FESE

FESE note on NCA product interventions on leveraged products

27th October 2023, Brussels

Key message:

FESE fully shares the objective of safeguarding investor protection and agrees that some product intervention measures both at European and national levels might occasionally be necessary for specific products. However:

- It is crucial to keep access to regulated capital markets open to retail investors. FESE encourages NCAs to take into consideration the trading circumstances and the regulated environment in which a specific product trades when adopting a decision.
- OTC products do not function and do not have the same characteristics and protection measures as exchange-traded products, such as ETDs. Product interventions should differentiate between the two.
- Regulators should give entities sufficient time and guidance to implement product interventions.

FESE suggests that policymakers and authorities establish a streamlined sequence of measures for ETDs that would render outright prohibitions as a means of last resort only.

In recent years, there has been an evident rise in retail participation in the capital markets, with some retail investors choosing more sophisticated products such as derivatives. In its recent report on retail conduct, IOSCO underlined an increased use of leverage by retail investors, which is closely associated with derivatives markets.[1] Leveraged products allow investors to use borrowed capital to increase the return on the investment, without owning the full financial asset. Leverage can help to amplify gains, but it also creates potential for losses. Particularly, retail investors who do not have the necessary financial knowledge may find themselves exposed to higher risks, and as a result, suffer significant losses.

In response to these developments, some product intervention analyses[2] indicated that many retail clients faced significant losses from buying leveraged OTC products, such as contracts for difference (CFDs). This was due to the massive and, in some cases, misleading publicity, high levels of leverages, and conflicts of interests derived from the fact that issuer, broker, and clearer of OTC leveraged products were sometimes the same entity (a scenario impossible with MiFID/R regulated entities). Following those analyses, various national jurisdictions introduced measures aiming to limit the access of retail investors to risky financial products, such as CFDs and binary options. In 2016, the FSMA Belgium prohibited

[1] The International Organization of Securities Commissions (IOSCO), March 2023, *Retail Market Conduct Task Force Final Report,* IOSCO Report, available here.

[2] ESMA Product Intervention Analysis, June 2018, Measures on Contracts for Differences & Measure on Binary Options, available here and here.

the distribution to retail investors of binary options traded via an electronic trading system, that have a duration of less than one hour or that directly or indirectly involve leverage. In March 2018, ESMA agreed on temporary product intervention measures on the provision of CFDs and binary options to retail investors in the EU.[3] The agreed measures included:

- For binary options: a prohibition on the marketing, distribution, or sale of binary options to retail investors
- For CFDs: a restriction on the marketing, distribution or sale of CFDs to retail investors.

Following the lapse of these measures in July 2019, individual member states adopted permanent national product intervention measures relating to CFDs that were similar to the ones adopted by ESMA. In the UK, the FCA imposed a complete ban on the sale of binary options to retail consumers and introduced various restrictions on the sale of CFDs to retail consumers. More recently, BaFin, the German Supervisory Authority imposed a restriction on the distribution, marketing, and sale of futures to retail investors in cases where futures lead to an additional payment obligation or are not used for hedging purposes[4]. Similarly, the CNMV, the Spanish national competent authority, announced in July intervention measures that target the marketing, sale, and distribution to retail clients of CFDs, imposing, additionally, a limit to the leverage to which retail investors can be exposed by requiring a "margin close-out protection" concerning leveraged products such as futures and options whose risk is either unknown or higher than the amount initially invested. In this regard, Regulated Market members were given a very short time to understand, adapt and inform their client base of the new measures, there was as well a lack of clear guidance to implement the rule, leading to widespread confusion.

ETDs are not OTC derivatives like CFDs

Futures contracts and financial options cannot be, and should not be, comparable to CFDs. They possess distinct characteristics that fundamentally distinguish them. We should consider that:

- Financial futures and options traded on regulated trading venues are standardised contracts adhering to MiFID II/R provisions. On-exchange trading facilitates multilateral trading and has in place mechanisms that safeguard market integrity and transparency, including the dissemination of information regarding price ranges and trading volumes. CFD markets do not, necessarily, abide by these standards. On top of it, exchanges and clearing members must fulfil trading venue and CCP regulations, that comply with ESMA and NCA rules.
- The only common point that links listed futures and options with CFDs is the leverage embedded in the contract. However, the leverage of derivative contracts traded on a regulated trading venue is modulated by the intervention of a CCP, which requires certain margins. Although most of the CCPs require margins of less than 20% for a futures position, there are also many underlyings for which CCPs require margins of more than 20%. The latter would have greater coverage of the risk associated with a position than the general rule employed for CFDs.
- It seems that some supervisors believe that high leverage in futures increases the probability that small investors will suffer losses or have to pay additional margins. However, the leverage of a futures contract is determined by the amount of initial margin required for each futures contract. The more volatile the underlying asset of a

[3] ESMA, 27th March 2018, Press release: ESMA agrees to prohibit binary options and restrict CFDs to protect retail investors, available here.
[4] BaFin, 30th September 2022, Press release: General Administrative Act – Product intervention regarding Futures, available here.

future is, the higher the initial margin requirement by the CCP. The leverage for futures with more volatile underlyings is, therefore, lower than for futures with underlyings that have only very small price fluctuations. The margin requirements set by CCPs also apply to exchange participants and intermediaries, which derive their own clearing and margin rules towards retail investors. Therefore, unlike other financial instruments, retail investors cannot use unreasonably high leverage on volatile underlying assets in futures.

Keep a wide array of ETDs available in the market

Measures such as the recent BaFin and CNMV interventions will have significant effects on some market practices. First and foremost, the number and types of ETDs available to trade will be narrowed. This not only will restrict investment possibilities, but also restrict in some cases hedging possibilities. In this context, it should be noted that hedging provides huge value to retail investors in the sense of being a financial strategy whose objective is to take a position that neutralises the risk[5] associated with price fluctuations of underlying assets, such as commodities, currencies, or interest rates, by locking in prices or rates for a future date. For example, a retail investor managing an ETF portfolio for long-term purposes, can decide to collect at some point its profits. However, since market instabilities and stock market crashes are a possibility, the investor could decide to hedge against these risks by opening a short position of a futures contract (e.g. Index Futures). In this way, financial profits from a short position compensate for the losses derived from a decreasing ETF portfolio value. This hedging use case could be especially valuable in view of the rising amount of retail investors managing portfolios based mostly on ETFs.[6] Hedging through futures can include other cases of risk neutralisation such as commodities, currencies, or interest rates.[7]

Against this background, there is a tangible risk that certain retail investors may transition to unregulated bilateral trading if they are unable to satisfy their investment or hedging requirements within regulated markets. FESE considers it incompatible with the objective of investor protection for retail clients if hedging of business transactions and investments can no longer take place within established and regulated market structures and with standardised contracts. Reduction in trading volumes in ETDs for retailers would go against the ambition of having a growing and prospering retail participation in financial markets.

In the above-mentioned report, IOSCO underlined that investment firms that trade retail OTC derivatives to retail investors have persistent conflicts of interest as they often both design and trade these financial products. As a result, it may negatively impact retail investors who are often unaware of the pricing mechanisms behind the delivery of OTC derivatives, especially CFDs. Promotion and sale of scams in a cross-border scenario are hard to identify due to the untransparent nature of OTC markets and the cross-border framework in which these financial products are traded. As a result, retail investors can find themselves exposed to a risky trading environment which can lead to significant financial losses.

A proportionate approach, with sufficient implementation time, for NCAs interventions

Authorities should acknowledge that prohibitions relating to certain types of exchange-traded derivatives are the most intrusive way of regulatory intervention into existing market practices, with outcomes and consequences sometimes hard to predict and reverse.

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[5] Hull, John, Options, Futures and Other Derivatives, Pearson, 11th Edition, p. 70.
[6] FMA, 29th June 2022, One-third of new retail investors invest in ETFs – the FMA explains how they work and about their composition, available here.
[7] IMF Blog, 8th August 2023, Tracking global financial stability risks from higher interest rates, available here.

As of 10th July, the Spanish CNMV announced intervention measures affecting both CFDs and "other leveraged products" whenever retail investors are involved. With this intervention, the CNMV expands the 2019 CFD resolution to futures and options traded on regulated exchanges, imposing limitations on leverage and the obligation to close positions once the value of the position is reduced to half the initial margin.[8][9] The CNMV resolution came into force on 3rd August after a very short implementation timeline of 20 days to adapt the systems and inform clients about the new circumstances. Giving a period of 20 days to design, develop, test, and put into production a supervision mechanism in the midst of summer has proven to be very challenging. For these reasons, some market participants have decided to stop offering access to certain leveraged products, including ETDs, as they were unable to guarantee full compliance with the new rules.

Taking the above situation as an example, any measure should be subject to a defined evaluation loop within a given timeframe to ensure the goal attainment and consequences of such measures are properly understood and evaluated. Such evaluation should enable NCAs to review and potentially amend any decision taken. In addition, beyond evaluating whether the measures were effective, targeted, and proportionate, this structured assessment would consider if there were any unintended harmful consequences for the retail investor ecosystem. Feedback indicates that, as mentioned above, some brokers decided to exit the Spanish market for ETDs altogether because of the short time allowed to implement and understand the new provisions. This is one of the unintended consequences of such rushed interventions.

Considering the aspects mentioned above and as a general approach, **FESE:**

- **Believes that it is crucial to keep access to capital markets open to retail investors.** While FESE acknowledges the complexity of ETDs and the need for investors' protection, we believe that the focus should be on empowering retail investors through financial education rather than preventing their participation in markets. Therefore, policymakers should retain a fair balance between necessary preventative measures and open market access for retail investors. The same intervention measure should not apply in the same way to both OTC and exchange-traded products or, alternatively, should at least produce substantive and differentiating analysis in both products.
- **Sees a concrete risk for some retail investors to automatically switch to unregulated bilateral trading in OTC markets** should they fail to meet their investment needs in regulated markets. Regulated trading venues are recognised for offering the highest degree of transparency, security, and fairness to all classes of investors. Retail investors should be strengthened to navigate regulated financial markets (as opposed to the OTC space) and not restricted from optimising their investment and/or hedging strategies using exchange-traded products. Retail access to regulated markets for derivatives products – contrary to OTC markets – is a key element to ensure sufficient investor protection, market transparency, and alignment with the objectives of MiFID II/R.
- **Calls on policymakers and authorities to establish a streamlined sequence of measures for ETDs that would render outright prohibitions as a means of last resort.** Authorities should acknowledge that prohibitions relating to certain types of ETDs are the most intrusive way of regulatory interference into existing market practices, with outcomes and consequences hard to predict and reverse. Against that background, a streamlined sequence of measures like, for example, enhanced disclosure requirements,

[8] CNMV press release, 12th July 2023, The CNMV restricts CFDs advertising and limits operations of leveraged instruments, available here.

[9] CNMV resolution, 11th July 2023, Product intervention measures relating to contracts for differences and other leveraged products, available here.

adaptations to existing contractual arrangements between broker and client, etc., would render outright prohibitions as a means of last resort only. This system would establish a clear intervention path for regulators while allowing market participants to plan in advance thanks to a streamlined intervention measure process.

- **Encourages NCAs and ESMA to take into account the material time needed to implement product intervention measures.** Regulators should give an appropriate period and clear guidance to market participants in order to have sufficient time to understand how to apply the new standards in different practical cases involving retail clients. This is especially crucial in case some entities stop offering certain ETD products to retail clients, nudging them, eventually, to switch in the short term to OTC markets where they can find similar but unregulated products.