FINANCIAL CONDUCT AUTHORITY

Regulator Assessment: Qualifying Regulatory Provisions

Title of proposal: PS19/18: Restricting contract for difference products sold to retail clients

Lead regulator: FCA

Date of assessment: 9 July 2019

Commencement date: 1 July 2019

Origin: Domestic

Does this include implementation of a Cutting Red Tape review? No

Which areas of the UK will be affected? Whole of UK

Brief outline of proposed new or amended regulatory activity

In December 2018, we published Consultation paper 18/38 'Restricting contract for difference products sold to retail clients and a discussion of other retail derivative products'. The CP proposed rules restricting how contracts for difference (CFDs) and CFD-like options could be sold to retail consumers.

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 difference, spread bets, and rolling spot forex products. They are most commonly offered in the UK on an Over the Counter (OTC) basis by firms acting as counterparty (i.e. 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.

In recent years, our supervisory work found evidence of poor conduct by firms who are marketing and selling CFDs to retail consumers who often do not fully understand the risks and find it difficult to value CFDs accurately. Firms have also offered CFDs with increasingly higher leverage (i.e. 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.

Reflecting EU-wide concerns, the European Securities and Markets Authority (ESMA) introduced temporary EU-wide restrictions on CFDs that limited how CFDs could be sold to retail consumers. Our rules are mostly the same as ESMA's in that they 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 protection 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

However, our prohibition goes further than ESMA’s by applying to a wider range of products by including CFD-like options, and limiting leverage for CFDs referencing certain government bonds to 30:1 (compared with 5:1 under ESMA’s measures).

Our Policy Statement, published 1 July 2019 summarised the feedback we received and set out our final policy position and Handbook rules that came into force on 1 July 2019.

Firms that carry out sales, marketing or distribution in, or from, the UK of the relevant products to retail clients, will be required to comply with these Handbook rules from:

- 1 August 2019 for CFDs
- 1 September 2019 for CFD-like options.

Which type of business will be affected? How many are estimated to be affected?

Our proposals will directly affect:
- MiFID investment firms[1], including Capital Requirements Directive (CRD) credit institutions as appropriate, who are marketing, distributing or selling CFDs and CFD-like options in, or from, the UK to retail clients
- UK branches of third-country investment firms who are marketing, distributing or selling CFDs and CFD-like options to retail clients.

We have seen significant changes in the retail CFD sector. Since 2009/10 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. Generally, growth in 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.

In 2018, 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. A similar number of businesses are likely to be affected by the proposals. On average, 279,000 retail client accounts traded CFDs each month in 2017.

Price base year	Implementation date	Duration of policy (years)	Business Net Present Value	Net cost to business (EANDCB)	BIT score
2018	2019	10 (indefinite)	-354.8	41.2	206.1

[1] MiFID Investment Firm Definition

Please set out the impact to business clearly with a breakdown of costs and benefits

One-off implementation costs

CFD restrictions

We do not expect any significant one-off costs for firms arising from our CFD restrictions because firms assumed these costs when implementing ESMA's intervention measures, which are mostly the same as ours. Where our CFD restrictions differ from ESMA's (i.e. setting leverage limits at 30:1 for CFDs referencing certain government bonds) firms have indicated that changing leverage limits for different asset classes and individual products within their existing systems is simple. Therefore, we understand that these costs are not material for firms.

CFD-like option restrictions

Potential initial implementation costs were identified for firms offering CFD-like options since these products were not within scope of ESMA's intervention We requested information on the implementation costs from the only two firms that offer CFD-like options. These two firms did not provide us with a clear quantification of implementation costs to enable us to undertake a CBA. We have no other information that would allow us to reliably estimate these costs or to suggest 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

We assessed the impact of CFD leverage limits on firm's profits by reviewing 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 (these firms do not offer CFD-like options and are not impacted by those restrictions). We used this information because it was the only publicly available information to assess expected impact on firms' due to loss of profits. We think that information from these firms is representative of the UK CFD market because they represent 43% of the UK CFD market based on client money. Moreover, the firms differ in their platforms, product offerings and business models, so that a range of products and business models is covered.

We think the data used is the data most representative of the market as a whole available and is an appropriate basis to assess expected costs to firms through loss of profits.

However, we recognise that this data may lead to an over-estimation because:

- Firms may offset declining profits by reducing costs, such as marketing costs and variable remuneration.
- Some firms are expanding to different jurisdictions unaffected by the measures.

We recognise that the resulting estimates for the loss of profits are imprecise. Hence, we present a range for this figure.

The reduction in net income for these two firms for the financial years 2019 - 2021 is close to £17mn per year on average comprising for Firm 1, a reduction of £4mn, £12 and £21mn in years 1-3 and for Firm 2, a reduction of £4mn, £4mn and £6mn in years 1-3. This represents a 6.7% decline in net income (around 6% for the first firm and 10% for the second).

Firm feedback also suggested that our restrictions on CFD-like options will cause disruption to one firm's business. Despite requesting this information, these firms did not provide an estimation of costs.

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. £38.5mn and £55.3mn. 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.

On-going costs to firms: negative balance protection

We consider that firms may experience small additional on-going costs due to the risk associated with negative balance protection and the additional cost of holding additional capital. To calculate on-going costs to firms, we contacted a number of firms representing an estimated 80% of the UK market at the time. 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. As such, the ongoing costs to firms would be nil. We expect these costs to be consistent across FCA -authorised firms.

On-going costs to firms: a standardised risk warning

Firms will incur minimal on-going costs associated with updating retail traders' loss figures on a quarterly basis, because 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.

Consequently, in our cost benefit analysis we explained that ongoing costs to firms would be nil. Whilst some firms suggested that there would be additional costs from requiring firms to display a risk warning at the top of the webpage, we did not receive any quantification of these costs. Because the net benefits of this measures are far greater than the expected costs, we do not think it was proportionate to assess these costs.

Please provide any additional information (if required) that may assist the RPC to validate the BIT Score.

We did not receive any substantive comments on the contents of the CBA. While we have made some refinements to our proposals in our PS, we do not consider that these changes will not significantly affect the figures we gave in the CBA. We have therefore concluded that the CBA set out in CP18/38 still applies.

https://www.fca.org.uk/publication/consultation/cp18-38.pdf

https://www.fca.org.uk/publication/policy/ps19-18.pdf