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Central Bank consults on CFDs for Retail Investors

The Central Bank has, on March 6, 2017, isssued Consultation Paper 107 (the "**CP**") on the protection of retail investors in relation to the distribution of contracts for difference ("**CFDs**").

The Central Bank has particular concerns in relation to CFDs and has set out two options which it is considering – and now consulting on – aimed at protecting the interests of retail clients, namely:

(i) prohibiting the sale or distribution of CFDs to retail clients in Ireland; or

(ii) implementing 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.

The Central Bank says that it is considering introducing such measures on a statutory basis, adding that "*From 3 January 2018, this will include the product intervention powers under MiFIR*".

The Central Bank's Questions

In Section 5 of the CP, the Central Bank poses five questions regarding the two options referenced above, including as to which may be most effective and most proportionately address the investor protection risks. Given the differing approaches – prohibition v. enhanced investor protection measures – most of the questions

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focus on the proposed elements of Option 2, with other questions focusing on the issue and impact more broadly.

The deadline for responses is May 29, 2017.

No Surprise

The industry should not be surprised with this development – other than perhaps the starkness of Option 1 - as the Central Bank's concerns regarding CFDs have been well flagged. In November 2015, it issued a statement noting that a themed inspection carried out in 2013 and 2014 found that 75% of retail Irish clients invested in CFDs with Irish-based investment and stockbroking firms during that period had made a loss.

Most recently, in July last year, the Central Bank issued a statement highlighting ESMA's warning in relation to CFDs issued on July 25, 2016. The Central Bank noted that it was "*a timely and important warning from the European Securities and Markets Authority about products, such as CFDs, which are available to retail investors where there is ample evidence that the probability of loss for the consumer is high*".

Other regulators have also expressed concerns regarding CFDs, including the UK FCA which in December 2016 proposed stricter rules for firms selling CFD products to retail customers. It had found that 80% of clients had lost money during the course of one year when trading CFDs.

The Proposed Measures

The key elements of Option 2 are spelled out in some detail within the CP, so we do not propose to address further here other than to note that key proposals include:

- *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.

Option 1 is clearly more straightforward.

An Interventionist Future?

What is perhaps most interesting about this development – and one which the Central Bank expressly refers to – is that it is, potentially, a foretaste of what we might expect of the new product intervention powers under MiFIR.

Under the current MiFID regime "*financial contracts for difference*" are one of the categories of investment instrument in respect of which MiFID firms can provide investment services. Such services can be provided cross-border by means of a MiFID passport, either by setting up a branch or by using the freedom of services concept. That allows a MiFID firm authorised in another EU Member State to sell products and services – including CFDs – into Ireland. Under the current MiFID regime, it should not be possible for the Central Bank to restrict a foreign MiFID firm from selling CFDs into Ireland if that is an activity which that firm is authorised by its own regulator to conduct and that firm is complying with its authorisation. MiFID states at Article 31(1) that "*Member States shall not impose any additional requirements on such an investment firm….in respect of matters covered by this Directive*" recognising MiFID's status as a so-called "maximum harmonisation" regime.

Presumably, that is why it seems (the timing is not entirely clear to us) that the Central Bank is not proposing to implement either of its proposals until January 3, 2018 which is when MiFID II, replacing the current MiFID regime, goes live. It may have a different approach in mind – the "on a statutory basis" reference – which may become clearer during the consultation process.

(i) Product Intervention Powers

One of the key themes of MiFID II (*MiFID II Directive; MiFIR; and accompanying delegated acts*) is a strengthening of investor protection, where one of the new powers is the capacity for national regulators to prohibit or restrict the marketing and distribution of certain financial instruments in particular circumstances, as outlined in Articles 42 and 43 of MiFIR.

Article 42 of MiFIR allows a competent authority (i.e. the Central Bank in an Irish context) to prohibit or restrict the following <u>in or from</u> its Member State:

(a) the marketing, distribution or sale of certain financial instruments or structured deposits or financial instruments or structured deposits with certain specified features; or

(b) a type of financial activity or practice.

That would allow the Central Bank to in future act as it now proposes and would restrict not only Irish firms operating in the Irish market but also foreign firms selling into the Irish market.

(ii) Conditions which must be met before such action can be taken

A variety of <u>cumulative conditions</u> must be met before a competent authority can take the action referred to above. It needs to be satisfied on reasonable grounds that:

(a) either

   (i) a financial instrument, structured deposit or activity or practice gives rise to significant investor protection concerns or poses a threat to the orderly functioning and integrity of financial markets or commodity markets or to the stability of whole or part of the financial system <u>within at least one Member State</u>; or

   (ii) a derivative has a detrimental effect on the price formation mechanism in the underlying market;

(b) existing regulatory requirements under Union law applicable to the financial instrument, structured deposit or activity or practice do not sufficiently address the risks referred to in point (a) and the issue would not be better addressed by improved supervision or enforcement of existing requirements;

(c) the action is proportionate taking into account the nature of the risks identified, the level of sophistication of investors or market participants concerned and the likely effect of the action on investors and market participants who may hold, use or benefit from the financial instrument, structured deposit or activity or practice;

(d) the competent authority has properly consulted competent authorities in other Member States that may be significantly affected by the action;

(e) the action does not have a discriminatory effect on services or activities provided from another Member State; <u>and</u>

(f) it has properly consulted public bodies competent for the oversight, administration and regulation of physical agricultural markets under Regulation (EC) No 1234/2007, where a financial instrument or activity or practice poses a serious threat to the orderly functioning and integrity of the physical agricultural market.

Each of those conditions must be met for the regulator to have the power to act.

(iii) Pre-Notification to ESMA and Other NCAs

The relevant competent authority must pre-notify, at least 1 month before the measure is intended to effect, both ESMA and all other competent authorities of what it intends and that notification must include the evidence upon which it has based its decision and upon which it is satisfied that each of the conditions in Article 42(2) are met.

(iv) Commission's Role

One of the conditions that must be met is set out at (a) above. The European Commission has been empowered to adopt (and has already adopted) a delegated act specifying the criteria and factors to be taken into account in determining when there is a significant investor protection concern or a threat to the orderly functioning and integrity of financial markets or commodity markets or to the stability of the financial system within at least one Member State referred to in paragraph 2(a).

(v) ESMA's Role

Article 43 also sets out a specific role for ESMA (and for structured deposits, the EBA), namely:

(a) ESMA shall perform a facilitation and coordination role in relation to action taken by competent authorities under Article 42. In particular, it shall ensure that action taken by a competent authority is justified and proportionate and that where appropriate a consistent approach is taken by competent authorities;

(b) after receiving notification under Article 42 of any action that is to be imposed under that Article, ESMA shall adopt an opinion on whether the prohibition or restriction is justified and proportionate. If it considers that the taking of a measure by other competent authorities is necessary to address the risk, it shall state this in its opinion. The opinion shall be published on ESMA's website; and

(c) where a competent authority proposes to take, or takes, action contrary to an opinion adopted by ESMA or declines to take action contrary to such an opinion, it shall immediately publish on its website a notice fully explaining its reasons for so doing.

In other words, although power is given to the national competent authorities, to exercise the power requires a series of conditions to be met where the European Commission has set down the elements of certain of those conditions and with ESMA having been given a type of co-ordination and quasi control role.

Timing

It will be interesting to see this process operate in practice. The timing remains somewhat unclear to us, including whether the pre-notification in this case can be given prior to the January 3, 2018 MiFID II go live date. It may be that that can only be given once MiFIR's application date goes live. We will have to wait and see.

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