

## FREQUENTLY ASKED QUESTIONS

### ESMA's product intervention measures in relation to CFDs and binary options offered to retail investors

#### *ESMA's Product Intervention Measures*

ESMA has agreed on measures in relation to binary options and contracts for differences, including rolling spot forex (CFDs). The measures agreed upon are the following:.

#### **Binary options**

The measure prohibits the marketing, distribution or sale of binary options to retail investors.

#### **CFDs**

The measure restricts the marketing, distribution or sale of CFDs to retail investors to circumstances where all of the following protections are provided:

- leverage limits on the opening of a position between 30:1 and 2:1, which vary according to the volatility of the underlying asset<sup>1</sup>:
  - 30:1 for major currency pairs;
  - 20:1 for non-major currency pairs, gold and major equity indices;
  - 10:1 for commodities other than gold and non-major equity indices;
  - 5:1 for individual equities and any underlying not otherwise mentioned;
  - 2:1 for cryptocurrencies;
- a margin close-out rule on a per account basis;
- a negative balance protection on a per account basis;
- a prohibition on benefits<sup>2</sup> incentivising trading; and
- a standardised risk warning.

#### **Why has ESMA chosen these measures?**

- CFDs and binary options are inherently risky and complex products. In recent years, ESMA and national competent authorities (NCAs) have been increasingly concerned about the rapid increase in the marketing, distribution or sale of these products to retail investors across the European Union.

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<sup>1</sup>The leverage limits have been set so that retail investors in CFDs face comparable levels of risk whatever the underlying asset. In particular, higher leverage is permitted for CFDs on relatively stable assets whereas lower leverage is permitted on relatively volatile assets.

<sup>2</sup> Non-monetary benefits in relation to information and research tools are excluded from the prohibition.

- In order to tackle these concerns, ESMA has issued specific warnings and developed dedicated Questions and Answers (Q&As). Furthermore, it has coordinated the work of a joint group and a task force to tackle issues related to a number of providers offering CFDs and other speculative products to retail investors on a cross-border basis across the European Union as well as to monitor the offer of these products to retail investors.
- In addition, some NCAs have adopted national measures to limit the provision of these products to retail investors.
- Despite these actions, significant concerns remain that the risks to investor protection posed by these products is not sufficiently controlled or reduced.
- Further to its statements of 29 June 2017 and 15 December 2017, ESMA has therefore agreed on product intervention measures.

#### **When are these measures applicable?**

- These measures have to be translated into all official languages of the European Union. This process is currently underway and will take a number of weeks.
- Once the translation process has been completed, ESMA intends to adopt the measures in the official languages of the European Union.
- Once adopted, the measures will be sent for publication in the Official Journal of the European Union in the official languages of the European Union.
- The measure on binary options would start to apply one month after publication in the Official Journal of the European Union. The measure on CFDs would start to apply two months after the publication in the Official Journal of the European Union.

#### **For how long will these measures apply?**

- These measures will apply for three months, at which point they may be renewed.

#### **To whom will these measures apply?**

- These measures apply to any person marketing, distributing or selling CFDs or binary options to retail investors in the Union that require an authorisation to do so under the new MiFID regime.
- This includes investment firms and banks.

#### **How will these measures apply?**

- These measures will be directly applicable. This means that, in order to apply, they will not have to be implemented by a separate national action.
- Product providers are required to comply with the measures as of when they become applicable. NCAs will supervise product providers to ensure that they adhere to the

measures.

## **Products**

### **What are CFDs?**

- CFDs are complex financial instruments, often offered through online platforms. They are a form of derivative trading.
- CFD trading enables you to speculate on the rise or fall of the price, level or value of an underlying, including such asset classes as currencies, indices, commodities, shares and government bonds. You do not need to own the underlying asset.
- CFDs are typically offered with leverage which means you only need to put down a portion of the investment's total value. However, financing costs and transaction costs (such as bid-ask spreads) are typically based on the investment's total value.
- Leverage also multiplies the impact of price changes on both profits and losses. This means you can lose money very rapidly. Leverage can contribute to losses being so rapid that people have ended up owing large sums of money to the product provider.
- A recent market event underscoring the importance of a Negative Balance Protection was when the Euro fell suddenly and dramatically against the Swiss Franc in January 2015. As a result of this event, in the absence of Negative Balance Protection, some retail investors ended up owing very large sums of money to providers, often much more money than the investors could afford.

### **What are binary options?**

- Binary options enable you to get a predetermined fixed pay-out if an underlying asset meets certain predetermined conditions, generally within a particular time-frame.
- A common form of a binary option is that you receive a fixed pay-out if the price of the underlying, such as an exchange rate, a share or a commodity, reaches a specified level. For example, a binary option might be issued at 1100 offering a return if the price of gold has increased by 1500 the same day. If the price of gold is lower at 1500 than it was at 1100, the investor loses the amount invested.
- Due to the characteristics of binary options, retail investors on average lose money with these products and there is no clear alternative investment purpose for them (e.g. hedging of risk).

- All types of binary options offered to retail investors are included in ESMA's measure. For example, sometimes binary options are known as binary bets. This is because they are highly speculative and the pay-out is quoted in a similar way to fixed-odds bets, such as those on sporting or political events.
- Binary options are distinct from other options. Unlike binary options, other options do not provide for a fixed pay-out. Instead, the return from the option falls within a continuous range. Common examples are call or put options, which are sometimes called 'vanilla' options. For instance, a put option is worth more the further the price of the underlying asset falls below the strike price. For this reason, non-binary options such as vanilla options can be well-suited for use in hedging another investment.

### ***Investor Protection***

#### **Why has ESMA not acted sooner?**

- ESMA's power to temporarily restrict or prohibit the marketing, distribution or sale of these products has only been applicable from 3 January 2018 as part of a strengthening of investor protection introduced by the new MiFID regime.
- Before then, ESMA and some NCAs warned repeatedly of the risks involved with CFDs and binary options. Some NCAs have also taken national measures. However, the detriment to retail investor caused by these products across the European Union still persists and therefore it is necessary for ESMA to exercise its new power.

#### **I am a retail investor and still want to trade CFDs, can I?**

- When the measures become applicable, you can still trade CFDs. The measures introduce some restrictions on the types of CFDs offered to retail investors and the ways in which they are marketed, distributed or sold to you, to reduce the risks involved in CFD-trading.

#### **I am a retail investor and have open CFD positions and/or binary options, what should I do?**

- The measures apply to product providers. As an investor you do not have to act. However, when the measures become applicable, you may want to verify with your provider(s) that you receive the level of protection which ESMA's measures require.

#### **What about professional clients who want to trade in binary options/CFDs?**

- The measures only apply in respect of retail investors. Professional clients are not in

scope.

- It should be noted, professional clients do not have the same investor protections and compensation rights as retail investors.
- If as a retail investor you wish to continue trading CFDs without being subject to the restrictions imposed by ESMA, or to continue trading binary options, you should discuss with your provider and you should consider carefully whether you could and should become a professional client.
- In this respect, ESMA notes that the new MiFID regime has strict rules regarding retail investors being categorised as professional clients.

### **What about unauthorised binary option providers?**

- ESMA's measures in relation to binary options stem from the high risks associated with the products themselves.
- However, ESMA is aware that unauthorised entities are providing services in binary options across the European Union.
- Unauthorised investment service providers pose a separate and serious problem for all Member States which is not limited to activities relating to binary options

### ***Product Intervention Measures***

#### **CFDs**

#### **What is a margin close-out (MCO) rule?**

- The margin close-out rule standardizes the percentage of the margin at which CFD providers are required to close out a CFD or multiple CFDs.
- The result of this standardization is a clear and consistent approach across providers, helping investors understand what will happen to their investments if they experience adverse price movements.
- The MCO has been set at 50% to ensure that investors' margin is not eroded close to zero. This is in line with examples of good practice in the industry to date. The rule will not prevent investors from choosing to 'top up' their margin if they wish to do so.

### **What is a margin close-out (MCO) rule per account?**

- Specifically, if the total margin in an account falls before 50% of the amount of initial margin required in respect of the open CFDs, the provider must close one or more of the CFDs.
- The MCO rule does not prescribe which positions must be closed out, or in what order. Some investors currently instruct their provider to close out positions in a specified order. In other cases of existing market practice, MCO is implemented on a position-by-position basis, i.e. any single CFD is closed out if the margin allocated to it falls below a certain level. These different ways of implementing MCO will still be possible, but importantly, the threshold of total margin in an account at which MCO is triggered will be standardized at 50%.

### **What is Negative Balance Protection?**

- The Negative Balance Protection limits the maximum losses that a retail investor could have. It is designed as a backstop for when MCO does not work effectively as a result of a very sudden price movement.
- By introducing a Negative Balance Protection per account the investor can never lose more than the total sum invested for trading CFDs. There can be no residual loss or obligation to provide additional funds beyond those in the investor's CFD trading account.
- Because the MCO rule (together with leverage limits) ensures a buffer of margin in normal market conditions, the Negative Balance Protection rule is expected to be needed only in rare situations, under extreme market conditions. Nonetheless, it is a very important backstop.
- A recent market event underscoring the importance of a Negative Balance Protection was when the Euro fell suddenly and dramatically against the Swiss Franc in January 2015. As a result of this event, in the absence of Negative Balance Protection, some retail investors ended up owing very large sums of money to providers, often much more money than the investors could afford.

### **What is leverage?**

- Leverage involves borrowing capital in order to get a greater exposure.
- For example a leverage of 20:1 implies that, for every 5 euro you invest, the product provider gives you an exposure of 100 euro (€5 x 20). To do this, the providers lends you, in economic terms, 95 euro (€100-€5).

### **What does a leverage limit imply?**

- A leverage limit of, for example, 5:1 on the opening of a CFD requires the client to post initial margin of at least 20% of the initial total exposure of the CFD.
- Similarly, a leverage limit of, for example, 20:1 on the opening of a CFD requires the client to post initial margin of at least 5% of the initial total exposure of the CFD.
- The leverage limits imposed in the measure on CFDs set the maximum leverage that providers can offer you when opening a CFD.
- Leverage limits on the opening of a position are also referred to as 'initial margin protection'. This term highlights that in requiring a certain amount of margin to be initially posted relative to total initial exposure (i.e. a leverage limit), the investor is protected from certain risks. These include:
  - the risk that charges (such as financing costs or transaction fees) applied to the total initial exposure instantly deplete much or all of the margin; and
  - the risk that even small price movements in the underlying drive large changes in the investor's available margin, making it likely that large losses will be crystallized.

### **Why are there different leverage limits?**

- The risk of CFDs is magnified by the leverage of the CFD. The impact of leverage becomes higher when the value of the underlying asset of the CFD (reference value) is volatile. Some underlyings are much more volatile than others. Setting different leverage limits helps ensure investors face a consistent level of risk.

### **Why is there a specific treatment for gold?**

- The risk of CFDs is magnified by the leverage of the CFD. The impact of leverage becomes higher when the value of the underlying asset of the CFD (reference value) is volatile. Some underlyings are much more volatile than others. Setting different leverage limits helps ensure investors face a consistent level of risk.
- CFDs in commodities are assigned a leverage limit of 10:1, in accordance with the historic price volatility of assets such as oil. However, ESMA recognises that gold has displayed lower historic price volatility than many other commodities. As such, a less stringent leverage limit of 20:1 is being introduced for gold.

### **Why is there a difference between major and non-major currencies/indices?**

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- The volatility of major and non-major currencies or indices differ significantly. For this reason the major and non-major currencies/indices are assigned different leverage limits.
- The major currencies are currency pairs comprising any two of the following currencies: US Dollar, Euro, Japanese Yen, Pound Sterling, Canadian Dollar or Swiss Franc. All other currencies are considered non-major.
- The major indices are 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); All other indices are considered non-major.

## **Binary options**

### **Why are binary options being treated differently to CFDs?**

- ESMA's measure prohibits the marketing, distribution or sale of binary options to retail investors. Unlike CFDs, binary options are not leveraged, but they are nonetheless extremely risky.
- Economically, binary options are inherently like gambling products which are not suitable for the purpose of hedging or for other economic functions that could form a compensating benefit.

## ***Legal Basis***

### **What is the legal basis for these measures?**

- The measures are based on Article 40 of Regulation (EU) No 600/2014 ('MiFIR').
- That provision empowers ESMA *inter alia* to temporarily prohibit or restrict the marketing, distribution or sale of certain financial instruments or financial instruments with certain specified features as well as a type of financial activity or practice.

### **How will the measures be adopted and when are they applicable?**

- These measures have to be translated into all official languages of the European Union. This process is currently underway and will take a number of weeks.



- Once the translation process has been completed, ESMA intends to adopt the measures in the official languages of the European Union.
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### ***ESMA Call for evidence***

#### **What was the ESMA call for evidence on?**

- On 18 January 2018, ESMA published a call for evidence on proposed product intervention measures on the offer of CFDs and binary options to retail investors. This call for evidence ran until 5 February 2018.

#### **Who responded to this call for evidence?**

- ESMA received approximately 18,500 responses to the call for evidence, which was the largest response ESMA has received to a call for evidence.
- The responses came from providers, trade organisations, stock exchanges and brokers involved in the CFD and/or binary option business, consumer representatives and individuals.
- The number of individual respondents is lower than this figure since ESMA also received:
  - multiple responses from the same respondents (e.g. a response on each of the proposed measures for CFDs in a separate e-mail); and
  - duplicative responses from the same respondents.

### ***Brexit***

#### **How does the UK's decision to withdraw from the European Union affect these measures?**

- The product intervention measures taken by ESMA are applicable in all Member States of the European Union.
- On the 29 March 2017, the UK notified the European Council of its intention to withdraw from the European Union pursuant to Article 50 of the Treaty on European Union. Subject to any extension of the withdrawal period, the withdrawal will take place on the date of entry into force of a withdrawal agreement or, failing that, two years after the notification on 30 March 2019. Until then, the UK is a Member State of the European Union. Therefore, UK product providers will be required to comply with ESMA's product



intervention measures.