

Restricting contract for difference products sold to retail clients and a discussion of other retail derivative products

Consultation Paper

CP18/38***

December 2018



How to respond

We are asking for comments on the proposed product intervention measures for retail contracts for differences in this Consultation Paper (CP) by 7 February 2019.

We are asking for comments on our discussion of other retail derivative products in this CP by 7 March 2019.

You can send them to us using the form on our website at: www.fca.org.uk/cp18-38-response-form

Or in writing to:
Wholesale Conduct Policy
Financial Conduct Authority
12 Endeavour Square
London E20 1JN

Telephone: 020 7066 1000

Email:
cp18-38@fca.org.uk

How to navigate this document onscreen



returns you to the contents list



takes you to helpful abbreviations

Contents

1	Summary	3
2	The UK retail CFD sector	8
3	Proposed product intervention measures for retail CFDs	16
4	A discussion on policy considerations for futures and other leveraged derivative products	30
Annex 1		
	Questions in this paper	35
Annex 2		
	Cost benefit analysis	37
Annex 3		
	Compatibility statement	48
Annex 4		
	Abbreviations in this document	54
Appendix 1		
	Draft Handbook text	

1 Summary

Why we are consulting

- 1.1** Contracts for difference (CFDs)¹ are complex, leveraged derivatives. They are typically offered to retail consumers² through online trading platforms.
- 1.2** We are proposing to intervene in this market to address poor conduct by UK and EEA firms who offer CFDs to retail consumers, and to limit the sale of CFDs and other directly substitutable products with excessive risk features that result in harm to retail consumers.
- 1.3** This Consultation Paper (CP) follows the European Securities and Markets Authority's (ESMA) decision to temporarily restrict how these products are sold to retail consumers because of the significant investor protection risks they pose. These restrictions are called 'temporary product intervention measures'.
- 1.4** This CP proposes making ESMA's temporary product intervention measures permanent in the UK. Our proposed intervention takes a wider scope than ESMA's intervention by including products with many of the same characteristics as CFDs, which we call CFD-like options.³ This is to stop firms getting around these measures by offering retail consumers CFDs in slightly different legal forms. We are also proposing to apply 30:1 leverage limits to CFDs referencing certain government bonds, to better reflect their risk (compared to 5:1 under ESMA's measures).
- 1.5** We are also concerned that firms may begin offering other products to retail consumers or that consumers migrate to existing products that can pose the same risk of harm as CFDs. We therefore discuss and seek feedback on whether we should extend these proposed measures to other complex retail derivative products, including futures contracts.
- 1.6** We will consult separately in early 2019 on a potential ban on the sale of CFDs and other derivatives referencing cryptocurrencies to retail consumers. This follows the commitment made in the UK [Cryptoasset Taskforce Final Report](#) published in October 2018. Therefore, the measures in this CP that apply to CFDs referencing cryptocurrencies may change as a result of our future consultation.
- 1.7** Today we also published a separate [CP](#) which proposes to permanently ban the sale of binary options to consumers treated by firms as retail clients.

1 References to CFDs in this CP include references to CFDs, spread bets, and rolling spot forex contracts that qualify as MiFID financial instruments.

2 References to retail consumers include references to consumers treated as retail clients according to [COBS 3.4](#).

3 We use this terminology through this CP. Please see Chapter 3 for further information and Appendix 1 for the proposed handbook definition of "restriction options", which our measures will apply to.



Who this applies to

1.8 Our proposals will directly affect:

- retail clients or potential retail clients who invest in CFDs and CFD-like options,
- UK MiFID investment firms and EEA MiFID investment firms, including Capital Requirements Directive (CRD) credit institutions as appropriate, marketing, distributing or selling CFDs and CFD-like options in or from the UK to retail clients⁴, and
- UK branches of third country investment firms marketing, distributing or selling CFDs and CFD-like options

1.9 This CP is also relevant to:

- consumer bodies
- current and prospective retail clients who invest in exchange-traded options and futures and similar over-the-counter (OTC) products, and
- MiFID investment firms and Capital Requirements Directive (CRD) credit institutions marketing, distributing or selling options and futures under the Regulated Activities Order (RAO) in, or from, the UK to retail clients

The wider context of this consultation

1.10 Since 2009, our supervisory work has found evidence of poor conduct by firms who are marketing and selling CFDs to retail consumers who often do not fully understand the risks. Firms have also offered CFDs with increasingly higher leverage (ie gaining exposure to an asset by paying only a small proportion of its value). This has resulted in a very high proportion of these consumers losing money.

1.11 In 2016, we initially sought to address our concerns by proposing a package of policy measures in [CP16/40](#). Reflecting EU-wide concerns, ESMA introduced temporary EU-wide restrictions on CFDs that limited how CFDs could be sold to retail consumers from 1 August 2018. This CP proposes making ESMA's temporary restrictions permanent within the UK and applies them to a slightly broader scope of products.

1.12 At an international level, the International Organisation of Securities Commissions (IOSCO) has also published [reports](#) on the risks of CFDs being inappropriately sold to retail clients.

⁴ As to the impact of the UK's exit from the Union please see paragraphs 3.19-3.20 below.

What we want to change

- 1.13** This CP proposes a package of policy measures to reduce the harm from selling CFDs and CFD-like options to consumers treated as retail clients.
- 1.14** Our proposed measures are mostly the same as ESMA's in that we are proposing to require firms to:
- limit leverage to between 30:1 and 2:1 depending on the volatility of the underlying asset
 - close out a customer's position when their funds fall to 50% of the margin needed to maintain their open positions on their CFD account
 - provide protections that guarantee a client cannot lose more than the total funds in their trading account
 - stop offering current and potential customers cash or other inducements to encourage retail consumers to trade, and
 - provide a standardised risk warning, telling potential customers the percentage of their retail client accounts that make losses
- 1.15** However, our proposed measures differ from ESMA's temporary intervention in that they:
- apply to a wider range of products by including CFD-like options (as defined in Chapter 3 and see proposed glossary term in Appendix 1), and
 - set leverage limits for CFDs referencing certain government bonds to 30:1 (compared to 5:1 under ESMA's measures)
- 1.16** We are also asking for feedback on whether exchange-traded futures and similar OTC products present similar risks of harm to retail consumers, and so may need similar rules (see Chapter 4).

Outcome we are seeking

- 1.17** We want to ensure that CFDs and CFD-like options are:
- offered and sold only to an appropriate target market of consumers who understand the risks and are capable of bearing potential trading losses, and
 - not sold with excessively high leverage to retail consumers, which have an inherent risk of harm because they result in higher losses
- 1.18** Initial evidence from ESMA's temporary intervention shows that retail consumers lost less money when trading CFDs under the same restrictions as those proposed in this CP. We will continue to monitor the market to assess the impact of the measures on client outcomes.



- 1.19** We also want to better understand the potential harm from other derivatives such as futures and similar OTC products that are available to retail consumers, whether we should consider similar rules for them and if this could cause unintended consequences.

Next steps

How to respond to our consultation

- 1.20** We are asking for feedback on our proposals for CFDs and CFD-like options by 7 February 2019.
- 1.21** We are asking for feedback on our discussion of other retail derivative products by 7 March 2019.
- 1.22** Use the online response form on our website: www.fca.org.uk/cp18-38-response-form or write to us at the address on page 2.

What we will do next

- 1.23** We will consider feedback on our proposals and aim to publish a Policy Statement (PS) and final Handbook rules by March 2019.
- 1.24** If finalised, the proposed rules for CFDs would come in to force shortly afterwards. Our intention is to apply the rules in relation to CFD-like options two months after the rules in relation to CFDs take effect.
- 1.25** If we consider extending the scope of our rules to products addressed in Chapter 4, we will consult on this later in 2019.
- 1.26** We will consult separately in early 2019 on banning the sale, marketing and distribution of derivatives that reference cryptocurrencies to consumers treated as retail clients. In the meantime, however, the relevant proposals in this CP will apply to CFDs referencing cryptocurrencies.

Implications of EU withdrawal

- 1.27** In March 2018, the UK and the EU reached agreement on the terms of a prospective implementation (or transitional) period following the UK's withdrawal from the EU.
- 1.28** The implementation period is intended to operate from 29 March 2019 until at least the end of December 2020. During this time, EU law would still apply in the UK, in accordance with the overall withdrawal agreement. Firms, funds and trading venues would continue to benefit from passporting between the UK and EEA as they do today. Obligations derived from EU law would continue to apply and firms must continue with implementation plans for EU legislation that is still to come into effect before the end of December 2020.
- 1.29** The implementation period forms part of the withdrawal agreement, which is still subject to ratification. We continue to work to ensure the UK's legal and regulatory framework for financial markets would also function in the absence of a withdrawal



agreement or implementation period. To do so, if EU law no longer applies, and we cannot finalise rules by 29 March 2019, we will likely adopt temporary, emergency product intervention measures to replicate ESMA's temporary intervention.

- 1.30** These measures would ensure that there is no loss of consumer protections in a period between ESMA's existing interventions ceasing to have effect in the UK, and finalising our domestic approach.



2 The UK retail CFD sector

- 2.1** This Chapter describes the UK market for retail CFD products and summarises the findings of our supervisory work. We also discuss the UK and international policy developments created in response to concerns about consumer protection in this market. We then summarise the feedback we received to CP16/40.

Harm in the UK retail CFD sector

Key features of CFDs and the UK CFD sector

- 2.2** CFDs are derivative instruments that retail consumers use to speculate on the rise and fall in price of a wide range of assets. CFDs include contracts for differences, spread bets, and rolling spot forex products. They are most commonly offered in the UK on an OTC basis by firms acting as counterparty (ie as principal) to the client's trade. They allow investors to gain indirect exposure to the price movements in an underlying index, single stock equity, commodity, FX pair, or cryptocurrencies.
- 2.3** In some other EEA jurisdictions, similar products are listed and traded on a regulated market. These products are marketed under different names, but are mostly known as 'turbo certificates'. These products are not widely sold in the UK and, from our understanding of the products we have seen, may qualify as options (see Chapter 3).

Our supervisory experience

- 2.4** We have seen significant changes in the retail CFD sector. Since 2009/2010 we have seen an increase in the number of authorised firms in the UK and incoming-EEA firms offering CFDs to UK retail consumers, as well as a significant increase in retail consumers trading CFDs. In 2017, there were around 100 FCA-authorised specialist CFD providers with over 800,000 funded retail client accounts holding over £1.5bn in retail client money. On average, 279,000 retail client accounts traded CFDs each month in 2017.⁵
- 2.5** The growth of the retail CFD sector is partly explained by the availability of 'off the shelf' trading platforms and the introduction of automated margin close out, which lowered barriers to entry for CFD providers. We have also seen firms use online, physical and social media to mass-market CFDs.
- 2.6** In our view, increased competition in this sector contributed to poor firm conduct before ESMA's intervention. We have seen firms increasingly offer CFD products to consumers who are, given the risks of these products, outside the appropriate target market. Firms have inappropriately marketed CFDs and have offered 'bonus' promotions, such as cash rewards or gifts, in return for opening accounts and trading CFDs.

⁵ These figures are based on responses to ESMA's information request from 63 firms representing over 90% of the UK retail CFD sector. Data were provided for 1 August to 31 October 2017 and the same period in 2018. This data request will be referred to as ESMA's information request throughout. The figures were calculated by taking the average of client account figures between August and October 2017. Active retail account numbers and total client money has decreased since ESMA's intervention (see Chapter 3).

- 2.7** UK CFD providers have lowered the barriers for retail consumers buying these products by reducing the minimum account and deal sizes, and by lowering the standards for assessing their appropriateness. For example, up to 48% of clients failed the firms' appropriateness tests but were accepted after seeing a standardised risk warning displayed. The average income of retail consumers at one firm was between £15,000 and £30,000 a year, implying they were not in a financial position to bear potentially heavy losses.⁶
- 2.8** At the same time, firms have lowered the margin requirements so that customers can gain a large exposure to assets with a very low upfront payment by offering CFDs with leverage up to 500:1. This had both made the products inherently riskier and facilitated mass selling to retail consumers.
- 2.9** These practices have led to persistently poor consumer outcomes. According to the standardised risk warnings of firms, an estimated 78% of active retail client accounts were loss-making.⁷ Retail consumers lost £268.4mn from trading over a 3-month period from August to October 2017, equal to a projected loss of £1.07bn a year.⁸ Other National Competent Authorities (NCAs) in EEA jurisdictions reported similar poor results for retail consumers.

6 These figures are based on data received from firms representing over 70% of the UK retail CFD market following CP16/40 in Q1 2017.

7 This figure was calculated by using weighted average of the risk warnings published by 7 firms that represent c. 65% of the UK's retail CFD market.

8 These figures are based on data from ESMA's information request. Client losses are calculated by adding the total from profit-making and loss-making retail client accounts. Actual annual client losses may differ from the projected figures as the 3-month period may not be a perfectly representative sample.



2.10 We have undertaken a number of supervisory initiatives to assess and improve firm conduct and reduce consumer harm, as outlined in table 1. Although our supervision work had some positive impact, we remain very concerned about the actual and potential harm to investors in this market.

Table 1: Summary of FCA supervisory work in the retail CFD sector

	Key findings	Publication date
Financial promotions	A Thematic Review of CFD firms found that their risk warnings were often disguised, diminished or obscured. Some providers did not tell clients they risked losing more than their deposited funds and used language that was inappropriate for their target audience and / or did not provide appropriate balance between describing the benefits and risks of trading on margin.	<u>2009</u> Ongoing review
Best execution	A Thematic Review found that CFD firms inappropriately claimed they were exempt from best execution obligations on the basis that they were executing client orders against their own books. A number of providers could not provide adequate information on their best execution obligations. FXCM was fined £4mn and paid c. £6mn of client redress as a result of our enforcement in 2014.	<u>2014</u> <u>2014</u>
Client money	The failure of Worldspreads revealed shortcomings in safeguarding client assets, which contributed to our review of the UK client asset regime for spread betting firms.	<u>2012</u>
Client onboarding, including appropriateness assessments	Our 'Dear CEO' letter confirmed that our review of firms' onboarding procedures found shortcomings in both the application of the appropriateness test, including inadequate risk warnings, and anti-money laundering checks across all firms in our sample. A follow up review in Q4 2016 found similar shortcomings in firms' appropriateness assessments.	<u>2016</u> <u>2017</u>
Advisory and discretionary managed CFD services	Our 'Dear CEO' letter confirmed that our multi-firm project had found that firms providing CFDs on an advisory or discretionary portfolio management basis had not adequately identified an appropriate target market. They also had not effectively monitored how the product was sold, or identified or managed conflicts between providers and distributors as a result of inappropriate remuneration or incentive structures.	<u>2018</u>

Domestic policy developments

2.11 On 6 December 2016, we consulted on a package of measures to restrict the sale of CFDs to retail clients. These measures aimed to address our concerns about poor conduct in the sector and clear harms to UK retail consumers. The proposed measures included:

- leverage limits between 50:1 and 5:1 depending on the volatility of the underlying asset and how experienced the client is
- a requirement for firms to close out a customer's position when their funds fall to 50% of the margin needed to maintain their open positions on their CFD account
- a ban on firms making promotional offers to encourage current and potential customers to trade
- strengthened disclosure requirements, including a standardised risk warning that requires firms to tell potential customers the percentage of their retail client accounts that make losses against those that make profits

2.12 We designed these measures to reduce the risks of the product (ie leverage limits and the margin close out rule) and to limit them being sold inappropriately through greater transparency and limits on marketing. The proposals in this CP build on these measures and on ESMA's product intervention measures.

Feedback to CP16/40

2.13 We summarise feedback that we received in response to CP16/40 below. We respond to this feedback in Chapter 3.

2.14 We received 2,278 responses to CP16/40 from firms, retail consumers and other interested stakeholders, including:

- 23 responses from firms, including specialist retail CFD providers and the retail FX and CFD industry association
- 7 responses from firms providing services to the retail CFD sector
- 1 response from a consumer and shareholder interest group, and
- 2,247 responses from consumers, the vast majority came from consumers who were encouraged to respond by UK CFD firms

2.15 Most respondents supported our aim of improving consumer protections. They also agreed that reforms were needed to raise standards of conduct in the UK retail CFD sector. There were, however, differences in responses to the specific measures we proposed:

- Some respondents said that applying our existing rules, such as appropriateness assessments, more robustly could limit CFDs being sold inappropriately. This would reduce the risk of harm to retail consumers without restricting consumer choice. These respondents also argued that our concerns about poor conduct were mainly due to the behaviour of a handful of UK firms and incoming-EEA firms who were not complying with existing rules.



- Most opposed our proposed leverage limits. They argued that consumers that know and understand the risks of trading CFDs should not have their choices reduced by leverage limits and that consumers can benefit from trading at higher leverage.
- Some respondents argued that CFDs provide exposure to comparatively expensive financial assets, such as stock market indices and commodities, and offered the opportunity for higher returns at lower cost than other forms of investment.
- Some stated that our proposed leverage limits would result in consumers seeking higher leverage from firms in other jurisdictions. This would cause greater harm as they would lose the protections of the UK's financial regulation.
- Some firms argued that retail clients would switch from CFDs to other speculative products with similar risk profiles or move to gambling.
- Some individual responses also suggested that some consumers lost money because they did not have enough knowledge or experience, but that this should not limit what experienced consumers can do.

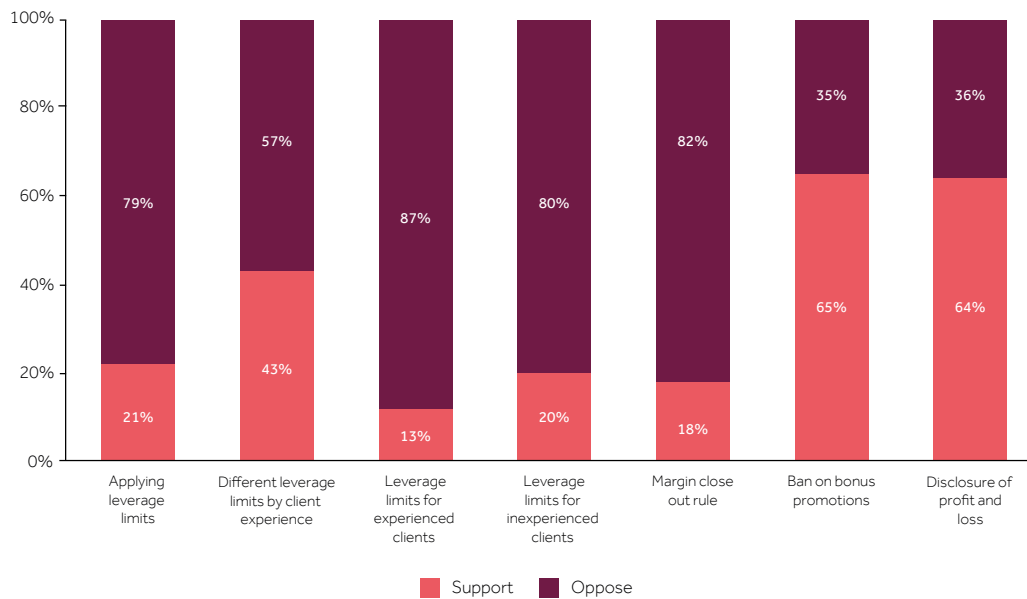
2.16 More specifically, firms' feedback included the following points:

- Profit and loss figures used for the standardised risk warning should be calculated and disclosed on an industry-wide basis to represent the risks of trading CFDs. Some argued that all financial instruments should disclose profit and loss figures because all financial products carry a risk of loss.
- Firms should be able to reward customer loyalty through rebates based on the volume (ie total value) of trades and by providing non-monetary benefits, such as research and information tools, that improve clients' likelihood of trading profitably.
- Firms said our justification for applying leverage limits and the level they were set was inaccurate. One firm stated that leverage does not affect the likelihood that a client makes a profit or loss (before transaction fees) from trading CFDs, until leverage goes above 200:1.
- Firms suggested that we should not consider transaction fees, including spreads and overnight funding costs, when assessing the impact of leverage, as retail consumers are willing to pay these fees for the enjoyment of trading. Firms did not provide quantitative evidence that higher leverage limits would improve client outcomes.
- Firms said we did not assess expected costs and benefits accurately (further detail below). One firm commented that we were wrong to compare Japanese and Singaporean client outcomes, which have leverage limits, with UK clients, that did not previously have leverage limits. This is because the Japanese and Singaporean CFD markets are dominated by passive forex 'carry traders' that buy and hold interest-generating positions in forex rates.
- Many firms said we had underestimated the costs of implementing the measures, which would require significant IT and systems changes.

2.17 Consumers who supported our leverage limits gave anecdotal evidence to highlight the significant harm caused by trading leveraged CFDs:

- One respondent reportedly made £300,000 in losses from spread betting and regularly made losses between £30,000 and £50,000 in a trading day because they could not monitor their position.
- Another individual reported £500,000 in losses from trading CFDs over a three-year period.
- One retail client reportedly lost £2.7mn trading CFDs from an initial investment of £200,000. This resulted in them owing £2.5mn to a CFD firm.

Figure 1: Summary of responses to CP16/40



Actions taken following feedback to CP16/40

2.18 ESMA began discussing its own EU-wide product intervention while we were analysing the responses to CP16/40. On 29 June 2017, we announced we would delay any final rules for the retail CFD sector in favour of awaiting the outcome of ESMA's product intervention. We worked closely with ESMA and other NCAs in developing the EU-wide intervention and used responses to CP16/40 to inform this work.

2.19 We also committed to carry out further cost benefit analysis (CBA). Specifically, we collected and analysed trade-level data from five CFD firms that represent c. 55% of the UK retail CFD market to assess the expected benefits from reducing leverage limits. This allowed us to compare UK client outcomes from one UK CFD provider which applied leverage limits, to outcomes for retail consumers who traded CFDs with unchanged leverage limits at the four other UK CFD providers (see Annex 2 and Technical Annex for details).



European policy developments

- 2.20** Similar consumer harm and misconduct by retail CFD firms has emerged across the EU. In response, ESMA published a series of Questions and Answers (Q&As) to promote common supervisory approaches towards the retail CFD sector.
- 2.21** Due to the limited success of supervisory tools and the application of existing rules, ESMA considered applying similar measures to those that we consulted on in CP16/40, across the EU. ESMA published these proposed measures in a Call for Evidence on 18 January 2018. Following feedback, ESMA decided to apply EU-wide product intervention measures restricting the 'sale, marketing and distribution' of CFDs to consumers treated as retail clients by firms from 1 August 2018.
- 2.22** ESMA's concerns about investor protection stemmed from the complexity of the product, the difficulty retail consumers face in properly valuing CFDs, inappropriate marketing and distribution activities, and risks from the particular features of CFDs, including the availability of high leverage.
- 2.23** ESMA temporarily restricted CFDs sold to retail clients by requiring firms to:
- limit leverage to between 30:1 and 2:1 depending on the volatility of the underlying asset
 - close out a customer's position when their funds fall to 50% of the margin needed to maintain their open positions on their CFD account
 - provide protections that guarantee a client cannot lose more than the total funds in their trading account
 - stop offering current and potential customers cash or other inducements to encourage them to trade, and
 - provide a standardised risk warning, which tells potential customers the percentage of their retail client accounts that make losses
- 2.24** In response to feedback to their Call for Evidence, ESMA clarified that these measures did not apply to certain derivatives with similar features to CFDs, which ESMA described as 'warrants' and 'turbo certificates'.

Impact of ESMA's measures

- 2.25** Since ESMA's temporary measures were adopted, we have seen fewer retail consumers trading CFDs. This has resulted in an overall reduction in trading volumes and lower retail consumer losses. Retail consumers also had fewer automatic margin close outs and fewer clients lost all of their invested funds (see Chapter 3 for details).
- 2.26** We have seen some firms, including UK CFD providers, using financial promotions and client communications in an attempt to suggest retail consumers opt up to 'elective professional' status, which means that they lose protections available to retail clients. This defines a more experienced category of client. This included firms encouraging clients by marketing the opportunity to trade on high leverage. Many of the promotions were misleading, unfair or unclear.

- 2.27** Some UK CFD providers have also encouraged retail clients to trade with firms outside the EU in third country jurisdictions, by using comparison tables to highlight that retail consumers can get higher leverage through third country intra-group entities. Some firms have failed to highlight the protections that retail consumers may lose by transferring their account. We have intervened, and will continue to do so, when firms use language that has not properly presented the risks of trading on higher leverage.
- 2.28** We will continue to focus on CFD firms' financial promotions and marketing activities on both of these issues in our supervision work.
- 2.29** We have also seen that firms have offered, or are considering offering, other derivative products that replicate the pay-out structure and risk features of CFDs sold to retail clients before ESMA intervened. We have taken, and will continue to take, supervisory action when we consider that the offer of these products is potentially a breach of Article 3 of the ESMA Decision Notice, which prohibits firms from circumventing the product intervention, and / or is not in the best interests of consumers. Our actions have ensured that some firms amended these products or restricted retail client access to comply with the intention of ESMA's intervention.
- 2.30** Firms have complained that ESMA's intervention measures have been inconsistently applied across products. This has created an uneven playing-field between firms and product types, and led firms to consider offering substitutes for CFDs, such as non-centrally cleared, OTC futures (commonly known as 'forwards').
- 2.31** We recognise the risk that firms will try to get around the proposed measures by offering products that do not qualify as CFDs or CFD-like options but have the same inherent risks. We want to ensure that retail consumers have consistent protections across these products and seek feedback on this in Chapter 4.

International policy developments

- 2.32** IOSCO is responsible for setting international standards and best practices in capital markets. In September 2018, it published a Report on Retail OTC Leveraged Products. The report highlights many of the risks identified in this CP and includes three toolkits to help regulators design an effective domestic policy approach to reduce harm and increase investor protection through:
- policy measures that address the risks from the inappropriate marketing and sale of CFDs and binary options to consumers by investment firms
 - educating consumers about the product risks, and
 - enforcement approaches to tackle the risks from unauthorised entities fraudulently claiming to offer these products
- 2.33** We have designed our proposed policy measures to be consistent with international best practice.



3 Proposed product intervention measures for retail CFDs

3.1 This Chapter outlines our proposed product intervention measures and explains our rationale for them. We set out the proposed Handbook rules in Appendix 1.

Overview

- 3.2** We propose to permanently restrict the sale, marketing and distribution of CFDs and CFD-like options to retail clients. We propose doing this by requiring firms that carry out these activities in, or from, the UK to:
- limit leverage to between 30:1 and 2:1 by collecting minimum margin as a percentage of the overall exposure that the CFD provides
 - close out a customer's position when their funds fall to 50% of the margin needed to maintain their open positions on their CFD account
 - provide protections that guarantee a client cannot lose more than the total funds in their CFD account
 - stop offering monetary and non-monetary inducements to encourage trading, and
 - provide a standardised risk warning, which requires firms to tell potential customers the percentage of their retail client accounts that make losses
- 3.3** These measures will be applied under Article 42 of the Markets in Financial Instruments Regulation (MiFIR).⁹ Where our measures go beyond the MiFIR power we will use our rule-making power under the Financial Services and Markets Act 2000 (FSMA).

Why we are intervening

- 3.4** We are intervening to address the significant concerns about investor protection from CFDs sold to retail clients. Our intervention follows our ongoing supervisory work and analysis that has identified poor conduct by UK retail CFD providers and harm to investors as a result.¹⁰
- 3.5** More specifically, under the criteria that we should take into account under Article 21 of the MiFIR Delegated Regulation (2017/567), we consider that:
- Retail consumers find it difficult to value CFDs accurately, given the impact of leverage and associated costs and charges. Retail consumers may not understand the likelihood of achieving consistent investment returns from trading them is low.¹¹

9 If the proposed rules are not made until after 29 March 2019 and there is no withdrawal agreement in place, we would expect to make the rules using a combination of our powers under 'the 'onshored' version of MiFIR and Financial Services and Markets Act 2000 (FSMA), as appropriate.

10 Article 42(2)(a)(i) of MiFIR.

11 Article 21 (2)(a) of Commission Delegated Regulation (EU) 2017/567

- CFDs have resulted in large losses for retail consumers trading with UK CFD providers. Prior to ESMA's temporary measures, an estimated 279,000 consumers treated by firms as retail clients traded CFDs per month and lost £268.4mn over a 3-month period, equal to a projected loss of £1.07bn a year.¹² These losses would continue if we do not adopt permanent product intervention measures.¹³
- Firms have sold CFDs outside their appropriate target market using aggressive marketing and distribution practices.¹⁴ For example, according to firm data from firms representing over 70% of the UK retail CFD market, between 20% and 48% of consumers treated as retail clients failed the appropriateness test. Yet these consumers were allowed to trade after being given a standardised risk warning¹⁵, and
- CFDs are sold with high leverage, which causes retail consumers to suffer significant losses (further details below).¹⁶

3.6 We have tried to address this harm through the existing regulatory requirements that apply to firms. Although our supervisory work has been extensive, it has not adequately addressed these concerns.¹⁷ Based on our domestic experience, and considering the ESMA's Decision Notice analysis, we have concluded that existing regulatory requirements do not sufficiently address our concerns about investor protections from the sale of CFDs to retail consumers. For the same reason, we consider that improved supervision or enforcement of existing requirements would not address our significant concerns about investor protection.¹⁸

3.7 Our proposals will address harm and provide proportionate protections for retail consumers. They will do this by targeting the specific risks from the product and its associated features, key distribution risks, and the different incentives of firms and consumers.¹⁹ In considering the proportionality of our proposals we have also taken into account the nature of the risks to retail consumers, the level of sophistication of the investors concerned, and the likely effect on investors and market participants.²⁰

3.8 We have consulted, and will continue to consult, NCAs in other Member States that might be significantly affected by our proposals. At this time, we have concluded our measures do not have a discriminatory effect on services or activities provided from another Member State.²¹ We will also comply with the notification requirements under MiFIR.²² We are consulting on largely the same measures that apply under ESMA's temporary intervention. We diverge from ESMA's intervention by applying the same restrictions to CFD-like options. The impact of this on firms in other EEA jurisdictions who sell these products will be low due to the currently limited demand from UK retail consumers. We are also proposing to set leverage limits for CFDs referencing certain

12 These figures are based on data from ESMA's information request. Client losses are calculated by adding the total from profit-making and loss-making retail client accounts. Actual annual client losses may differ from the projected figures as the 3-month period may not be a perfectly representative sample.

13 Article 21 (2)(b) of Commission Delegated Regulation (EU) 2017/567.

14 Article 21 (2)(c) of Commission Delegated Regulation (EU) 2017/567.

15 These figures are based on data received from firms representing over 70% of the UK retail CFD market following CP16/40 in Q1 2017.

16 Article 21 (2)(e) of Commission Delegated Regulation (EU) 2017/567.

17 Article 42(2)(b)(i) of MiFIR.

18 Article 42(2)(b) of MiFIR.

19 Article 42(2)(c) of MiFIR.

20 Article 42(2)(c) of MiFIR.

21 Article 42(2)(d)(e) of MiFIR.

22 Article 42(3) of MiFIR.



government bonds at 30:1. This is unlikely to have a significant impact on consumers or firms in other EEA jurisdictions.

Detailed policy measures

Scope

Products

- 3.9** We propose to apply our measures to CFDs, spread bets²³, rolling spot forex products and CFD-like options that are marketed, sold or distributed by firms in, or from, the UK to retail clients.
- 3.10** In addition to CFDs, we also propose to include CFD-like options, which are not within the scope of ESMA's temporary intervention on CFDs. These are sold under a variety of labels, including 'turbo certificates', 'knock out options' and 'delta one options'. The leverage in such products can be significantly higher than what's proposed in this CP.
- 3.11** Our Handbook does not currently define CFD-like options. So, we are proposing a new glossary definition of 'restriction options', which is intended to catch CFD-like options. The glossary definition (see Appendix 1) may be refined as a result of this consultation if we conclude that amendments are necessary to ensure the products we intend to catch are in fact caught and those we do not intend to catch are not. We intend to capture options that include additional product features, which ensure the value of the option changes in a linear manner with the value of the underlying asset, excluding costs, charges, and spreads (ie the difference between the bid-price and ask-price). The proposed scope is not intended to capture traditional or 'vanilla' options.
- 3.12** The most commonly traded CFD-like options are so-called 'turbo certificates'. These products are more widely offered in other EEA jurisdictions by large wholesale banks. While they are similar to the CFDs typically offered in the UK market, they differ in that they:
- may qualify as transferable securities and are sold with a prospectus that complies with the [Prospectus Directive](#)
 - are commonly traded on a trading venue, and
 - typically limit client's losses to the amount initially invested
- 3.13** Our market intelligence suggests that there is currently little demand from UK consumers for these products. Only 2 FCA-authorized firms offer access to turbo certificates in the UK and there was £289.5mn in annual trading volume in 2017, which is relatively small compared to retail CFD trading volumes in the UK. Client outcomes from trading these products are similar to CFDs. According to firm data, 67% of retail client accounts lost money trading 'turbo certificates' and the average outcome from trading was a loss of £2,620.
- 3.14** Other CFD variations, which UK CFD providers have recently started offering, include 'knock outs' and 'delta one options'. Knock outs are an OTC variant of turbo certificates that similarly track the value of the underlying asset, allow retail consumers

23 Our proposed rules exclude sports spread bets, as our rules only apply to MiFID financial instruments.

to trade on leverage, and client losses are limited to the amount initially invested. Delta one options also track the value of the underlying asset by issuing a strike price (ie the price at which you have the right to buy or sell the underlying asset) far from the current market price (eg 3500 FTSE call option when the FTSE is trading at 7000). Firms have sold these options as the underlying asset of a CFD or financial spread bet, but CFD firms have said they would like to offer these, or similar products, as 'standalone' options.

- 3.15** We have considered whether to exclude these products from our intervention measures as some of their features may reduce the risk of consumer harm, compared with CFDs. In our view, these products pose the same risk of harm as CFDs and the differences do not sufficiently reduce this risk. Specifically, we consider that consumers' ability to get excessive leverage will lead to the same levels of losses we have seen in CFDs. We think that they should therefore be subject to the same leverage limits. Our proposed risk warning and ban on monetary or non-monetary inducements for trading will also reduce the risk of mis-selling to retail consumers who do not adequately understand the risks from trading.
- 3.16** These variants of products are not commonly traded in the UK. But we consider future harm is likely as firms switch to them and away from CFDs. As UK CFD providers have already considered offering these products, this risk is high.
- 3.17** We consider that our proposed Handbook definition of restricted options in Appendix 1 captures these products and does not capture vanilla options. We welcome feedback on this.
- 3.18** Our intention is to apply the rules in relation to CFD-like options two months after the rules in relation to CFDs take effect. This is because these products are not within scope of ESMA's temporary intervention measures and firms will require time to comply with our proposed rules.

Q1: Do you support our proposal to capture CFD-like options and other products that have the same or similar features to CFDs?

Q2: Does the scope of our glossary definition of 'restricted option' sufficiently capture these products? If not, what amendments would further clarify our intended scope?

Firms and activities

- 3.19** The MiFIR intervention powers override the general approach in MiFID II that firms operating on a services passport with no physical presence in a member state are generally subject to home state regulation.
- 3.20** Before 29 March 2019, when the UK is due to exit the EU, our measures, if in force, will apply to:
- MiFID investment firms and CRD credit institutions doing MiFID business in the UK with a presence (ie a head office or a branch) in the UK. They will apply to activity conducted in the UK. They will apply to services within the scope of the rules that are provided from the UK into another jurisdiction.



- EEA MiFID investment firms and CRD credit institutions doing MiFID business using their rights to carry out activities or provide services into the UK using passporting rights. They will apply to activity within scope of the rules conducted in the UK, and
- Third country investment firms with a branch in the UK carrying out activity in the UK and / or providing services that are within scope of the measures from the UK into another jurisdiction.

3.21 After 29 March 2019, this position will change if the UK leaves the EU without a withdrawal agreement. If this happens, our intention is to capture these same firms and activities in our rules. We would therefore draft the rules so that they cover anyone who would have been in one of the categories above immediately before EU withdrawal. We will not re-consult on such amendments to the draft rules. Without a withdrawal agreement, we would expect to make the rules using a combination of our powers under the 'onshored' version of MIFIR and the Financial Services and Markets Act 2000 (FSMA) as appropriate.

Leverage limits

3.22 We propose to apply ESMA's leverage limits on a permanent basis. This will require firms to collect initial margin from retail clients that is equal to a specified percentage value of the exposure that the CFD contract gives the client when they enter the trade. The leverage limits range between 30:1 and 2:1, depending on the volatility of each asset class. Table 2 outlines the leverage limits we are currently proposing alongside those initially proposed in CP16/40.

3.23 We have set our proposed leverage limits using the same methodology as ESMA's temporary intervention. This is calibrated so that firms require enough initial margin (ie cash) to cover the likelihood of a retail client being closed out at 50% of the initial margin required over the course of a trading day.²⁴

3.24 Under ESMA's intervention, government bonds are subject to a leverage limit of 5:1 by qualifying as 'other assets'. Following firm and consumer feedback to the FCA that 5:1 leverage limits were disproportionate for these underlying assets due to their historic volatility, we propose applying 30:1 leverage limits to CFDs on certain government bonds.²⁵

²⁴ Set using historical price data and according to a 95% confidence interval.

²⁵ See proposed Handbook term for relevant government debt in Appendix 1 of this CP.

Table 2: Proposed leverage limits in comparison to CP16/40

	Proposed leverage limits		CP16/40			
	All retail clients		Inexperienced		Experienced	
	Leverage ratio	Minimum margin	Leverage ratio	Minimum margin	Leverage ratio	Minimum margin
Major FX pairs & certain government bonds	30:1	3.33%	25:1	4%	50:1	2%
Major stock market indices, minor FX pairs, and gold	20:1	5%	20:1	5%	40:1	2.5%
Minor indices and commodities (excl. gold)	10:1	10%	10:1	10%	20:1	5%
Single stock equities and all other assets	5:1	20%	5:1	20%	10:1	10%
Cryptocurrencies	2:1	50%	*	*	*	*

* Cryptocurrencies were not listed in our draft rules in CP16/40. Therefore, they would have fallen within the "other assets" category.

3.25

At this stage, we are proposing 2:1 leverage limits for CFDs referencing cryptocurrencies to maintain the current level of protection for retail consumers based on ESMA's temporary measures. However, in early 2019, we will consult separately on a possible ban on the sale, marketing and distribution of all derivatives (including CFDs, options, futures and derivatives that qualify as transferable securities) referencing cryptocurrencies to retail consumers as indicated in the [Cryptoasset Taskforce Final Report](#). Therefore, if the proposals in this CP are adopted as rules, those rules in relation to CFDs referencing cryptocurrencies may change as a result of our future consultation.



3.26 2:1 leverage limits are intended to apply to the same set of assets that ESMA calls cryptocurrencies under their rules. We will be consulting more broadly on guidance on cryptoassets, including on how to appropriately define them, in January 2019. Stakeholders may want to review that CP before responding to this CP.

3.27 We are requiring firms to collect initial margin based on the value of the underlying asset when the client enters the trade, rather than the CFD's value (as required under ESMA's measures). It will ensure that firms do not offer products with higher 'implied' leverage to retail consumers than is intended under our proposed rules (see Figure 2) and is expected to reduce losses by reducing their trading volumes (see below).

Figure 2: Examples of implied or inherent leverage

Example 1

A firm offers a CFD on a 5 x leveraged index on gold. The client enters the contract when leveraged index on gold is priced at \$1,000, granting the consumer exposure of \$5 for every \$1 move in the price of gold. If applying leverage limits to the value of the gold index, the firm would only collect \$50 (\$1000 x 5%), creating implied leverage of 100:1. Under the proposals, firms will be required to collect initial margin of \$250 (\$5,000 X 5%), equivalent to 20:1.

Example 2

A firm offers a CFD on a synthetic GBPUSD call option that expires in 18 months with a strike price of GBPUSD 0.6500, which grants the consumer the right to buy GBP at 65 US cents. The client buys a CFD on USD100,000 when the GBPUSD exchange rate is 1.3000. This grants the client exposure to \$130,000. When entering the contract, the value of the CFD is equal to the option's intrinsic value, which due to the option being deep 'in the money', is equal to \$65,000. By applying the maximum leverage to the premium of the option, the firm would only collect \$2,145 (\$65,000 x 3.33%), creating implied leverage of 60:1. Under our proposals, firms will be required to collect initial margin of \$4,290 (\$130,000 X 3.33%), equivalent to 30:1.

Example 3

A firm offers a CFD on a FTSE call option that expires in 18 months with a strike price and knockout barrier at 7,000 (ie an OTC turbo certificate). A consumer enters the contract when the price of the FTSE index is at 7,070, meaning that they buy the option when you have the right to purchase the underlying asset (ie it is 'in the money') when they enter the contract. They buy the contract with the value of £1 per point. Although the total funds at risk is £70, the notional value that the contract grants the client is £7,070. The implied leverage of this product is 101:1. Under the proposals in this CP, the firm would be required to collect initial margin of £353.50 (ie £7,070 x 5%).

We recognise that this would require margin deposits in excess of the option premium in some cases, for example if the 'knock out barrier' / price is very close to the current market price. Customers will still be able to limit their potential loss to a proportion of the margin funds by selecting a preferred 'knock out barrier' (or guaranteed stop), which firms may offer.

3.28 Consistent with ESMA, our draft rules are intended to limit payments for entering a CFD contract to cash. This will prevent firms from using a credit line or collateralised client assets (eg single stock equities, ISAs etc) as cash to fund retail consumers' CFD accounts.

How the measure reduces harm

3.29 Leveraged CFDs present an information asymmetry for retail consumers. This is because they are difficult to value, given the impact of leverage and transaction fees on their returns. Lower leverage will reduce the impact of this information asymmetry by encouraging retail consumers to trade at lower volumes (ie a lower total exposure),

resulting in fewer losses. The higher up-front margin requirements will help discourage trading by retail consumers who cannot readily afford losses that are likely to occur.

An example of how leverage affects retail consumers' trading behaviour and performance

Bemi has £5,000 in her CFD trading account, which is the most she is willing to put at risk as part of her wider investment portfolio.

In the first year, Bemi traded CFDs with a provider that offered leverage of up to 500:1 for some assets. Bemi's total notional exposure over the year (ie total trading volume) was £500,000 and her return on her total notional exposure after transaction fees was 1%, equal to a £5000 loss.

In year 2, the firm reduced leverage from 500:1 to 30:1. Bemi's total notional exposure over the year was reduced by 50% to £250,000 but her return on her total exposure after transaction fees remained the same. In year 2, Bemi lost £2500.

- 3.30** Our analysis of trade-level data across five UK CFD providers (see Annex 2 and Technical Annex) found that retail consumers' net profit or loss as a percentage of their total exposure remained nearly or completely unchanged after firms lowered leverage limits, but resulted in a 28% reduction in trading volumes.
- 3.31** This finding is consistent with [academic research](#). This research compared trading outcomes for US retail traders who had to comply with leverage limits of 50:1 for major foreign exchange pairs, with European retail traders, who did not have to comply with leverage limits. Their analysis found that US retail consumers subject to leverage limits had 40% lower trading losses and an 18% improvement in investment returns.
- 3.32** Retail consumers find it difficult to make sustained profits from trading CFDs, suggesting it is hard for retail clients to accurately value the impact of trading at higher leverage on the performance of their CFDs. This is consistent with [academic research](#) indicating that retail consumers are 'overconfident' about their ability to profitably trade. Leverage limits improve consumer outcomes by reducing the negative effect of their overconfidence by placing limits on their trading exposure.
- 3.33** Firm data also suggest that lower leverage reduces profits for profit-making accounts. However, taking in to account both profits and losses for consumers, clients lose less money trading CFDs at lower leverage.



- 3.34** Combined with our other proposals, lower leverage limits will reduce the risk that these products will be sold to consumers who are too inexperienced to understand the risk of CFDs. Retail consumers with sufficient knowledge and experience can still trade CFDs but will have to commit more funds to have the same notional exposure.

Response to feedback in CP16/40 and ESMA's temporary intervention measures

In response to ESMA's temporary intervention, some firms suggested that, as most retail clients hold CFDs for less than an hour, it would be more relevant to set leverage limits to a 1 hour time horizon (resulting in leverage limits close to 100:1) as opposed to intraday. This would mean that 'day-traders' would not be so badly affected.

We propose to set leverage limits to a 1-day time horizon because of the risk that retail consumers are unable to monitor their open positions during the trading day. Our proposed leverage limits will allow retail consumers to make an informed investment decision.

In response to CP16/40, we received feedback that it would be costly for firms to have to categorise retail clients as 'inexperienced' and 'experienced'. Respondents also argued it could limit competition by making it difficult for consumers to switch providers. So, we are proposing a single set of leverage limits for all retail clients.

In response to CP16/40 and ESMA's intervention, firms stated that retail consumers will seek leverage from firms in third country jurisdictions. We recognise this risk and will continue to work with third country jurisdictions and IOSCO to promote best practices to reduce consumer harm.

In response to ESMA's intervention, firms have stated that, if provided responsibly, the use of collateralised client assets as cash for trading CFDs is appropriate for a certain sub-set of experienced retail consumers. It saves them from having to liquidate their assets for cash. Allowing retail consumers to trade CFDs through collateralised assets, such as retirement savings creates significant risks and may not be in the best interests of retail consumers. We are, however, open to suggestions for potential rules that could appropriately balance the risks and benefits of using collateralised client assets.

Expected benefits

- 3.35** We expect the application of leverage limits to reduce overall losses for retail consumers trading CFDs by reducing overall volumes of trading. The increased margin requirements will also discourage retail consumers who are less able to bear potential losses from trading these products. We do not expect that leverage limits will necessarily increase the percentage of accounts that make a profit (see Annex 2).
- 3.36** This is backed up by evidence from ESMA's application of leverage limits. This reduced total losses for retail clients of UK firms by £77.3mn between August and October 2018, equal to a projected reduction of £309.1mn per year. The number of active retail clients has also decreased by 72,783.²⁶ We recognise that a proportion of this client activity may have moved to firms in third country jurisdictions.
- 3.37** We also expect that fewer consumers will be automatically closed out or go in to negative equity. ESMA's intervention reduced the number of automatic margin close outs for retail clients by 99.5% between August and October 2017 and the same period in 2018. The total amount of debt forgiven by firms because retail consumers went in to negative equity has decreased by £33.4mn.²⁷

²⁶ These figures are based on data from ESMA's information request. Reduction in total losses was calculated by adding total profits from profit-making accounts and total losses from loss-making accounts. The reduction of active retail clients takes in to consideration the increase in elective professional.

²⁷ These figures were obtained from ESMA's information request to firms. The figures represent client outcomes at UK firms only.

- Q3: Do you agree with the proposed leverage limits for retail clients? If not, please indicate alternative leverage limits and provide supporting evidence as to why they will produce better outcomes for retail clients.**
- Q4: Do you have any comments on the draft Handbook rules for leverage limits?**

Margin close out rule

3.38 We propose to standardise market practice by requiring firms to close out a retail client's position when their funds fall to 50% of the margin needed to maintain their open positions on their CFD account. We previously consulted on this in CP16/40.

How the measure reduces harm

3.39 This measure is designed to reduce unexpected consumer losses by limiting retail client losses to close to 50% of their investment in CFD trading. This protects retail consumers from excessive losses when sudden changes in the price of the underlying asset causes a large loss in the total value of their CFD position(s). Negative balance protection (see below) provides a further backstop against greater losses.

3.40 Before ESMA's intervention, we saw firms applying automated margin close out in different ways. Some firms allowed the net equity in the client's account to fall close to zero. This meant that retail consumers lost their entire investment.

3.41 Our proposals consider firm feedback to ESMA's Call for Evidence. This feedback suggested that a margin close out rule based on individual positions would not be helpful to retail consumers. It would also create significant implementation costs for firms.

3.42 We have not received evidence to suggest that requiring firms to close client positions at a higher or lower percentage would improve consumer outcomes.

Expected benefits

3.43 We expect applying our margin close out rule will support our leverage limits by reducing overall client losses and by providing broadly consistent terms of trading for retail consumers. It will also reduce the risk that firms will have to waive their retail client's debts.

- Q5: Do you agree with the proposal to set a margin close out rule at 50% of initial margin required? Do you have any comments on the draft Handbook rule for margin close out?**

Negative balance protection

3.44 We propose to require firms to guarantee that retail clients cannot lose more than the funds in their CFD trading account. We did not consult on protection against negative balances in CP16/40.



How the measure reduces harm

- 3.45** This will limit the amount of money that retail consumers lose unexpectedly because some retail consumers do not properly understand that they could lose more than their deposited funds when they trade CFDs on a leveraged basis and in the absence of negative balance protection.
- 3.46** Cases of clients going in to negative equity are relatively rare. But they can happen during large market events that cause price 'gapping' and may cause very large losses for individual clients. Gapping refers to the difference in the price the firm automatically closes the client out at and the price the client actually receives once the order made to close out their position is executed. A sudden change in the price of the asset, such as during a flash crash, can create a significant difference between the price the client may otherwise have expected to be closed out at, and the actual price at which an order is filled. This creates the risk of significant and unexpected losses, which may be more than a client's deposited funds.
- 3.47** This happened when the Swiss National Bank ceased pegging the Swiss Franc to the Euro, which resulted in a sudden and significant change in the value of the Swiss Franc and large losses for consumers. For example, German regulator Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) reported that one client lost €280,000 from an initial investment of €28,000, during the Swiss Franc event. A UK retail client lost £2.7mn from a £200,000 initial investment.
- 3.48** In response to CP16/40, some retail consumers reported that their debts to CFD providers have had a distressing impact on their lives, and suggested we require firms to provide negative balance protection.
- 3.49** We are aware that a number of firms already provide negative balance protection or have written off small debts owed to retail consumers. However, many firms did not do this.
- 3.50** Retail CFD providers widely supported ESMA's proposal for the provision of negative balance protection to retail consumers. However, firms said that retail consumers may abuse negative balance protection by opening off-setting positions on different accounts ahead of significant and expected market events. This would limit potential losses on one position while gaining the full profit on the other. We recognise this risk. However, firms should be able to detect abusive strategies through existing surveillance and monitoring systems, and the benefits to consumers of negative balance protection outweigh these risks to firms.

Expected benefits

- 3.51** We expect that negative balance protection will reduce retail consumer losses in both normal and extreme market conditions. Following ESMA's intervention, for example, the value of retail client debt that was forgiven by firms due to negative balance protection between August and October 2018 was £1.45mn, equal to a projected benefit of £5.8mn annually.²⁸

28 These figures were obtained from ESMA's information request to firms. In the CBA (Annex 2), we estimate the benefits of negative balance protection to be €6.4mn. This is because the number is scaled up to represent the projected benefit for the entire UK retail CFD market.

- 3.52** We also expect that this will reduce harm by reducing the impact of significant, unexpected losses during large market events.

Q6: Do you agree with the proposal to require firms to limit client losses to the funds deposited in their CFD trading account? Do you have any comments on the draft Handbook rule for negative balance protection?

Ban on monetary and non-monetary benefits

- 3.53** We are proposing a ban on monetary and non-monetary benefits (excluding information and research tools) that incentivise retail consumers to trade CFDs.
- 3.54** Following feedback to CP 16/40 stating that information and research tools can help investors trade more effectively, we are proposing to allow firms to offer these benefits to retail consumers. Firms also said that volume-based rebates were beneficial to retail consumers. These benefits will not be permitted as our analysis suggests that higher trading volumes are correlated with higher losses.
- 3.55** Price discounts offered to the entire retail client base are not considered to be a monetary benefit. Firms are not prohibited from competing on price.

How the measure reduces harm

- 3.56** A ban on monetary and non-monetary incentives addresses the risk that these incentives distract retail consumers from the risks and complexity of the product.
- 3.57** As stated in CP16/40, firms previously offered bonus promotions and introductory offers to retail consumers inappropriately to induce new and inexperienced retail consumers to trade CFDs. We have also observed that the terms and conditions of these bonuses are often misleading and that retail clients have had difficulty claiming their initial bonus offers.

Expected benefits

- 3.58** We expect that this measure will reduce the likelihood that retail consumers who do not adequately understand the risks and complexity of CFDs begin or continue trading CFDs.
- 3.59** Firms will also be incentivised to compete on terms that are in the best interests of retail consumers (eg lower costs and charges, improvements in client experience etc.).

Q7: Do you agree with the proposal to ban monetary and non-monetary benefits for account opening or trading? Do you have any comments on the draft Handbook rule for the ban on monetary and non-monetary benefits?



Standardised risk warning

- 3.60** The standardised risk warning will require firms to provide a standardised disclosure to retail clients. The disclosure outlines the key risks of trading CFDs and requires the firm to disclose the percentage of loss-making accounts over the previous 12 months.
- 3.61** Firms are required to update these figures on a quarterly basis to ensure they are accurate and up to date. New firms that do not have client accounts over the past 12 months are required to provide a modified risk warning, disclosing the fact that most retail clients lose money trading CFDs. Consistent with ESMA's measures, firms are required to comply with a specified methodology and rules on the prominence of financial promotions.
- 3.62** Under our proposals, firms are required to provide the standardised risk warning on all client communications and marketing. In response to feedback on the length of the previously proposed risk warning, we have provided amended risk warnings to ensure the size is proportionate for different communication mediums.
- 3.63** There was broad support for this transparency-based measure in response to CP16/40 and ESMA's Call for Evidence.

How the measure reduces harm

- 3.64** This measure will help to address the information asymmetry between the firm and the client regarding the prospects of profitably trading CFDs. This will offset the tendency for firms and retail consumers to focus on prospective profits, rather than the high probability of loss.
- 3.65** Standardised risk warnings should reduce the likelihood that CFDs are traded by retail consumers who do not adequately understand the risks of trading CFDs. This is supported by [academic research](#), which showed that the proportion of individuals who understood the high likelihood of losing money from trading CFDs increased from 54% to 91.5% when shown a standardised risk warning.
- 3.66** Responses to CP16/40 and ESMA's Call for Evidence supported this measure. We considered whether it was appropriate for firms to disclose an industry-wide figure on the percentage of loss-making accounts. We concluded that this would be an inefficient use of FCA resources to gather and process industry-wide data on a quarterly basis. There may also be competition benefits from requiring firm-specific figures.

Expected benefits

- 3.67** We expect the standardised risk warning will allow retail consumers to make better informed investment decisions in relation to CFDs. Some retail clients may choose not to trade given the transparency of the high risk of loss. Alternatively, they may moderate their investment behaviour to minimise their losses.

Q8: Do you agree with the proposal to apply a standardised risk warning, including the disclosure of the firm's percentage of loss-making retail client accounts? Do you have any comments on the draft Handbook rule for the standardised risk warning?

Q9: Are there are modifications to the methodology in the draft Handbook rule that would ensure that the percentage of loss-making accounts disclosed by the firm provides an accurate indication of client performance?

Equality and diversity considerations

- 3.68** We have considered the equality and diversity issues that may arise from the proposals in this CP. We do not believe they raise concerns with regards to equality and diversity issues.
- 3.69** We recognise that leverage limits for retail consumers will increase the costs for individuals who want to gain exposure to a range of financial assets through CFDs. 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 – who commonly have a protected characteristic under the Equality Act 2010 – to have less access to these products, is appropriate given the risk of harm.
- 3.70** We will, however, 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 meantime, we welcome your input to this consultation on this.



4 A discussion on policy considerations for futures and other leveraged derivative products

4.1 As we said in our [statement](#) published on 1 August 2018, other derivative products can create the same kinds of risks for retail consumers as CFDs. These substitute products could be sold under a variety of labels but share similar features with CFDs. So, retail consumers may have similarly poor outcomes when trading these derivative products. Some firms have said they intend to offer these products as they are not currently covered by ESMA's temporary intervention measures.

4.2 This chapter sets out a discussion on the nature of the wider UK retail derivatives market and our initial concerns, and asks for evidence and views from market participants. We also discuss potential policy options that we could consider if evidence suggests potential or actual consumer harm. We then look at the potential unintended consequences of applying similar measures to futures and other relevant derivative products.

Risk of harm from futures **Product features**

4.3 Exchange-traded futures and similar OTC products (commonly known as forwards) are similarly complex, derivative instruments that give leveraged exposure to financial assets. Retail consumers trading these products do not have the same protections as retail consumers trading CFDs, as they are not covered by ESMA's intervention.

4.4 A future²⁹ is defined as a contract in which two parties agree to sell property or financial assets for delivery at a future date and at a price agreed to when the contract is made. Derivatives that qualify as futures may be traded on a regulated market (ie be exchange-traded) and / or cleared by a central counterparty (CCP) (ie be centrally-cleared) or offered OTC. Similar to CFDs, the value of futures moves 'one-for-one' with the change in price of the underlying asset. Futures are therefore the most likely derivative that firms could substitute for CFDs.

4.5 Futures are also leveraged, and are commonly traded by exchange members on a regulated exchange. Exchange-traded futures are subject to a central clearing obligation under Article 29 of MIFIR. They are therefore cleared by a CCP via a clearing member. All EU CCPs impose minimum margin requirements on their clearing members in relation to these exchange-traded futures to comply with Article 41 of the European Market Infrastructure Regulation (EMIR) (similar requirements apply in third country jurisdictions).

4.6 However, in the UK, the CCP's minimum margin requirements for clearing members may not feed through from clearing members to the end retail client. This means that brokers executing retail client trades are not required to collect the same margin that CCPs require from clearing members. This allows brokers to provide 'margin discounts'. Our market intelligence suggests that UK brokers provide margin discounts of up to 50%. This effectively doubles the leverage retail consumers can get, resulting in retail

29 See [PERG 2.6.21 – 2.6.22A G](#)

consumers being offered futures with leverage greater than 80:1. Firms can also offer similar OTC futures (commonly known as forwards) with similar levels of leverage.

Distribution risks

- 4.7** Our current understanding is that futures are not widely sold by UK firms to retail consumers. Futures may also be more commonly used as products for hedging and risk management rather than to speculate on changes in the value of a financial asset. For example, small businesses may use futures to reduce their exposure to currency or commodity risks.
- 4.8** The current low level of retail consumer demand for futures could be due to:
- firms targeting appropriate consumers that use these products for hedging and risk management purposes
 - options and futures not being exempt from capital gains tax unlike financial spread bets in the UK. This means that they have fewer tax benefits than spread bets, and
 - the availability of higher leverage, bonus offers, and lower minimum account sizes for retail consumers trading CFDs
- 4.9** However, the current distribution trends may change, particularly if CFD providers start offering these products as speculative investments to retail consumers. Our supervision work is currently trying to discourage firms from doing this.
- 4.10** To assess the extent of actual or potential harm from futures and options, we are keen to receive feedback from firms who currently offer these products in, or from, the UK to retail consumers.

Q10: **If you currently offer futures products to retail clients, please provide the following information (covering the period 1 January 2018 to 31 December 2018):**

- a. the number of retail clients using futures;**
- b. the volumes of trading, including numbers of trades and value;**
- c. any evidence as to the investment outcomes experienced;**
- d. the typical purpose for which they are used; and**
- e. any other information you consider relevant to help our understanding this market?**

Q11: **Have we accurately described the current distribution and typical target market for futures?**

Q12: **Do you have any views on the potential likelihood and risk of futures being sold more widely as a substitute for CFDs?**



Q13: Have we correctly identified the key features of futures that could pose similar risks of harm to retail consumers? Are there any mitigating features that reduce such risks?

Risk of harm from other leveraged derivative products

- 4.11** CFDs and futures are the most likely instruments that retail consumers will use to get leveraged exposure to a wide range of underlying assets. However, we recognise that firms could manufacture products under different legal structures to create products that pose the same risk of harm to retail consumers.
- 4.12** We are aware that certain types of exchange-traded funds or notes can provide leveraged exposure. However, we understand these products are not currently offered with leverage greater than that available for CFDs or futures.
- 4.13** Options may also be used for speculative purpose. They are leveraged because they give consumers exposure to a financial asset at a fraction of its potential value. Options are derivative contracts that provide the right, but not the obligation, to buy (ie a call option) or sell (ie a put option) an underlying asset at a future point in time.³⁰ Retail clients do not generally buy options that put them at risk of losing more than their initial investment.³¹
- 4.14** Options, other than CFD-like options, may not pose the same risk of harm as CFDs or futures because the pricing structure of options naturally limits leverage. This is because the price (known as the premium) of the option takes the historic and implied volatility of the underlying asset in to account. This means that options are more expensive, and therefore less leveraged, when the underlying asset is more volatile, and vice-versa. Most options also have a different pricing structure than CFDs. Options are more or less sensitive to changes in the price of the underlying asset depending on the difference between the current market price and the strike price. This means that they do not provide 'one-for-one' exposure to the underlying asset.

Q14: Are there any other products that could pose similar risks for retail clients to those created by CFDs that we should consider? Please explain.

Possible policy approaches to futures for discussion

- 4.15** Any potential product intervention measures applied to exchange-traded futures and similar OTC products would seek to protect retail consumers from the actual and potential harm from comparable product features to CFDs. In particular, our focus is on excessive leverage and complexity that may expose retail clients to unacceptable risks and result in a high likelihood of loss. We will only consider intervening if the benefits of addressing harm to consumers outweighs the potential costs to firms, and we can adequately mitigate any unintended consequences.
- 4.16** Our starting assumption would be to limit any evidenced harm by considering applying our proposed CFD measures (or similar) to limit product arbitrage. We will also consider the specific product characteristics and features of the existing regulatory framework.

30 There are various types of option which vary in terms of whether they can only be exercised at expiry (i.e. a European option), can be exercised at any time up to an expiry date (i.e. an American option), or other variations.

31 This occurs when retail clients 'write' an option.

Leverage limits

- 4.17** There is a risk that firms could provide excessive leverage to retail consumers who use futures for speculative purposes, resulting in poor client outcomes, as seen for CFDs. If consumers use these products to reduce their risk exposure (ie to hedge), we assume that firms or clients are more likely to agree to post more initial margin with their broker to ensure a position remains open until maturity or for as long as the client needs to hedge a risk. Therefore, these consumers may voluntarily trade at lower leverage than what's made available by firms.
- 4.18** To address the risk of excessive leverage, we could apply consistent leverage limits to futures as those proposed for retail CFDs. For centrally cleared futures offered to retail clients, we could require market intermediaries executing retail client orders to collect:
- i.** initial margin equal to 110% of the initial margin required by the CCP from its clearing members for entering the trade.³² This would apply a look-through approach from the CCP to the end-client, and would result in similar leverage limits as those we are proposing to apply to retail CFDs, or
 - ii.** margin equal to the minimum margin requirements that we are proposing to apply to retail CFDs.
- 4.19** In relation to the first option, we are aware that CCPs may not routinely disclose the amount of margin applicable on a position-by-position basis, which may make it impractical to require firms to collect initial margin at a percentage of the margin required by CCPs. We welcome feedback on this policy option.
- 4.20** For non-centrally cleared forwards, we could require firms to either:
- i.** align these products with the minimum margin required for centrally-cleared futures (subject to the same challenges highlighted above in relation to futures), or
 - ii.** comply with the same proposed leverage limits for retail CFDs, given they are directly comparable to CFDs as a form of OTC derivative product
- 4.21** Applying higher margin requirements / lower leverage limits may require retail consumers to post more margin (depending on current market practices). This may increase the costs of hedging and may limit some consumers' access to these products.
- Margin close out rule and negative balance protection**
- 4.22** Retail consumers trading futures may also benefit from receiving the additional protections provided by a margin close out rule and negative balance protection. We understand that most futures contracts are closed significantly above 50% of the initial margin required. Therefore, most firms are already compliant with this rule.
- 4.23** Negative balance protection would protect retail consumers from losing more than the funds in their futures trading account. This could increase costs to firms because it increases their risk exposure, requiring them to hold more capital. However, feedback from CFD firms to the proposals in this CP suggests that negative balance protection may not impose additional costs if it is applied alongside lower leverage limits.

³² In Europe, CCPs can offer client clearing models where all the clients' positions are netted into one account, meaning that the margin required by the CCP is not calculated on a per position basis, but will reflect the netted down exposure for all clients.



Transparency measures

4.24 As a precautionary measure, a ban on monetary and non-monetary benefits could limit the risks that futures are inappropriately sold or distributed, while incurring no costs for existing firms.

4.25 A standardised risk warning for futures may assist retail consumers' understanding of the trading risks and help reduce harm. A standardised risk warning disclosing the percentage of loss-making account may not be appropriate if futures are primarily used for hedging purposes.

Q15: What are your views on the potential application of similar measures to those we are proposing for CFDs to exchange-traded futures and similar OTC products? Would any of the individual measures be more or less appropriate and proportionate for these products, including alternative leverage limits? Please explain why.

Potential other issues to consider *Commercial purpose exemption*

4.26 We understand that futures are more commonly used for commercial hedging purposes than CFDs. If feedback suggests that it is appropriate to carve out retail clients that invest in futures for a legitimate business purpose, we could carve out business consumers that qualify as retail clients by applying a commercial purpose exemption. An exemption could also extend to retail consumers using these products for personal hedging purposes (eg as part of an investment portfolio). However, this creates a greater risk that firms provide inappropriate exemptions for consumers who claim this exemption and may actually use the products as a speculative investment product.

Q16: Do you have any comments on a possible exemption for retail clients that use these products for commercial hedging purposes?

Other substitutable derivative products

4.27 We expect there are other derivative products that have similar products features to CFDs and pose similar risks of harm, that we are unaware of. If so, we see merit in applying comparable measures to those proposed for CFDs and discussed in relation to futures.

Q17: Would applying comparable measures to other substitutable derivative products be proportionate and appropriate?

Annex 1

Questions in this paper

We seek responses to the following consultation questions:

- Q1:** Do you support our proposal to capture CFD-like options and other products that have the same or similar features to CFDs?
- Q2:** Does the scope of our proposed glossary definition of 'restricted option' sufficiently capture these products? If not, what amendments would further clarify our intended scope?
- Q3:** Do you agree with the proposed leverage limits for retail clients? If not, please indicate alternative leverage limits and provide supporting evidence as to why they will produce better outcomes for retail clients.
- Q4:** Do you have any comments on the draft Handbook rules for leverage limits?
- Q5:** Do you agree with the proposal to set a margin close out rule at 50% of initial margin required? Do you have any comments on the draft Handbook rule for margin close out?
- Q6:** Do you agree with the proposal to require firms to limit client losses to the funds deposited in their CFD trading account? Do you have any comments on the draft Handbook rule for negative balance protection?
- Q7:** Do you agree with the proposal to ban monetary and non-monetary benefits for account opening or trading? Do you have any comments on the draft Handbook rule for the ban on monetary and non-monetary benefits?
- Q8:** Do you agree with the proposal to apply a standardised risk warning, including the disclosure of the percentage of loss-making retail client accounts? Do you have any comments on the draft Handbook rule for the standardised risk warning?
- Q9:** Are there any modifications to the methodology in the draft Handbook rule that would ensure that the percentage of loss-making accounts disclosed by the firm provides an accurate indication of client performance?



- Q10:** If you currently offer futures products to retail clients, please provide the following information (1 January 2018 to 31 December 2018):
- a. the number of retail clients using futures;
 - b. the volumes of trading, including numbers of trades and value;
 - c. any evidence as to the investment outcomes experienced;
 - d. the typical purpose for which they are used; and
 - e. any other information you consider relevant to help our understanding this market?
- Q11:** Have we accurately described the current distribution and typical target market for futures?
- Q12:** Do you have any views on the potential likelihood and risk of futures being sold more widely as a substitute for CFDs?
- Q13:** Have we correctly identified the key features of futures that could pose similar risks of harm to retail consumers? Are there any mitigating features that reduce such risks?
- Q14:** Are there any other products that could pose similar risks of excessive leverage or risks for retail clients comparable to those create by CFDs that we should consider? Please explain.
- Q15:** What are your views on the potential application of similar measures to those we are proposing for CFDs to exchange-traded futures and similar OTC products? Would any of the individual measures be more or less appropriate and proportionate for these products, including alternative leverage limits? Please explain why.
- Q16:** Do you have any comments on a possible exemption for retail clients that use these products for commercial hedging purposes?
- Q17:** Would applying comparable measures to other substitutable derivative products be proportionate and appropriate?

Annex 2

Cost benefit analysis

Introduction

1. This analysis presents estimates of the material impacts of our proposal. We provide monetary values for the impacts where we believe it is reasonably practicable to do so. For others, we provide qualitative estimates of outcomes.
2. We have conducted this CBA to assess the proportionality of our proposed intervention and its likely effects on retail consumers and market participants, consistent with our obligations under Article 42(2) of MiFIR. MiFIR does not specifically require a CBA.
3. As mentioned in this CP, we rely on our rule-making powers under FSMA in addition to the powers under Article 42 MIFIR. We are required under FSMA to undertake a CBA for any 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'. We have therefore undertaken a CBA for that purpose as well.

Problem and rationale for intervention

4. This CP proposes a package of product intervention measures to permanently restrict the sale, marketing and distribution of CFDs³³ and CFD-like options³⁴ to retail consumers treated as retail clients. Our proposed measures are similar to ESMA's (see Chapter 3), but proposes extending the scope to CFD-like options.
5. Based on firm data, we estimate the total annual volume of trading CFDs and CFD-like options by retail clients of UK firms to be c. £4.2trn and the total annual losses of retail clients trading CFDs to be c. £1.2bn in 2014/5.^{35 36} According to firm data, the UK market for CFD-like options is estimated to be very relatively small compared to CFDs.

33 For the purposes of this CBA, CFDs should be read as all products within scope of the proposed rules, including CFDs, spread bets, and rolling spot forex contracts that qualify as MiFID financial instruments.

34 For the purposes of this CBA, CFD-like options should be read as all products within scope of the proposed definition of restricted options, which is defined in the proposed Handbook term in Appendix 1.

35 Based on firm data collected to calculate the expected benefits of leverage limits (see technical annex for more details on this) reflecting retail client trading volumes and losses in 2014 / 2015. We considered the total trading volume between 19 November 2015 and 20 January 2015 of £392.5 bn. The firms included cover c.54% of the market (considering client monies held; based on recent responses an information request by ESMA). We multiplied these figures by 1.85 to reflect the size of the total market and by a further 5.78 to reflect a full year. The total losses of c.£116.7 mn in those nine weeks are scaled up in the same way to reflect the total losses per year for the full market. These data predate ESMA's intervention and the publication of CP16/40. These figures do not include CFD-like options as current UK trading volumes are very low and would not impact these figures.

36 Based on information received in response to a recent information request by ESMA, we estimate the total trading volume of CFDs and CFD-like options by retail clients of UK firms to be c.£7.6trn and the total losses of retail clients trading CFDs to be c.£1.2bn in 2017. These figures were calculated by multiplying figures from a 3-month period between August and October 2017 by 4 to annualise the figures and multiplied by 1.11 to reflect the size of the total UK market. The announcements were published on the [FCA's website](#) and [ESMA's website](#) (announcement of [further work](#) and of the [introduction of temporary measures](#)).



Our estimates of retail CFD trading activity and client outcomes for retail consumers trading CFD-like options will likely reflect the impact of ESMA's temporary measures, the market's response to them, and our statement supporting ESMA's intervention.³⁷

6. Retail consumers may experience large, unanticipated financial losses and therefore harm from CFDs and CFD-like options. This harm is caused by two main factors:
 - Retail investors in CFDs are likely to overestimate the low probability of winning and to be overconfident. This behavioural bias is well-known in economics (also see Chapter 3 of the CP)³⁸, and
 - This behaviour is exacerbated by information asymmetries between firms and retail consumers, and misleading mass-market financial promotions. Information asymmetries arise because retail consumers find it more difficult than CFD firms to assess the extent to which the price offered reflects the value of the underlying asset and to monitor the performance of their investment.
7. The remedies in the CP aim to protect retail consumers by reducing unwittingly incurred losses and mitigating information asymmetries.

Our intervention

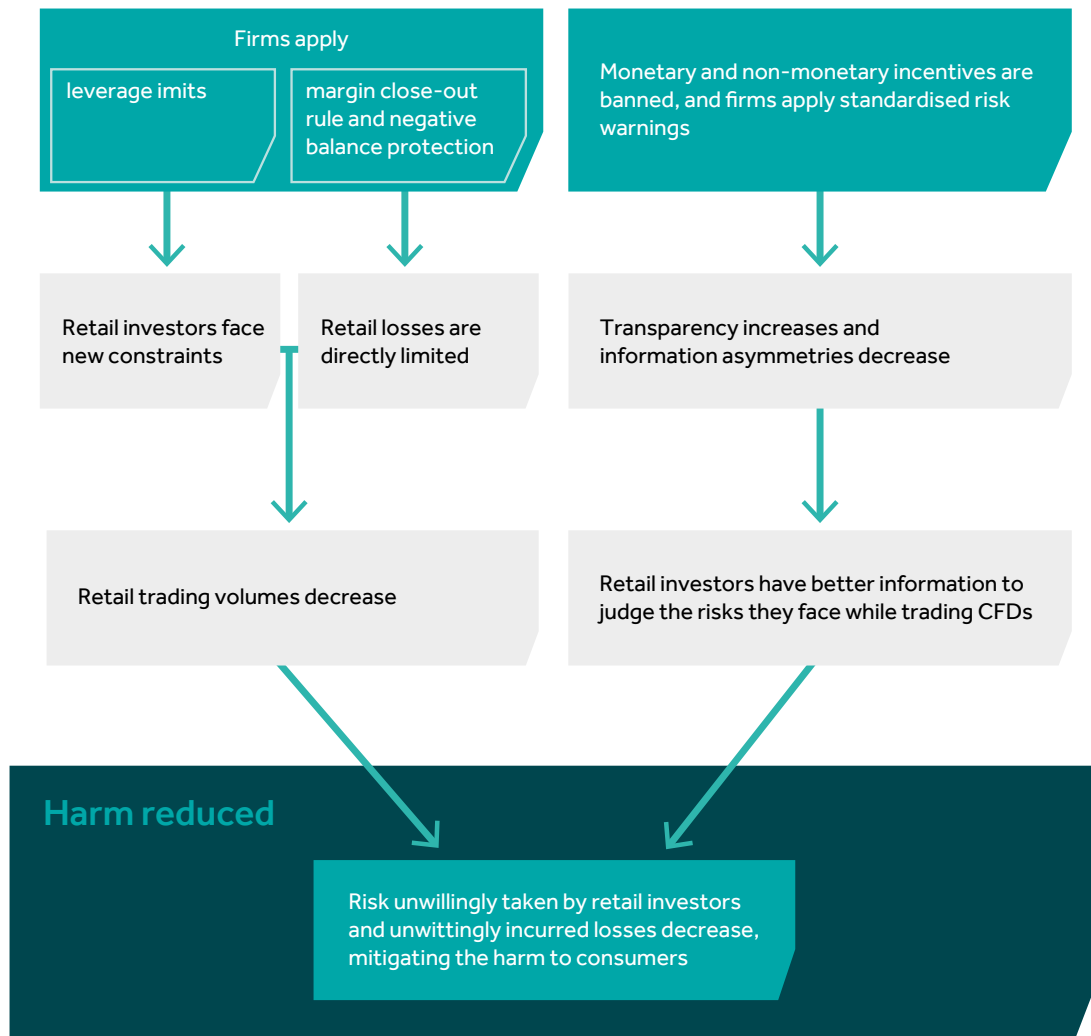
8. Our remedies aim to:
 - **Reduce the harm to retail consumers** by requiring firms to apply
 - leverage limits
 - a margin close-out rule, limiting retail traders' losses close to 50% of their invested funds (in most circumstances), and
 - negative balance protection, ensuring that losses cannot not exceed deposited funds
 - **Improve transparency** by
 - banning monetary and non-monetary incentives to trade products in scope, and
 - requiring standardised risk warnings

³⁷ The announcements were published on the [FCA's website](#) and ESMA's website (announcement of [further work](#) and of the [introduction of temporary measures](#)).

³⁸ See for example Shleifer, 2000, Kyle and Wang (1997), Daniel, Hirshleifer, and Subrahmanyam (1998), Peng and Xiong (2006) and Scheinkman and Xiong (2003). The main predictions of these models are that individual investors tend to trade too much and lose more the more they trade. Several empirical studies back up these predictions (e.g. Barber and Odean, 2000, 2001, Dorn and Huberman, 2005, and Grinblatt and Keloharju, 2009). See [Technical Annex](#) for further information on these references.

Figure 3 below summarises how our proposed measures are intended to work and improve the functioning of the market.

Figure 3: Causal pathway diagram



Baseline and key assumptions

9. Under Article 40 of MiFIR, ESMA can only introduce temporary measures. They will expire if not renewed. Therefore, our counterfactual is a situation where ESMA's temporary measures cease to apply.
10. In our assessment of the impact of our intervention, we assume CFD firms will not experience initial implementation costs for proposals which are similar to ESMA's measures because firms already have to comply with them. We also assume that firms will not experience familiarisation costs because they have already have incurred these costs when assessing what the need to implement ESMA's temporary measures. Extending the scope to CFD-like options creates new costs (discussed below).



Summary of the costs and benefits

- 11.** Our analysis suggests that the main impact of a (voluntary) lowering of leverage limits by a UK CFD firm was a reduction in trading volumes of c. 28%. The imposition of higher margin requirements by a regulator may have a stronger effect because traders may interpret it as a product warning and may change their trading behaviour to reflect that. The reduction in trading volumes from the application of our proposed leverage limits may therefore be larger. For example, we observed that trading volumes for consumers treated by firms as retail clients across all UK CFD firms decreased by 75% following ESMA's intervention under the same leverage limits proposed in this CP. Taking account of the corresponding increase in trading volumes for consumers treated by firms as elective professionals, trading volumes fell by 41%.³⁹ The spread between bid-price and ask-price and the net profit or loss in percent (of the value of trades at open) will likely remain unaffected.
- 12.** This translates into costs and benefits (see table 3 below) in the form of:
- firms making lower profits from CFDs, and
 - retail consumers:
 - no longer incurring losses on CFD volumes which they no longer trade
 - saving transaction costs, but
 - possibly losing some profits on CFD volumes they do trade⁴⁰
- 13.** Our assessment of firms' lost revenues based on analysts' estimates covers all measures proposed for CFDs. Given the large reduction in trading activity suggested by our analysis, we believe that the loss of revenues is mainly driven by lower commissions, transaction fees and financing revenue due to the decrease in leverage limits. These lost revenues are in part transferred to retail consumers as a consequence of enhanced protections that result in lower trading volumes.
- 14.** Firms' lost net income is lower than the trading losses and transaction costs which retail consumers no longer incur due to lower leverage limits. Our analysis to estimate the benefits to retail consumers is based on trade data provided by CFD firms after one UK CFD firm voluntarily lowered leverage limits. These data are different to the data we used to estimate costs. We have used firm data because the analysts' estimates do not allow us to isolate the effects of leverage limits.
- 15.** However, the analysis of these data cannot reflect that some retail traders will move into trading as professionals, move to third country jurisdictions, or trade substitutable products in response to our policy. This may mean we have overestimated the benefits to retail consumers. However, an intervention by a regulator may plausibly have a larger effect on trading volumes (as has been observed from firm data in response to ESMA's information request) than a voluntary change in leverage limits by a CFD firm. This would work in the opposite direction and lead us to underestimate the benefits to retail consumers to an extent. The net effect of this over- and under-estimation is uncertain

39 Calculated based on data for the three months before and three months after 1 August 2018. This reduction in trading activity is not necessarily only due to ESMA's intervention.

40 Some robustness checks suggest a weak negative effect on the net P&L in percent. Whether leverage limits have such an impact is hence not clear. To avoid overstating the benefits to consumers we show the resulting small increase in the net losses.

but in any event, since our aim with this intervention is consumer protection, we would consider the proposed policy to be beneficial even if firms' lost profits would be equal to the net benefits for retail consumers, because it would be a transfer of welfare from firms to retail consumers.

- 16.** According to our estimates in CP16/40 the transparency measures, including the ban on monetary and non-monetary benefits and standardised risk warning, will provide an estimated benefit of £1.6mn for retail consumers. We have not received information to suggest that this estimate is inaccurate.
- 17.** We expect that the margin close out rule and negative balance protection will reduce unexpected losses from retail trading. The benefits of the 50% margin close out rule will likely be negligible as many firms applied it prior to ESMA's intervention so it is already part of our baseline. Requiring its application makes sure that the retail consumers of UK firms will trade on consistent terms in the UK and across the EU. Negative balance protection will provide a further backstop for retail consumers, ensuring that they do not lose more than their deposited funds during significant market events. We estimate the annual ongoing benefit of negative balance protection to be £6.4mn.
- 18.** Expanding the scope of our intervention to CFD-like options will bring only a small amount of retail volume into scope. Given the low trading volume, firms would have incurred disproportionate costs for providing information on implementation costs or retail clients' losses. The primary benefit of expanding the scope of the intervention is to address the risk that UK CFD providers begin offering CFD-like options that replicate the key risk features of CFDs offered prior to ESMA's intervention.

Table 3: One-off and annual on-going net benefits (£mn)

Cost/benefit	lower	upper
Leverage limits		
Cost: firms' loss of profit	(38.5)	(55.3)
Cost: retail consumers' possible loss of net P&L	(0.1)	(1.0)
Benefit: retail consumers' avoided net losses	205.5	350.7
Benefit: retail consumers' saved transaction costs	53.9	92.0
Margin close out rule		
Costs: initial and ongoing costs	0	0
Benefits: retail consumers' avoided net losses	*	*
Negative balance protection		
Costs: initial and ongoing costs	0	0
Benefits: retail consumers' avoided losses	6.4	6.4
Standardised risk warning and ban on monetary and non-monetary incentives		
Costs: initial and ongoing costs	0	0
Benefits: retail consumers' avoided net losses	1.6	1.6
Total net benefits	228.8	394.4

Note: While our analysis covers the loss of profits due to all proposed measures, we believe it is mainly due to the application of lower leverage limits. *The benefit is non-quantifiable (see paragraph 17).

Initial and ongoing costs to firms

One-off implementation costs for products not in scope of ESMA's temporary restrictions on CFDs sold to retail clients

19. In our assessment of the impact of our intervention, we assume that firms offering CFD-like options will experience initial implementation costs because these products were not within scope of ESMA's intervention. We have requested information on the implementation costs from the two firms that offer these products. They told us that they do not offer monetary or non-monetary incentives, but have not provided a clear quantification of implementation costs within the time requested that could be used for the purposes of the CBA. We have no other information that would allow us to reliably estimate these costs.

20. We have no information that suggests that the costs of extending the scope of the policy to cover these would outweigh the benefits. As only two firms currently offer such products, we do not believe that their implementation costs will materially affect our estimates of the total costs and benefits of our proposals.

On-going costs to firms: loss of profits

Loss of profits

21. To assess the impact of CFD leverage limits on firms' profits, we reviewed the earnings and revenue estimates from sell-side analysts for two UK-based CFD firms before and after the implementation of ESMA's temporary measures. We use expected changes in the net income as the closest proxy to estimate the loss of profits due to our proposals; see table 4 below. A part of these losses will be transaction costs avoided or trading losses avoided by retail consumers (ie transfers between CFD firms and their clients). So we also consider these in the benefits section below. While not all of the changes in analysts' estimates of firms' profits can necessarily be attributed to the implementation of ESMA's measures as other factors may be influencing the forecasts, it is plausible that they account for most of them.

Table 4: Net Income Average Estimates before and after the ESMA intervention (in £mn)

Firm		2019	2020	2021
Firm 1	before	195	208	229
	after	191	196	208
Firm 2	before	35	45	52
	after	31	41	46
Total	before	230	253	281
	after	222	237	254

Source: Bloomberg BEst Estimates (which have been made available to the public).⁴¹

22. There are important differences between these two firms in their platforms, product offerings and business models.
23. As of August 2018, both firms achieve the majority of their CFD income from professional investors who are not subject to the new requirements. Therefore, a large proportion of these firms' profits will not be affected by our proposals. Additionally, firms will offset declining profits by reducing costs, such as marketing costs and variable remuneration. Some firms are expanding to different jurisdictions unaffected by the measures. The analysts' estimates reported in the tables above will likely reflect this.

⁴¹ The estimates for the first firm are as of 12 August 2018 (before) and 1 October 2018 (after). The estimates for the second firm are as of 27 July 2018 (before) and 27 September 2018 (after).



24. The two firms under consideration jointly account for a large proportion of the UK retail CFD market. The reduction in net income for these two firms for the financial years 2019 - 2021 is close to £17mn per year on average. This represents a 6.7% decline in net income (around 6% for the first firm and 10% for the second).
25. Since firms' business models differ, scaling up this loss of net revenue for the whole market will not yield a precise estimate of CFD firms' total loss of profit. To reflect this we calculated lower and upper bounds for the estimates for the remaining CFD firms based on the expected decline in net income of 6% and 10% for these two firms. The corresponding reduction for all firms is therefore c. £38mn and £55mn. If we scale up the losses based on trading volumes to account for losses on CFD-like options, these figures remain unchanged because of the low retail trading volumes of CFD-like options.

Negative balance protection

26. Firms may experience additional ongoing costs due to the risk associated with negative balance protection and the associated cost of holding additional capital. To calculate on-going costs to firms, we contacted a number of firms representing an estimated 80% of the current UK market. We requested information on any additional capital they hold as a consequence of ESMA's intervention measures, taking into consideration negative balance protection and other requirements, including leverage limits and the margin close out rule. Firms informed us that they did not add additional capital because, although negative balance protection resulted in additional risk to the firm, these risks were often offset through lower leverage or through amendments to the firm's business model. We expect these costs to be consistent across FCA-authorized firms.
27. The FCA expects firms to conduct their own review on the impact on their Pillar 2 capital assessment (eg the additional market risk, the risk of counterparty failures, and other relevant risks) and to hold appropriate capital to cover the additional risks of providing negative balance protection.

A standardised risk warning

28. Firms will incur minimal on-going costs associated with updating retail traders' loss-figures on a quarterly basis, but we expect that firms have already automated the process for calculating retail traders' loss figures, and cover this as part of their existing running costs.

Initial and on-going costs to retail consumers

29. We do not expect that our measures will impose any initial or on-going costs to retail consumers. Firms may increase costs and charges to compensate for lost revenues, but we do not have any evidence that firms have increased their transaction fees following ESMA's intervention.
30. We have also considered whether negative balance protection will impose any additional costs to retail consumers on the basis that firms may charge them for these additional protections. However, as firms have not indicated that this measure imposes any additional costs, we do not expect that this measure will impose any initial or on-going costs to retail consumers.

Initial and on-going benefits to retail consumers

Leverage limits

31. We assessed the effects of lower leverage limits on outcomes for retail consumers on:

- the spreads between bid price and ask price at trade open and close
- their profits and losses (P&L) measured as net P&L as percentage of the value of trades at open⁴², and
- the value of the trades opened⁴³

Additionally, we considered the effect on these outcomes on the net P&L (in £) and on transaction costs. Further details on the results, and the data and methodology used can be found in the supplemental [technical annex](#).

32. We considered the effect of a lowering of leverage limits by one UK CFD firm for a wide range of CFDs on 21 January 2015 (treated group) and compared them to the change in consumer outcomes for trades in products with unchanged leverage limits offered by four other UK CFD firms (control group).⁴⁴ This intervention is the change most similar to our proposed leverage limits we are aware of.

33. Comparing the changes for the treated and control group around 21 January 2015 should allow us to isolate the effect of the change in leverage limits from other factors affecting CFDs or the markets for the underlying assets. This analysis does not consider the parallel introduction of other proposed measures, such as the margin close out rule, and responses by clients or by firms to the policy (such as encouraging retail consumers to trade as 'elective professionals' who are not affected by our proposals).

34. Our analyses suggest that the lowering of the leverage limits resulted in:

- no significant effect on the bid-ask spreads at opening or closing the trades.
- no likely effect on the net P&L expressed as ratio over the value of trades opened; and
- a decrease in trading volume by c. 28%

Expected impact on transaction costs

35. To estimate the likely saving of transaction costs due to lower trading volumes we estimated the total annual transaction costs prior to the lowering of leverage limits (c. £260mn⁴⁵) and multiplied it by a range of 21% to 35% around our estimate of a decrease in trading volumes⁴⁶ (to reflect the uncertainty around this estimate). This suggests that the intervention will lead to an estimated £54mn to £92mn benefit in the form of saved transaction costs for retail consumers.

42 It is measured as gross P&L net of transaction costs and financing costs as a percentage of the value of trades at open.

43 We would like to thank our academic advisor, Dr. Pasquale Schiraldi, for his advice of these analyses.

44 That is, we consider $\Delta P\&L = (P\&L_{after}^{TG} - P\&L_{before}^{TG}) - (P\&L_{after}^{CG} - P\&L_{before}^{CG})$. To implement this difference-in-difference analysis we run ordinary least square regressions which additionally include indicator variables for each account, each product, and each week. Standard errors are clustered on the accounts.

45 We scaled up the total transaction costs in the nine weeks prior to the reduction of leverage limits to reflect a full year and the whole market. The firms in our dataset account c. 55% of all monies held by CFD firms in the UK.

46 This is the minimum and maximum of the ranges of one standard deviation around the estimated fall in trading volumes (including and excluding currency pairs involving Swiss francs; see table 8 for the estimates and standard deviations).



Expected impact on the net P&L (in £)

- 36.** To assess the effect of the net P&L we estimate two effects that are shown by our econometric analysis:
- the impact of the reduction in trading volumes, and
 - the possible effect that retail consumers lose slightly more money for the volumes they continue to trade.
- 37.** To estimate the impact of the reduction in trading volumes, we take the total annual net P&L, which is c. -£971mn, and apply the estimated reduction in volumes.⁴⁷ Considering again the range for the reduction in trading volumes of 21% to 35%, the range of net loss no longer incurred is £202mn to £344mn.
- 38.** Some of our econometric tests suggests that the lowering of the leverage limits may have caused a very small increase in the losses experienced by retail consumers for a given trade. To avoid overestimating the benefit of our proposals we derived an estimate of this possible loss. Including this effect results in a reduction in the overall benefits to retail consumers by up to £1mn per year. The impact of this effect is therefore immaterial to the overall CBA.
- 39.** The benefit to retail consumers is plausibly higher than the reduction in firms' net earnings discussed above. Firms need to cover the costs of providing CFDs from the transaction costs and will likely offset a part of the decline in net income by reducing costs and by expanding into areas of business unaffected by our proposals. Moreover, not all of the changes in firms' profits above are necessarily due to the implementation of ESMA's measures and firms' reaction to these.
- 40.** **Margin close out rule**
We expect the benefits of the proposed margin close out rule will be negligible and are unlikely to have a significant impact on investor outcomes from trading. Most firms applied margin close out at 50% of the initial margin required for the open CFDs prior to the implementation of ESMA's measures.⁴⁸ Requiring its application will ensure that retail consumers of UK firms will trade on consistent terms in the UK and across the EU. We therefore estimate that there will be minimal initial and on-going benefits to retail consumers.
- 41.** **Negative balance protection**
We have calculated the expected benefits for retail consumers by using data from 63 firms representing over 90% of the UK's retail CFD market, which we received as part of ESMA's information request. These figures indicate that the total value of retail clients' positions that went in to negative equity and their resulting debt was written off by the firm between August and October 2018 was £1.45mn. To calculate the ongoing benefit to retail consumers we multiplied the figure by 1.11 to reflect the size of the UK

⁴⁷ We used the dataset for the difference-in-difference analysis and scaled the net P&L in the nine weeks prior to the reduction of leverage limits of c. £92.5mn to reflect a full year and the whole market. The firms in our dataset account c. 55% of all money held by CFD firms in the UK. The range is calculated in the same way as for the decrease in trading volumes.

⁴⁸ Based on FCA market intelligence.

market and then by 4 to establish the estimated annual benefit. Based on this analysis, we calculate that negative balance protection will provide an annual ongoing benefit to retail consumers of £6.4mn.⁴⁹

A ban on monetary and non-monetary benefits and standardised risk warning

42. In CP16/40, we estimated that the ban on bonus promotions and standardised risk warning would reduce the number of retail consumers trading CFDs by 4,100 consumers would lose £400 on average. Based on these assumptions, we estimated that these measures will provide a total benefit of £1.6mn for retail consumers. We have not received any additional information to suggest that this assessment of expected benefits is inaccurate.

49 These data cover a 3-month period between 1 August and 30 October 2018 received from firms representing over 90% of the UK retail CFD market. It records negative balances incurred by traders. Due to ESMA's intervention such debt has to be forgiven by CFD firms. We cannot exclude that these data reflect a behavioural response by traders to this intervention.



Annex 3

Compatibility statement

Compliance with legal requirements

1. As noted in the CP, we are relying upon our powers under Article 42 of MiFIR to make our product interventions, and to the extent that those interventions are not within the scope of MiFIR we rely upon our rule-making powers under FSMA.
2. When consulting on new rules, under FSMA, the FCA is required by section 138I(2) (d) FSMA to include an explanation of why it believes making the proposed rules is (a) compatible with its general duty, under s. 1B(1) FSMA, so far as reasonably possible, to act in a way which is compatible with its strategic objective and advances one or more of its operational objectives, and (b) its general duty under s. 1B(5)(a) FSMA to have regard to the regulatory principles in s. 3B FSMA. The FCA is also required by s. 138K(2) FSMA to state its opinion on whether the proposed rules will have a significantly different impact on mutual societies as opposed to other authorised persons.
3. This Annex records the FCA's compliance with a number of legal requirements applicable to the proposals in this consultation, including an explanation of the FCA's reasons for concluding that our proposals in this consultation are compatible with certain requirements under FSMA.
4. This Annex also sets out the FCA's view of how the proposed rules are compatible with the duty on the FCA to discharge its general functions (which include rule-making) in a way which promotes effective competition in the interests of consumers (s. 1B(4)). This duty applies in so far as promoting competition is compatible with advancing the FCA's consumer protection and/or integrity objectives.
5. In addition, this Annex explains how we have considered the recommendations made by the Treasury under s. 1JA FSMA about aspects of the economic policy of Her Majesty's Government to which we should have regard in connection with our general duties.
6. This Annex includes our assessment of the equality and diversity implications of these proposals.
7. Under the Legislative and Regulatory Reform Act 2006 (LRRRA) the FCA is subject to requirements to have regard to a number of high-level 'Principles' in the exercise of some of our regulatory functions and to have regard to a 'Regulators' Code' when determining general policies and principles and giving general guidance (but not when exercising other legislative functions like making rules). This Annex sets out how we have complied with requirements under the LRRRA.

The FCA's objectives and regulatory principles: Compatibility statement

8. Our proposals contribute to the FCA's operational objective of consumer protection.
9. We have considered what is the appropriate degree of protection for consumers in light of the matters set out in section 1C of FSMA. In considering what degree of protection may be appropriate we are required to have regard to the 8 matters listed in FSMA s.1C(2)(a)-(h).

The differing degrees of risk involved in different kinds of investment or other transaction

10. As outlined in Chapter 3, our proposals are designed to address the specific risks of the product and are tailored according to the relative risks of each product type, by setting leverage limits according to the volatility of the underlying asset.

The principle that consumers are provided with a level of care that is appropriate given the risk involved in the transaction and capabilities of the consumer and the differing degrees of experience and expertise that consumers may have

11. CFD and CFD-like options are inherently difficult to value due to the risks and complexity of expected price changes in the underlying asset and expected returns, taking in to consideration leverage and the impact of costs and charges. The measures are tailored to ensure that consumers are able to speculate on changes in the price of financial assets whilst mitigating the risks from trading by restricting certain product features, such as excessive leverage, and requiring additional protections for retail consumers (eg negative balance protection and a margin close out rule). In combination, our proposals will afford consumers the appropriate level of care given the risks involved in trading CFDs.
12. We are proposing to limit the scope of these measures to consumers that are treated as retail clients and not to extend their application to consumers treated as professionals on request. This reflects the fact that elective professions are likely to know and understand the risks, including the significant risk of loss, and are more likely to be capable of bearing potential losses from trading.

The needs that consumers may have for the timely provision of information and advice that is accurate and fit for purpose

13. In addition to existing disclosure requirements for firms, we are proposing that firms provide a standardised risk warning, which includes the percentage of client accounts that are loss-making. This measure will ensure that consumers have timely information that allows them to assess the risks of trading and prospects of making a profit from trading CFDs.

The general principle that consumers should take responsibility for their decisions

14. Our proposals ensure that investors have the freedom to invest in retail CFD products that are compliant with our proposals and potentially bear losses.

The different expectations that consumers may have in relation to different kinds of investment

15. Under our proposals, CFDs will remain complex and high-risk investments that should only be sold to appropriate retail consumers. The proposed measures mitigate the risk of harm and help ensure that retail consumers are informed about the risk of trading CFDs.



Having regard to any information which the consumer financial education body has provided to us in the exercise of consumer financial education function

16. We have given due regard to this principle, but we have not received any information from a consumer financial education body in relation to retail consumers trading CFDs.

Having regard to any information received from the Financial Ombudsman Service

17. We have received information from the Financial Ombudsman Service, including information on the number of complaints received and the number of complaints upheld. This information partially reflects poor outcomes for consumers. However, we think that actual harm to consumers is not fully reflected in these numbers and that the size of retail client losses are more indicative of the extent of harm in the UK.

18. In preparing the proposals set out in this consultation, the FCA has had regard to the regulatory principles set out in s. 3B FSMA.

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

19. We have already used our supervisory tools and addressed poor conduct by firms using our existing conduct of business rules on a case-by-case basis and have concluded that they have not adequately addressed our investor protection concerns. The proposed measures will provide the FCA with a clear and effective set of rules to enforce against poor conduct by firms and the sale of products that are detrimental to consumers.
20. We consider that the proposals in this CP are consistent with an efficient and economic use of our resources. They provide a clear view of our expectations of firms in terms of what we consider to be in the best interests of clients, in terms of the appropriate level of leverage and in providing negative balance protection, and appropriate marketing and distribution practices when offering CFDs to retail consumers.

The principle that a burden or restriction should be proportionate to the benefits

21. We consider the benefits of our proposals to outweigh the potential costs for firms and consumers. We have undertaken a cost-benefit analysis of our proposals, which is included in Annex 2 of this CP.

The desirability of sustainable growth in the economy of the United Kingdom in the medium or long term

22. Our proposals will likely reduce demand for retail CFD products and may impact the revenues of CFD providers. This reduced demand will likely be offset by demand in other areas of the UK economy and could lead to more productive forms of investment. We therefore consider that our proposals support sustainable growth in the economy in the medium and long term.

The general principle that consumers should take responsibility for their decisions

23. Our proposals ensure that investors have the freedom to invest in retail CFD products that are compliant with our proposals and potentially bear losses.

The responsibilities of senior management

24. Our proposals provide a clear set of expectations for firms when providing CFD products to retail consumers. These requirements supplement the existing responsibilities of senior management.

The desirability of recognising differences in the nature of, and objectives of, businesses carried on by different persons including mutual societies and other kinds of business organisation

25. We have had regard to this principle and we do not consider that our proposals will impact on this.

The desirability of publishing information relating to persons subject to requirements imposed under FSMA, or requiring them to publish information

26. We have had regard to this principle and we do not consider that our proposals will impact on this.

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

27. We have engaged with stakeholders and taken in to consideration feedback to CP16/40, and feedback to ESMA's temporary intervention measures for CFDs to retail clients. We will continue to engage with stakeholders through this consultation process prior to making any final rules.

28. In formulating these proposals, the FCA has had regard to the importance of taking action intended to minimise the extent to which it is possible for a business carried on (i) by an authorised person or a recognised investment exchange; or (ii) in contravention of the general prohibition, to be used for a purpose connected with financial crime (as required by s. 1B(5)(b) FSMA). This is not relevant for our proposals.

Expected effect on mutual societies

29. The FCA does not expect the proposals in this paper to have a significantly different impact on mutual societies.

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

30. In preparing the proposals as set out in this consultation, we have had regard to the FCA's duty to promote effective competition in the interests of consumers.
31. We designed the proposed policy measures to ensure that UK firms compete in the best interests of retail consumers, rather than by lowering conduct standards and / or offering products or services that are inappropriate for retail consumers and who may suffer detriment as a result.

Equality and diversity

32. We are required under the Equality Act 2010 to 'have due regard' to the need to eliminate discrimination and to promote equality of opportunity in carrying out our policies, services and functions. As part of this, we conduct an equality impact assessment to ensure that the equality and diversity implications of any new policy proposals are considered.



- 33.** The outcome of the assessment in this case is stated in paragraph 3.68 to 3.70 of the Consultation Paper.

Legislative and Regulatory Reform Act 2006 (LRR)

- 34.** We have had regard to the principles in the LRR for the parts of the proposals that consist of general policies, principles or guidance and 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 proposals have 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 retail consumers.
 - **Consistent:** Our proposed approach is applied to firms distributing the investments covered by this consultation exercise and to products that have been a significant source of harm to retail consumers. We are discussing whether to apply broadly consistent measures to products that pose a similar risk of harm.
 - **Targeted only at cases in which action is needed:** We have identified clear evidence of consumer harm and conclude that there is a strong case for applying the proposed measures as discussed in this paper.
- 35.** We have had regard to the Regulators' Code for the parts of the proposals that consist of general policies, principles or guidance and consider that the proposals are proportionate to the market failures identified.

Treasury recommendations about economic policy

- 36.** We have had regard to the Treasury's recommendations under s.1JA FSMA.
- 37.** Treasury's recommendations most relevant to our proposals are the following:
- The government's economic policy – 'continuing to strengthen the financial system, improving the regulatory framework to reduce risks to the taxpayer and building resilience, so it can provide finance and financial services to the real economy and realise better outcomes for consumers supporting sustainable economic growth and encouraging product investment'.
 - Matters about aspects of the government's economic policy that related to 'Better outcomes for consumers'.



- 38.** Our proposals address the significant risks to consumers when trading CFDs, which will likely result in lower aggregate losses for retail consumers. Therefore, they intend to have a positive impact on the financial system by improving the regulatory framework to reduce risks and realise better outcomes for consumers.



Annex 4

Abbreviations in this document

CBA	Cost Benefit Analysis
CCP	Central Counterparty
CEO	Chief Executive Officer
CHF	Swiss Franc
COBS	Conduct of Business Sourcebook
CP	Consultation Paper
CRD	Capital Requirements Directive
DP	Discussion Paper
EEA	European Economic Area
EMIR	European Market Infrastructure Regulation
ESMA	European Securities Markets Authority
EU	European Union
FCA	Financial Conduct Authority
FSMA	Financial Services and Markets Act 2000
FTSE	Financial Times Stock Exchange Index
FX	Foreign Exchange
GBP	British Pound Sterling
IOSCO	International Organisation of Securities Commissions
ISA	Investment Savings Account
IT	Information Technology
LRRA	Legislative and Regulatory Reform Act 2006
MiFID II	Markets in Financial Instruments Directive II

MiFIR	Markets in Financial Instruments Regulation
NCA	National Competent Authority
OTC	Over-the-counter
P&L	Profit and Loss
PERG	Perimeter Guidance Manual
PS	Policy Statement
RAO	Regulated Activities Order
RIC	Reuters Instrument Code
UK	United Kingdom
USD	United States Dollar

Disclaimer

We have developed the policy in this Consultation Paper in the context of the existing UK and EU regulatory framework. The Government has made clear that it will continue to implement and apply EU law until the UK has left the EU. We will keep the proposals under review to assess whether any amendments may be required in the event of changes in the UK regulatory framework in the future.

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.

You can download this Consultation Paper from our website: www.fca.org.uk.

All our publications are available to download from www.fca.org.uk. If you would like to receive this paper in an alternative format, please call 020 7066 9644 or email: publications_graphics@fca.org.uk or write to: Editorial and Digital team, Financial Conduct Authority, 12 Endeavour Square, London E20 1JN



Appendix 1

Draft Handbook text

CONDUCT OF BUSINESS (CONTRACTS FOR DIFFERENCE) INSTRUMENT 2019

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 137D (FCA general rules: product intervention);
 - (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.
- C. The Financial Conduct Authority also makes the restrictions contained within this instrument in the exercise of the power under Article 42 of Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012.

Commencement

- D. Part 1 of Annex A and Part 1 of Annex B of this instrument come into force on *[date]*.
- E. Part 2 of Annex A and Part 2 of Annex B of this instrument come into force on *[date]*.

Amendments to the Handbook

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

Citation

- H. This instrument may be cited as the Conduct of Business (Contracts for Difference) Instrument 2019

By order of the Board
[date]

Annex A

Amendments to the Glossary of definitions

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

Part 1: coming into force [date]

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

major foreign exchange pair two different currencies from the following list of currencies: US dollar, euro, Japanese yen, pound sterling, Canadian dollar and Swiss franc.

minor foreign exchange pairs a pair of two different currencies whose exchange rates are traded in the foreign exchange market which are not a *major foreign exchange pair*.

major stock market index one of the following stock market indices:

- (a) Financial Times Stock Exchange 100 (FTSE 100);
- (b) Cotation Assistée en Continu 40 (CAC 40);
- (c) Deutsche Bourse AG German Stock Index (DAX 30);
- (d) Dow Jones Industrial Average (DJIA);
- (e) Standard & Poor's 500 (S&P 500);
- (f) NASDAQ Composite Index (NASDAQ);
- (g) NASDAQ 100 Index (NASDAQ 100);
- (h) Nikkei Index (Nikkei 225);
- (i) Standard & Poor's/Australian Securities Exchange 200 (ASX 200); and
- (j) EURO STOXX 50 Index (EURO STOXX 50).

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

relevant sovereign debt a debt issuance, issued by or on behalf of:

- (a) the government of the *United Kingdom*;

- (b) the Scottish Administration;
- (c) the Executive Committee of the Northern Ireland Assembly;
- (d) the National Assembly of Wales;
- (e) a member state of the *EU* that has adopted the Euro as its currency;
- (f) the United States of America;
- (g) Japan;
- (h) Canada; or
- (i) Switzerland.

*restricted
speculative
investments*

Any of the following *investments*:

- (1) *contracts for differences*;
- (2) *spread bets*; and
- (3) *rolling spot forex contracts* (other than a *future* in limb (a) of the *Glossary* definition of *rolling spot forex contract*).

but only where such *investments* are *financial instruments*.

Amend the following definitions as shown.

commodity

...

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

...

...

margin

- (1) (in *COLL*) 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.

- (2) (in COBS 22) cash paid, transferred or deposited under the terms of a derivative; for these purposes cash 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.

Part 2: coming into force [date]

Insert the following new definition into the appropriate place. The text is not underlined.

- restricted option* An option:
- (1) that is *in the money* at the point of sale;
 - (2) where the value is determined by one-to-one fluctuations in the value or price of the underlying asset; and
 - (3) for which the value is not significantly affected by the time to expiry.

Amend the following definition as shown.

- restricted speculative investments* Any of the following *investments*:
- (1) *contracts for differences*;
 - (2) *spread bets*; ~~and~~
 - (3) *rolling spot forex contracts* (other than a *future* in limb (a) of the *Glossary* definition of *rolling spot forex contract*); and
 - (4) *restricted options*,
- but only where such *investments* are *financial instruments*.

Annex B

Amendments to the Conduct of Business sourcebook (COBS)

[*Editor's Note:* if rules are made after 29 March 2019, when the United Kingdom leaves the Union, and there is no withdrawal agreement, our intention is to capture the same firms and activities as outlined in the application provisions in this instrument. We would therefore re-draft the rules so that they cover anyone who would have been in one of the categories listed in this instrument immediately before EU withdrawal. We will not re-consult on such amendments to the draft rules. Without a withdrawal agreement, we would expect to make the rules using a combination of our powers under the onshored version of the Markets in Financial Instruments Regulation (which is within the draft Markets in Financial Instruments (Amendment) (EU Exit) Regulations 2018, available on HM Treasury's website), and the Act, as appropriate.]

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

Part 1: coming into force [*date*]

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 not underlined.

22.4 **Restrictions on the retail marketing, distribution and sale of contracts for differences and similar speculative investments**

Application

22.4.1 R This section applies to:

- (1) *MiFID investment firms* with the exception of *collective portfolio management investment firms*; and
- (2) *branches of third country investment firms*,

in relation to the marketing, distribution or sale of *restricted speculative investments* in or from the *United Kingdom* to a *retail client*.

- 22.4.2 G *Firms* are reminded that the *Glossary* definition of *MiFID investment firm* includes *CRD credit institutions* when those institutions are providing an *investment service* or *activity*.
- 22.4.3 G For the avoidance of doubt, marketing *restricted speculative investments* includes *communicating* and/or *approving financial promotions*, and distribution or sale of *restricted speculative investments* includes *dealing* or *arranging (bringing about) deals in investments* and/or *advising on investments* in relation to *restricted speculative investments*.
- 22.4.4 R These rules do not apply to derivative instruments for the transfer of credit risk to which article 85(3) of the *Regulated Activities Order* applies.

Standardised risk warning

- 22.4.5 R (1) A *firm* must not:
- (a) market, publish, provide or communicate in any other way any communication or information in a *durable medium* or on a webpage or website; or
 - (b) *approve* or *communicate a financial promotion* in a *durable medium* or on a webpage or website,
- regarding *restricted speculative investments* to a *retail client*, or disseminate such communication or information, or *financial promotion* in such a way that it is likely to be received by a *retail client*, without including the following risk warning:
- “CFDs are complex instruments and come with a high risk of losing money rapidly due to leverage.

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

You should consider whether you understand how CFDs work and whether you can afford to take the high risk of losing your money.”
- (2) The risk warning must be modified as necessary to refer to the percentage of *retail client* accounts that lost *money* relevant to the *firm*.
 - (3) The *firm's* disclosure of the percentage of *retail client* accounts that lost *money* shall include an up-to-date percentage based on a calculation of the percentage of *retail client* accounts held with the *firm* that lost *money*.
 - (4) The calculation in (3) shall be performed every three *months* and shall cover the 12-*month* period preceding the date of the calculation.
 - (5) For the purposes of the calculation in (3), an individual *retail client* account shall be considered to have lost *money* if the sum of all

realised and unrealised net profits on *restricted speculative investments* traded in a *retail client's* account during the 12-month calculation period is at or below zero.

- (6) The calculation in (3) shall include all costs, fees, *commissions* and any other charges.
- (7) The calculation in (3) shall not include:
- (a) a *retail client* account that did not have an open *restricted speculative investment* connected to it within the calculation period;
 - (b) any profits or losses from *investments* other than *restricted speculative investments*;
 - (c) all deposits of funds; and
 - (d) all withdrawals of funds.
- (8) The *firm* must retain records of the *retail client* accounts used for these calculations for five years.
- (9) 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*.
- (10) Where the communication or information is in a medium other than a *durable medium* or a website or webpage, the following risk warning shall be included:

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

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

- (11) For the purposes of *COBS 22.4.5R(10)*, if the number of characters contained in that risk warning exceeds the character limit permitted by a third party marketing provider, the following risk warning shall be used:

[insert percentage per provider]% of retail CFD accounts lose money.”

- (12) Where the risk warning in *COBS 22.4.5R(11)* is used, the *firm* must ensure that the risk warning is accompanied by a direct link to the *firm's* webpage which contains the risk warning in *COBS 22.4.5(1)R*.

- 22.4.6 R (1) If, when required to perform the calculation of percentage of loss, a *firm* has not entered into a single trade involving a *restricted*

speculative investment with a *retail client* in the previous 12 months, the *firm* must use the following risk warnings as appropriate for the purposes of *COBS 22.4.5R*:

- (a) where the communication or information is provided in a *durable medium*, website or webpage:

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

The majority of retail investor accounts lose money when trading CFDs.

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

- (b) where the communication or information is in a medium other than a *durable medium* or a website or webpage:

“The majority of retail investor accounts lose money when trading CFDs.

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

- (c) For the purposes of *COBS 22.4.6R(1)(b)*, where the number of characters contained in that risk warning exceeds the character limit permitted by a third party marketing provider, the following risk warning shall be used:

“The majority of retail CFD accounts lose money.”

22.4.7 R The relevant risk warning in *COBS 22.4.5* or *COBS 22.4.6* must be:

- (1) prominent;
- (2) contained within its own border and with bold and unbold text as indicated;
- (3) if provided on a website or via a mobile application, statically fixed and visible at the top of screen even when the *retail client* scrolls up or down the page; and
- (4) if provided on a website, included on each linked webpage on the website.

22.4.8 G The relevant risk warning, including the font size, should be:

- (1) proportionate, taking into account the content, size and orientation of the marketing material as a whole; and
- (2) published against a neutral background.

Margin requirements for retail clients

- 22.4.9 R A *firm* must not open a position in relation to a *restricted speculative investment* for a *retail client* unless the *margin* posted to open the position is in the form of *money*.
- 22.4.10 R A *firm* must require a *retail client* to post *margin* to open a position of at least the following amounts:
- (1) 3.33% of the value of the exposure that the trade provides when the underlying asset is a *major foreign exchange pair* or *relevant sovereign debt*;
 - (2) 5% of the value of the exposure that the trade provides when the underlying asset is a *major stock market index*, *minor foreign exchange pair* or gold;
 - (3) 10% of the value of the exposure that the trade provides when the underlying asset is a *minor stock market index* or a *commodity* other than gold;
 - (4) 50% of the value of the exposure that the trade provides when the underlying asset is a cryptocurrency; or
 - (5) 20% of the value of the exposure that the trade provides when the underlying asset is a *share* or an asset not otherwise listed in *COBS 24.4.10R(1) - (4)* above.
- 22.4.11 G For the purposes of *COBS 22.4.10R*, “*exposure*” means the total value of the exposure that the *restricted speculative investment* provides. An example is set out below.
- (1) A *firm* offers a *restricted speculative investment* when the underlying asset is a 5 x leveraged index on gold. The value of the index is £800. The value of the exposure that the trade provides is therefore £800 x 5, or £4000.

Margin close out requirements for retail clients

- 22.4.12 R (1) A *firm* must ensure a *retail client’s* net equity in an account used to trade *restricted speculative investments* does not fall below 50% of the *margin* requirement (as outlined in *COBS 22.4.10R*) required to maintain the *retail client’s* open positions.
- (2) Where a *retail client’s* net equity falls below 50% of the *margin* requirement, the *firm* must close the *retail client’s* open position(s) as soon as market conditions allow.
- (3) In this rule, “*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*.

- 22.4.13 R *A firm must not maintain an open position in relation to a restricted speculative investment for a retail client unless the margin posted to maintain the open position is in the form of money.*
- 22.4.14 R *A firm must provide to a retail client a clear description in a durable medium or make available on a website (where that does not constitute a durable medium) that meets the website conditions of how the retail client's 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.*
- 22.4.15 G *Firms are reminded that they must comply with COBS 2.1.1R (the client's best interests rule) and COBS 11.2A.2R (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).*

Negative balance protection

- 22.4.16 R *The liability of a retail client for all restricted speculative investments connected to the retail client's account is limited to the funds in that account.*
- 22.4.17 G *COBS 22.4.16R means that a retail client cannot lose more than the funds specifically dedicated to trading restricted speculative investments.*
- 22.4.18 G *For the purposes of COBS 22.4.16R, funds in a retail client's account are limited to the cash in the account and unrealised net profits from open positions. "Unrealised net profits of all open positions" means the sum of unrealised gains and losses of all open positions recorded in the account. Any funds or other assets in the retail client's account for purposes other than trading restricted speculative investments should be disregarded.*

Restrictions on monetary incentives and non-monetary incentives

- 22.4.19 R *A firm must not offer to a retail client, or provide a retail client with, any of the following when marketing, distributing or selling a restricted speculative investment:*
- (1) *a monetary incentive; or*
 - (2) *a non-monetary incentive.*
- 22.4.20 G *For the purposes of COBS 22.4.19R:*

- (1) monetary incentives include, but are not limited to, the offering of bonuses in relation to the opening of a new account or the offering of rebates on fees (including volume-based rebates);
- (2) lower fees, not linked to volumes, offered to all *retail clients* do not constitute a monetary incentive; and
- (3) information and research tools do not constitute non-monetary incentives.

Other Products

- 22.4.21 G *Firms* that market, distribute or sell *derivatives* with similar features to *restricted speculative investments* (particularly where the *derivatives* are leveraged) to *retail clients*, should have particular regard to how they comply with applicable obligations found elsewhere in the *FCA Handbook*, including, where relevant:
- (1) *COBS* 2.1.1R (The client’s best interests rule);
 - (2) *COBS* 4.2.1R (The fair, clear and not misleading rule);
 - (3) *COBS* 9A Suitability (MiFID and insurance-based investment products provisions);
 - (4) *COBS* 10A Appropriateness (for non-advised services) (MiFID and insurance-based investment products provisions);
 - (5) *PRIN*, particularly *principles* 1, 2 and 6; and
 - (6) *PROD* 3 (Product governance: MiFID).

Part 2: coming into force [date]

Amend the following provision as shown.

22.4 Restrictions on the retail marketing, distribution and sale of contracts for differences and similar speculative investments

...

- 22.4.11 G For the purposes of *COBS* 22.4.10R, “exposure” means the total value of the exposure that the *restricted speculative investment* provides. ~~An example is~~ Examples are set out below.
- (1) A *firm* offers a *restricted speculative investment* when the underlying asset is a 5 x leveraged index on gold. The value of the index is £800.

The value of the exposure that the trade provides is therefore £800 x 5, or £4000; or

- (2) A firm offers a contract for differences where the underlying asset is a restricted option that references the FTSE 100. For this contract for differences, the value of the exposure that the trade provides is equal to the value of the underlying asset of the restricted option. For the purpose of pricing the restricted option, the firm offers £1 of exposure for each point of the FTSE 100. Under these terms, if the client buys the contract for differences on a restricted option when the FTSE 100 is trading at 7070, the value of the exposure that the trade provides is £7070 (i.e. 7070 x £1).

