

Additional information on the agreed product intervention measures relating to contracts for differences and binary options

1 Introduction

The European Securities and Markets Authority (ESMA) has agreed on temporary product intervention measures on the provision of contracts for differences (CFDs) and binary options to retail investors in the European Union (EU).

This document provides additional information on the measures that have been agreed pursuant to ESMA's new product intervention power under Article 40 of Regulation (EU) No 600/2014 (MiFIR).

ESMA intends to adopt these measures in the official languages of the EU in the coming weeks, following which ESMA will publish a notice on its website. The measures will be published in the Official Journal of the EU (OJ) and will start to apply one month, for binary options, and two months, for CFDs, after their publication in the OJ.

2 Agreed measure relating to CFDs

The product intervention measure ESMA has agreed under Article 40 of MiFIR for CFDs include:

1. Leverage limits on the opening of a CFD by a retail client from 30:1 to 2:1, which vary according to the volatility of the underlying:
 - 30:1 for major currency pairs;
 - 20:1 for non-major currency pairs, gold and major indices;
 - 10:1 for commodities other than gold and non-major equity indices;
 - 5:1 for individual equities and other reference values;
 - 2:1 for cryptocurrencies;
2. A margin close out rule on a per account basis. This will standardise the percentage of margin (at 50% of minimum initial required margin) at which providers are required to close out one or more of a retail client's open CFDs;
3. Negative balance protection on a per account basis. This will provide an overall guaranteed limit on retail client losses;
4. A restriction on the incentives offered to trade CFDs; and

5. A firm-specific risk warning, including the percentage of losses on a CFD provider's retail investor accounts, delivered in a standardised way.

2.1 Why has ESMA agreed on this measure?

CFDs that offer leveraged exposure to price, level or value changes in underlying asset classes have existed as a speculative short-term investment product provided to a niche client base in some jurisdictions for several years. However, in recent years, a large number of national competent authorities (NCAs) have raised concerns about the widening distribution of CFDs to a mass retail market, despite these products being complex and inappropriate for the large majority of retail investors, as further explained below.

These concerns have materialised across several jurisdictions, with a majority of retail investors in those jurisdictions typically losing money. NCAs' analysis¹ on CFD trading across different jurisdictions in the EU shows that 74-89% of retail investor accounts typically lose money on their investments, with average losses per investor ranging from €1,600 to €29,000. In an attempt to address these concerns, some NCAs took measures in this area. However, in the light of the persisting significant investor protection concerns across the EU and the cross-border nature of these activities, ESMA's product intervention power is the most appropriate and efficient tool to address these concerns and to ensure that retail investors across the Union are provided with a common minimum level of protection.

Furthermore, before agreeing on product intervention measures, ESMA conducted a call for evidence on the possible use of its product intervention power² (the call for evidence). ESMA duly considered all the responses to the call for evidence, including concerns expressed by individuals and CFD providers. After taking these concerns into account and considering the detriment caused by the offer of CFDs to retail investors, ESMA believe this measure to be a necessary and proportionate means to address such detriment.

2.1.1 The complexity and poor transparency of CFDs

CFDs are complex products. The pricing, trading terms, and settlement of such products is not standardised, impairing retail investors' ability to understand the terms of the product. In addition, CFD providers often require investors to acknowledge that the reference prices used to determine the value of a CFD may differ from the price available in the respective market

¹ Examples of analysis by NCAs include: (i) the study by the Comision Nacional del Mercado de Valores (CNMV) available at <http://www.cnmv.es/Portal/verDoc.axd?t=%7bf1a92bb1-5f1b-420b-b58c-122d64a1ed9a%7d>; (ii) the study by the Autorité des marchés financiers (AMF) available at: <http://www.amf-france.org/technique/multimedia%3FdocId%3Dworkspace%253A%252F%252FSpacesStore%252F9bf2caa8-1ce4-4832-85f4-4dffface8644%26>; (iii) the thematic review by the Central Bank of Ireland (CBI) available at: <https://www.centralbank.ie/docs/default-source/publications/Consultation-Papers/cp107/consultation-paper-107.pdf?sfvrsn=4>. See page 1 and 2; (iv) the study of the Komisja Nadzoru Finansowego (KNF) Available at: https://www.knf.gov.pl/o_nas/komunikaty?articleId=50315&p_id=18; and studies from the Financial Conduct Authority (FCA) Available at: <https://www.fca.org.uk/publication/consultation/cp16-40.pdf> and Available at: <https://www.fca.org.uk/publication/correspondence/dear-ceo-letter-cfd-review-findings.pdf>.

² ESMA35-43-904.

where the underlying is traded, making it difficult for retail investors to check the accuracy of the prices received from the CFD provider.

The costs and charges applicable to trading in CFDs can be complex and lack transparency for retail investors. In particular, retail investors typically find it difficult to understand and assess the expected performance of a CFD, also taking into account the complexity arising from the impact of transaction fees on such performance. In addition to transaction fees, spreads and various other financing costs and charges may be applied. Financing charges are also usually applied to keep a CFD open, such as daily or overnight charges, to which a mark-up can also be added. The number and complexity of the various costs and charges and their impact on investors' trading performance contribute to the lack of sufficient transparency in relation to CFDs in order to enable a retail investor to make an informed investment decision.

2.1.2 The particular components and features of CFDs

CFDs operate on leverage. While leverage can increase the possible profit for investors, it can also increase the possible losses. As far as retail investors are concerned, the application of leverage may increase the probability of a larger loss to a greater extent than the probability of a larger gain.

Leverage affects an investment's performance by increasing the impact of transaction fees incurred by retail investors. High leverage also increases the probability that the investor has insufficient margin to support their open CFDs by making the investor's position(s) sensitive to small fluctuations in the price of the underlying to the investor's disadvantage.

Another risk related to trading in leveraged products is linked to the interaction of high leverage and the practice of automatic margin close-out. Automatic margin close-out provides a degree of protection for investors as it reduces, but does not eliminate, the risk that the investor (particularly at high levels of leverage) loses all or more than their initial margin. However, the interaction between high leverage and automatic margin close-out is that it increases the probability that an investor's position will be closed automatically by the CFD provider in a short timeframe or an investor has to post additional margin in the hope of turning around a losing position.

Trading at high leverage levels also increases the impact of 'gapping' during periods of significant market volatility. Gapping occurs when there is a sudden movement in the price of the underlying. Gapping is not unique to CFDs, but the risks related to such events are exacerbated by high leverage. If gapping occurs, the investor on the losing side may be unable to close an open CFD at their preferred price and can result in significant client losses when trading at high leverage. Some providers of CFDs offer very high leverage to retail investors (up to 500:1).

2.1.3 Marketing and distribution activities in relation to CFDs

Although CFDs are complex products, they are offered to retail investors most commonly via electronic trading platforms, without the provision of investment advice or portfolio

management. An assessment of appropriateness is required in such cases pursuant to Article 25(3) of Directive 2014/65/EU (MiFID II). However, this assessment does not prevent CFD providers or their investors or potential investors proceeding with a transaction, subject to a simple warning to the client, even in cases where the investor has provided no or insufficient information to the provider as to their knowledge and experience in the investment field relevant to the specific type of product as well as where the provider has concluded that the product is not appropriate for the investor. This enables retail investors to access products, such as CFDs, which, by their features, should not be distributed to them.

Furthermore, the offer of CFDs to retail investors has increasingly featured aggressive marketing practices as well as misleading marketing communications. A common feature of marketing and sales techniques adopted by the CFD industry has been the offer of trading (monetary and non-monetary) benefits, such as bonuses to attract and encourage retail investors to invest in CFDs, the offer of gifts (for example holidays, cars, electronic goods), trading tutorials or reduced costs (for example spread or fees). Bonuses and other trading benefits can act as a distraction from the high-risk nature of the product. They are typically targeted to attract retail investors and incentivise trading. Retail investors can consider these promotions as a central product feature to the point they may fail to properly assess the level of risks associated with the product. Furthermore, such trading benefits to open CFD trading accounts often require investors to pay funds to the provider and conduct a specified number of trades over a specified period of time.

In addition, distribution models used in this sector of the market bear certain conflicts of interest. The pressure to maintain a pipeline of new investors increases the potential for conflicts of interest to occur. Conflicts of interest have arisen and may arise from the fact that some CFD providers are counterparties to investors' trades without hedging their exposure, therefore placing their interests in direct conflict with that of their investors. There is also a risk that providers may seek to exploit asymmetric slippage (for example pass on any loss as a result of slippage to the client, while retaining any profit obtained as a result of slippage) or purposefully delay the time between quotes and execution of CFD trades to further exploit this practice.

2.2 What are the details of the agreed measure?

2.2.1 Scope of application

For the purposes of the agreed measure, contract for differences or CFD is any derivative other than an option, future, swap or forward rate agreement, the purpose of which is to give the holder a long or short exposure to fluctuations in the price, level or value of an underlying, irrespective of whether it is traded on a trading venue, and that must be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event.

ESMA confirms that only CFDs, as described in the paragraph above, are in scope of the agreed intervention measure. Warrants and turbo certificates are not in scope. ESMA

acknowledges that there are similarities between CFDs and warrants and turbo certificates but the products also differ in various respects. Following adoption of the agreed measure, ESMA intends to closely monitor whether similar detrimental consequences for retail investors develop from these products on a pan-European basis and will act as necessary.

On the other hand, securitized derivatives that are CFDs are not explicitly excluded from the definition of CFDs. Although ESMA is not aware of securitized CFDs at this stage, the wrapper of a security and the tradability on a trading venue do not change the key characteristics of a CFD. In case such products were to be launched, these products would be in scope of this agreed measure.

2.2.2 CFDs with cryptocurrencies as underlying

With particular regard to CFDs with cryptocurrencies as an underlying, ESMA has agreed on a 2:1 leverage limit on the opening of a CFD. However, CFDs with cryptocurrencies as an underlying raise separate and significant concerns as CFDs on other underlyings. Cryptocurrencies are a relatively immature asset class that pose major risks for investors. ESMA and NCAs have significant concerns about the integrity of the price formation process in underlying cryptocurrency markets, which makes it inherently difficult for retail clients to value these products. ESMA and other regulators have repeatedly warned³ of the risks involved with investing in cryptocurrencies. For CFDs on cryptocurrencies many of these concerns remain present. Due to the specific characteristics of cryptocurrencies as an asset class the market for financial instruments providing exposure to cryptocurrencies, such as CFDs, will be closely monitored, and ESMA will assess whether stricter measures are required.

2.2.3 Content of the measures

The agreed measure will impose a three-month restriction on the marketing, distribution or sale of CFDs to retail investors. The restriction consists of the following:

Leverage limits on the opening of a CFD position

Initial margin means any payment for the purpose of entering into a *CFD*, excluding commission, transaction fees and any other related costs. CFD providers will have to require retail investors to pay the following initial margin on the opening of a CFD (initial margin protection):

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

- (a) 3,33% of the notional value of the CFD when the underlying currency pair is composed of any two of the following currencies: US dollar, Euro, Japanese yen, Pound sterling, Canadian dollar or Swiss franc;
- (b) 5% of the notional value of the CFD when the underlying index, currency pair or commodity is: (i) any of the following equity indices: Financial Times Stock Exchange 100 (FTSE 100); Cotation Assistée en Continu 40 (CAC 40); Deutsche Bourse AG German Stock Index 30 (DAX30); Dow Jones Industrial Average (DJIA); Standard & Poors 500 (S&P 500); NASDAQ Composite Index (NASDAQ), NASDAQ 100 Index (NASDAQ 100); Nikkei Index (Nikkei 225); Standard & Poors / Australian Securities Exchange 200 (ASX 200); EURO STOXX 50 Index (EURO STOXX 50); (ii) a currency pair composed of at least one currency that is not listed in point (a) above; or (iii) gold
- (c) 10% of the notional value of the CFD when the underlying commodity or equity index is a commodity or any equity index other than those listed in point (b) above;
- (d) 50% of the notional value of the CFD when the underlying is a cryptocurrency; or
- (e) 20% of the notional value of the CFD when the underlying is a share, or is not otherwise listed above.

Margin close-out rule per account

A margin close-out rule will be imposed on a per account basis (rather than a per position basis). CFD providers shall close one or more of a retail investor's open CFD positions on terms most favourable to the client in accordance with Articles 24 and 27 of MiFID II when the sum of funds in the CFD trading account and the unrealised net profits of all open CFDs connected to that account falls to less than half of the total initial margin protection for all those open CFDs.

The provision of a margin close-out protection and the standardisation of the percentage at which CFD providers are required to close-out one or more investor's open CFDs is also designed to address the inconsistent application of margin close-out practices by CFD providers. In certain cases CFD providers allow their investors' funds to fall to 0 – 30% of the initial margin required to open a CFD. By allowing investors to erode their margin close to zero, providers are placing investors at risk of losing more than the money they had invested, particularly during a gapping event. Conversely, too high of a level of margin close-out would expose investors to be frequently closed out which might not be in their interest. The 50% threshold set out in ESMA's measure mitigates the risk of substantial loss by retail investors .

In the call for evidence, ESMA described a margin close-out protection per position. Such approach was justified on the basis that the initial margin protection is intended to be applied based on the underlying type in the CFD. Therefore, applying a margin close-out rule on a per position basis would ensure the effective application of the initial margin protection for each underlying class as well as a hard cap on leverage available per underlying class. Furthermore,

a margin close out protection per position would help ensure that retail investors are aware and understand their exposure to each individual underlying.

However, based on the responses from the call for evidence and additional analyses, ESMA considers a standardised margin close-out rule per account at 50% of the total initial margin protection more proportionate while ensuring an adequate common minimum level of protection for retail investors.

The margin close-out protection proposed by ESMA will not prevent a provider from applying a per position close-out rule at 50% of the initial margin requirement of the specific position instead of a per account close-out rule; indeed, as explained above, this could reduce the complexity for retail investors. Furthermore, by applying a per position close-out rule at 50%, the provider would inherently fulfil the close-out requirement on a per account basis as each single position would be closed in accordance with the 50% close-out rule.

Negative balance protection

A negative balance protection on a per account basis will be imposed, limiting a retail investor's aggregate liability for all CFDs connected to a CFD trading account with a CFD provider to the funds in that CFD trading account.

The purpose of a negative balance protection is to ensure that an investor's maximum losses from trading CFDs, including all related costs, are limited to the total funds related to trading CFDs that are in the investor's CFD trading account. This includes any funds yet to be paid into that account due to net profits from the closure of open CFDs connected to that account. An investor should not incur any additional liability connected with its trading of CFDs. Other accounts are not be part of the investor's capital at risk. In case a trading account also includes other financial instruments (for example, UCITS or shares), only the funds explicitly dedicated to CFD trading, and not those dedicated to other financial instruments, will be at risk.

Restriction on the incentivisation of CFD trading

CFD providers will be required not to provide, directly or indirectly, retail investors with a payment, monetary or excluded non-monetary benefit (i.e. any non-monetary benefit other than, insofar as they relate to CFDs, information and research tools) in relation to the marketing, distribution or sale of a CFD, other than the realised profits on any CFD provided. This measure will apply to all clients, including existing and prospective clients.

Financial promotions offering bonuses or other incentives to trade CFDs often distract retail investors from the high-risk nature of CFD products. They draw in retail investors who may not otherwise choose to invest in these products. Such benefits are often contingent on clients depositing money on the account or on executing a certain volume of trades.

Risk warning

CFD providers will not be allowed to send, directly or indirectly, a communication to or publish information accessible by a retail investor relating to the marketing, distribution or sale of a CFD unless it includes an appropriate risk warning.

In the risk warning, each CFD provider will be required to provide the percentage of its retail investor CFD trading accounts that lost money over the last 12-month period.

The calculation will be performed on a quarterly basis and cover the 12-month period preceding the date on which it is performed (12-month calculation period). The percentage used in the warning will be updated accordingly.

For these purposes, an individual retail investor CFD trading account is considered to have lost money if the sum of all realised and unrealised net profits on CFDs connected to the CFD trading account during the calculation period is negative. Any costs relating to the CFDs connected to the CFD trading account are included in the calculation, including all charges, fees and commissions.

The calculation shall not take into account (i) the trading accounts that did not have any open CFD position within the calculation period, (ii) any profits or losses from products other than CFDs if these are connected with the CFD trading account, and (iii) any deposits or withdrawals of funds from the CFD trading account.

For newly established CFD providers or CFD providers that did not provide an open CFD connected to a CFD trading account in the last calculation period, a standard risk warning which refers to the percentage range of losses found by NCAs in their analysis (74-89% of retail investor accounts lose money when trading CFDs) will be used instead.

3 Agreed measure relating to binary options

The product intervention measure ESMA has agreed under Article 40 of MiFIR is a prohibition on the marketing, distribution or sale of binary options to retail investors.

3.1 Why has ESMA agreed on this measure?

The risks related to the inherent features of binary options, such as a structural expected negative return and in-built and unmanageable conflicts of interest, make these products unsuitable for retail investors. These risks are often amplified by the aggressive marketing techniques used by binary option providers. Furthermore, unlike options which can serve a valuable role in hedging exposure to certain assets, binary options do not meet any genuine investment needs for retail investors. Being inherently like gambling products, binary options can also attract compulsive gambling behaviour.

Despite being unsuitable for retail investors, binary options have been increasingly offered to them across the Union. The significant concerns raised by the increasing dimension of this

market sector have led to the adoption of a number of national measures aimed *inter alia* at banning the commercialisation of these products to retail investors. However, given the cross-border dimension of the activities of binary option providers as well as the need to ensure a common minimum level of investor protection across Member States, ESMA has decided to agree on a product intervention measure which prohibits the marketing, distribution or sale of binary options to retail investors.

Before agreeing on such measure, ESMA has duly considered all the responses to the call for evidence, including concerns expressed by individuals and binary option providers on the imposition of a full ban on the offer of these products to retail investors. After taking into account these concerns and considering the significant detrimental impact of binary options on retail investors, ESMA is satisfied that the agreed measure is necessary and proportionate. A less stringent measure would not adequately address the investor protection concerns identified. As further described below, the complexity and lack of transparency of binary options, the lack of reasonable investment objectives, the negative expected return of the product, the in-built conflicts of interest for providers, the misleading and aggressive nature of marketing and distribution activities, all mean that binary options should not be offered to retail investors.

3.1.1 The complexity and poor transparency of binary options

Binary options are complex financial instruments. For example, their pricing structure presents a number of challenges for retail investors. This is because the pricing structure of binary options requires retail investors to assess accurately the value of the option in relation to the expected probability of the reference event occurring. Although retail investors may use common research and pricing tools to price binary options, they face significant information asymmetries compared to providers which have much greater access to information and systems to properly price these products.

Furthermore, retail investors in the Union typically invest in binary options OTC. As such their pricing, performance and settlement is not standardised. This impairs retail investors' ability to understand the terms of the product.

Binary option providers are also typically the counterparty to their retail investors' trades, with the provider determining the price at execution and the payment at expiry.

3.1.2 The particular features or components of binary options

The binary outcome nature of binary options mean that they are primarily used for speculative purposes. The payment of a fixed monetary amount or zero limits the value of binary options as a hedging tool in contrast to traditional options, which allow the investor to manage their risk by setting a 'ceiling' or 'floor' for a specific asset that they may have direct exposure to. This is exacerbated by the typical very short term of binary options (in some cases these products expire minutes after having been entered into).

Furthermore, binary options are priced according to the probability of an event occurring, quoting payoffs in a similar manner as traditional fixed-odds bets (for example bets on sporting

events or election outcomes). Trades are mostly very short term and investors stand either to make a substantial return or to lose their entire investment. These fundamental features are also found in gambling products, which are linked with addictive behaviour and poor outcomes for consumers.

In addition to being highly risk and speculative investments, binary options structurally have negative expected returns. This feature implies that the more positions an investor takes, the more likely they are to lose money on a cumulative basis.

As mentioned above, binary option providers usually act as direct counterparty to the investor's trade, hence taking the investor's trade onto their own book. This business model places the provider's interests in direct conflict with those of its investors, which increases the risk that the provider may manipulate the price of the underlying at expiry of the binary option or extend the term of the binary option by seconds or milliseconds so as to avoid having to pay-out on the option contract. The risk of conflict of interest is particularly acute for binary options, as the payment structure of these products is determined by whether the underlying has reached the specified strike price at expiry.

3.1.3 Marketing and distribution activities in relation to binary options

Although binary options are complex products, they are offered to retail investors most commonly via electronic trading platforms, without the provision of investment advice or portfolio management. An assessment of appropriateness is required in such cases pursuant to Article 25(3) of Directive 2014/65/EU. However, this assessment does not prevent binary options providers or their investors or potential investors proceeding with a transaction, subject to a simple warning to the client. This can occur where the client has provided no or insufficient information to the provider as to their knowledge and experience in the investment field relevant to the specific type of product as well as where the provider has concluded that the product is not appropriate for the client. This enables retail investors to access products, such as binary options, which, by their features, should not be offered to them.

3.2 What are the details of the agreed measure?

3.2.1 Scope of application

For the purposes of the agreed measure, a binary option is any cash settled derivative in which the payment at close out or expiry of a predetermined fixed monetary amount or zero depends on whether one or more specified events in relation to the underlying occur at, or prior to, the

derivative's expiry⁴ (for example the underlying has reached a specified price (the strike price) at expiry).

Binary options give the investor the option to make a bet on the occurrence of a specified event, generally in relation to the price, level or value, of one or more underlying(s) (for example a share, a currency, a commodity or an index). If the event does not occur, the investor loses their money (that is the option finishes 'out-of-the-money'). If the event occurs, the option pays out or the contract remains open with the opportunity to receive a pay out if a separate event occurs (the option finishes 'in-the-money'). In this sense, binary options can be regarded as 'yes/no propositions'.

All binary options, regardless of whether they are traded OTC or on a trading venue and regardless of the names under which they may be marketed, distributed or sold, will fall within the scope of the agreed measure. For example, the agreed measure will include all-or-nothing options, up-or-down options, trend options, digital options and one-touch options. Furthermore, securitized binary options will also be in scope.

The agreed measure will also include binary options that have several different predetermined conditions which have to be met (or not met) before the payment is provided. This may include, for instance, the case of a binary option that provides payment of (i) a predetermined amount if the underlying meets a certain predetermined condition (for example the value of the underlying rises on a specific date), as well as (ii) an additional predetermined amount (a 'bonus') if the underlying meets another predetermined condition (for example the value of the underlying rises above a certain percentage).

3.2.2 Content of the measure

The agreed measure will impose a three-month prohibition on the marketing, distribution or sale of binary options to retail investors.

⁴ Typically, the lower of the two monetary payoffs is zero, but this need not be the case. Binary options are distinct from other speculative products sold to retail investors, such as CFDs, in that the payment is of a predetermined monetary amount not directly linked to the size of the change in the price, level or value of the underlying.