Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

2017

Consultation on the Protection of Retail Investors in relation to the Distribution of CFDs

Consultation Paper 107

Contents

Introduction 1

Market Overview 3

Proposed Measures 6

Legal Basis 8

The Consultation Process 8

Annex 1 – Leverage Analysis 10

1 Introduction

1.1. Financial Contracts for Difference (CFDs) are complex, leveraged, derivative instruments which enable investors to speculate on the short-term price movements of an underlying reference asset. Investment firms offering CFDs to retail clients typically do so through online trading platforms on an execution-only basis and with non-standardised product features and terms and conditions.

1.2. The Central Bank has on several occasions in the past raised concerns over the high risks facing retail clients from CFDs.

1.3. This consultation paper discusses the Central Bank's concerns in relation to CFDs and outlines proposed measures currently under consideration which are aimed at protecting the interests of retail clients.

1.4. The options under consideration as part of this consultation process are:

a) The prohibition of the sale or distribution of CFDs to retail clients in and from Ireland; or
b) The implementation of enhanced investor protection measures including a limitation on leverage and a requirement that retail clients may not lose more than the amount(s) deposited on a per-position basis.

This consultation paper is seeking feedback on the above proposals and, in particular, responses to the questions posed in Section 5.

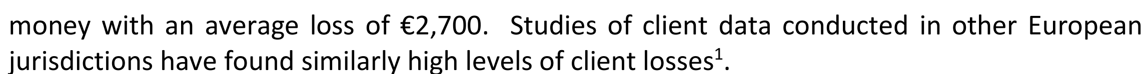
Background

1.5. In recent years the Central Bank has undertaken a number of thematic and supervisory inspections of investment firms offering CFDs which have provided strong evidence of the elevated investor protection risks arising in relation to the product.

1.6 The Central Bank conducted a thematic inspection of CFD providers in 2011. This inspection noted that losses to retail clients when trading CFDs can be significant and that firms were failing to inform and provide adequate warnings to consumers of the risks involved. Low levels of compliance with the relevant consumer protection requirements were broadly observed within the industry.

1.7 A follow-up thematic inspection of CFD providers was carried out by the Central Bank in 2015. This inspection found that 75% of retail CFD clients who invested in CFDs during 2013 and 2014 made a loss, of which the average loss was €6,900. It was observed that retail clients generally were not sufficiently aware of the high risk and complex nature of the product. The Central Bank concluded that CFDs are not suitable for investors who have a low risk appetite due to the volatile nature of the CFD market, coupled with the potential for the consumer to lose more than the initial investment.

1.8 A recent follow-up review by the Central Bank of a sample of the largest CFD providers in Ireland found that in the two-year period up to 31 December 2016, 74% of retail clients lost



money with an average loss of €2,700. Studies of client data conducted in other European jurisdictions have found similarly high levels of client losses[1].

1.9 The European Securities and Markets Authority (ESMA) has taken action to publicise the risks in relation to CFDs by issuing two investor warnings, first in 2013 and again 2016, each of which was published on the Central Bank website. A press release was also issued by the Central Bank following the most recent ESMA warning to ensure Irish investors were made fully aware of the risks relating to CFDs. In its most recent warning, ESMA cautioned that CFDs are inherently risky, complex and speculative.

1.10 ESMA has also published Q&As focused on enhancing investor protection measures and developing supervisory practices in respect of the industry, which were highlighted by the Central Bank in its Markets Updates.

1.11 In recent months, a number of European National Competent Authorities (NCAs) have introduced, or have proposed the introduction of, measures aimed at restricting the distribution of CFDs to retail clients. These further emphasise the investor protection concerns that arise in relation to the sale or distribution of CFDs.

1.12 In light of recent publications by other NCAs and the continuing supervisory focus, both at European and domestic level, on the sale or distribution of CFDs to retail clients, it is now timely for the Central Bank to set out its own policy considerations on this matter.

1.13 This consultation paper also takes into consideration the new product intervention powers outlined in Article 42 of the Markets in Financial Instruments Regulation (MiFIR) (Regulation (EU) No 600/2014) which will come into effect from 3 January 2018.

1.14 Although not provided for in this consultation paper, the Central Bank is prepared to expand the scope of the measures proposed and/or implement additional investor protection measures in relation to other speculative financial products where there is a need to safeguard the interests of retail clients.

1.15 The proposed measures set out in this consultation paper relate to the sale or distribution of CFDs to retail clients. CFDs are considered to include contracts for difference as well as spread bets and rolling spot forex contracts.

[1] In a review from 2014 the Autorité des Marchés Financiers (AMF) in France found that 89% of retail investors lost money trading CFDs. A 2016 review carried out by the Financial Conduct Authority (FCA) in the UK found that 80% of clients lost money during the course of one year when trading CFDs.

2 Market Overview

2.1 CFDs allow investors to gain an indirect exposure to the upwards or downwards price movement in an underlying reference asset. Clients enter into a contract with an investment firm to settle the difference between the price of a reference asset at two different points in time. Upon closing the position, the difference between the opening and closing price is paid to either the retail client or the investment firm.

2.2 The most commonly traded CFDs are priced with reference to the underlying markets in foreign exchange (FX) pairs, single stock equities, indices and commodity futures.

2.3 CFDs are predominantly sold through online trading platforms on a non-advisory basis. CFDs are sold over-the-counter (OTC) without standardised terms and conditions. As a result, the trading environment can differ materially between firms.

2.4 Investment firms offering CFDs often act as the '*market maker*' or '*principal*' to the client's trades. Such firms assume some or all of the market risk arising from a trade. If a client speculates on the price of a reference asset increasing, the CFD provider takes the opposite position and benefits from the price falling. Therefore, there is a direct correlation between the client's loss and the CFD provider's gain.

2.5 Other investment firms which distribute CFDs adopt a '*matched principal*' business model which involves hedging each client trade with an institutional counterparty.

2.6 There are 19 investment firms currently authorised in Ireland which have the capacity to distribute CFDs. A further 18 firms authorised in other EU Member States have established branches in Ireland and have the ability to distribute CFDs. In excess of 550 firms authorised throughout the EU can offer CFDs to Irish investors under the MiFID freedom of services passport.

2.7 The Central Bank has observed that CFD providers typically have high levels of client turnover and short average client lifecycles.

Key Product Risks

- Leverage

2.8 CFDs are sold on margin which allows clients to deposit a percentage of the overall notional value of the exposure at the point at which the position is opened. This creates leverage which means any change in the price of the reference asset is amplified in terms of the gain or loss to the client. In highly leveraged CFD trades, a small fluctuation in the value of the overall position can have a significant impact on the value of the client's deposited margin.

2.9 A key characteristic of the CFD market is the availability of excessively high levels of leverage. The Central Bank has commonly observed leverage levels of 400:1 offered to retail clients with minimal experience of trading CFDs. In other European jurisdictions, leverage levels of up to 500:1 have been observed. With only a small percentage of the overall contract value deposited as margin, it is often difficult for retail clients to have an appreciation of the quantum of risk being assumed when trading CFDs.

2.10 For example, if a retail client is offered a 400:1 leverage ratio and opens a position with a total exposure value of €50,000, the position can be funded with an initial margin payment of €125. A 0.1% price movement against the client would see their position fall in value by €50 (40%). Therefore, this 0.1% price movement is amplified by the level of leverage (400) and results in a 40% loss against the client's deposited margin.

2.11 A standard fee charged on CFDs relates to the financing cost of holding a long position overnight. This is calculated on the basis of the total position value. Therefore, as leverage increases, so too does the associated financing cost for maintaining the position open.

- Potential for Unlimited Loss

2.12 An important related feature of CFDs is the use of automatic close outs by investment firms. This involves open positions automatically being liquidated by the CFD provider when the client's available margin falls below a certain specified level (the '*maintenance margin'* level). This can be done without notifying the client and without allowing for additional margin to be deposited.

2.13 The price at which a position is automatically closed can result in client losses crystallising which are in excess of the level of margin on deposit. During turbulent market periods, the firm may only be able to close a position at a price which leaves the client owing additional funds on their account. Theoretically, in the case of short CFD trades, potential client losses are limitless.

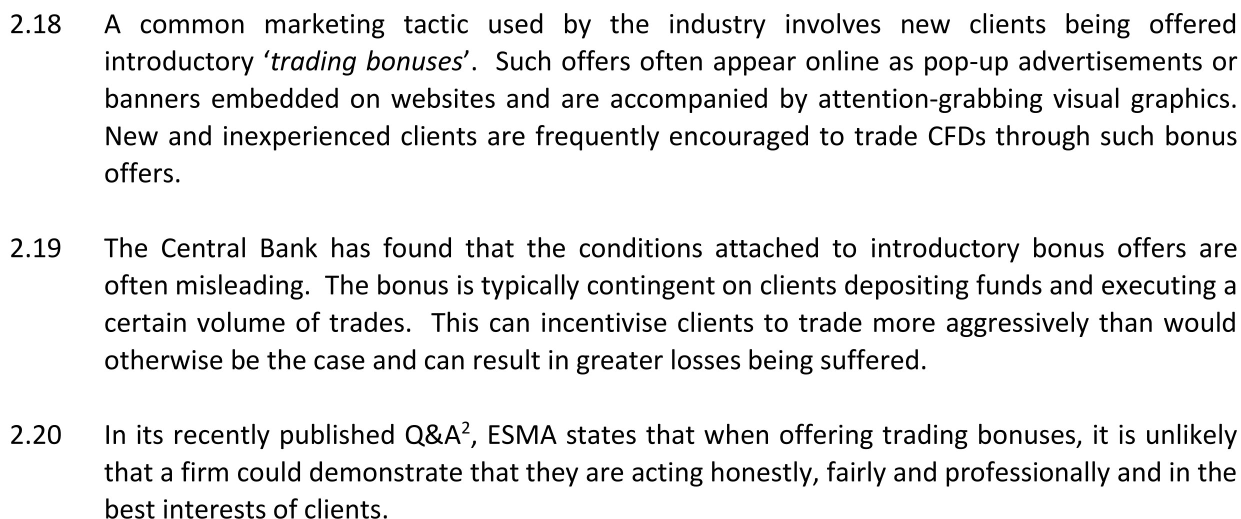
2.14 Retail clients are often able to open new CFD trading accounts with initial deposits of €100. With excessive leverage, an inexperienced retail client who deposits €100 could assume a €40,000 exposure in a single trade. Under normal market conditions with such a high level of leverage, the probability of the client's position being automatically closed is high.

2.15 Retail clients cannot reliably limit their losses through the use of stop-loss orders which can be placed to set an indicative floor on potential losses. In general, CFD providers are not obliged to execute stop-loss orders at the price specified by the client, but only at the next available market price of the underlying asset. The next available price can be different to the client's preferred price, particularly when market conditions are volatile and prices move suddenly from one level to another ('*price gapping*'). Given the amplification effect of leverage on the position, this can generate significant losses for retail clients.

2.16 The opening and closing price of a CFD is based on the price which is determined by the CFD provider. While there is an expectation that each price will closely mirror available asset prices on reference markets, in practice most CFD providers adopt a degree of discretion which enables them to set prices during times of market volatility. This can lead to consumer detriment when positions are automatically closed out at unfavourable prices or when clients are unable to close-out positions until firms determine a price level at which they are prepared to trade.

- Aggressive Marketing and Promotions

2.17 As the number of CFD providers in Europe has grown in recent years so too has competition in the sector. With increased competition, firms have sought to attract new clients and retain existing clients through the use of aggressive online marketing strategies.



2.18 A common marketing tactic used by the industry involves new clients being offered introductory ‘*trading bonuses*’. Such offers often appear online as pop-up advertisements or banners embedded on websites and are accompanied by attention-grabbing visual graphics. New and inexperienced clients are frequently encouraged to trade CFDs through such bonus offers.

2.19 The Central Bank has found that the conditions attached to introductory bonus offers are often misleading. The bonus is typically contingent on clients depositing funds and executing a certain volume of trades. This can incentivise clients to trade more aggressively than would otherwise be the case and can result in greater losses being suffered.

2.20 In its recently published Q&A[2], ESMA states that when offering trading bonuses, it is unlikely that a firm could demonstrate that they are acting honestly, fairly and professionally and in the best interests of clients.

[2] ESMA Questions and Answers Relating to the provision of CFDs and other speculative products to retail investors under MiFID (ESMA 2016/1165)

3 Proposed Measures

The Central Bank is considering two options in relation to the distribution of CFDs to retail clients.

Option 1: The Prohibition of the Sale or Distribution of CFDs to Retail Clients

3.1 The Central Bank is considering the option of prohibiting the sale or distribution of CFDs to retail clients in and from Ireland. The Central Bank is also considering a restriction or prohibition of the marketing of CFDs in conjunction with this measure.

3.2 The Central Bank has warned consumers to be fully aware of the high-risk and complex nature of CFDs before making investment decisions. A prohibition on the sale or distribution of CFDs to retail clients could have the greatest impact in terms of limiting investor losses. In considering the options that will be available to the Central Bank, this form of intervention would seek to ensure that retail clients are not exposed to a product which delivers such a high probability of loss.

Option 2: Enhanced Investor Protection Measures

3.3 The Central Bank is also considering requiring firms which distribute or market CFDs to retail clients to comply with some or all of the following measures which are designed to ensure that existing or potential retail clients are better protected and informed. The key proposals are:

- **Leverage Limit** – in order to prevent excessive risk taking arising from the availability of high levels of leverage, it is proposed that a maximum leverage limit of 25:1 (4% initial margin) will be set for retail clients trading all financial CFDs;

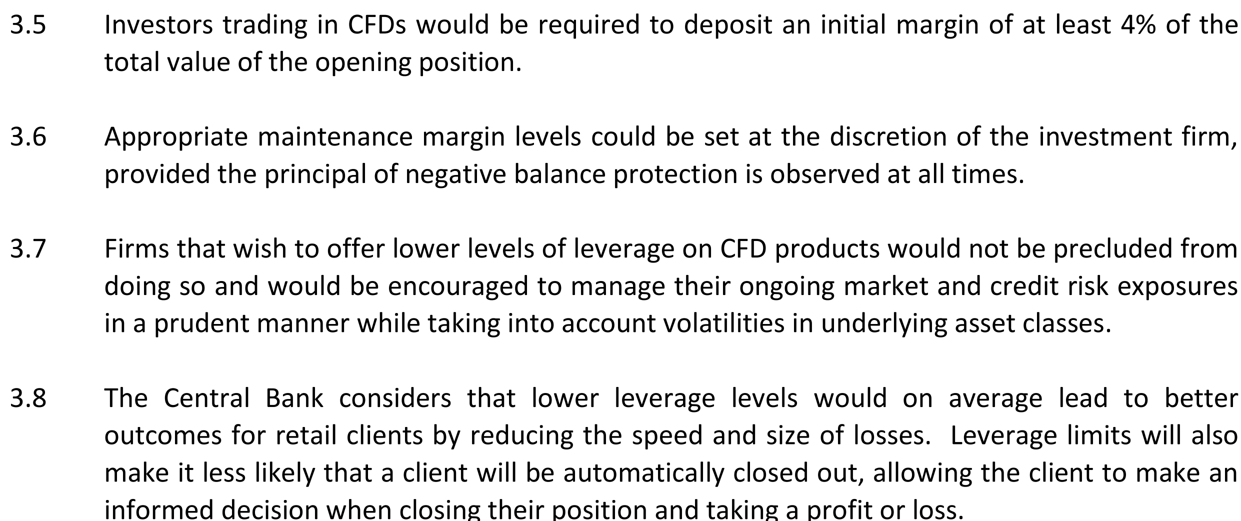
- **Negative Balance Protection** – in order to mitigate the possibility of clients losing more than they have deposited into their CFD trading accounts and noting that such losses are potentially limitless, it is proposed that firms will be required to provide negative balance protection (a guaranteed stop loss) to all retail clients on a per-position basis;

- **Bonuses and other Promotions** – in order to restrict their widespread misuse, it is proposed that firms will be prohibited from offering any form of trading incentives or account opening bonuses to retail clients in respect of CFD accounts; and

- **Risk Disclosure** – in order to make the risk warnings in relation to CFDs more meaningful, it is proposed that all firms offering CFDs to retail clients will be required to prominently display a standardised risk warning with details of the profit-loss ratio of retail CFD clients over the previous calendar quarter and also over the previous 12-month period.

Leverage Limit

3.4 In order to reduce the risk of significant losses being suffered, the Central Bank is considering the imposition of a maximum leverage level of 25:1 for all CFDs sold to retail clients. This maximum leverage level would apply uniformly to all CFDs sold to retail clients irrespective of the underlying reference asset. An overview of the analysis undertaken to assess the effect of leverage on an investors ability to absorb a market shock is outlined in annex 1.



3.5 Investors trading in CFDs would be required to deposit an initial margin of at least 4% of the total value of the opening position.

3.6 Appropriate maintenance margin levels could be set at the discretion of the investment firm, provided the principal of negative balance protection is observed at all times.

3.7 Firms that wish to offer lower levels of leverage on CFD products would not be precluded from doing so and would be encouraged to manage their ongoing market and credit risk exposures in a prudent manner while taking into account volatilities in underlying asset classes.

3.8 The Central Bank considers that lower leverage levels would on average lead to better outcomes for retail clients by reducing the speed and size of losses. Leverage limits will also make it less likely that a client will be automatically closed out, allowing the client to make an informed decision when closing their position and taking a profit or loss.

Negative Balance Protection

3.9 In order to reduce the risk of retail clients suffering substantial losses, we are considering a proposal that firms distributing CFDs would be required to provide negative balance protection on a per position basis. Retail clients will therefore only be at risk of losing the initial margin posted per trade and any additional margin deposited by the client to maintain a position open.

3.10 This measure would help to ensure that retail clients can more easily understand and control the level of risk assumed through their CFD trading activities. It would provide certainty to investors in relation to the maximum potential loss which they might suffer and provide protection during significant market turbulence.

3.11 This measure would not prohibit clients from independently placing limit or stop loss orders on their accounts which enable them to manage market risk within their own tolerance levels.

3.12 It is acknowledged that the implementation of negative balance protection could elevate the market and operational risk exposure for firms distributing CFDs. For example, it will place an additional operational burden on firms to ensure CFD positions are automatically closed-out before available margin is depleted. The increased minimum margin requirement of 4% however is expected to somewhat offset this risk.

Bonuses and other Promotions

3.13 In order to reduce the incidence of retail clients being inappropriately incentivised to trade CFDs, the Central Bank is considering putting in place a requirement that investment firms would not be permitted to offer bonuses and other inducements to retail clients to open CFD trading accounts or to conduct additional trading in CFDs.

3.14 In practice, such promotions serve to distract investors from the significant risk of trading CFDs. They are aggressively marketed online and are designed to incentivise and draw-in inexperienced retail clients, who may not have otherwise sought to trade in CFDs.

3.15 Promotional offers other than direct trading bonuses are considered to include any incentives which result in individual clients or groups of clients being offered more advantageous terms

of trading than those which are available to the wider retail client population.

3.16 The complementary provision of educational material or access to training by investment firms which enables clients to understand the products in greater depth is not considered to be a promotion or inducement provided it is freely available to all clients of the firm.

Risk Disclosure

3.17 The Central Bank has noted on numerous occasions in the past the failure of CFD providers to adequately warn retail clients of the risks associated with trading CFDs. In particular, risk disclosures have been found to be overly generic and not to sufficiently articulate the high risk of potential capital loss associated with CFDs.

3.18 In order to ensure the risk warning in relation to CFDs is meaningful and understandable for retail clients, we are now considering a proposal that investment firms would be required to prominently publish a risk warning on their website and on all marketing communications which would include details of the percentage of retail client accounts that made a loss over the previous calendar quarter and also over the previous 12-month period.

3.19 Clients who did not enter into at least one trade during the period would be excluded from the calculation of total client numbers.

3.20 The intention of this measure would be to ensure that investors are fully informed and can gauge more accurately whether CFDs align with their appetite for risk and ability to bear loss.

4 Legal Basis

4.1 The Central Bank is considering introducing the proposed measures on a statutory basis. From 3 January 2018, this will include the product intervention powers under MiFIR.

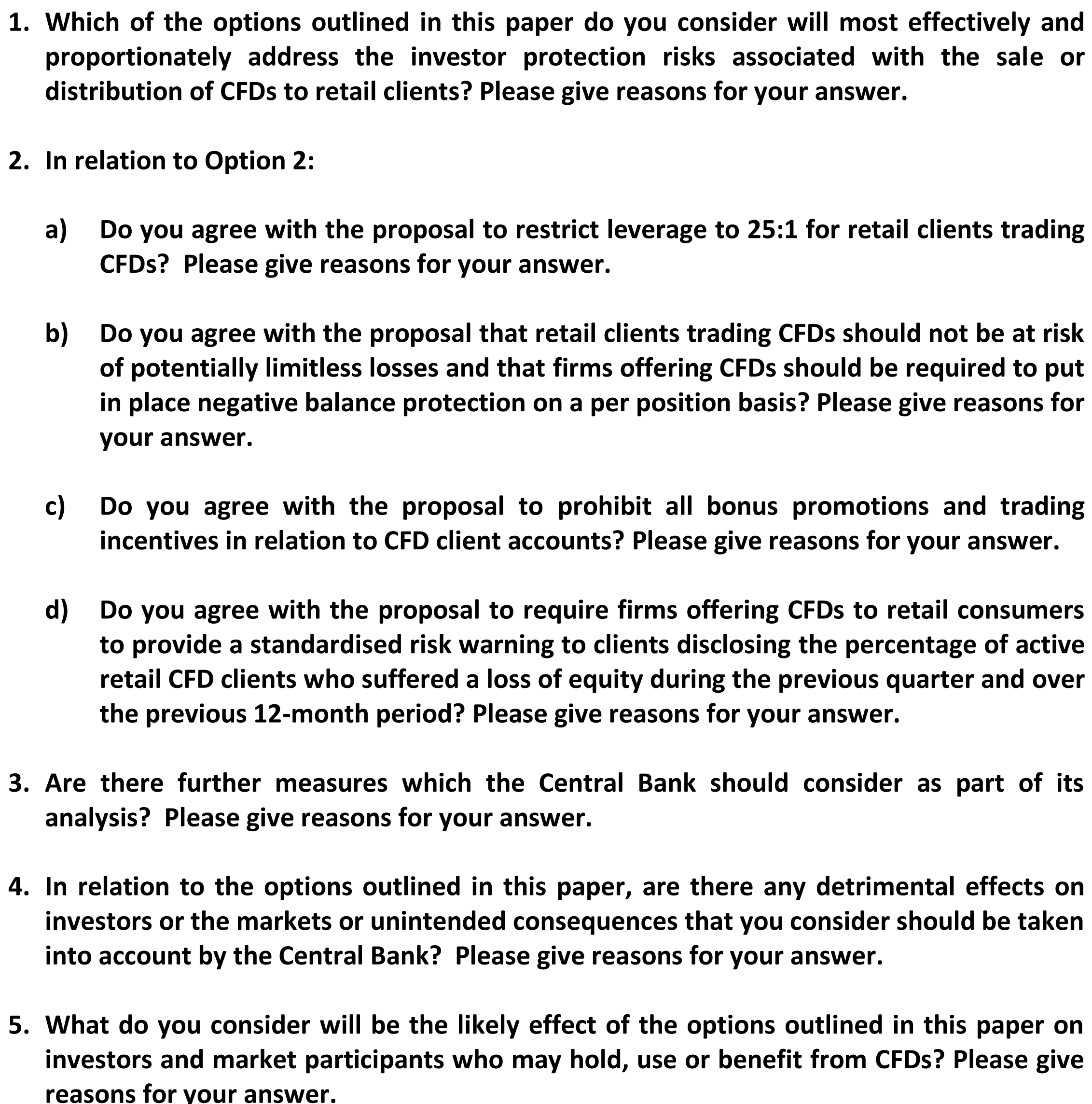
5 The Consultation Process

5.1 The Central Bank invites all stakeholders to provide comments on the proposed measures outlined in this consultation document and on the questions raised below. In particular, the proposed measures will affect existing and future retail clients trading in CFDs as well as providers and distributors of CFDs. Consumer bodies may also be interested in the contents of this consultation paper.

5.2 When the consultation process is complete, the Central Bank will consider the responses received and communicate its feedback and next steps.

Questions for Consideration

5.3 We request your responses to the below questions in relation to the proposed investor protection measures outlined in this consultation paper;



1. **Which of the options outlined in this paper do you consider will most effectively and proportionately address the investor protection risks associated with the sale or distribution of CFDs to retail clients? Please give reasons for your answer.**

2. **In relation to Option 2:**

   a) **Do you agree with the proposal to restrict leverage to 25:1 for retail clients trading CFDs? Please give reasons for your answer.**

   b) **Do you agree with the proposal that retail clients trading CFDs should not be at risk of potentially limitless losses and that firms offering CFDs should be required to put in place negative balance protection on a per position basis? Please give reasons for your answer.**

   c) **Do you agree with the proposal to prohibit all bonus promotions and trading incentives in relation to CFD client accounts? Please give reasons for your answer.**

   d) **Do you agree with the proposal to require firms offering CFDs to retail consumers to provide a standardised risk warning to clients disclosing the percentage of active retail CFD clients who suffered a loss of equity during the previous quarter and over the previous 12-month period? Please give reasons for your answer.**

3. **Are there further measures which the Central Bank should consider as part of its analysis? Please give reasons for your answer.**

4. **In relation to the options outlined in this paper, are there any detrimental effects on investors or the markets or unintended consequences that you consider should be taken into account by the Central Bank? Please give reasons for your answer.**

5. **What do you consider will be the likely effect of the options outlined in this paper on investors and market participants who may hold, use or benefit from CFDs? Please give reasons for your answer.**

5.4 Please make your submissions electronically by email to cfdconsultation@centralbank.ie, or in writing to:

CFD Requirements Consultation
Asset Management Supervision Division
Central Bank of Ireland
New Wapping Street
North Wall Quay
Dublin 1

Responses should be submitted no later than 29 May 2017.

It is the policy of the Central Bank to publish responses to its consultations on our website. Commercially confidential information should not be included in consultation responses. We will send an email acknowledgement to all responses sent by email. If you do not get an acknowledgement of an emailed response, please contact us on +353 1 2246000 to correct the situation.

Annex 1 – Leverage Analysis

Data from a number of commonly traded instruments was obtained with 1 minute resolution over a period of 20 days. The price change between "ticks" was found to conform closely to a log-normal distribution, see Fig. 1.

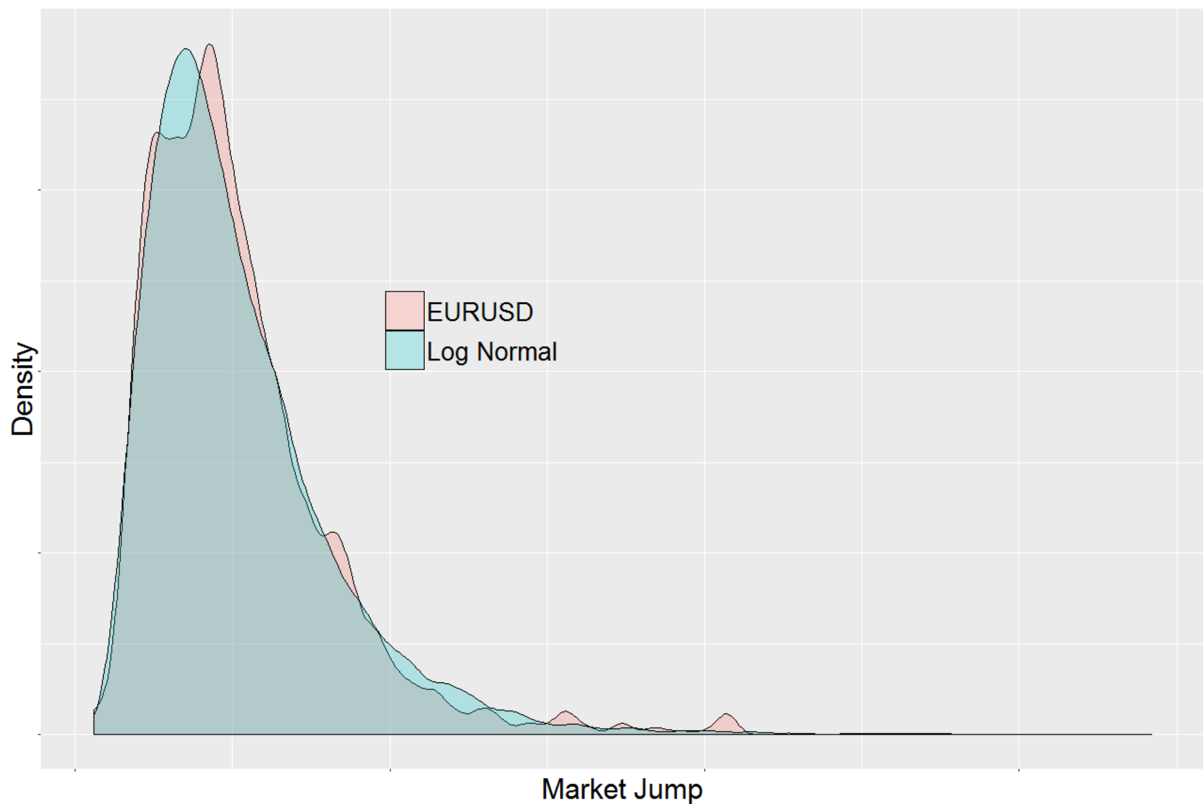


Fig. 1 Distribution of market moves

Given this, a realistic "shock" figure was determined for each instrument by transforming the 84th normal percentile of the price fluctuations within a three hour window. The table below shows typical shock values for each instrument.

Instrument	*Shock %*
EUR/GBP	0.36
EUR/USD	0.33
GBP/USD	0.38
USD/JPY	0.39
FTSE	0.58
Amazon	1.1

For a given instrument, the shock required to deplete 50% of the initial deposit is given as:

$$S_{0.5} = \frac{1}{2L} - \frac{2 * F}{P}$$

Where L is the leverage, P is the initial strike price of the instrument and F is the fee charged to enter and exit the contract. F is doubled to account for entering and exiting the trade. Fig. 3a shows the influence of leverage vs $S_{0.5}$ for any instrument assuming proportional fee of 0.03%. Fig. 3b shows the same chart after one shock has been applied.

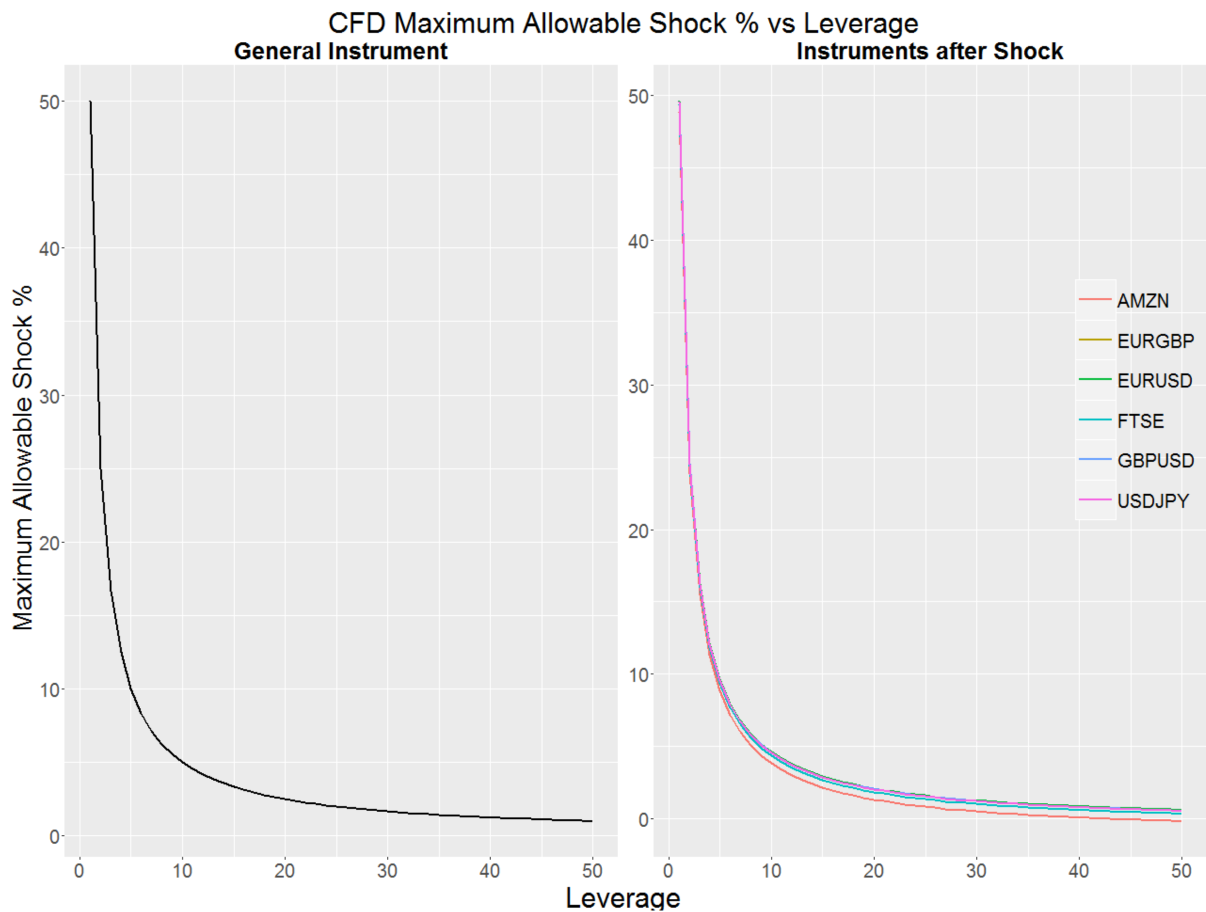
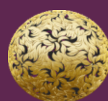


Fig. 2 Leverage vs allowable shock for any CFD instrument and specific instruments

As the leverage approaches 50 the shock required to deplete 50% of the initial margin drops below 1% after fees have been considered. The leverage levels required to completely eradicate 50% margin with one typical shock move for each of the instruments is as follows:

Instrument	*Leverage*
Amazon	43
EURGBP	120
EURUSD	129
GBPUSD	113
USDJPY	111
FTSE	78

T +353 1 2246000 www.centralbank.ie cfdconsultation@centralbank.ie



Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem