined effect of these measures is a total benefit of £1,640,000 for retail investors.
- 47.** As well as these quantifiable benefits, we believe that the standardised risk warning and enhanced disclosure requirements will ensure that investors are better informed about the risks of CFDs and have greater awareness of how they function and the likelihood of their success. As such, it is reasonable to expect that clients may adjust their risk appetite and adopt different trading strategies, which may or may not provide greater returns or lower levels of loss.
- 48.** Leverage limits are expected to reduce the probability that investors will, on average, lose money on these products as well as the average amount that clients lose per trade. Analysis of internal figures suggest there is evidence that average investor losses in jurisdictions with leverage limits are between 20 – 40% lower than in jurisdictions without leverage limits. This is based on data comparing average losses per client account from a sample of active client account data from a jurisdiction with comparable leverage limits to those proposed in this CP, and UK clients. Our estimates of expected consumer benefits are calculated on the basis that we will observe similar declines in average client losses.
- 49.** We have calculated our expectations of welfare gains for investors on the basis that our leverage limits will not affect all overseas clients, as some clients currently live in jurisdictions with leverage limits that are observed by CFD firms. We estimate that 50% of overseas clients will be affected by our leverage limits, totalling 200,000 clients, in addition to the 125,000 active UK-based clients. Given the expected impact of standardised risk warnings and the proposed ban on bonus promotions, and the estimated distribution of inexperienced and experienced clients, our analysis assumes a population of 120,900 inexperienced retail clients and 195,000 experienced retail clients.
- 50.** Our baseline scenario assumes that inexperienced retail investors lose on average £400 and that experienced retail clients lose on average £3,500. We calculate investor benefits on the expectation that investor losses will be between 20% and 40% lower after introducing leverage limits, inexperienced client losses will fall between £80 and £160 per investor and experienced client losses will fall between £700 and £1,400 per investor. This produces a benefit of between £9,672,000 and £19,344,000 for all inexperienced retail clients and a benefit of between £136,500,000 and £273,000,000 for all experienced retail clients. It is expected that the proposed leverage limit will save retail clients between £146,172,000 and £292,344,000 in total.
- 51.** Although these estimates are clearly uncertain, we are clear that a reduction in leverage limits will mean investors make fewer losses. Clearly we cannot estimate precisely the outcomes for investors under market conditions that have not yet happened.
- 52.** However, we have undertaken analysis that simulates the impact of lower leverage limits on investors by illustrating the lower likelihood of investors losing half of their initial margin under lower levels of leverage for a representative financial asset across a year.
- 53.** The graph and tables below describe the impact of different levels of leverage on a representative group of 1000 investors. The example below describes what would occur if each investor

invested £100 of initial margin per trade every two hours – at 8am, 10am, 12pm, and 2pm each day – over the course of a year for a range of underlying assets. This equates to a total of £100.8 million in invested funds. The financial assets analysed are the FTSE 100, GBP-USD FX pair and Brent oil. The figures represent the total losses for the group of 1000 investors based on the likelihood that they would lose half of their initial margin because of price movements of the underlying assets which trigger an automatic margin close out over a two hour period.

54. This includes an analysis of the expected losses per investor if different proportions of the market were invested in short or long positions, from between 0% of market participants being short and 100% of market participants being long, and vice versa. This is reflected in the maximum value of losses and minimum value of losses while an average loss is also represented.
55. The data we used to assess these welfare effects is actual trading data derived from 11 months to one year of data for each financial asset, from November 2015 to October 2016.
56. It is important to note that the values contained in the graph are not denoting actual welfare losses. Instead, the graph demonstrates the impact of leverage limits on the likelihood of investors being automatically closed out by a firm.⁴² It also demonstrates the likely benefits of lower leverage limits for experienced and inexperienced retail clients.
57. The results of the representative example is outlined in the table and graphs below:

Table 4: Expected margin loss through automatic close out over one year by level of leverage and underlying asset

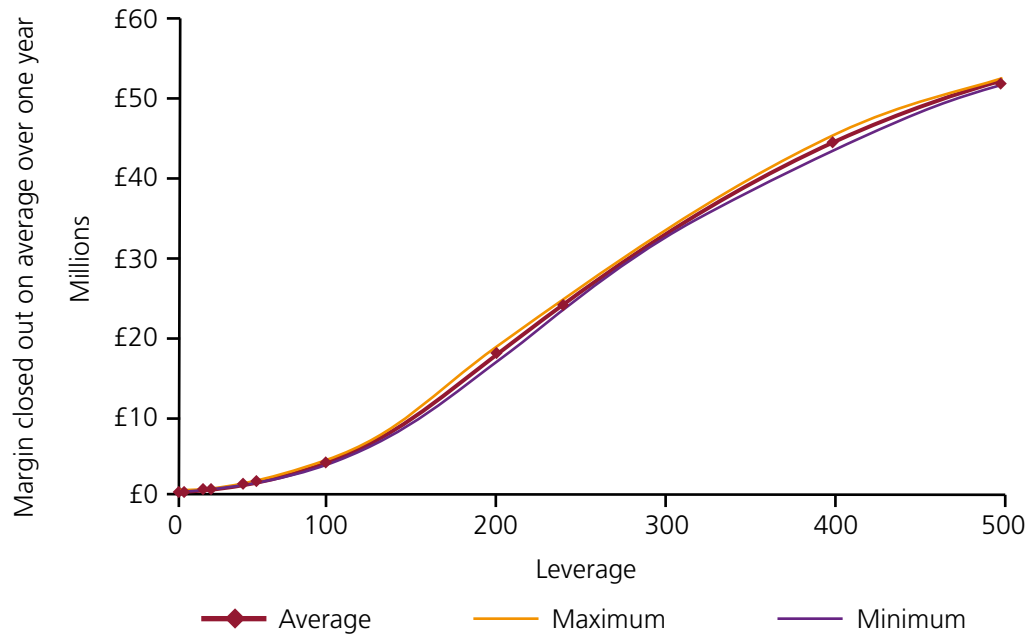
Expected margin loss through automatic close out over one year

Leverage	£/\$	FTSE	Brent Oil
500	£49,512,512	N/A*	N/A*
400	£41,852,085	N/A*	N/A*
250	£24,335,867	N/A*	N/A*
200	£17,562,929	£37,842,000	N/A*
100	£4,203,892	£16,128,000	£19,480,342
50	£794,069	£4,158,000	£5,456,410
40	£607,229	£2,646,000	£3,350,427
25	£280,259	£588,000	£717,949
20	£280,259	£210,000	£335,043
10	£93,420	£42,000	£47,863

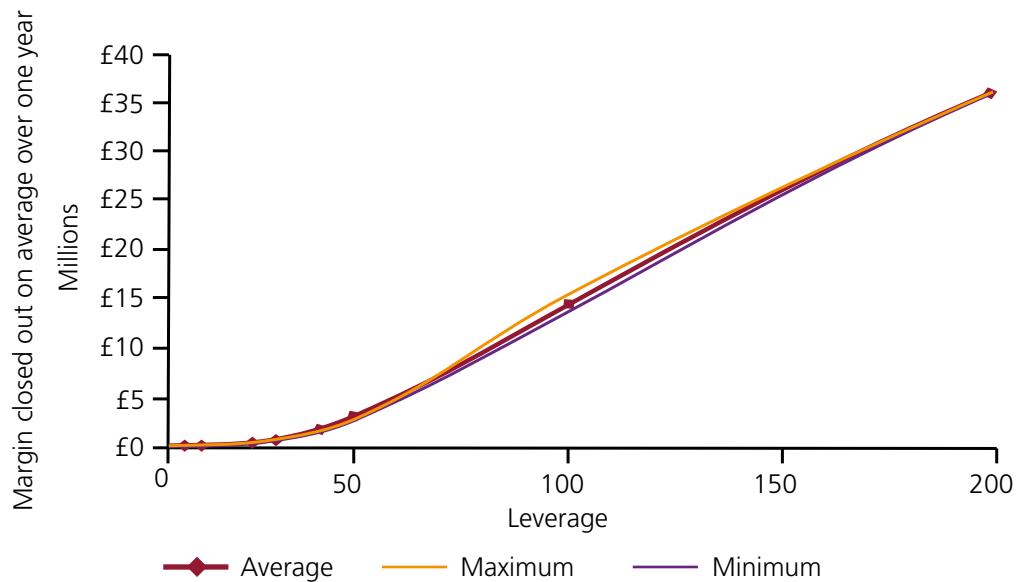
* We have not included calculations of expected margin loss for these assets at higher leverage limits because CFD firms do not typically offer these levels of leverage to their retail clients.

⁴² In order to establish the likelihood of clients being automatically closed-out, we utilized data in the form of prices of traded financial instruments for every two hour interval beginning at 8am and ending at 4pm. For each 2 hour time period, price data was collected for the open price, high within the period, low within the period, and the closing price. Data on these assets were collected from the previous 11 month period. From the data gathered the largest movement within each period window was calculated. Observations of price volatility were categorised into price volatility bins before a distributions of price volatilities was constructed. An observation is counted for each price volatility interval where the price volatility has exceeded either one of the open-high or open-low observations. The tallies of the price volatility intervals were then assessed and tabulated. This data was then used to calculate the observed / back-tested frequency of automatic close-out of positions and loss of margins, based on the frequencies that certain thresholds of price volatility had been exceeded.

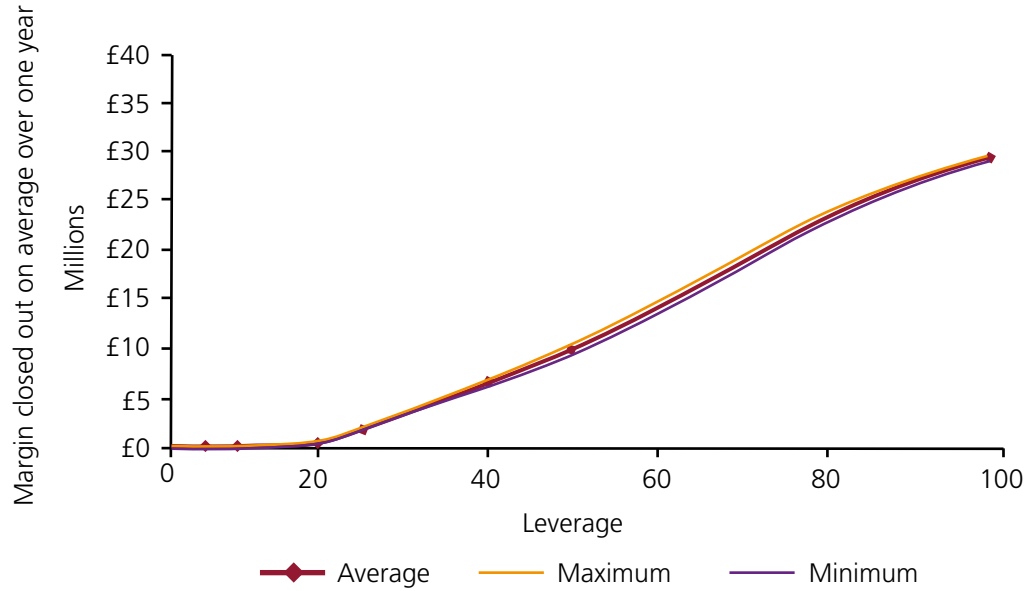
Expected loss of margin over one year: £/\$



Expected loss of margin over one year: FTSE100



Expected loss of margin over one year: Brent Oil



- 58. These figures demonstrate that lower leverage limits lower the likelihood that clients will be automatically closed out over a two hour period and that a higher level of leverage is positively correlated with an increased probability of loss through automatic margin close out under normal levels of market volatility. This provides support for the expectation that the probability of clients losing money and the size of client losses will decline under lower leverage limits.

Annex 3

Compatibility statement

1. We are required by section 181(2)(d) of FSMA to explain why we believe our proposed rules are compatible with our strategic objective, advance one or more of our operational objectives and have regard to the regulatory principles in section 3B of FSMA.

Compatibility with our general duties

2. The proposals in this consultation are designed to advance our objective of securing an appropriate degree of consumer protection by:
 - ensuring that retail clients of CFD products are given information that is timely and fit for purpose
 - reducing the risks of excessive levels of leverage being made available to retail clients
3. The proposals in this consultation are also designed to advance our competition objective by ensuring that retail CFD providers do not compete on terms that are harmful to the client and that CFD firms promote these products to suitable investors. We believe this will promote effective competition in a way that meets the interests of investors.

The need to use our resources in the most efficient and economical way

4. Our proposed leverage limits will ensure that the leverage which firms offer to retail clients is consistent with their obligation to act in the client's best interests under COBS 2.1.1. Introducing leverage limits ensures that levels of leverage offered to retail clients according to the underlying asset and experience of the client is matched to the underlying volatility of the asset as well as the client's knowledge and understanding of leverage and its risks. The use of leverage limits is more resource efficient than a case-by-case supervisory approach.
5. The standardised risk warning and enhanced disclosure requirement are intended to ensure firms comply with their requirements under COBS 14.3.2. Introducing a standardised risk warning ensures CFD firms provide information to the client that accurately depicts the risks of the investment. Providing a standardised risk warning requirement to firms is more efficient than reviewing CFD firms' disclosure to clients on a case-by-case basis.

Proportion of burdens or restrictions imposed on persons or on carrying on an activity

6. We consider our proposals to be appropriate and proportionate. They protect the interests of retail clients, ensure that retail clients with adequate knowledge, experience, and expertise can use these products for legitimate investment purposes and ensure that firms can continue to promote and sell retail CFD products to appropriate investors.

Recognition of differences in the nature and objectives of businesses

7. We have developed our package of policy measures to reflect the specific risks of retail CFD products. The intention is to balance the ability of CFD firms to sell an investment product with potentially high rates of return at a higher level of risk, with the interests of investors who may not fully understand these risks and how likely it is they will make a profit.

The principle that we should exercise our functions as transparently as possible

8. We have undertaken ongoing supervisory work through our thematic reviews and engaged with the industry through our Dear CEO letter. This work has demonstrated our ongoing concerns about poor market conduct and investor protection in the retail CFD sector. We will consult industry and investors on our proposed package of retail CFD policy measures over a three month period. We also invite feedback on our discussion of binary bets. We will consult on any formed policy proposals for binary bets in due course, once the final RAO legislation bringing them within our perimeter is finalised.

The general principle that consumers should take responsibility for their decisions

9. Our proposed policy measures ensure that investors have the freedom to invest in retail CFD products and potentially bear losses. The suite of policy measures are designed to ensure that potential losses match the consumer's risk appetite and their ability to bear losses.

Legislative and Regulatory Reform Act 2006 (LRR)

10. We are required under the Legislative and Regulatory Reform Act 2006 (LRR) to have regard to the principles in the LRR and to the Regulators' Compliance Code when determining general policies and principles and giving general guidance (but not when exercising other legislative functions). We consider that our proposal is:
- **Transparent:** We are following a consultation process in making these rules.
 - **Accountable:** We are seeking feedback from this consultation paper on whether stakeholders agree with our proposed approach.
 - **Proportionate:** Our proposed approach has been carefully developed to ensure a sufficient balance between adequate protections for retail clients, the freedom of investors to make informed investment choices and the ability of firms to compete for business on reasonable terms that act in the best interests of investors.
 - **Consistent:** Our proposed approach is applied to firms distributing the investments covered by this consultation exercise.
 - **Targeted only at cases in which action is needed:** We believe that there is a strong case for these measures as discussed in this paper.

Compatibility with the duty to promote effective competition in the interests of consumers

- 11.** In making any rule, we ensure that it is compatible with our duty to promote effective competition in the interests of consumers. We designed the proposed policy measures to ensure that UK firms compete in the interests of clients, rather than by lowering conduct standards and/or offering products or services to retail clients for whom they are inappropriate, and who may suffer detriment as a result.

Appendix 1

Draft Handbook text

CONDUCT OF BUSINESS (CONTRACTS FOR DIFFERENCE) INSTRUMENT 2017

Powers exercised

- A. The Financial Conduct Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 (“the Act”):
- (1) section 137A (The FCA’s general rules);
 - (2) section 137R (Financial promotion rules);
 - (3) section 137T (General supplementary powers); and
 - (4) section 139A (Power of the FCA to give guidance).
- B. The rule-making provisions listed above are specified for the purposes of section 138G(2) (Rule-making instruments) of the Act.

Commencement

- C. This instrument comes into force on [*date*]

Amendments to the Handbook

- D. The Glossary of definitions is amended in accordance with Annex A to this instrument.
- E. The Conduct of Business sourcebook (COBS) is amended in accordance with Annex B to this instrument.

Citation

- F. This instrument may be cited as the Conduct of Business (Contracts for Difference) Instrument 2017

By order of the Board
[*date*]

Annex A

Amendments to the Glossary of definitions

In this Annex, unless otherwise indicated, underlining indicates new text and striking through indicates deleted text.

Insert the following new definitions into the appropriate places. The text is not underlined.

<i>active trading experience</i>	<p>(a) in a calendar quarter: the <i>execution</i> of at least ten trades in <i>contracts for differences</i> traded on a leveraged basis, <i>spread bets</i> or <i>rolling spot forex contracts</i>; or</p> <p>(b) in a continuous period of twelve <i>months</i>: at least forty such trades in the period with at least two trades carried out per calendar quarter.</p>
<i>currency pair</i>	a <i>major foreign exchange pair</i> or a <i>minor foreign exchange pair</i> .
<i>experienced retail client</i>	(in COBS 22.4) a <i>retail client</i> with <i>active trading experience</i> of at least a continuous period of twelve <i>months</i> or four calendar quarters within the twelve calendar quarters prior to the current trade.
<i>inexperienced retail client</i>	(in COBS 22.4) a <i>retail client</i> who is not an <i>experienced retail client</i> .
<i>major foreign exchange pair</i>	two different currencies from the following list of currencies: US dollar, euro, Japanese yen, pound sterling, Canadian dollar and Swiss franc.
<i>minor foreign exchange pairs</i>	a pair of two different currencies whose exchange rates are traded in the foreign exchange market which are not a <i>major foreign exchange pair</i> .
<i>major stock market index</i>	<p>a stock market index from one of the following stock market indices:</p> <p>(a) Financial Times Stock Exchange 100 (FTSE 100);</p> <p>(b) Cotation Assistée en Continu 40 (CAC 40);</p> <p>(c) Deutsche Bourse AG German Stock Index (DAX30);</p> <p>(d) Dow Jones Industrial Average (DJIA)</p> <p>(e) Standard & Poors 500 (S&P 500)</p> <p>(f) NASDAQ Composite Index (NASDAQ)</p> <p>(g) Nikkei Index (Nikkei 225)</p>

- (h) Standard & Poors/Australian Securities Exchange 200 (ASX 200)

minor stock market index a stock market index which is not a *major stock market index*.

Amend the following definitions as shown.

commodity (1) ...

(2) (for the purpose of calculating *position risk requirements* and for the purposes of COBS 22) any of the following (but excluding gold):

...

...

margin (in *COLL* and in COBS 22) cash or other property paid, transferred or deposited under the terms of a *derivative*; for these purposes cash or property will be treated as having been paid, transferred or deposited if it must be paid, transferred or deposited in order to comply with a requirement imposed by the market on which the contract is made or traded.

Annex B

Amendments to the Conduct of Business sourcebook (COBS)

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

Part 1

4 Communicating with clients, including financial promotions

...

4.7 Direct offer financial promotions

...

4.7.1 R (1) ...

- (a) such of the information referred to in the *rules* on information disclosure (*COBS 6.1.4R, COBS 6.1.6R, COBS 6.1.7R, COBS 6.1.9R, COBS 14.3.2R, COBS 14.3.3R, COBS 14.3.4R and, COBS 14.3.5R and COBS 22.4.4R*) as is relevant to that offer or invitation; and

...

...

...

...

22 Restrictions on the distribution of certain ~~regulatory capital instruments~~ complex investment products

...

After COBS 22.3 (Restrictions on the retail distribution of contingent convertible instruments and CoCo funds) insert the following new section COBS 22.4. The text is new and is not underlined.

22.4 **Restrictions on the retail distribution of contracts for differences traded on a leveraged basis, spread betting and rolling spot forex contracts**

Application

- 22.4.1 R This section applies to a *firm* in relation to *dealing or arranging (bringing about) deals* in any of the following for a *retail client*:

- (1) *contracts for differences* traded on a leveraged basis such that the *margin* posted is less than the value of the contract;
- (2) *spread bets*; and
- (3) *rolling spot forex contracts*,

but excluding derivative instruments for the transfer of credit risk to which article 85(3) of the *Regulated Activities Order* applies.

22.4.2 R The restrictions on *financial promotions* (COBS 22.4.21R to COBS 22.4.23R):

- (1) apply in accordance with COBS 4.1.8R; and
- (2) do not apply to an *excluded communication*.

Standardised risk warning

22.4.3 R (1) The *firm* must provide a *retail client* with the following risk warning, modified as necessary to refer only to the categories of products offered by the *firm*.

“You are at risk of losing money rapidly due to leverage. Your losses may exceed your deposits. Most investors lose money on these products.

Over the last quarter and the last 4 quarters respectively, retail client accounts at [insert firm name] made an overall profit or loss from live trading activity as follows:

Latest quarter: [x%] made a loss; [y%] made a profit.

Cumulative for last 4 quarters: [x%] made a loss; [y%] made a profit.

You should consider whether these products are suitable for you and whether you can afford to lose all of your deposited funds or more.”

- (2) The risk warning must be provided on every page of the website or mobile applications of the *firm* containing any reference to the benefits of *contracts for differences* traded on a leveraged basis, *spread bets* or *rolling spot forex contracts*.
- (3) Where the *retail client* has not approached the *firm* through a website or mobile application, the risk warning must be provided in a *durable medium* in good time before the *firm* carries on any business for the *retail client*.
- (4) The *firm*'s disclosure of percentage profitable versus loss-making *retail client* accounts must include the realised and unrealised gains and/or losses on all *contracts for differences* traded on a leveraged basis, *spread bets* and *rolling spot forex contracts* for each *retail*

client account, inclusive of all fees, *commissions* and any other charges.

- (5) The following must be excluded from calculating the total percentage of *retail client* accounts that are profitable or loss making:
 - (a) all deposits of funds;
 - (b) all withdrawals of funds; and
 - (c) all accounts that have not entered into a single trade over the relevant period.
- (6) The *firm* must use the following quarterly periods in calculating the profitable versus loss-making *retail client* accounts:
 - (a) January to March;
 - (b) April to June;
 - (c) July to September; and
 - (d) October to December.
- (7) The *firm* must retain records of the *retail client* accounts used for these calculations for five years.

22.4.4 R The standardised risk warning must be:

- (1) prominent;
- (2) contained within its own border and with bold and unbold text as indicated; and
- (3) if provided on a website or via a mobile application, remain fixed on the screen even when the *retail client* scrolls up or down the page.

Standardised point of sale risk warning

22.4.5 R A *firm* must provide the following risk warning to a *retail client* in a *durable medium* or available on a website (where that does not constitute a *durable medium*) that meets the *website conditions*, deleting references to any products that the *firm* does not provide:

“CFDs, spread betting and rolling spot forex are complex, high-risk financial products. These products pose the following risks:

- (1) You are at risk of losing money rapidly, due to leverage. Your losses may exceed your deposits.
- (2) Most investors lose money on these products.

In addition to these risks you should be aware that:

- Your provider may make a margin call requiring you to deposit further funds to cover open positions and if you fail to post additional margin your provider may close out your position without warning.
- Trading fees, commissions, or spreads will be based on the full investment exposure of your deposited funds. An additional fee will be applied for overnight financing arrangements to maintain your position. These charges will impact your financial return.”

- 22.4.6 R (1) The *firm* must require the *retail client* to acknowledge receipt of the standardised point of sale risk warning using the following terms:
- “I accept that investing in CFDs, rolling spot forex, and spread betting products is risky. I am at risk of rapidly losing my money and I am aware that a majority of clients lose money on these products.”
- (2) The acknowledgement of the standardised point of sale risk warning must be:
- (a) separate to the *retail client*'s acknowledgement of any terms and conditions applicable to the *retail client*'s relationship with the *firm*; and
- (b) given in a *durable medium*.

Timing of standardised point of sale risk warning

- 22.4.7 R *COBS* 14.3.9R applies to the provision of the risk warning required by *COBS* 22.4.5R.
- 22.4.8 R The *firm* must not open a trading account for a *retail client* until the *retail client* has acknowledged receipt of the standardised point of sale risk warning.
- 22.4.9 G Compliance with *COBS* 22.4.3R to *COBS* 22.4.6R does not replace *firms*' obligations under *COBS* 14.3.2R.

Initial margin requirements for retail clients

- 22.4.10 R A *firm* must require a *retail client* to post initial *margin* to open a position of at least the amounts set out in the applicable *rule* below.
- 22.4.11 R Where the *client* is an *inexperienced retail client* the *firm* must require initial *margin* of at least:
- (1) 4% of the notional value of the trade when the underlying asset is a

major foreign exchange pair;

- (2) 5% of the notional value of the trade when the underlying asset is a *major stock market index, minor foreign exchange pair* or gold;
- (3) 10% of the notional value of the trade when the underlying asset is a *minor stock market index, commodity* or a security that gives rise to a cash settlement determined by reference to *commodities*; or
- (4) 20% of the notional value of the trade when the underlying asset is a *listed share* of a *company* or a *share* of a *company* which is *admitted to trading* on an *overseas investment exchange*.

22.4.12 R Where the *client* is an *experienced retail client*, the *firm* must require initial *margin* of at least:

- (1) 2% of the notional value of the trade when the underlying asset is a *major foreign exchange pair*;
- (2) 2.5% of the notional value of the trade when the underlying asset is a *major stock market index, minor foreign exchange pair* or gold;
- (3) 5% of the notional value of the trade when the underlying asset is a *minor stock market index, commodity* or a security that gives rise to a cash settlement determined by reference to *commodities*; or
- (4) 10% of the notional value of the trade when the underlying asset is a *listed share* of a *company* or a *share* of a *company* which is *admitted to trading* on an *overseas investment exchange*.

22.4.13 R Where the underlying assets are not included in *COBS 22.4.11R* or *COBS 22.4.12R* the *firm* must require initial *margin* of at least:

- (1) 20% of the notional value of the trade for *contracts for differences* where the *client* is an *inexperienced retail client*, or
- (2) 10% of the notional value of the trade for *contracts for differences* where the *client* is an *experienced retail client*.

Margin close out requirements for retail clients

- 22.4.14 R
- (1) A *firm* must ensure a *retail client's* net equity does not fall below 50% of the initial *margin* requirement (as outlined in *COBS 22.4.11R* to *COBS 22.4.13R*) required to maintain their open positions.
 - (2) Where a *retail client's* net equity does fall below 50% of the initial *margin* requirement, the *firm* must close the *retail client's* open position(s) as soon as market conditions allow.
 - (3) "Net equity" means the sum of the *retail client's* net profit and loss on their open position(s) and the *retail client's* deposited *margin*.

- 22.4.15 R A *firm* must provide to a *retail client* a clear description in a *durable medium* or available on a website (where that does not constitute a *durable medium*) that meets the *website conditions* of how their *margin* close out level will be calculated and triggered:
- (1) in good time before the *retail client* opens their first position; and
 - (2) in good time before any change to the terms and conditions applicable to the *retail client* takes effect.
- 22.4.16 G *Firms* are reminded that they must comply with *COBS 2.1.1R* (the client's best interests rule) and *COBS 11.2.1R* (obligation to execute orders on terms most favourable to the client) when:
- (1) making a *margin* call to a *retail client*; or
 - (2) exercising a discretionary right to close a *retail client's* position; or
 - (3) closing a *retail client's* position(s).

Experienced and inexperienced retail clients

- 22.4.17 R A *firm* must categorise all *retail clients* as either an *inexperienced retail client* or an *experienced retail client*.
- 22.4.18 R A *firm* must only categorise a *retail client* as an *experienced retail client* if:
- (1) it has received records of the *retail client's active trading experience* in a *durable medium*; and
 - (2) where the *retail client* is relying on records showing *active trading experience* gained with a different *firm*, the records provided give the *firm* reasonable grounds to conclude that they record actual trading conducted by the *retail client*.
- 22.4.19 R A *firm* must not allow a *retail client* to enter into a trade as an *experienced retail client* before the *firm* has received records of the *retail client's active trading experience*.
- 22.4.20 R Use of a demonstration account or training account by a *retail client* does not amount to *active trading experience*.

Restrictions on financial promotions

- 22.4.21 R A *firm*, including an *incoming EEA firm*, must not *communicate* or *approve* a *financial promotion* relating to *contracts for differences* traded on a leveraged basis, *spread bets* or *rolling spot forex contracts* that is addressed to, or is disseminated in such a way that it is likely to be received by, a *retail client* if it includes any of the following offered contingent on opening a trading account:

- (1) a bonus offer; or
 - (2) a monetary incentive; or
 - (3) a non-monetary incentive.
- 22.4.22 G *COBS* 22.4.21R applies irrespective of any conditions that may be attached to the opening of the account or the bonus offer or incentive such as a requirement to deposit funds, execute a trade or a specified volume of trades.
- 22.4.23 R A *firm*, including an *incoming EEA firm*, must not *communicate* or *approve* a *financial promotion* relating to *contracts for differences* traded on a leveraged basis, *spread bets* or *rolling spot forex contracts* that is addressed to, or is disseminated in such a way that it is likely to be received by, a *retail client* unless:
- (1) the *retail client* will be subject to minimum *margin* requirements equivalent to or higher than those set out in *COBS* 22.4.11R to *COBS* 22.4.13R; and
 - (2) a risk warning equivalent to that specified in *COBS* 22.4.3R will appear on any version of the website or mobile application accessible to the *retail client* or otherwise be provided to the *retail client* in accordance with *COBS* 22.4.3R(3).

[*Editor's Note:* This Part 2 sets out the consequential changes to COBS 22.4 consulted on in CP16/29 (*Markets in Financial Instruments Directive implementation – Consultation Paper II*) and in Part 1 of this Annex as if they have been made.]

Part 2

4 Communicating with clients, including financial promotions

...

4.7 Direct offer financial promotions

...

4.7.-1D G *Firms communicating direct offer financial promotions in relation to contracts for differences traded on a leveraged basis, spread bets, and rolling spot forex contracts should also have regard to COBS 22.4.*

...

22 Restrictions on the distribution of certain regulatory capital instruments

...

22.4 Restrictions on the retail distribution of contracts for differences, spread betting and rolling spot forex contracts

...

Timing

22.4.7 R ~~COBS 14.3.9R~~ 14.3A.7EU applies to the provision of the risk warning required by ~~COBS 22.4.3R~~.

...

22.4.9 G Compliance with ~~COBS 22.4.3R~~ to ~~COBS 22.4.6R~~ does not replace *firms'* obligations under ~~COBS 14.3.2R~~ 14.3A.3R to COBS 14.3A.5EU.

...

Margin close out requirements for retail clients

...

22.4.16 G *Firms* are reminded that they must comply with ~~COBS 2.1.1R~~ (the client's best interests rule) and ~~COBS 11.2.1R~~ 11.2A.4R (obligation to execute orders on terms most favourable to the client) when:

...



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