



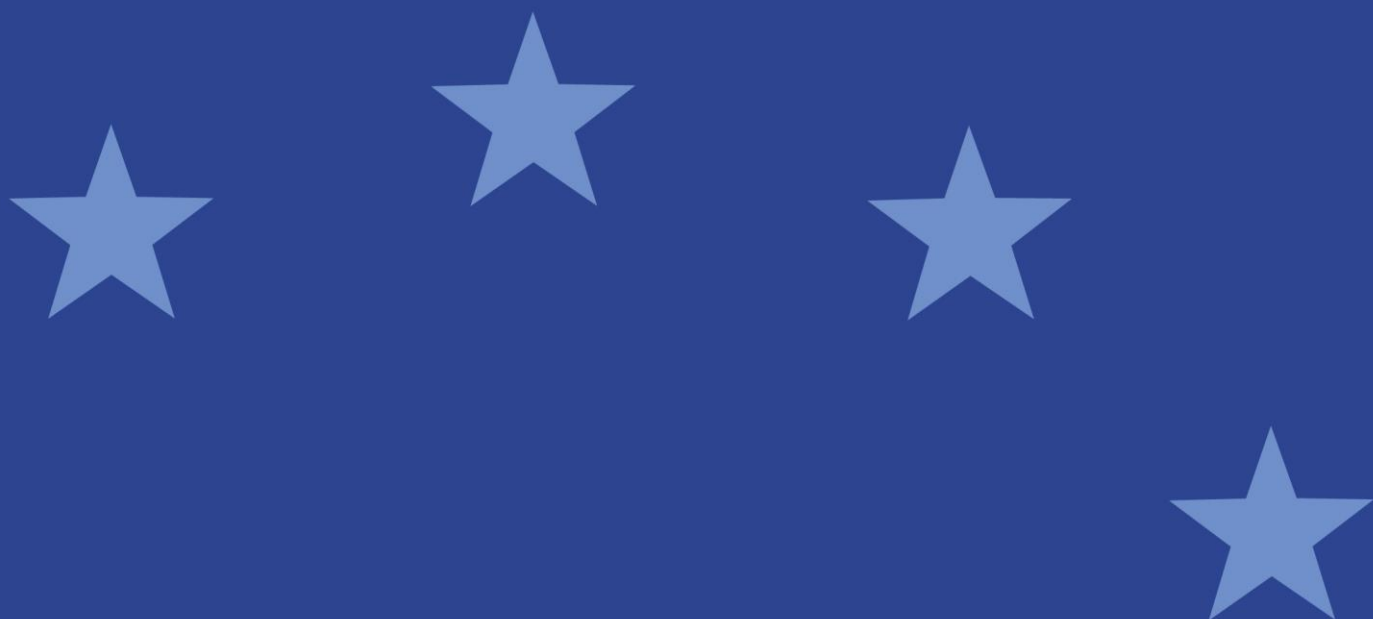
European Securities and  
Markets Authority

Topic4  
p42

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p88-91

# Questions and Answers

**Relating to the provision of CFDs and other speculative products to retail investors under MiFID**





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# 1 Background

## *MiFID and MiFID II*

1. The Markets in Financial Instruments Directive (MiFID)<sup>1</sup> is designed to help integrate Europe's financial markets and to establish a common regulatory framework for Europe's securities markets. It does this, inter alia, by allowing investment firms to operate throughout the EU on the basis of authorisation in their home Member State (the 'single passport') and by regulating regulated markets and multilateral trading facilities (MTFs). MiFID also introduced new and more extensive requirements for firms, in particular for their conduct of business and internal organisation, with the objective to harmonise and strengthen investor protection throughout Europe.
2. MiFID (or MiFID I) is made up of the following European legislation:
  - a. Directive 2004/39/EC, which was adopted in April 2004. It is a 'framework' Level 1 Directive, which has been supplemented by technical implementing measures (see the Level 2 legislation in b. below).
  - b. Implementing Directive 2006/73/EC<sup>2</sup> and Implementing Regulation 1287/2006<sup>3</sup> (the Level 2 legislation).<sup>2</sup>
3. In June 2014, the final legislative texts of the new Markets in Financial Instruments Directive (MiFID II)<sup>3</sup> and the Markets in Financial Instruments Regulation (MiFIR)<sup>4</sup> entered into force (collectively referred to, together with the MiFID II implementing measures, as 'the MiFID II package'). The MiFID II package will enter into application in January 2018.
4. ESMA is required to play an active role in building a common supervisory culture by promoting common supervisory approaches and practices. In this regard, ESMA develops questions and answers (Q&As) as and when appropriate to elaborate on the provisions of certain EU legislation or ESMA guidelines.

## *The provision of CFDs and other speculative products to retail investors*

5. When looking to enhance their returns, many investors consider investing in complex speculative financial instruments, including financial contracts for difference (CFDs), binary options, and rolling spot forex. Although these are complex products and it may be difficult

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<sup>1</sup> Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments, 30.4.2004, OJ L 145/1.

<sup>2</sup> Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council regarding organisational requirements and operating conditions for investment firms and defined terms for the purpose of that Directive, 2.9.2006, OJ L 241/1, and Commission Regulation (EC) No 1287/2006 of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purpose of that Directive, 2.9.2006, OJ L 241/1.

<sup>3</sup> Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (recast) 12.6.2014 OJ L 173/349.

<sup>4</sup> Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012 12.6.2014 OJ L 173/84.

for a majority of retail investors to understand the risks involved, they are widely advertised to the retail mass market by a number of firms, often via online platforms.<sup>5</sup>

6. CFDs, binary options and rolling spot forex<sup>6</sup> allow retail clients to speculate on the shortterm movements in the price of financial instruments. They are typically sold on an over-the-counter (OTC) basis and not through a regulated market or multilateral trading facility (MTF). Although the population of firms offering these products is diverse, there are two main types of firm<sup>7</sup> that offer CFDs and other speculative products to retail clients: (i) firms acting as the client's counterparty, which offer the products directly to retail clients; and (ii) firms acting as intermediaries between retail clients and liquidity providers. Many of these firms use an online business model to distribute CFDs and other speculative products to retail clients across the European Economic Area (EEA). These highly speculative products are often non-standardised and commonly incorporate product features, such as high leverage and automatic close-out, which makes them difficult to understand for a majority of retail investors. However, these products are commonly sold without the provision of investment advice.
7. ESMA has developed Q&As dedicated to the topic of the provision of CFDs, binary options and rolling spot forex to retail clients under MiFID as this is an area in which many competent authorities have serious concerns about the protection of investors and where there is a considerable degree of cross-border activity across Europe.

## 2 Purpose

8. The purpose of this document is to promote common supervisory approaches and practices in the application of MiFID and its implementing measures to certain key aspects that are relevant when CFDs and other speculative products are marketed and sold to retail clients. It does this by providing responses to questions identified by competent authorities in relation to practical aspects of the day-to-day supervision of firms involved in offering these products.
9. The content of this document is aimed at competent authorities as defined in MiFID to ensure that in their supervisory activities, their actions are converging along the lines of the responses adopted by ESMA. However, the answers are also intended to help firms by providing clarity as to the content of the MiFID rules. This document has been produced with reference to the current (i.e. MiFID I) legislative framework that is in application at the time of publication of this document. However, it should be noted that the principles and requirements underpinning the content of this document will remain unchanged once the MiFID II package, which overall strengthens the protections for investors, enters into application. ESMA will also consider the need for any further work on this topic, in the

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<sup>5</sup> ESMA, together with the European Banking Authority (EBA), published an investor warning about contracts for difference in February 2013, available at: <https://www.esma.europa.eu/sites/default/files/library/2015/11/2013-267.pdf>.

<sup>6</sup> These instruments are collectively referred to throughout this document as "CFDs and other speculative products". The underlying assets are typically mainstream products (for example, most underlyings are also available as leveraged futures contracts). Differently from leveraged futures contracts, CFDs, binary options and rolling spot forex are more commonly mass marketed to retail clients by some firms and as such are the subject of these questions and answers.

<sup>7</sup> Unless otherwise specified, the term 'firm' in this Q&A document should be read to include investment firms and credit institutions performing investment services and activities.



medium term, in light of new aspects of the MiFID II framework, such as in relation to the application of product **governance** requirements and product intervention powers.

10. The content of this document is not exhaustive and it does not constitute new policy.

### **3 Status**

11. The question and answer (Q&A) mechanism is a practical convergence tool used to promote common supervisory approaches and practices under Article 29(2) of the ESMA Regulation.<sup>8</sup>

12. Due to the nature of Q&As, formal consultation on the draft answers is considered unnecessary. However, even if they are not formally consulted on, ESMA may check them with relevant ESMA groups, or where specific expertise is needed, with other external parties.

13. ESMA will review these questions and answers on a regular basis to update them where required and to **identify if**, in a certain area, there is need to incorporate some of the material into ESMA guidelines, recommendations or other supervisory convergence tools. In such cases, where applicable, the **procedures** in Article 16 of the ESMA regulation will be followed.

### **4 Questions and answers**

14. This document is intended to be continually edited and updated as and when new questions or issues are received. The date each question was last amended is included after each question for ease of reference.

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<sup>8</sup> Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC Regulation, 15.12.2010, L331/84.

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## Section 1: Authorisation of firms offering CFDs or other speculative products to retail investors

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### 1. Introduction

1. In the life cycle of supervision, a National Competent Authority (NCA) first has the opportunity to understand and **assess** the proposed business model and activities of a firm when the firm applies to be authorised. Article 7(1) of MiFID states that an **NCA** shall not grant authorisation unless and until such a time as it is fully satisfied that the applicant complies with all its MiFID obligations. Article 7(2) of MiFID also requires an applicant seeking authorisation to provide all information necessary to enable the competent authority to satisfy itself that the firm has the necessary arrangements in place.
2. This section identifies certain key aspects that supervisors should take into account when considering an application for authorisation from a firm that is proposing to offer CFDs or other speculative products to retail clients. It does this by posing a series of questions and answers that are intended to help NCAs obtain and consider relevant information as part of their **procedures** for granting and refusing requests for authorisation from these types of firms. The topics discussed in this section are therefore designed to help NCAs **identify** certain factors that may require additional scrutiny during the authorisation process, given the complex and speculative nature of these products and certain business model features and practices that are commonly observed in this sector of the market.
3. It is particularly important for NCAs to carefully **assess** applications for authorisation from firms offering CFDs and other speculative products to retail clients considering the degree of cross-border activity observed in this sector, and taking into account that an authorisation, once granted, allows such a firm to provide investment services and activities to retail investors throughout the European Economic Area (EEA), pursuant to Article 6(3) of MiFID.



**Question 1 [last update 8 April 2016]: An applicant firm seeking authorisation plans to use an online business model to offer CFDs or other speculative products to retail investors. What particular business model aspects and organisational arrangements may be particularly relevant for national competent authorities (NCAs) to take into account when considering the request for authorisation?**

**Answer 1a: Effective Supervision**

1. One of the fundamental requirements for an applicant firm seeking authorisation under MiFID is that the firm must be able to be effectively supervised by the relevant competent authority. This has a particular dimension when an applicant firm is seeking to provide CFDs, binary options or rolling spot forex to retail clients, given that many of these firms plan to operate using online business models, often with a limited footprint in the jurisdiction where they are seeking authorisation. Once authorised, such firms may freely perform investment services and activities within other Member States under Article 31 of MiFID, subject to the notification **procedures** set out therein.
2. In order to ensure at the point of authorisation that the applicant firm is capable of being effectively supervised, an **NCA** should consider the information provided in the applicant firm's programme of operations (Article 7(2) of MiFID). In particular, NCAs should consider the following points, taking into account the nature and complexity of the applicant firm's planned activities, the complexity of the products offered, the way the business is organised, the impact of the **group** structure (where the entity is part of a group), and the impact of any other close links:
  - a. Can the **NCA** obtain adequate information from the applicant firm?
  - b. Can the **NCA** obtain adequate information from the persons with whom the applicant firm has close links?
  - c. Is the applicant firm ready and willing to engage with the **NCA** in an open and co-operative way?
  - d. If the applicant firm is part of a group, can the **NCA assess** the overall financial position of the group?
  - e. Have sufficient details been supplied of the persons that have qualifying holdings in the applicant firm?
  - f. Where there are complex ownership structures in place, are these adequately explained?
3. An **NCA** should closely consider an application for authorisation from an applicant firm with a more complex **group** or ownership structure, to ensure this does not prevent the effective exercise of the supervisory functions of the competent authority (Article 10(1) of MiFID). Where this condition is not satisfied, NCAs should consider withholding authorisation from the applicant. Some examples of complex ownership structures include: (i) an applicant firm with links to entities based in a third country, non-EEA jurisdiction with whom an **NCA**

has limited formal or informal information sharing arrangements; or (ii) a firm with less known individuals owning qualifying holdings, for example individuals controlling the firm from behind a trust structure.

4. Where an applicant firm has significant controls, funding or operational links to an entity that is located in a third country, and the NCA has insufficient existing knowledge about that third country entity, or does not have reasonable means to obtain information to verify material facts that the applicant firm has asserted, such as the regulatory status of a third country entity or its resources and capability to act in a particular capacity (for example as a hedging counterparty), this may provide grounds for the refusal of an application, pursuant to Article 10(2) of MiFID.
5. Taking into account the need to ensure the sound and prudent management of the firm, authorisation should not be granted to a firm where the NCA is not satisfied of the suitability of the shareholders or members that have qualifying holdings, whether direct or indirect (Article 10 MiFID). There are a number of ways that NCAs can assess the suitability of shareholders and members with qualifying holdings, including agency searches on publicly available information, media and news archives, law enforcement databases, or credit rating agency databases on the relevant directors. Furthermore, NCAs should check whether shareholders or members with qualifying holdings, or any natural or legal persons with close links to the applicant firm have been subject to any enforcement action by the home competent authority or by other competent authorities. After an authorisation request has been granted, NCAs should also carefully consider applications to acquire or increase a qualifying holding in an authorised firm. A change to the shareholders or members that have qualifying holdings in a firm should not be perceived as a means to circumvent the authorisation process.<sup>9</sup>
6. In assessing an application for authorisation, NCAs should also consider whether the 'mind and management' of the applicant firm is in the jurisdiction in which the applicant is seeking authorisation, by establishing where the persons who effectively direct the business are located and where other senior management and key function holders (such as compliance and risk) are based. This is particularly relevant in an online business model, where the applicant firm may have a limited physical presence in the home Member State. For evidence, NCAs could consider information such as home addresses of the relevant individuals or rental agreements of the firm's offices, including the length of such agreements. For example, if an applicant firm indicates that members of its management body will relocate their domicile to the home Member State after the request for authorisation is granted, the NCA should consider whether any individuals relocating can demonstrate genuine long-term commitment to the business and their relocation. It is also important for NCAs to consider the past career history and other information about the persons who will effectively direct the business, in order to assess the reputation and experience of such persons, and to determine how likely it is that they will stay in their roles

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<sup>9</sup> NCAs should also refer to the CEBS, CESR and CEIOPS 'Guidelines for the prudential assessment of acquisitions and increases in holdings in the financial sector required by Directive 2007/44/EC' (CESR/08-543b), and which were the basis for the development of ESMA's draft technical standards on the assessment of acquisitions and qualifying holdings (ESMA/2015/613).

once authorisation has been granted to ensure the sound and prudent management of the firm (Article 9 MiFID).

7. After authorisation has been granted, supervisory visits can be used to confirm that the firm operates from the premises noted in the application, and that the persons who effectively direct the business have fulfilled any statements made as part of the application for authorisation stage, to ensure they have adequate oversight of the firm.
8. Where a firm and/or persons who effectively direct the business have not established a meaningful presence in the jurisdiction, for example where the senior management and/or persons in key compliance and risk functions do not reside in the home Member State, such that the NCA believes that the firm is not genuinely operating from the home Member State jurisdiction or that the persons directing the business do not have sufficient control and oversight of the business, this may provide grounds to withdraw authorisation, pursuant to Article 8(b) or Article 8(c) of MiFID.

#### **Answer 1b: Appropriate financial and non-financial resources**

9. When considering an application for authorisation, an NCA should ensure that the applicant firm's resources are appropriate in relation to the activities the firm intends to carry out. The applicant firm's financial and non-financial resources<sup>10</sup> must be sufficient for the firm to operate the business effectively and meet its MiFID obligations.
10. NCAs should consider whether the applicant firm is adequately capitalised and whether it is likely to meet its capital requirements on an on-going basis (Article 12 of MiFID), taking into account whether the proposed business model is sustainable to support the financial information provided as part of the application.<sup>11</sup> An NCA can do this by assessing the proposed revenue generation model, e.g. considering whether it is based on transactions and volumes, whether there is a fixed fee element included in the fee structure, and whether the applicant firm will be acting as the client's trading counterparty.
11. In assessing the applicant firm's non-financial resources, NCAs should consider information about the firm's human resources,<sup>12</sup> premises, and operational resources. In particular, the applicant firm should be able to demonstrate as part of the authorisation process that it has adequate compliance resources to minimise the potential risks posed by an online business model offering speculative and complex products to retail clients, including where the applicant proposes to offer services on a cross-border basis, and that the firm can monitor, on a regular basis, the adequacy and effectiveness of the policies

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<sup>10</sup>Article 13 of MiFID requires investment firms to employ appropriate and proportionate systems, resources and procedures to ensure continuity and regularity in the performance of its services and activities. In relation to key persons directing the business, there is a requirement under Article 9 of MiFID for them to be of sufficiently good repute and experience to ensure the sound and prudent management of the investment firm.

<sup>11</sup> This includes the firm's verified or audited set of accounts, the firm's projections, or any other evidence the firm has provided of financial resources held. The following information about the financial position of the applicant may be particularly relevant: the applicant firm's opening balance sheet; monthly cash flow forecast and profit & loss for the first years of trading or until breakeven and the monthly forecast or regulatory capital versus the regulatory capital requirement for the first years of trading or until breakeven.

<sup>12</sup> In the assessment of human resources, NCAs should also consider whether the persons effectively directing the business of the applicant are of sufficiently good repute and sufficiently experienced (Article 9(1) of MiFID), and that and those responsible for key functions, such as risk and compliance, have the necessary skills, knowledge and expertise to carry out their roles (Article 5 of the MiFID Implementing Directive).

and procedures it has in place to manage these risks (Article 6 of the MiFID Implementing Directive).

12. More generally, NCAs should also consider whether all other relevant personnel are appropriately qualified and have the necessary experience to perform their roles (Article 5(1)(d) of the MiFID Implementing Directive). For example, NCAs could review training plans and qualifications of staff, particularly in situations where CVs suggest little experience. Especially in smaller start-up firms, it may also be helpful to establish whether there is any 'key person risk' (which may occur as a result of the same individual being responsible for performing several key roles or functions) and if so, how the firm plans to mitigate and manage this risk (Article 5(1)(g) of the MiFID Implementing Directive).
13. When an applicant firm is proposing to adopt an online business model to provide CFDs or other speculative products, NCAs should pay particular attention to the extent to which the firm is reliant on technology and/ or bespoke IT systems, to understand whether the use of such IT systems presents a risk to the continuity of service provided by the firm and ensure the firm complies with the outsourcing requirements set out in Article 13(5) of MiFID and Articles 13 and 14 of the MiFID Implementing Directive. This should include a consideration of whether the applicant's disaster recovery and business continuity plans are sufficient to ensure the preservation of essential data and functions in the case of a system interruption, or where not possible, the timely recovery of essential data and functions and the timely resumption of services to clients, as required by Article 5(3) of MiFID Implementing Directive. Where the relevant expertise is not available within the competent authority, NCAs may choose to employ operational experts to review the applicant firm's proposed electronic platform or systems, or to engage the services of third party audit providers.

#### Answer 1c: Programme of operations

14. In assessing an application for authorisation, an NCA should first consider whether the business plan the firm has provided within its programme of operations offers sufficient information about what the firm is planning to do and how and where it will operate, as required by Article 7(2) of MiFID. The applicant firm should be clear about the scope of authorisation it is seeking and NCAs should be able to accord this with the business plan the firm has presented.
15. As one example, if a parent firm is already authorised in one EEA jurisdiction and an NCA in another Member State receives an application for authorisation from a subsidiary entity, which has the same or very similar business model and the same persons effectively directing or controlling the business, the NCA should carefully consider the rationale for such a business model. In such instances, NCAs should consider, inter alia:
  - a. Whether the same persons can effectively control multiple firms based in different jurisdictions;
  - b. Whether there are any conflicts of interest inherent in such arrangements and how the applicant firm proposes to manage these, given that the different firms may be closely connected, for example through outsourcing arrangements; and

- c. How clients will clearly understand which legal entity they are contracting with. This may be particularly relevant given the online business models that are common in this sector. For example, upon receiving an application to open an account from a retail client, if an applicant firm that is part of a **group** plans to redirect the retail client to do business with another **group** entity (e.g. based on the IP address of the client), it should be made clear to the client that it is no longer contracting with the first entity, whose website the client initially visited online.
16. In assessing an application for authorisation, NCAs should consider the sustainability of the business model presented and any potential risks within the business plan, including the applicant firm's product strategy, planned fee and incentive structures, and growth strategy. To do this, an **NCA** can consider the applicant firm's financial and business projections, including those concerning client take-on and transaction levels. In assessing such projections, an **NCA** should consider that the nature of CFDs and other speculative products means that they may not be appropriate for the majority of retail clients, and that the typical duration of a retail client account for such products is relatively short. Therefore, financial projections based on a large and/or long-term retail client base are unlikely to be realistic. An aggressive projected business plan based on selling complex, **high-risk** products to retail clients should also prompt an **NCA** to consider whether an applicant firm adopting such a business model can demonstrate that it has in place adequate **policies** and **procedures** to ensure it complies with its MiFID obligations, in particular whether it can demonstrate that it is acting in the best interests of its clients on an ongoing basis (Article 19(1) of MiFID).
17. Given the **inherent** conflicts of interest present in some typical business models of providers of CFDs and other speculative products to retail customers, particularly in relation to trading models where the applicant firm plans to deal on own account as a counterparty to the client's trade, NCAs should ensure that the applicant firm can demonstrate that it has considered the potential conflicts of interest within its business model and operations, and how conflicts of interest will be identified, managed and mitigated (Article 13(3) MiFID). The hedging arrangements that the firm plans to implement will be of particular significance where a firm plans to deal on own account. Certain conflicts of interest arising from common business models adopted by firms offering CFDs and other speculative products to retail clients are discussed in Section 2 of this document.
18. One key aspect for applicant firms offering CFDs and other speculative products to retail clients is how the firm will meet its MiFID obligations to deliver best execution (Article 21 of MiFID). At a minimum, NCAs should **assess** an applicant firm's order execution policy to ensure it is adequate and to consider how the firm will monitor the trading results obtained for its clients. To further evaluate the applicant firm's **compliance** with best execution rules, NCAs can also examine how the firm will trade with different liquidity providers, and/or review agreements with its liquidity providers. As a part of the assessment, NCAs should consider whether the applicant firm is transparent about its trade flow and whether it is clear to the customer what the firm's hedging arrangements are and where the trades are executed. Where an applicant firm plans to hedge trades intra-group, NCAs should consider the proposed hedging arrangements beyond the intra-group hedge trade and be



satisfied that the firm can demonstrate sufficient oversight of these arrangements to ensure delivery of best execution.

19. MiFID requires a firm's control framework and policies to be proportionate in view of the nature, scale, and complexity of its business model and the nature and range of investment services and activities undertaken. Although many firms planning to offer speculative products to retail clients may be small in size, NCAs should ensure that any applicant firm adopting a business model based on selling complex, high-risk products to retail clients can demonstrate that it has in place in place robust and comprehensive controls to manage the risks inherent in such a business model. Furthermore, where an applicant firm indicates in its programme of operations its intention to carry out cross-border business, the NCA should also consider how the additional complexity and risks arising from the provision of investment services outside the home Member State will be overseen and managed by the firm. Some examples of the types of information that NCAs should take into account when a firm proposes to offer CFDs or other speculative products on a cross-border basis include the following:

- a. How the applicant firm will have sufficient oversight and controls to ensure that marketing and communication materials comply with the relevant MiFID requirements, in particular where these are produced in a language other than the language(s) of the home Member State.
- b. What controls the firm will have in place over the activities of any branches or tied agents it plans to use as part of its distribution of CFDs or other speculative products to retail clients in host Member State(s).
- c. What controls the firm will have in place to ensure that it will not offer investment services or activities in other jurisdictions that it is not authorised to perform in its home Member State (e.g. providing investment advice).

20. An NCA's assessment of how an applicant firm plans to oversee its business and manage the risks arising from its cross-border activities should be proportionate to the volume and complexity of the planned cross-border operations. An NCA should also consider, in deciding whether to grant or refuse a request for authorisation, the extent to which the applicant's planned operations in other jurisdictions might impact the NCA's ability to effectively supervise the operations of the firm. It will also be important for NCAs to devote particular attention to the cross-border operations of firms offering CFDs and other speculative products to retail clients as part of their ongoing supervisory activity. For example, if, after the point of authorisation, an NCA becomes aware that a firm authorised in its jurisdiction carries on its cross-border activities in a manner different to that indicated in the programme of operations provided as part of the firm's request for authorisation (e.g. if all of its activities are actually in another Member State than the home Member State), the NCA should consider whether to maintain or withdraw the authorisation.

21. NCAs should pay particular attention to an applicant firm's planned promotional and marketing activity by considering how the applicant intends to offer speculative products, to which clients, and how the proposed marketing and distribution strategy will be used to support the business plan. This is particularly important given that many firms seek to adopt

a mass-market distribution model for CFDs and other speculative products. NCAs should also consider how the applicant plans to provide warnings to clients about the high-risk nature of the products, for example on its website(s) and in promotional materials.

22. More generally, other aspects that should be considered by NCAs at the authorisation stage relevant to the business model of firms offering CFDs and other speculative products to retail clients include: the applicant's ability to monitor its systems for market abuse; its controls to ensure compliance with other organisational and conduct of business requirements (such as the safeguarding of client assets); and the overall governance and risk management processes. These aspects can be assessed as part of the information provided in the request for authorisation or through further information requests or dialogue with the applicant. In particular, NCAs may find it helpful to request evidence of the applicant firm's plans to assess the appropriateness of CFDs and other speculative products to retail clients, to ensure that firm applies a robust approach when assessing the knowledge and experience of customers wishing to purchase the products, and the firm's client on-boarding policy and procedures, to ensure the firm appropriately mitigates anti-money laundering (AML) risks.
23. In assessing the applicant firm's policies and procedures, NCAs should ensure that documents are tailored to the specific business model and risks of the firm seeking authorisation. The use of generic, off-the-shelf policies and procedures should be identified and carefully considered by NCAs as part of the authorisation process. For example, an NCA could assess the knowledge of senior management and the compliance function about the firm's MiFID obligations in key areas (such as best execution or the assessment of appropriateness), to establish that the applicant firm understands the procedures and controls that it has or will put in place.

#### Answer 1d: Overall ability to comply with regulatory obligations

24. NCAs should determine whether the applicant is ready to be a regulated entity (Article 7 of MiFID), by considering whether the applicant firm is able to comply with all its regulatory requirements, whether it has due regard to the interest of its clients, and whether it is committed to carry on business with integrity. In doing so, NCAs should consider whether the applicant firm has governance and control structures in place that sufficiently address the activities and risks of the firm. NCAs can do this by examining the applicant firm's corporate governance structures (e.g. reporting lines, Board and other Committee structures), and by considering the proportion of staff dedicated to compliance, risk and internal audit, including whether these functions are carried out in-house or are outsourced.
25. Where the applicant firm outsources any of its key business functions, it is important for NCAs to be satisfied that the firm exercises effective oversight over the outsourced activities, including those provided by intra-group entities. At the authorisation stage, NCAs should establish which functions are outsourced and assess how the firm maintains effective oversight of the outsourced services provided, for example by considering any outsourcing agreements that the applicant firm plans to have in place. In addition, NCAs may expect certain roles, such as those exercising significant influence over the applicant firm's conduct, to not be outsourced or to be performed by individuals situated in the home Member State of the applicant firm.

26. If an applicant firm plans to outsource multiple critical or important client facing functions, such as website design, trading software, financial promotions, client disclosures, and/or client on boarding processes (such as “know your client” information gathering and appropriateness testing), to third parties in other jurisdictions, the nature of controls needed to effectively oversee and assess the performance of such service providers will be more complex. If an applicant firm cannot demonstrate how it will ensure effective oversight of outsourced functions to ensure meet its regulatory obligations under Article 13(5) of MiFID and Articles 13 and 14 of the MiFID Implementing Directive, an NCA should consider withholding authorisation.

**Question 2 [last update 8 April 2016]: Under what circumstances could an applicant firm adopting an online business model to offer CFDs and other speculative products to retail investors and planning to make use of outsourcing arrangements be considered to not meet the MiFID requirements?**

**Answer 2:**

27. NCAs should carefully consider requests for authorisation from applicant firms planning to offer CFDs or other speculative products that plan to outsource central management activities, key functions and/or key infrastructure (such as the compliance function, customer support activity or the provision of the trading platform), to a third party or another entity within the same group. If a firm cannot demonstrate sufficient internal controls and oversight over an outsourcing arrangement, and/or is not able to provide adequate information in timely manner to the relevant NCA, this would not meet the MiFID requirements.

28. Under Article 13(5) of MiFID, firms are required to ensure that they take reasonable steps to avoid undue operational risk when relying on a third party for the performance of any critical operational functions. Any outsourcing of critical or important operational functions that results in the delegation by senior management of its responsibility, altering of the relationship and obligations of the firm towards its clients, or removing or modifying any of the conditions subject to which the firm’s authorisation was granted, is prohibited (Article 14(1) of the MiFID Implementing Directive). For example:

- a. If a firm offering CFDs and other speculative products outsources the provision of educational or training materials to another party (e.g. a financial education provider), it remains for the authorised firm to ensure that any information or marketing communication provided to clients and potential clients is clear, fair and not misleading (Article 14 of the MiFID Implementing Directive).
- b. A firm cannot enter into an outsourcing arrangement with a trading platform provider, if such an arrangement shifts the responsibility for any damages caused to clients as a result of the improper performance of the trading platform away from the authorised firm to the outsource provider.

29. As a part of an NCA’s assessment of outsourcing arrangements, it is important to consider the extent to which an applicant firm could continue to function and provide services to clients if a particular outsourcing arrangement was terminated (Article 14(2)(g) of the MiFID



Implementing Directive). Especially when an applicant firm proposes to offer CFDs or other speculative products to retail clients based on an online business model, the applicant firm's business continuity planning (BCP) arrangements should be an important consideration. It is also important for an NCA to assess the extent of an applicant firm's dependency on a particular outsourcing arrangement with another entity, given many firms in this sector seek to outsource functions such as:

- a. Website design;
- b. The trading platform and trade processing;
- c. Compliance activity; and/or
- d. Client support services, often to call centres.

30. If an applicant firm proposes a single outsourcing arrangement for several of these functions, the NCA should consider seeking further information from the applicant firm, to ensure it is not effectively delegating its senior management responsibilities (Article 14(1) of the MiFID Implementing Directive), or putting at risk its ability to maintain service continuity or timely resumption of investment services if an outsourcing partner failed (Article 5(3) and 14(2) of the MiFID Implementing Directive).<sup>13</sup> A firm must also exercise due skill, care and diligence in entering into any such outsourcing arrangements. For example, if an applicant firm proposes as part of a request for authorisation to enter into an outsourcing arrangement under which a third party call centre will provide support services for its clients, it should be able to demonstrate to the NCA how it is able to effectively supervise and oversee the activities of the call centre, and any risks associated with these activities.

31. After the initial authorisation, supervisory visits can be used to determine whether a firm actually operates from the premises noted in the application and otherwise complies with the conditions under which authorisation was first granted. From time to time, it has been observed in this sector of the market that an applicant firm establishes a sufficient minimum presence to meet the necessary conditions for authorisation in the relevant Member State, for example by ensuring that the key management and persons responsible for the key functions (such as compliance and risk) reside in that Member State. However, once authorisation is granted, a firm may seek to reduce its physical presence in its home Member State, for example it may wish to move certain management<sup>14</sup> or infrastructure activities to a parent company that is in a different jurisdiction, possibly outside the EEA. Even when a firm outsources activities within the same group, the MiFID outsourcing obligations still apply. Article 16(2) of MiFID also requires firms to notify the relevant NCA of any material change to the conditions for initial authorisation.

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<sup>13</sup> Some other examples of the types of information that NCAs can take into account as part of the authorisation process in relation to outsourcing arrangements are also discussed in paragraphs 25-26 of this document.

<sup>14</sup> Article 9(2) of MiFID requires a firm to inform the relevant NCA of any changes to its management and to provide all information necessary to assess the repute and experience of the proposed new management.

32. NCAs should consider withdrawing authorisation if a firm ceases to meet the conditions under which authorisation was granted, which would be the case if a firm has outsourced its activities to such an extent that it no longer complies with its MiFID obligations (Article 8(c) of MiFID).

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## Section 2: Conflicts of interest arising from business models that may be adopted by firms offering speculative products to retail investors

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### 1. Introduction

1. Article 13(3) of MiFID requires firms to take all reasonable steps to prevent conflicts of interest. Article 18 of MiFID and Articles 22 and 23 of the MiFID Implementing Directive further define the steps that firms should take to identify, manage, prevent, and/or disclose conflicts of interest.
2. This section identifies certain business model characteristics and practices that give rise to particular conflicts of interest but are often observed in firms offering CFDs and other speculative products to retail clients. Many of these conflicts of interest arise as a result of the remuneration models adopted by firms in this sector, for example when the firm is the other side of the client's trade or if the firm or other relevant parties are remunerated based on the volume or value of trades placed by retail clients speculating in CFDs, binary options and rolling spot forex. This is particularly important given that the average life span of a retail client account in relation to speculative products is relatively short, which may place a certain pressure on the overall business model of a firm to maintain a steady stream of new clients and increase the potential for conflict of interest between the firm and the client to occur.
3. The topics discussed in this section are presented in the form of questions and answers that are intended to help NCAs assess firms' approaches to the application of the MiFID conflicts of interest rules when offering CFDs and other speculative products to retail clients.

**Question 1 [last update 8 April 2016]: In the case of some providers of CFDs or other speculative products dealing on own account, there is a direct correlation between the profit/loss made by the client and the profit/loss made by the firm. In such cases, how can the firm demonstrate that it has met its MiFID obligations to act honestly, fairly and professionally in accordance with the best interests of its clients, to take all reasonable steps to avoid conflicts of interest, and to execute orders on terms most favourable to the client?**

**Answer 1:**

1. Where a firm offering CFDs or other speculative products to retail clients is dealing on its own account and acting as the client's counterparty to a particular transaction, this may present conflicts of interest between the firm and the client, in particular if a loss incurred by the client equates to a profit made by the firm. In such cases, in pursuing its own commercial interests, the firm is incentivised to act in a manner that is not in the client's best interests because it cannot make money unless the client loses money (Article 21 of the MiFID Implementing Directive). Such a conflict of interest may be exacerbated as a result of high leverage often offered to retail clients trading CFDs or other speculative products, which increases the potential profits and losses at stake.
2. NCAs should pay careful attention, at the point of authorisation and as part of ongoing supervision, to the possible conflicts of interest arising as a result of the different business models of firms acting as the retail client's counterparty when offering CFDs and other speculative products, to ensure that such firms comply with their obligation to take all reasonable steps to prevent conflicts of interest (Article 13(3) of MiFID). In doing so, it is important to note that the typical business models of binary options, CFD and rolling spot forex providers may differ in their structural characteristics, which will impact the extent to which certain conflict of interests occur and the extent to which they can be prevented or managed.
3. When a firm is offering CFDs or other speculative products and is acting as the client's counterparty (i.e. is on the other side of the client's trade), a distinction can be drawn between the following possible business models:
  - a. Firm executing orders on behalf of clients and acting as the client's counterparty whilst managing its market risk exposure by hedging all client orders on either a one-to-one or aggregated basis;
  - b. Firm dealing on own account and acting as the client's counterparty, without hedging against client orders; and
  - c. Firm dealing on own account and partially hedging client orders, for example hedging above a specific limit, triggered if firm's transaction volume crosses a predefined threshold of risk tolerance/appetite, or hedging for only a sub-set of clients (hybrid model).
4. The same firm may use one or a combination of hedging models when it offers CFDs or other speculative products to retail clients.

5. Firms adopting the first model can make a profit regardless of whether CFDs or other speculative products sold to their retail clients are profitable or not, as the market risk is passed on to another party (the so-called liquidity provider). In this first model, there is less incentive for the firm to pursue its own commercial interests to the detriment of the client, as the firm's profit is not dependent on the position of each client. However, when assessing the firm's compliance with MiFID conflicts of interest rules, NCAs should pay close attention to the nature of the hedging arrangements in place. For example:
  - a. If the firm hedges with another entity within the same group, given the link between the commercial interests of the firm and the group that it is part of, a conflict of interest will still exist that would need to be managed.
  - b. A firm would not be taking all reasonable steps to avoid conflicts of interest if it executes its hedging strategy in such a way that the firm benefits when there are favourable market movements between the time the order is placed by the client and the hedge is made by the liquidity provider, whilst all or part of any losses as a result of unfavourable market movements are passed on to clients (so-called asymmetric price slippage).
  - c. Where a firm executes client orders using a trading platform (e.g. using a straight through processing (STP) model that connects the firm to a liquidity provider at one end and the client at the other), and the firm is remunerated based on the profit and losses of the platform, a conflict of interest would still exist.
6. The second and third models can be characterised by a correlation between the profit/loss made by the client or the overall position of clients, and the profit/loss made by the firm. In the third hybrid model, that correlation may exist to a greater or lesser extent, depending on the extent and the precise nature of the partial hedging in place.
7. When assessing the conflicts of interest presented by the business model of a firm offering CFDs and other speculative products to retail clients, it would also be appropriate for NCAs to take into account other relevant factors, such as the proportion of the firm's business and revenue streams linked to provision of investment services and activities relating to CFDs or other speculative products, versus other types of investment business. A firm that is heavily reliant on a single source of revenue may face a greater conflict of interest between its commercial imperative and the best interests of its clients.
8. Where a firm is adopting a dealing model under which the profit made by the firm is dependent upon the clients of the firm making losses, such that the execution of relevant transactions is inseparable from a material conflict of interest between the firm and its clients, NCAs should consider whether the conflicts of interest arising from such a model can be managed, and, as a consequence, whether such a business model can comply with firm's obligation to act honestly, fairly and professionally in accordance with the best interests of its clients (Article 19(1) of MiFID), and to take all reasonable steps to avoid conflicts of interest (Article 13(3) of MiFID). For example, a firm offering CFDs or other speculative products acting as the counterparty to a retail client's trade without any hedging arrangements in place has no incentive to execute orders in the best interest of the client, because if the client "wins", the firm "loses." Such a conflict of interest in all likelihood

cannot be managed and should therefore be avoided, by not adopting such a business model.

9. Regardless of the type of model adopted, a firm should always disclose to the client that it is the client's counterparty, in order to meet its obligations to provide appropriate information to clients about the firm and its services (Article 19(3) of MiFID) and, where relevant, to disclose conflicts of interest to the client before undertaking business on its behalf (Article 18 of MiFID).<sup>15</sup>
10. In addition, certain conflicts of interest can arise as a result of the execution of orders by the firm, for example: (i) in those cases where the execution of orders is based on quotes (bid and offer prices) provided by the firm; or (ii) where prices are determined without reference to a relevant benchmark or market. In these cases, the firm may be incentivised to execute orders on terms that are not the most favourable to the client (Article 21 of MiFID). Even where prices are quoted with reference to a market or benchmark, the contractual terms and conditions of a firm offering CFDs and other speculative products to retail clients may require the client to acknowledge that the prices used to determine the value of the contract may differ from those available in the respective underlying market, which means that it may not always be possible for the clients to check and verify the accuracy of the prices received from the firm.
11. In order to meet the requirement to execute client orders on terms most favourable to the client and to ensure that client orders are executed in a transparent way, when firms execute orders from retail clients in CFDs and other speculative products, the pricing methodology should be transparent and should be based on the relevant market, asset, or benchmark price. For example, prices of speculative products relating to financial instruments admitted to trading on a regulated market should be derived from external benchmarks, based on data received from independent market data providers or publicly available sources. Firms should also set and disclose a maximum mark-up limit for each underlying reference product.
12. Only in cases where such data is temporarily not available, e.g. where prices on the underlying assets are not available or orders are placed outside of normal trading hours, the provider of CFDs and other speculative products to retail clients may set prices at its discretion, provided that the firm's order execution policy specifies precisely how such discretion will be exercised. The conditions to be met when exercising discretion should be clear and verifiable, with clear records kept by the firm to enable it to demonstrate to the relevant NCA that it took reasonable steps to obtain the best possible result for its clients in a situation where discretion is exercised.<sup>16</sup>

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<sup>15</sup>It is implicit in the MiFID Implementing Directive that firms should not over-rely on disclosure or use it as a self-standing measure to manage conflicts. Recital 27 of the MiFID Implementing Directive states: "... In particular, the disclosure of conflicts of interest by an investment firm should not exempt it from the obligation to maintain and operate the effective organisational required under Article 13(3) of Directive 2004/39/EC. While disclosure of specific conflicts of interest is required by Article 18(2) of Directive 2004/39/EC, an over-reliance on disclosure without consideration as to how conflicts may appropriately be managed is not permitted."

<sup>16</sup> In some cases, for example in cases of extreme market volatility resulting in market data not being available, the most appropriate course of action for the firm to take in order to meet its best execution obligations and to act in the best interest of clients may be to temporarily cease accepting client orders to trade in CFDs and other speculative products. However, this should

13. A firm offering CFDs and other speculative products to retail clients should provide appropriate information to its clients about its order execution policy as required by Article 21(2) and Article 21(3) of MiFID, including detailed and easily understandable information about how exactly orders will be executed by the firm for the client. The information provided to clients should include, inter alia, information about the source(s) that order prices are derived from, and the factors used by the firm to determine the execution price, e.g. in the case that multiple pricing sources are used. The information provided should also make clear to the client the circumstances under which the execution price may differ from the evidenced **independent** market price, for example due to time delays.
14. When demonstrating to its clients, at a client's request, that client orders have been executed in accordance with the firm's execution policy, the firm should provide the client with the market data that the execution of the order in question was based on. In those cases where prices have been set at the firm's discretion, in order to demonstrate that such discretion has been exercised in accordance with the firm's order execution policy and in the best interests of clients, the firm should provide clients with all evidence needed to verify the firm's **compliance** with its order execution policy.

**Question 2 [last update 8 April 2016]: An online platform for trading CFDs remunerates its sales staff based on the volume and value of the CFD transactions executed by retail clients on the platform. Is it possible for firms to demonstrate **compliance** with MiFID conduct of business and conflict of interest requirements, where remuneration **policies** and practices link remuneration directly to the sale of financial instruments?**

**Answer 2:**

15. In assessing whether a firm meets its MiFID obligations to take all reasonable steps to prevent conflicts of interest from adversely affecting clients (Article 13(3) of MiFID), NCAs should consider the extent to which the remuneration **policies** and practices for staff involved in the distribution of products or investment services to clients encourage responsible business conduct and the fair treatment of clients, as well as avoid conflicts of interest in the firm's relationships with its clients. A firm should not remunerate the performance of its own staff when the activities to be remunerated are executed in a way that conflicts with the firm's duty to act in the best interests of its clients.
16. Paragraph 15 of ESMA's guidelines on remuneration **policies** and practices under MiFID<sup>17</sup> states that where firms' remuneration **policies** and practices link remuneration directly to the sale of specific financial instruments, or of a specific category of financial instrument, it is unlikely that such firms could, in this situation, demonstrate **compliance** with MiFID conduct of business or conflict of interest requirements. A firm offering CFDs and/or other speculative products to retail clients should not remunerate its sales staff based on the volume or value of the client transactions unless it can satisfy the relevant **NCA** that the conflicts of interest arising from such remuneration arrangements can be managed, in an

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be determined by the firm in accordance with its best execution policy and taking into account the specific market situation and the position of the client.

<sup>17</sup> ESMA/2013/606.



objective and demonstrable manner. If the firm cannot prevent and manage this conflict of interest, the firm should re-design such remuneration schemes.

17. Before offering a speculative product to a retail client such as a CFD or a binary option, a firm should assess whether the remuneration features related to the distribution of that product to specific target groups of clients comply with its remuneration policies and practices, and therefore do not create conduct of business or conflict of interest risks. This is particularly relevant in the case of firms offering CFDs and other speculative products to retail clients, given that these are complex products that may not be appropriate for a majority of retail investors. This process should be appropriately documented by the firm.<sup>18</sup>
18. The design of remuneration policies and practices is discussed in more detail in ESMA's guidelines on remuneration policies and practices under MiFID.<sup>19</sup> In the context of the provision of CFDs and other speculative products to retail clients, some examples of good practice include:
  - a. Subjecting an appropriate proportion of variable remuneration to a retention condition, e.g. not awarding the variable remuneration until a specific period of time has passed or until a particular event has occurred, in order to ensure that the variable remuneration takes into account the long-term outcome for the retail client speculating in CFDs or other similar products. The retention bonus is awarded only after the retention period ends or the retention condition is met.<sup>20</sup>
  - b. Linking the criteria for variable remuneration to the outcome of the staff member's activities in terms of acting in the best interests of the client, by applying an ex post adjustment measure to the variable remuneration, in cases where the staff member's activities lead to outcomes that are not in the best interests of the relevant clients, e.g. if it is identified that the staff member has failed to act honestly fairly and professionally in accordance with the best interests of the client, or in the case of poor customer service.<sup>21</sup>
19. Some examples of poor practice include:
  - a. If remuneration policies or practices provide an incentive for sales staff based on the recommendation of speculative financial products sold to retail clients whose needs may be better met by other products.
  - b. If any variable remuneration awarded to sales staff is related to transactions by clients where speculative products have been sold even though the client did not pass the appropriateness test, either because the client failed to demonstrate the

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<sup>18</sup> Paragraph 26 of ESMA's guidelines on remuneration policies and practices (MiFID) (ESMA/2013/606).

<sup>19</sup> ESMA/2013/606.

<sup>20</sup> Paragraph 19 of ESMA's guidelines on remuneration under MiFID (ESMA/2013/606) states: "Where remuneration is, in whole or in part, variable, firms' remuneration policies and practices should define appropriate criteria to be used to align the interests of the relevant persons or the firms and that of its clients. [...]"

<sup>21</sup> Paragraph 20 of ESMA's guidelines on remuneration under MiFID (ESMA/2013/606) states: "In determining the performance of relevant persons, firms should also take into account the outcome of their activities in terms of compliance with the conduct of business rules and, in general, with the duty to care about the best interests of clients."



necessary knowledge and experience criteria, or because insufficient information was provided regarding the client's knowledge and experience).<sup>22</sup>

20. In order for NCAs to assess a firm's compliance in its implementation of MiFID conflicts of interest and conduct of business requirements in the area of remuneration, the firm should have in place written remuneration policies, specifying in detail the performance objectives for the firm and staff, and the methods for the measurement of performance including the performance criteria and the structure of variable remuneration.

**Question 3 [last update 1 June 2016]: What conflicts of interest aspects should national competent authorities (NCAs) consider when a firm offering CFDs or other speculative products to retail investors makes use of other parties to perform activities, including conflicts of interest arising from remuneration arrangements with such parties?**

**Answer 3:**

21. It is commonly observed in this sector of the market that firms offering CFDs and other speculative products to retail clients engage third parties or other entities within the same group to perform certain activities on their behalf. Some examples include:

- a. The outsourcing of certain activities to call centres (e.g. the execution of marketing campaigns or the provision of client support services), located within the home Member State or in other Member States or third countries;
- b. The outsourcing of information-gathering activities required to support the client onboarding process (including for the assessment of appropriateness);
- c. The outsourcing of the provision of trading platform software solutions to specialist IT firms; and
- d. The use of specialist providers to provide educational or training materials for clients or potential clients.

22. When considering such arrangements, NCAs should ensure that it is not possible for a firm offering CFDs or other speculative products to retail clients to use any arrangement with another party to avoid discharging its MiFID obligations, including those relating to conflicts of interest under Articles 13(3) and 18 of MiFID. NCAs should also ensure that the responsibility for the outsourcing of critical or important operational functions remains with the authorised firm (Article 14(1) of the MiFID Implementing Directive) and that a firm entering into an outsourcing arrangement exercises due skill, care and diligence and avoids undue operational risk.<sup>23</sup>

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<sup>22</sup> Firms are also required to implement and maintain robust procedures to assess appropriateness, in accordance with the requirements in Article 19(5) of MiFID and Article 36 of the MiFID Implementing Directive.

<sup>23</sup> Section 1, Question 2 of this document also discusses key factors that NCAs should consider at authorisation and as part of ongoing supervision when a firm offering CFDs or other speculative products to retail clients makes use of outsourcing arrangements as part of its business model.

23. When entering into any commercial arrangement with a **third party** or an intra-group entity, the firm should identify, assess, manage, and disclose any conflict of interests arising from such an arrangement, including those arising as a result of the terms of the remuneration arrangements between the two parties. Some examples of remuneration arrangements that create conflicts of interest that should be managed or avoided include:
- a. A call centre providing marketing activities on behalf of an authorised firm, which is remunerated by the authorised firm based only on the sales or trading volumes of the authorised firm. In this case, the call centre may be incentivised to act in a manner that is not necessarily in the best interests of retail clients, for example by pursuing more aggressive marketing strategies. This is of particular relevance given that the speculative nature of CFDs and other similar products means they may not be appropriate for the mass retail market.
  - b. A firm outsources client on-boarding activity, including the gathering and provision of information relevant for the assessment of appropriateness, to a third party, and that **third party** is remunerated based only on the volumes of new clients on-boarded. In this case, the outsource provider may be incentivised to act in a manner that is not in the best interests of clients in order to maximise the numbers of new client accounts. This is especially important given that CFDs and other speculative products are complex products that may not be appropriate for a majority of retail clients.
  - c. A firm is acting as the client's trading counterparty and operates a CFD trading platform for retail clients that was developed and is maintained by a specialist IT service provider. If the IT service provider is remunerated based on the trading revenue or the profit and losses of the CFD trading platform, it may be incentivised to develop a platform that processes trades in a manner that maximises the profit of the firm, even where this is to the detriment of the interests of the firm's clients.
  - d. A firm engages a specialist financial education provider to provide online training for its clients and potential clients on how to use market data when deciding how to trade in CFDs or other speculative products. The education provider is remunerated by the authorised firm based on the volume of clients who received the online training and who subsequently trade CFDs or other speculative products with the authorised firm. In this case, the education provider may be incentivised to act in a manner that is not in the best interests of clients in order to maximise the number of clients transacting in CFDs or other speculative products.
24. By way of comparison, a **third party** or intra-group entity providing any of the above services that is remunerated by fixed fee (e.g. on an annual basis) would be less likely to make a financial gain or avoid a financial loss at the expense of a client as a result of this remuneration arrangement (Article 21 of the MiFID Implementing Directive).
25. When assessing the conflicts of interest arising from the use of third parties or intra-group entities that perform activities on behalf of a firm offering CFDs or other speculative products to retail clients, an **NCA** should consider at least the following aspects:

- a. How the firm establishes, implements and maintains an effective conflicts of interest policy that takes into account its relationships with other parties (Article 22(1) of the MiFID Implementing Directive). Where activities and functions are outsourced to another member of the same group, the firm's conflicts of interest policy should also take into account conflicts of interest arising from such intra-group arrangements, in particular given the link between the commercial interests of the firm and the other entities in the group that it is part of.<sup>24</sup>
  - b. Whether the remuneration arrangements in place between the firm and other parties are in compliance with the firm's conflicts of interest policy, to ensure that such arrangements do not impair the firm's duty to maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest from adversely affecting the interests of its clients. In particular, NCAs should consider whether the firm should be required to restructure its remuneration agreements with other parties to avoid or better manage any conflicts of interest presented by such agreements. Firms should not be permitted to over-rely on disclosure without adequate consideration as to how a conflict of interest may appropriately managed (Recital 27 of the MiFID Implementing Directive).
26. It is also important for NCAs to consider how the firm's organisational arrangements and internal controls enable it to supervise on an ongoing basis the activities of other parties performing services on behalf of the firm, to ensure that such activities are performed in compliance with the firm's MiFID obligations, including in relation to conflicts of interest. Furthermore, the arrangements in place between the firm and other parties performing critical or important operational functions should not impair the firm's duty to exercise due skill, care and diligence in outsourcing critical or important operational functions, or the ability and capacity of other parties to perform outsourced functions, services or activities reliably and professionally (Article 14(2) of the MiFID Implementing Directive). For example, an NCA may review the agreements and procedures in place between the firm and other parties performing activities on its behalf, including any key performance indicators agreed and regular reporting to the firm about the activities of the other party.
27. NCAs should pay particular attention to the arrangements in place if a firm engages another party to perform services on its behalf and that other party is located in another Member State or a third country. NCAs should assess whether the oversight and supervision by the authorised firm addresses the additional complexities presented by such cross-border arrangements, for example arising as a result of the geographical distance between the two parties, or if the activities of the other party are being performed in a language other than the language of the home Member State.
28. NCAs should also consider the principles of ESMA's guidelines on remuneration policies and practices (MiFID)<sup>25</sup> when a firm enters into any arrangement with another party to perform services on its behalf, to ensure that such an arrangement does not allow the firm

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<sup>24</sup> Section 2 Question 1 of this document considers the potential conflicts of interest arising from the relationship between a provider of CFDs or other speculative products dealing on own account and its hedging counterparties.

<sup>25</sup> ESMA/2013/606.

to avoid its MiFID conflicts of interest obligations. For example, in the case that a firm offering CFDs or other speculative products to retail clients outsources aspects of its client support services to a call centre, and the staff of that call centre can have a material impact on the service provided and/or corporate behaviour of the authorised firm, the same remuneration principles should apply to those staff employed by the call centre acting on behalf of the authorised firm that perform the equivalent activities of the staff that are or would be directly employed by the firm.<sup>26</sup>

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<sup>26</sup> ESMA's guidelines on remuneration policies and practices (MiFID) (ESMA/2013/606) state that relevant persons for the purposes of those guidelines are persons who can have a material impact on the service provided and/or corporate behaviour of the firm, including persons who are client-facing front-office staff, sales force staff, and/or other staff indirectly involved in the provision of investment and/or ancillary services whose remuneration may create inappropriate incentives to act against the best interests of their clients.

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## Section 3: Information provided to clients and potential clients about the functioning of CFDs or other speculative products, including marketing communications

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### 1. Introduction

1. MiFID requirements concerning the information to be provided to clients and potential clients are contained in Article 19(2) and Article 19(3) of MiFID and Articles 27-34 of the MiFID Implementing Directive. The general principle is that all information has to be fair, clear and not misleading, and that marketing communications must be identifiable as such. Appropriate information must be provided by investment firms to their clients and potential clients in a comprehensible form, including about the firm and its services, the risks associated with investing in financial instruments or in respect of particular investment strategies, and about costs and charges, so that investors are reasonably able to understand the nature and risks of the investment service and of the specific type of financial instrument that is being offered and, consequently, to take investment decisions on an informed basis.<sup>27</sup>
2. As CFDs and other speculative products are complex products and given that they may be sold online without the provision of investment advice, it is especially important that retail investors are provided with clear and unbiased information about the functioning of the products and in particular, the risks involved, so that they can make informed investment decisions. If retail investors are not able to understand the risks, costs and expected returns of CFDs or other speculative products, this increases the likelihood of consumer detriment (for example, unexpected losses).
3. This section identifies certain key aspects that NCAs should take into account as part of their supervisory activity when considering the quality of information provided to clients and potential clients about CFDs and other speculative products, including marketing communications.

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<sup>27</sup> In addition to MiFID requirements, pursuant to the PRIIPs regulation (Regulation EU No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products), from January 2017, those producing or selling CFDs, binary options and rolling spot forex will have to produce a key information document (KID) that presents standardised information about the characteristics, risks, performance and costs of the product.

**Question 1 [last update 25 July 2016]: What particular aspects should NCAs take into account when considering the information that firms present to clients and potential clients about the functioning of CFDs or other speculative products?**

**Answer 1:**

1. As firms in this sector of the market commonly offer CFDs and other products via online trading platforms, the information provided to clients and potential clients would typically be presented on the firm's website. This may be supported by the provision of information in downloadable format or via email.<sup>28</sup> It is important that firms ensure that all information provided in relation to the provision of CFDs or other speculative products is fair, clear and not misleading, to meet their MiFID obligations and to enable a retail client to make an investment decision on an informed basis.
2. Information should not be presented in a manner that is aggressive, misleading or biased. Some examples of bad practices that would not meet the MiFID requirement to present information to clients and potential clients in a manner that is fair, clear and not misleading include:
  - a. Website content or information presented in a language that is not an official language of the Member State where the services are to be provided, or presented in an official language of the Member State where the services are to be provided but based on translations of insufficient quality, such that this is likely to hamper the ready comprehension of the information presented;
  - b. Information spread over multiple different webpages or documents in such a way as to complicate its readability and comprehensibility;
  - c. Presenting information that emphasises the possible benefits associated with investing in CFDs and other speculative products without also giving a fair and prominent indication of the relevant risks, e.g.:
    - i. For leveraged products such as CFDs, focussing on the potential for increased returns without indicating the risk of multiplying losses; or
    - ii. Explaining the possible benefits in simple terms whilst describing the possible risks in ambiguous terms or using jargon that may be difficult to understand;
  - d. Suggesting that CFDs and other speculative products are suitable or appropriate for all investors (e.g. "trading binary options is as easy as 1-2-3");
  - e. Stating or implying that the firm is authorised by an NCA in one Member State when it is actually authorised elsewhere and is instead operating under the freedom to provide services in that Member State;

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<sup>28</sup> Mandatory information must be provided in a durable medium, pursuant to Article 29 of the MiFID Implementing Directive.

- f. Presenting marketing material that is not clearly distinguished from other information (such as legally required information or educational material) and, as a result, not recognisable as such (Article 19(2) of MiFID);<sup>29</sup> and
- g. Including a disclaimer (e.g. on the website or in the terms and conditions agreed with the client) stating that the firm “is not and shall not be responsible in any way for the accuracy of any information published on its website by itself or others.”

#### Information to be provided

- 3. In order to provide information that is fair, clear and not misleading, NCAs should monitor that firms offering CFDs and other speculative products to retail investors include at least the below information on their websites and in other relevant material.

#### *Information about the firm and the service(s) performed*

- 4. Information should be provided so that the retail client is reasonably able to understand the nature and risks of the investment service(s) that are offered and who will provide the service(s), including inter alia:
  - a. Information about the firm and its services, including any other key parties involved or with whom the client might be in contact during the course of the provision of an investment or ancillary service to the client, including intra-group entities, and the capacity and responsibilities of each party (such as the commercial and legal name of the party, its home country, its legal status, its authorisation (if authorised) and the name of the authority that provided the authorisation). This would include, for example, the investment firm itself, the custodian, the trading counterparty or execution venue, any firm providing marketing material or handling complaints. Information on other parties should also include a summary of measures adopted by the firm to select such parties and monitor the quality of their services or input after having been selected;
  - b. The firm's order execution policy (Article 21(3) of MiFID); and
  - c. Disclosures relating to the circumstances which constitute or may give rise to conflicts of interest and the procedures to be followed and measures adopted to manage such conflicts (Article 30(1)(h) of the MiFID Implementing Directive). In particular, where the firm is the clients' trading counterparty (i.e. is the other side of the client's trade), clients and potential clients should be informed of this. Where relevant, this disclosure should be sufficient to enable the client to understand that the firm may profit as a result of the client losing money (Article 18 of MiFID).<sup>30</sup>

#### *Information regarding the market and the product:*

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<sup>29</sup> Section 3, Question 2 in this document discusses controls over marketing communications in more detail.

<sup>30</sup> Section 2 Question 1 in this document discusses the conflicts of interest arising when a firm is the client's trading counterparty. It should be noted that firms should not over-rely on disclosure of conflicts of interest without appropriate consideration of how they may be managed (Recital 27 of the MiFID Implementing Directive).



5. Information should be provided so that the client can reasonably understand the nature of the product(s), including the key product features and other information about how the product operates.<sup>31</sup> This should include, inter alia:
  - a. For all OTC derivatives:
    - i. What the underlying asset is and how a derivative works;
    - ii. The fact that a product is sold OTC and not centrally cleared, as well as the implications of this;
    - iii. Where applicable, information about the software system used for the transmission and execution of orders, as well as relevant information to enable the client to use the software system appropriately; and
    - iv. The execution venues.
  - b. For CFDs and rolling spot forex contracts:
    - i. The concept of leverage and its implications (i.e. that losses as well as profits can be multiplied); and
    - ii. The implications of 'long' and 'short' positions when prices rise or fall.
  - c. For binary options:
    - i. The type of binary option concerned and how the instrument operates;
    - ii. The duration of the option;
    - iii. An explanation of call and put options;
    - iv. Pay-out ratios for losing and winning trades per type of binary option;
    - v. An adequate explanation of the strike price, the methodology of its calculation and the factors affecting its price; and
    - vi. An adequate explanation of the expiry price (including the reference value of the expiry price per different underlying asset of the binary option) and the methodology of its calculation.
6. In order to facilitate the retail client's reasonable understanding of the nature and risks of the products, NCAs should monitor whether firms provide clear numerical examples illustrating the key characteristics of the service and product offered, for example including

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<sup>31</sup> It should be noted that, pursuant to the PRIIPs regulation, from January 2017, a firm producing or selling CFDs, binary options and rolling spot forex will also have to present standardised information about the nature of the product and the types of investors to whom the product is intended, as part of the PRIIPs KID.



aspects such as leverage, margin calls or stop-loss mechanisms where relevant. Such examples should cover both negative and positive scenarios.

*Information regarding the price and pay-out:*

7. Information should be provided so that the client understands how the price of the instrument is derived, including:

- a. How and at which time the price of the underlying asset will be determined;
- b. Where the reference price will be obtained:
  - i. When dealing on own account, a firm should disclose how the relevant public reference price will be obtained (e.g. market, asset or benchmark, data) and the methodology for calculating any fees and charges, or a mark-up or mark-down.<sup>32</sup> If a firm dealing on own account bases the price it offers to its clients on a price provided to it by a liquidity provider or quotation provider, the firm should disclose information about quotation providers and liquidity providers, and the methodology used to calculate any fees and charges, or a mark-up or mark-down;
  - ii. When not dealing on own account, a firm should disclose the following information regarding its liquidity provider(s) used to determine the price:
    1. the exact name of the liquidity provider(s);
    2. where relevant, any intra-group links to the liquidity provider(s);
    3. the country of incorporation of the liquidity provider(s);
    4. the competent authority responsible for the authorisation and supervision of the liquidity provider(s);
    5. the pricing source of the liquidity provider(s), which should be publicly available; and
    6. the methodology for calculating any fees and charges, including any mark-up or mark-down; and
- c. How profits or losses for the client are related to the price of the underlying asset.

*Information about costs and associated charges*

8. Information should be provided that covers the elements set out in Article 33 of the MiFID Implementing Directive. This should include information distinguishing the different types of costs and charges, how they work, the impact of leverage on costs and charges (where

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<sup>32</sup> Section 2, Question 1 of this Q&A document also discusses the requirement to have a transparent pricing methodology.

relevant), and how costs and charges may impact on returns. In particular, the following elements should be disclosed:

- a. Any commissions charged - a general commission or a commission on each trade – i.e. on opening and closing a contract;
- b. If the firm adds any form of mark-up to market prices it receives from an external source, thereby increasing the spread for the client, the amount of the mark-up;
- c. Any financing charges that are applicable, such as daily and overnight financing charges for CFDs;
- d. If the firm makes a mark-up when calculating any financing charges, the amount of the mark-up;
- e. Where relevant, any costs and charges that are applicable if a client is seeking to sell or exit early; and
- f. Any applicable account management fees or taxes, which are not already included in the fair value.

#### *Information regarding risks*

9. Information should be provided so that clients are reasonably able to understand the risks associated with the service and instruments offered. This should include:
  - a. Risks associated with the underlying market;
  - b. Where relevant, a clear indication that the investor could lose more than the sum invested;
  - c. Where relevant, an explanation of the impact of the leverage, the level of leverage possible, and an explanation that leverage can increase the possible losses (as well as the possible gains);
  - d. Where relevant, an explanation of margin requirements, including that margin calls may occur and that not responding to a margin call may result in the closure of a position at the discretion of the firm (also known as automated margin close-out);
  - e. Where relevant, an explanation of the relationship between the margin and the level of leverage;
  - f. Where relevant, an explanation of stop-loss orders, which should include clear information about whether or not a stop-loss is “guaranteed” (i.e. it would operate whatever the market circumstances are), and that in the case that it is not guaranteed, it may not limit client losses in the event of highly volatile trading conditions in an underlying asset or reference price;

- g. Explanation that these products are generally designed for short-term trading and require regular monitoring, especially when positions are taken with higher leverage and/or in volatile market conditions; and
  - h. The risk of slippage, i.e. a divergence between the price at which a trade was approved and the price at which it was executed.<sup>33</sup>
10. In order to facilitate a retail client's reasonable understanding of the risks related to CFDs or other speculative products (Article 31 of the MiFID Implementing Directive), NCAs should consider requiring a firm offering such products to retail clients to disclose (e.g. on the firm's website) the percentage of client accounts that have won/lost over each of the previous four quarters as well as over a rolling one year period, as compared to the starting balance of the same client account at the beginning of the period. This percentage should be reflective of clients' trading performance and should be based on the amount of money that clients can effectively withdraw at the given point in time, i.e. after all relevant costs and charges have been applied, and excluding any trading benefits (such as bonuses or referral compensation), that do not equate to funds that can be withdrawn.
11. Information should also be provided about other relevant risks that impact the functioning of the product, including:
- a. Foreign exchange (FX) risk, where applicable; and
  - b. Counterparty risk related to the provider of the investment.

#### *Information about safeguarding of client assets*

12. Firms should provide information stating where client assets are held and what protective measures apply. For example, where client assets are held in a Member State that is different to the Member State in which the services are offered or in a third country, this should be expressly stated along with a description of the relevant protections (such as compensation schemes) in that Member State or third country, including that such protections may differ from those in the Member State in which the services are being offered.

#### *Information about complaints*

13. Firms should disclose to clients and potential clients the existence and details of the complaints procedure they are required to establish, in accordance with Article 10 of the MiFID Implementing Directive.

#### Presentation and timing of information

14. NCAs should monitor that the information provided by firms is appropriate for the target audience, i.e. retail clients. The level of detail provided should be proportionate to the complexity of the product, i.e. the more complex the product, the more detailed the

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<sup>33</sup> Section 2, Question 1 of this document notes that a firm dealing on own account should not take advantage of slippage to act in a manner that benefits the commercial interests of the firm, to the detriment of its clients (so-called asymmetric price slippage).

information should be in order to facilitate the retail client's understanding. Technical terms should be explained in a straightforward manner and firms should avoid using jargon or ambiguous terms such as "absolute" or "hedged."<sup>34</sup>

15. NCAs should also monitor that all information is provided in an easily accessible and comprehensible form. For example, webpage titles and menu titles should be self-explanatory. Information should be provided in an official language of the Member State in which the services are being offered and, where such information is based on a translation, the translation should be of sufficiently high quality and should not impede the retail client's understanding.
16. In addition, information that must be provided pursuant to Article 29 of the MiFID Implementing Directive should be provided in a durable medium (as specified in Article 29(4) of the MiFID Implementing Directive).
17. The timing of the provision of information is an important factor impacting the retail client's ability to understand the nature and risks of the investment service and of the specific type of financial instrument that is being offered and, consequently, to take investment decisions on an informed basis. Pursuant to Article 29 of the MiFID Implementing Directive, information about trading CFDs or other speculative products should be provided in good time before a retail client or potential retail client is bound by any agreement or provided with any services, i.e. prior to a trading account being opened.

**Question 2 [last update 25 July 2016]: How can national competent authorities (NCAs) assess a firm's oversight over the marketing communications used to offer CFDs or other speculative products to retail clients?**

**Answer 2:**

18. As a result of their complexity, CFDs and other speculative products are not appropriate for the majority of retail clients. ESMA's Opinion on MiFID practices for firms selling complex products states that "NCAs should monitor that trading platforms that give access to complex products only market complex products to those clients for whom they would be potentially suitable, or appropriate (where the client would possess the necessary level of knowledge and experience)."<sup>35</sup>
19. When marketing CFDs or other speculative products, given that they may not be appropriate for a majority of retail investors, particular attention should be given to ensuring that any client communication is fair, clear and not misleading.
20. This is to be contrasted with bad practices reported of aggressive or misleading mass marketing communications, mostly appearing online, often also implying that speculative products such as CFDs, binary options and rolling spot forex are suitable or appropriate for the mass retail market and/or are more likely to result in profits than losses, without insufficient referring to the risks involved. Examples of communications that NCAs and

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<sup>34</sup> ESMA's Opinion on MiFID practices for firms selling complex products (ESMA2014/146) (p.7).

<sup>35</sup> ESMA/2014/146 (p.3).

firms should regard as not clear, fair and not misleading in relation to these products include the following kinds of statements:

- a. "1 click 60 seconds 85% profit"
- b. "Trading has never been so easy"
- c. "Gain up to 85% return every 60 seconds"
- d. "Start your career as a trader right now"
- e. "Suggestions are great – it is hard not to win"
- f. "95% return in a few minutes"
- g. "Our Pro signals have been tested to have over 65% daily success rates"
- h. "What can you do in 60 seconds? Trade binary options and double your money."
- i. "Learn how to turn market opportunities into profit"
- j. "\$10,000 – Get your bonus now."

21. NCAs should monitor that firms have in place adequate internal controls over the processes of developing and using marketing materials to offer CFDs or other speculative products to retail clients, in order to avoid detrimental practices towards clients. Those responsible for approving marketing material should fully understand the nature and workings of the complex product offered. Given the risks associated with distributing CFDs or other speculative products to retail clients, the compliance function should play a crucial role in this process, for example by assessing and pre-approving all communications used by the firm. This should include an assessment of the content of marketing communications and publicity as well the selected distribution channels for such material, with the aim of ensuring consistency with the likely target market in view of the complexity of CFDs and other speculative products and the fact that they are not appropriate for a majority of retail clients. Certain marketing communications and promotional activity, for example in the form of sponsorship affiliations with sports teams, may result in the firm giving the misleading impression to its potential clients that CFDs or other speculative products are appropriate for the mass retail market.

22. Moreover, the firm's controls should include verifying that marketing communications are actually distributed as approved, i.e. without any changes being made subsequent to the assessment and approval by the compliance function. The firm's processes and internal controls relevant to the development and distribution of marketing communications should be documented.

23. The firm's internal control framework should be adequate to ensure that all its marketing communications are fair, clear and not misleading, including those distributed in other jurisdictions or by other parties. Where a firm issues marketing communications in other languages or other Member States (operating under the freedom to provide investment

services and activities), or where a firm uses another party to distribute marketing communications on its behalf, NCAs should pay particular attention to the firm's oversight and controls over marketing activity in order to assess whether the additional complexity presented by such arrangements is adequately reflected in the firm's policies and processes. NCAs should consider the following aspects, inter alia:

- a. How the firm ensures that the content and distribution of marketing materials issued in languages other than the language of the home Member State are compliant with the relevant MiFID obligations;<sup>36</sup> and
  - b. What arrangements the firm has in place to oversee and monitor the activities of other parties issuing marketing communications on its behalf, including affiliates or intra-group entities.
24. Especially in these types of cases, NCAs should request all information necessary to assess the firm's oversight and controls over marketing activity, for example, by asking the firm to evidence its process for producing marketing materials including the design, drafting, translation and distribution of material, and the relevant approval processes. The firm should be able to demonstrate all current marketing materials in circulation at any particular point in time. The firm should also be able to provide translations of marketing material, where relevant, to demonstrate that its marketing communications are MiFID compliant.
25. Moreover, ESMA considers that NCAs should themselves review marketing materials relating to CFDs or other speculative products, whether on an ex-ante or a timely ex-post basis. NCAs should take into account that ESMA's 2014 peer review on this topic<sup>37</sup> concluded that complex products such as CFDs, binary options or rolling spot forex should be a focus of NCA's supervisory activity in relation to marketing communications.

**Question 3 [last update 25 July 2016]: Under what circumstances might the activity of an education provider be considered to be the provision of marketing communications?**

**Answer 3:**

26. NCAs should ensure that firms under their supervision providing marketing communications to potential or actual retail clients do so in accordance with the relevant MiFID requirements. If educational material, such as training, seminars or 'webinars' on trading in CFDs or other speculative products, is in fact marketing material, it should be (i) clearly identifiable as such, and (ii) fair, clear and not misleading. This implies, for example, that any marketing communication provided by an education provider to retail clients about trading in CFDs or other speculative products showing the possible positive returns should also include examples of the possible negative returns. Such communication should also make explicit that past performance is not an indication of possible future performance.

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<sup>36</sup> The firm should also have processes in place to ensure that it complies with relevant legislation or regulation applicable in all the Member States where the firm is active.

<sup>37</sup> ESMA/2014/1485.

27. Whilst MiFID does not require NCAs to pre-approve marketing communications, NCAs should **assess** whether a firm offering CFDs or other speculative products uses education providers to market CFDs or other speculative products to retail clients. NCAs should consider, for example, whether the nature and scope of any 'webinars' or other educational material are clearly stated to the retail client, including who is providing the educational material and whether the material is for commercial or educational purposes (for example, whether the educational material is intended to market the services of an authorised firm, designed to provide training about the products, intended to provide an explanation of the functionality of a particular trading platform, etc.). NCAs should also consider the remuneration arrangements between an authorised firm and an education provider and the extent to which there are common ownership structures or any other close links between the education provider and the authorised firm, in order to **identify** instances where an education provider may be incentivised, in pursuing its commercial interests, to perform marketing activities on behalf of the investment firm without this being clearly identified as such, or to otherwise act in a manner that is not in the best interests of its clients.
28. If the material issued by an education provider introduces clients to platforms or products offered by them, or otherwise has the intent or effect of guiding potential clients towards opening an account with a particular firm, this should in ESMA's view be considered as a form of marketing. In such cases, an **NCA** should consider whether it is clearly notified to training participants, website users and other recipients of 'educational' material that the materials are offered for promotional purposes and do not entail any obligation to purchase investment services from the firm.
29. Where an education provider that is not an authorised entity is effectively introducing clients to a particular authorised firm, for example because of the content of the material it issues or the nature of the activities it performs, or if the education provider has financial or other close links to the firm, the **NCA** should consider whether the education provider is in fact acting as a tied agent of the authorised firm.<sup>38</sup> If the education provider is deemed to be a tied agent and the applicable Member State allows for the use of tied agents, the **NCA** should ensure the authorised firm has sufficient **oversight** and responsibility over the activities of the tied agent and that the tied agent is appropriately registered (Article 23 of MiFID). If an education provider is not considered to be a tied agent but is in fact performing MiFID investment services or activities, it should be an authorised investment firm. In such cases, the **NCA** should require the firm it has authorised to ensure that the education provider seeks the necessary authorisation, or to desist from carrying out such activities. In these types of cases, the **NCA** should also consider whether the arrangements that the authorised firm has in place are adequate to ensure that all the relevant MiFID obligations are met when it enters into a commercial arrangement with an education provider.

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<sup>38</sup> In some cases, the activities of an education provider may require an authorisation or notification under applicable national regulation, even where such activities are not MiFID investment services or activities.



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## Section 4: The assessment of appropriateness when offering CFDs or other speculative products to retail investors

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### 1. Introduction

1. Due to the nature of CFDs and other speculative products, they are more difficult to understand and are appropriate only for experienced retail investors. This is reflected in the requirement to **assess** appropriateness as part of the account opening process, where such products are not sold with investment advice. Firms offering CFDs or other speculative products to retail clients without advice are required by Article 19(5) of MiFID to seek information from a client or potential client about his or her **knowledge** and experience (i.e. ability) to understand the risks involved with the product or service. The objective of this obligation is to enable the firm to determine whether the product or service is appropriate for the client. Article 37 of the MiFID Implementing Directive sets out a non-exhaustive list of information that the firm will need to ask the client in order to evaluate his or her **knowledge** and experience, and also provides that the precise components should vary according to the nature of the client, the nature and the extent of the service to be provided, and the type of product or transaction envisaged.
2. It is important that firms offering these products to retail investors adopt robust processes to **assess** the **knowledge** and experience of retail clients and potential retail clients, to check whether they understand the risks involved and to determine whether CFDs or other speculative products are appropriate for them.
3. This section sets out certain key aspects that NCAs should consider as part of their supervisory activity, when evaluating how firms **assess** the appropriateness of CFDs or other speculative products for retail clients.



**Question 1 [last update 25 July 2016]: What information should be gathered by firms to assess the appropriateness of CFDs and other speculative products for retail clients?**

**Answer 1:**

1. NCAs should pay particular attention to the assessment of appropriateness when a firm offers CFDs or other speculative products to retail investors, given that these are complex products that are not appropriate for a majority of retail investors.<sup>39</sup> First of all, it is important that the assessment of appropriateness is introduced to the potential client in an objective manner. The test should be presented as assessing the client's financial experience and knowledge with a view to determining whether specific financial products are appropriate. The test is therefore in the client's interest, and should be presented as such, rather than a 'tick box' exercise.
2. In order to be able to assess the appropriateness of CFDs or other speculative products for retail investors, firms should ensure that the information collected about the client's knowledge and experience is sufficiently detailed and granular, including covering the specific product to be traded and the relevant underlying asset class. The more complex or risky the instrument is, the more detailed the information collected by a firm should be in order to be able to correctly assess the appropriateness of the product for a retail investor, especially when there may be no face-to-face contact with the client, as is common in this sector (i.e. in an online or telephone sales environment).
3. Firms in this sector typically seek information about the knowledge and experience of clients or potential clients by asking questions, usually in the form of a questionnaire. The questionnaire may be completed directly by the client or potential client (e.g. in an online environment, on a webpage). Alternatively, a sales representative may ask a client or potential client to answer questions, e.g. on the telephone or face-to-face. The answers provided to the questions asked are then used by the firm as a basis to ascertain the client or potential client's knowledge or experience to understand the risks of CFDs or other speculative products.
4. When a firm uses a questionnaire to collect information that is used to establish knowledge and experience, the firm should include different types of questions depending upon the precise characteristics of the product(s) at stake, and the responses provided by the client. Firms offering CFDs or other speculative products should therefore ask specific questions to identify relevant experience and knowledge of the retail client of both the underlying asset and market, and types of speculative financial instruments that will be offered to the client. For example, the questions designed to ascertain a retail investor's knowledge and experience, to trade in binary options (which are not usually leveraged products, but do require an understanding of probabilities) should be different from the questions designed to assess a retail investor's knowledge and experience to trade in CFDs, which incorporate the element of leverage.

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<sup>39</sup> This Q&A should be read in conjunction with ESMA's supervisory briefing on appropriateness (ESMA/2012/851).

5. Bad practices that have been observed in this sector of the market include:

- a. Asking overly broad questions (e.g. asking questions about knowledge and experience in trading financial instruments in general, not specific to the speculative products to be traded);
- b. Asking questions that are overly reliant on the investor's self-assessment of his or her knowledge and experience, without sufficient information gathering to allow the firm to independently assess whether the responses provided can be regarded as accurate;
- c. At the extreme, using binary (yes/no) questions (e.g. "do you understand the risks associated with trading CFDs?") without collecting any / sufficient supplementary information; and
- d. Using information that is not relevant to the assessment of appropriateness or that does not necessarily demonstrate the client's knowledge and experience of the product or service as the basis for concluding that the product or service is appropriate for the client, such as:
  - i. the client possessing certain personal characteristics (home ownership/ disposable income/ a certain value of assets under management);
  - ii. the client having opened a 'demo' or training account without ascertaining whether the demo or training account has ever been used or has actually enhanced their knowledge of the products/services offered; or
  - iii. allowing incorrect or 'don't know' answers to contribute towards the demonstration of knowledge or experience.

6. Some good practice examples include:

- a. The use of questions that test the client's understanding of the key characteristics of the product or service (e.g. through the use of multiple choice questions), rather than relying on the client's self-assessment of knowledge and experience;
- b. When a scoring metric is used to assess appropriateness, only relevant criteria is entered into the metric, i.e. answers that demonstrate actual knowledge and experience that is specific to the type of financial products envisaged, while incorrect answers or 'don't know' are given zero scoring or are included in the scoring metric in a manner that reduces the likelihood of the products or services being assessed as appropriate;
- c. When a scoring metric is used, the answers to more pertinent questions are weighted more heavily, e.g.:
  - i. more weighting is given to the demonstration of actual trading experience than the demonstration of theoretical knowledge;

- ii. trading experience in CFDs or other speculative products over a longer period is weighted more heavily than a relevant trading experience a shorter period;
    - iii. length of trading experience is not considered in isolation, but is instead scored also on trading volume with higher activity levels weighted more heavily; and
  - d. The questions and possible answers (where multiple choice questions are used) are displayed in a randomised order, so that the content of the appropriateness assessment appears in a different order each time the test is taken.
7. NCAs should ensure that, when a firm determines the appropriateness of CFDs or other speculative products for a retail client, a 'pass' is consistent with a client demonstrating the requisite knowledge and experience to understand the risks involved and to make informed investment decisions.
8. NCAs should also pay close attention to the way that information is presented to retail clients and potential retail clients when they complete an appropriateness test, both when the client completes the assessment directly, or when the client provides information to a sales representative. The client should not be prompted to complete the appropriateness test in such a way as to influence its likely outcome, to allow for the 'gaming' of the appropriateness test, or to support or encourage the possibility for the client to not provide the necessary information.

### *Experience*

9. In the context of CFDs and other speculative products, the information to be collected to determine the experience of clients should include the following, inter alia:
- a. Information about the client's previous experience of trading relevant financial instruments:
    - i. For CFDs:
      - 1. Previous trading in CFDs or similar speculative instruments such as rolling spot FX; and
      - 2. Previous trading in other derivative instruments traded with margin, such as futures or options.
    - ii. For binary options: previous trading in binary options or other similar products.
  - b. Information about how often and / in what volumes the client has traded in each relevant instrument, e.g. within the last 12, 24, 36 months (None, 1-5, 6-10, more than 10, etc), the value of the trades carried out (X €, y €, etc) and, where relevant, the common level of leverage of previous trades.

- c. Information about the client's professional experience, e.g. whether the client has worked in a financial services firm in a role that is relevant to trading in OTC leveraged financial instruments (e.g. for at least one year, within the last 3 years etc.).

### Knowledge

10. In order to be specific enough to enable the firm to assess correctly the appropriateness of a product for a given retail client, questions about the client's knowledge should assess his or her understanding of at least the key risk areas for each product that will be offered, such as:
  - a. The characteristics of the product, including its nature as a derivative product and the relevant underlying assets;
  - b. The characteristics of the underlying asset, including the main market factors that determine its price;
  - c. The implications of the OTC character of the product, including that there is counterparty risk and the client will remain in a principal-to-principal contract once they have opened a position (i.e. they will have to close their position with the same counterparty);
  - d. For CFDs and rolling spot forex, the concept, effects and risks of leveraged trading, both in a normal trading environment and in stressed market conditions;
  - e. For CFDs and rolling spot forex, how negative price movement in the underlying can potentially lead to a margin call and the subsequent triggering of an automated margin close-out of positions;
  - f. Where relevant, the effect of different types of orders, in particular, where relevant, stop-loss orders (including explanation of the difference between an ordinary and guaranteed stop loss);
  - g. For binary options, the application of probability theory and the asymmetric risk/return profile of the instruments.
11. The assessment of knowledge should also take into account information about academic or professional experience that may demonstrate knowledge relevant to trading in CFDs or other speculative products. Information requested about educational qualifications should be sufficiently granular. Firms should not count general education, courses or qualifications in non-financial service related topics as relevant knowledge for trading in CFDs or other speculative products.
12. NCAs should pay particular attention to how firms take into account information about a client or potential client's use of 'demo' or training (i.e. not real-life) trading accounts. The use of demo accounts should only be counted as contributing towards the demonstration of knowledge if a firm can demonstrate that: (a) the client has actually used that demo account for a sufficiently long period of time and has carried out a number of trades in

relevant instruments; and (b) the client has acquired sufficient knowledge of the products that will be accessible to him on the live platform as a result of the use of such a demo account. Where a client or potential client indicates that he/she has a demo account, the firm should nonetheless assess and evidence that the client has sufficient knowledge and experience based on their understanding of the key features and risks of the products/services offered, as noted in the preceding paragraphs.

**Question 2 [last update 25 July 2016]: What action should a firm take where the assessment of appropriateness indicates that a CFD or another speculative product is not appropriate for a client, but the client wishes to proceed with the transaction?**

**Answer 2:**

13. Taking into account the complex nature of CFDs and other speculative products and the best interests of the client, in cases where the assessment of appropriateness indicates that the product or service is not appropriate for a retail client or where insufficient information is available to assess appropriateness, the best practice would be for the firm to not allow the client to proceed. ESMA (CESR)'s MiFID Q&A dated 9 July 2009<sup>40</sup> states that if a client wishes to proceed with a transaction after the client has been given a warning, it is for the investment firm to decide whether to do so, having regard to the circumstances of the case.<sup>41</sup> The same Q&A also notes that in such cases, it may be prudent for the investment firm to ask the client or potential client to confirm in a durable medium his or her intention to proceed with the service.
14. NCAs should monitor that, if a firm offering CFDs or other speculative products to retail clients chooses to permit a client to proceed with a transaction, the warning provided by the firm and the resulting confirmation given by the client are not presented as a 'tick-the-box' exercise. For example, the warning should be designed in such a way that it is an actual interruption in the process of authorising the opening of an account or entering a particular transaction. The warning should be stated in clear language, indicating that, on the basis of the answers provided, the specific product or service in question is not appropriate for the client as the client is not likely to understand the risks involved. It should also recommend clearly that the client does not proceed. When presenting the warning, confirming an intention to proceed with the transaction should not be presented to the retail client as the first logical next step. Good practice examples include:
  - a. Including a mandatory 'cooling off' period after the provision of a warning, to demonstrate that the client has considered the information presented in the warning before deciding whether to proceed; and/or
  - b. Requiring the client to sign and return a form or to respond to a separate email, which includes a warning such that the client must separately acknowledge its

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<sup>40</sup> CESR/09-697.

<sup>41</sup> Taking into account the best interests of the client, this may also include a firm offering CFDs or other speculative products to retail clients, considering any additional information it has about the client before determining whether to allow the client to proceed or not (regarding this topic, see Section 4 Question 3).

receipt and contents, and such that the client does not have the option to proceed immediately.

15. Overly generic or vague warnings, e.g. stating that the product or service “may not be appropriate” for the client are unlikely to make the client sufficiently aware of the risks of proceeding. Other bad practice examples include: warnings that include the ability to immediately retake the assessment (e.g. via a website link); overly long warnings that obscure the key message that the client has failed to demonstrate the necessary knowledge and experience for the product or service; and warnings containing language specifically designed to encourage the retail client to agree to a disclaimer and proceed with the transaction.
16. If a client who fails the appropriateness test is directed towards educational tools, webinars or ‘demo’ trading platforms with the aim of improving his or her knowledge and experience to trade CFDs or other speculative products, the firm should subsequently conduct another appropriateness test before determining whether the product or service is appropriate for the client.

**Question 3 [last update 25 July 2016]: In addition to information collected to establish the knowledge and experience of the client, how should a firm offering CFDs or other speculative products consider other information that may be available relating to the client’s situation?**

**Answer 3:**

17. Apart from the collection of information about knowledge and experience that is required for the assessment of appropriateness, it may be common for firms in this sector to collect other information about their clients, for example during the client on-boarding process or as part of the firm’s internal assessment of credit risk (in particular due to the characteristics of products such as CFDs that incorporate the use of leverage). This may include information related, among other things, to the client’s personal or financial situation.<sup>42</sup>
18. Where the appropriateness assessment indicates that CFDs or other speculative products are not appropriate for a client, and the client has been warned accordingly but nonetheless wishes to proceed, it would be good practice for a firm, in acting in the best interest of the client, to consider any additional information it has about the client before it decides whether or not to allow the client to proceed. NCAs may reasonably expect the firm to not permit a prospective client to proceed if, for example, the firm is in possession of information that indicates potential vulnerability, e.g. due to the client’s age and/or financial situation.
19. In the case that a retail client wishes to proceed with a transaction and the firm has not determined that the client should not continue (having taken into account the results of the appropriateness test, the best interests of the client and the circumstances of the case),

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<sup>42</sup> Although it may be good practice for the firm to use such information where it is available to them (as discussed in this Q&A), it should be noted that this does not imply that firms are required to collect such additional information (e.g. about the client’s financial situation), or that an assessment of suitability is required, unless the products are sold with investment advice.

the firm could nonetheless consider whether the product or service to be offered to the client should be adapted based on the information gathered as part of the assessment of appropriateness. For example, if a client has demonstrated limited or no actual experience of trading in CFDs or other speculative products compared to their indicated knowledge of the product, whether or not the client passed the appropriateness test, it may be in the client's best interest, if the firm chooses to allow the client to proceed in such a situation, to limit the level of leverage available to that client and/or to limit the sum that the client can invest, in any one transaction for a period of time (e.g. in their first 12 months of trading).

20. A firm offering CFDs or other speculative products to retail clients without investment advice should not, however, use any additional information collected about the client's situation to count as a demonstration of knowledge and experience for the purposes of artificially "passing" the appropriateness test.<sup>43</sup> For example, the service or product should not be considered more appropriate for a wealthier client than for a less wealthy client, given that the financial position of the client does not indicate any particular knowledge or experience relevant to the product or service being offered.
21. A firm would not be meeting its MiFID obligations if it uses any information it has obtained about its clients, to act in a manner that is not in the clients' best interests, for example targeting wealthier clients to encourage them to place higher deposits in their trading accounts or to make bigger trades.

**Question 4 [last update 25 July 2016]: What methods can NCAs use to assess whether the appropriateness assessment is being performed correctly?**

**Answer 4:**

22. Several means of assessment are available to NCAs when evaluating whether an authorised firm is continuously in compliance with its MiFID obligations, ranging from investment firms self-reporting on the application of the MiFID conduct of business rules to mystery shopping, desk-based reviews and on-site inspections.
23. NCAs should assess the quality and relevance of the information collected by firms offering CFDs and other speculative products to retail clients, and how that information is used to assess the appropriateness of the product or service for a given retail client. NCAs should therefore consider at least the following aspects:<sup>44</sup>
- a. The nature and content of the questions asked by the firm (e.g. are there a sufficient number of questions? Are the questions clear? Is self-certification by the client of his or her level of knowledge or experience avoided, or supplemented by objective questions/criteria?);<sup>45</sup>
  - b. The methodology or scoring mechanism used to determine if a product or service is appropriate (i.e. does the methodology or scoring system correctly take into

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<sup>43</sup> Section 4, Question 1 discusses the content of the appropriateness test in more detail.

<sup>44</sup> This Q&A should be read in conjunction with ESMA's supervisory briefing on appropriateness (ESMA/2012/851).

<sup>45</sup> Section 4, Question 1 considers the content of the appropriateness test in more detail.



account information collected to determine the retail client's knowledge and experience to trade CFDs or other speculative products and avoid 'pass' scores resulting from non-relevant information?);

- c. The content of warnings made to clients for whom a product or service is not appropriate, or where insufficient information is available to assess appropriateness (e.g. Do warnings clearly state the product is not appropriate for the client based on the answers they have provided and clearly emphasise that the client should not proceed with the application? How is the warning provided and how is the client requested to confirm his or her intention to proceed?);<sup>46</sup> and
  - d. The process adopted by the firm to deal with 'insistent' clients who wish to transact in CFDs or other speculative products, even after having been warned that the product or service is not appropriate for them.<sup>47</sup>
24. NCAs should also consider whether CFDs or other speculative products and associated services offered are in line with the client profile established as part of the assessment of appropriateness.
25. NCAs can also assess the quality of the firm's assessment of appropriateness as well as identifying potential compliance issues by considering: (i) the proportion of clients passing the appropriateness test; (ii) the proportion of clients not passing the appropriateness test, both where they did not demonstrate sufficient knowledge and experience and where there is insufficient information available to assess appropriateness; and (iii) the proportion of clients proceeding to trade where they have not passed the appropriateness test. A high proportion of 'pass' results may be an indicator that the quality of the appropriateness assessment requires review. Whilst a higher proportion of clients not passing the appropriateness test could potentially be an indication of a robust assessment of appropriateness, in the case that a significant proportion of the business of a firm is based on the sale of CFDs or other speculative products to retail clients who have failed to demonstrate sufficient knowledge and experience to understand the risks involved but have nonetheless proceeded to trade in such products, this could indicate that the firm is not acting in the best interests of its clients. ESMA's opinion on MiFID practices for firms selling complex products<sup>48</sup> also states that NCAs should carefully monitor internal controls and processes of firms that have a consistently high number of clients that refuse to provide information for the appropriateness assessment.
26. When performing an on-site inspection, an NCA can examine the following records to assess the quality of the assessment of appropriateness: (a sample of) records of the assessment of appropriateness performed for clients; transaction records, including transactions made following a warning that the product or service is inappropriate for the client or that the client has not provided the necessary information to assess appropriateness; records of other measures adopted by the firm when the client has not

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<sup>46</sup> Section 4, Question 2 sets out the steps that a firm should follow in such cases.

<sup>47</sup> Section 4, Questions 2 and 3 consider such cases.

<sup>48</sup> ESMA/2014/146.



demonstrated sufficient knowledge and experience in CFDs or other speculative products; and relevant voice recordings.<sup>49</sup>

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<sup>49</sup> Article.13(6) of MiFID provides that the need for records to be kept is determined based on the necessity “to enable the competent authority to monitor compliance with the requirements under this Directive.”

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## Section 5: Factors for NCAs to take into account when considering commercial arrangements between two authorised firms that result in the offer of CFDs or other speculative products to retail clients

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### 1. Introduction

1. There are several ways that an authorised firm offering CFDs or other speculative products may seek to make use of commercial arrangements with other authorised firms as part of its business model. Such commercial arrangements can operate in different ways, and may even be referred to by different names at national level.
2. This section describes some examples of certain commercial arrangements that are observed in this sector of the market and identifies key aspects that NCAs should take into account when considering such arrangements, when assessing a request for authorisation and/or as part of ongoing supervisory activity. It does not endorse any such arrangements and it should be noted that in providing investment services to clients, authorised firms must meet all relevant MiFID obligations.
3. An NCA should request all necessary information to understand any proposed arrangements between a firm offering CFDs and other speculative products to retail clients and another authorised firm, in order to assess how the risks arising from such commercial agreements will be managed to ensure that the relevant MiFID conduct of business and organisational requirements will be met, and to ensure that all parties involved in the provision of investment services and activities are appropriately authorised.

**Question 1 [last update 25 July 2016]: A MiFID investment firm (Firm B) offers an online equity and funds trading platform for retail clients. Firm B wishes to also offer its retail clients the possibility to trade CFDs online. In order to do so, Firm B negotiates a partnership arrangement with another authorised MiFID investment firm that already offers an online CFD trading platform (Firm A). Under the terms of the agreement between Firm A and Firm B, Firm B will introduce its existing retail clients to use the platform offered by Firm A. Firm A will provide a bespoke version of its CFD trading platform to reflect aspects of Firm B's branding and will link its CFD trading platform to the equity and funds trading platform already offered by Firm B.**

**What key aspects should an NCA take into account when considering this type of partnership arrangement?**

**Answer 1:**

1. A commercial arrangement such as the partnership arrangement described in the example above should in no way diminish the regulatory obligations owed to clients for the MiFID investment services and activities provided by either Firm A or Firm B. Indeed, such partnerships should align regulatory obligations with commercial incentives, since Firm B will have some reputational risk as a result of its association with the CFD provider (Firm A), and Firm B should perform due diligence given that it will clearly disclose and introduce the services offered by Firm A to its retail clients.
2. NCAs should carefully assess, as part of a risk-based supervisory approach, the terms of such commercial partnership arrangements and how they are conducted in practice to ensure that, in this example, a retail client introduced by Firm B to Firm A's trading platform understands who is providing the CFD trading platform and to ensure that all relevant MiFID obligations are met by Firm B and Firm A, as detailed in the paragraphs below. Firm B may also, as part of the terms of its contractual agreement with Firm A, set minimum performance requirements to be fulfilled by Firm A, to ensure that the clients introduced by Firm B receive a high level of customer service.

#### Firm B

3. Firm B is an authorised firm, although in the partnership arrangement described above it is introducing its existing retail clients to Firm A for the provision of MiFID investment services and activities relating to CFDs that it does not itself directly offer. On that basis, NCAs should ensure that Firm B:
  - a. Ensures its own client communications with respect to introducing the services of Firm A are clear, fair and not misleading (Article 19 MiFID). This should include, for example, making clear that the client will enter into a separate agreement with Firm A for the MiFID investment services and activities relating to CFDs or other speculative products, and is not a client of Firm B for the purposes of such services. Firm B should also ensure that, in the tailoring of the platform carried out by Firm A as part of their agreement, it remains clear and prominently displayed that Firm A is the service provider to the client once they take up that service, notwithstanding the fact that Firm B may wish to indicate its association in the partnership;

- b. Firm B should ensure that, if it passes on any client information to Firm A in the process of mediating an instruction on behalf of the client, such client information is complete and accurate (Article 20 of MiFID). Firm A will however be responsible for taking the necessary steps to conclude a client agreement for the provision of investment services and activities in relation to CFDs, including for example carrying out an assessment of the appropriateness of the product or service offered (see also paragraph 8 below);
- c. Firm B should also identify whether, in relation to the other investment services and activities it provides to its client, the introducing 'partnership' arrangement with Firm A gives rise to any potential conflicts of interest and if so take steps to prevent or manage these. This may include disclosing any payments it receives from Firm A as part of the arrangement, to the extent that they could influence the services Firm B provides to that client (Article 18 MiFID).

#### Firm A

4. In this example, Firm A is authorised to execute orders and deal on own account in relation to CFDs. Firm A owes the client all relevant MiFID duties and obligations for these services. As a consequence, NCAs should consider the following key areas in relation to Firm A's partnership arrangement with Firm B.

#### *Information provided to clients and potential clients*

5. Firm A is responsible for providing the retail client with clear, fair and not misleading information about the firm and the services offered (Article 19(3) of MiFID and Article 30 of the MiFID Implementing Directive), including information about CFDs and their risks (Article 31 of the MiFID Implementing Directive), information about costs and charges (Article 33 of the MiFID Implementing Directive) and information on how client financial instruments or funds will be held (Article 32 MiFID Implementing Directive).<sup>50</sup>
6. In particular, because in this example the retail client will use a CFD trading platform interface that incorporates elements of Firm B's branding, the identity of Firm A as the CFD platform provider should be clearly disclosed, including the fact that it is a distinct and separately authorised firm, and its location and contact details. In all relevant documentation, including website material, it must be clear to the client that Firm A is responsible for all aspects of the MiFID services and activities related to CFDs, and not Firm B. The platform presented to the client for trading purposes should also clearly and prominently indicate that Firm A is the provider. Notwithstanding that Firm A's association with Firm B may be indicated, the documentation, the website material and/or trading platform should not present the retail client with the overall impression that the CFD trading service is offered by Firm B. Some examples of bad practice include:

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<sup>50</sup> The Q&As in Section 3 of this document relating to the information to be provided to clients and potential clients about CFDs or other speculative products is also relevant for Firm A.

- a. Clearly displaying the corporate branding and logo of Firm B without giving sufficient prominence to the fact that the service is offered by Firm A (e.g. only mentioning Firm A in the small print at the bottom of the web page); and/or
  - b. Stating on the website of Firm B and/or the trading platform provided by Firm A that the CFD trading service is offered by Firm B “in partnership” with Firm A without providing a sufficient supporting explanation, or otherwise diminishing the significance of the activities performed by Firm A.
7. Firm A must also provide details of the order execution policy (Article 21(3) MiFID), which should clearly indicate that it is the counterparty to the client.

#### *The assessment of appropriateness*

8. Firm A is responsible for the assessment of the appropriateness of the service or product offered to the retail client (Article 19(5) of MiFID). In carrying out an appropriateness test, Firm A may receive some client information from Firm B (see paragraph 3(b) above). However, Firm A will also need to ascertain more detailed and specific information about the client's **knowledge** and experience in relation to CFDs, to ensure it has sufficient information to **assess** their appropriateness for the retail client, in particular given the complex and speculative nature of CFDs and the risks involved. Firm A should not encourage clients not to provide such information or avoid seeking information (Article 36 of the MiFID Implementing Directive). Firm A should not consider a client's experience in trading shares or other non-complex instruments with Firm B as evidence of **knowledge** and experience relevant to CFDs or other speculative instruments.<sup>51</sup>

#### *Other MiFID obligations*

9. Firm A must enter into its own client agreement and contract for the MiFID services and activities associated with the CFD trading platform that it provides to retail clients introduced by Firm B (Article 19(7) of MiFID and Article 39 of the MiFID Implementing Directive).
10. Firm A must meet best execution obligations (Article 21 MiFID), client order handling (Article 22), safekeeping of client assets (Article 13) and other organisational and conduct obligations connected to its transactions with the client, and must keep adequate records of its activities (Article 13(6) MiFID and Article 51 of the MiFID Implementing Directive).
11. Firm A should have in place complaints-handling **procedures** (Article 10 of the MiFID Implementing Directive). It should be made clear to the retail client, even if Firm A wishes to indicate its association with Firm B when dealing with a retail client introduced by Firm B, that Firm A is responsible for handling any complaints about the services provided in relation to CFDs or other speculative products, including in the event that a client complains to Firm B.

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<sup>51</sup> Section 4 discusses the assessment of appropriateness when offering CFDs or other speculative products to retail clients in more detail.

12. NCAs should also consider whether Firm A clearly discloses any relevant inducements received from or paid to either Firm B or other relevant entities, and justifies that these do not impair the firm's duty to act in the client's best interests and are designed to provide a quality enhancement for inducements (Article 26(b) of the MiFID Implementing Directive). For example, any commission payments or revenue sharing between Firm B and Firm A should be disclosed to clients and justified. Where there are inducements passing between Firm A and Firm B, linked to a retail client's ongoing trading activity, NCAs should consider asking the firms to justify how such payments are designed to enhanced the quality of service provided to the client, in particular because in this example the introduction of Firm A to the retail clients of Firm B is a one-off activity performed by Firm B.
13. One possible variant of this type of partnership arrangement is where Firm B wishes to enter into a partnership arrangement but does not have a sufficient customer base to commercially justify the costs involved for the CFD platform provider (Firm A) to offer a trading platform incorporating elements of Firm B's branding. In such an example, the two firms may instead enter into a partnership arrangement under which Firm A provides a generic, unbranded (i.e. neither branded in the name of Firm A nor Firm B) trading platform.
14. As with the earlier example, Firm B would introduce its existing retail clients to Firm A's CFD trading platform if its clients wish to trade CFDs. This variation means that the retail client is less likely to perceive a brand association with Firm B, however there remains a risk that the status of Firm A, who is providing services to the client, could be unclear. Contractual agreements and other required disclosures, policies and communications with clients about the provision of the CFD trading platform should clearly indicate that Firm A is the service provider and outline the relevant regulatory obligations they owe to the client. An NCA should therefore consider the same areas of focus as described in the paragraphs above.

**Question 2 [last update 25 July 2016]: A MiFID investment firm (Firm B) is authorised to deal on own account for its retail clients, who use Firm B's online trading platform to trade CFDs and other speculative products. Firm B then uses a trading platform hosted by another authorised investment firm (Firm A) to execute hedging orders against the position of its underlying retail clients, via one or more sub-accounts.**

**What key aspects should an NCA take into account when considering this type of trading omnibus account<sup>52</sup> arrangement?**

**Answer 2:**

15. In this example, Firm B is authorised to deal on own account and execute orders for retail clients trading CFDs and other speculative products, and Firm B owes the client all the relevant regulatory obligations under MIFID, including in relation to best execution, client order handling and the safeguarding of client assets. Firm A is also authorised to deal on

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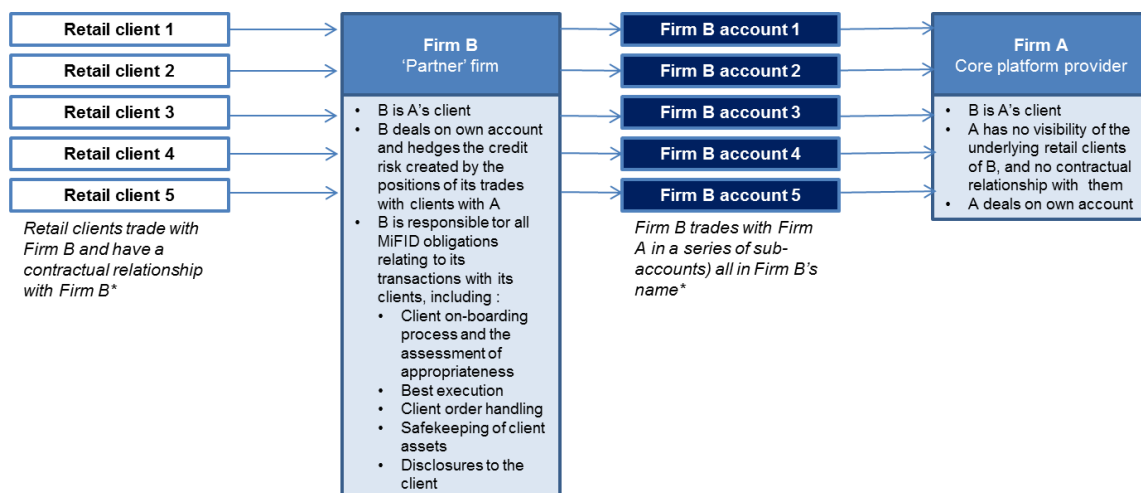
<sup>52</sup> Such trading omnibus accounts should be clearly distinguished from an omnibus account maintained by a third party and used to hold financial instruments on behalf of the client, as discussed in relation to securities financing transactions in Article 19(2) of the MiFID Implementing Directive, and in relation to the information provided to clients in Article 32(3) of the MiFID Implementing Directive.



own account, but it is possible, depending on the national regime in the relevant Member State, for Firm A's authorisation to be limited to dealing with professional clients or eligible counterparties if it does not also offer its services directly to retail clients, since Firm B is its client in this instance.

16. Under this type of trading omnibus account arrangement, Firm B is a client of Firm A for the purposes of Firm B's hedging activity. Firm B's clients are therefore not disclosed to Firm A, and Firm A does not have any direct contractual relationship with them. In practical terms, Firm B receives an order to trade CFDs from the retail client online and then executes a corresponding hedging trade online through one or more sub-accounts with Firm A. This process may be automated via Straight Through Processing (STP) technology.
17. Such arrangements may be popular because they allow Firm B to utilise Firm A's technology to manage its credit risk on a client-by-client basis, as each sub-account that Firm B holds with Firm A can be an account that mirrors the position of Firm B with an individual retail client.<sup>53</sup>

Figure 1: Trading omnibus account:



\* In an automated straight through processing (STP) environment, as is common in this sector, the retail client's trade will be executed with Firm B and the corresponding trade will be executed by Firm B with Firm A instantaneously, when the client enters instructions using B's online trading platform.

18. One key aspect for NCAs to be aware of under this type of arrangement is that, in the event of a period of market volatility, Firm A would likely base any decision to close its exposures to Firm B based on the aggregate exposure of its accounts and aggregate margin available to support these, thereby treating Firm B as its single client (regardless of any separate sub-accounts). In such an event, there is a risk that Firm B may be incentivised to seek to minimise its credit risk exposure by closing the open positions of retail clients who have a

<sup>53</sup> It should be noted that, in accordance with the MiFID obligations relating to the safeguarding of client assets (Article 13(7) and 13(8) of MiFID), Firm B is not permitted to use the assets or funds of a retail client to conclude its transaction with Firm A.

fully margined position, as a result of Firm B having had all its corresponding hedge trades closed by Firm A.

19. Firm B, in meeting its MiFID conflicts of interest obligations, should not pursue a hedging strategy that damages the interests of its clients (Article 21 of the MiFID Implementing Directive). NCAs should therefore assess how firms seeking to use such a trading model have considered this risk as part of their risk management policies and procedures, and have appropriate organisational arrangements in place to manage it (required by Article 7 of the MiFID Implementing Directive). NCAs should also check that Firm B has clear, fair and not misleading contractual terms in any client agreements and execution policies to cover such events, and that such terms are consistent with the firm's duty to act in their clients' best interests (Article 19(1) and (2) of MiFID).

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## Section 6: The use of trading benefits when offering CFDs or other speculative products

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### 1. Introduction

1. It has been observed in this sector of the market that firms may offer trading benefits to attract and encourage retail clients to speculate in CFDs or other speculative products. For example, “bonuses” may be promoted as an introductory offer to new retail clients, or as a reward for existing retail clients that invest a certain sum of money with the firm. Given the complex and speculative nature of the products, it is especially important for NCAs to consider the use of trading benefits by firms offering CFDs and other speculative products to retail clients, in order to ensure that the MiFID obligation to act honestly, fairly and professionally and in the best interests of clients (Article 19(1) of MiFID) is met.
2. This section describes some bad practices relating to the use of trading benefits that have been observed in this sector of the market and highlights the key considerations that NCAs should take into account as part of their supervisory activity.

**Question 1 [last update 11 October 2016]: How can firms that offer bonuses to retail clients trading in CFDs or other speculative products do so in a way that ensures they are meeting their MiFID obligation to act in the best interests of their clients?**

**Answer 1:**

1. A trading benefit such as a “bonus” may lower the psychological threshold of retail clients to invest in speculative products by encouraging them to trade. It has been observed in this sector of the market that firms seeking to attract retail clients may advertise and offer various types of bonuses, which generally offer the possibility for the retail client to increase his or her possible profit on the trading account. However, the acceptance of such a bonus by a retail client may also result in that client taking a greater risk of loss than they would do otherwise. This could be the case because:
  - a. It has been observed in this sector of the market that a bonus may not equate to the allocation of real-life funds to the retail client’s trading account, but rather provide the possibility for the client to increase his or her potential profit by increasing the sum that the client has to speculate with (i.e. offer the retail client additional leverage). Additional leverage also therefore also increases the risk to the client, by increasing the potential losses that may be incurred; and/or
  - b. Even where the offer of a bonus equates to, or may be converted to, real life funds, it has also been observed in this sector of the market that the client may be required to meet certain criteria in order to realise the benefit, for example to execute a number of transactions in a particular time period. In such a case, it may be unlikely for a majority of retail investors to meet the criteria without any losses being incurred.
2. ESMA considers that the following poor practices, which have been observed in this sector of the market, are not consistent with the requirement for a firm to act honestly, fairly and professionally and in the best interests of its retail clients (Article 19(1) of MiFID) and, in some cases, other relevant MiFID obligations:
  - a. A bonus or trading benefit being offered and presented to the client in such a way as to give the impression that the trading benefit is real money, free trades or risk-free trades, when in reality that trading benefit equates to additional leverage on the client’s account (and therefore additional risk);<sup>54</sup>
  - b. Firms awarding virtual sums of money as bonuses that in practice would be impossible or rarely possible to convert to real-life client funds that can be withdrawn (e.g. as a result of the criteria that the client is required to fulfil to realise the bonus);
  - c. Where a bonus has been awarded, firms presenting misleading information on the trading platform about the retail client’s account balance, such that the retail client

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<sup>54</sup> Information presented to clients and potential clients should be clear, fair and not misleading as required by Article 19(2) of MiFID.

is not able to readily distinguish between 'virtual' sums on the account and actual client funds that can be withdrawn at that point in time (e.g. including both real-life client funds and the 'bonus' in the total balance of the client's account that is displayed online);

- d. Firms not being able, at any time and without delay, to distinguish client assets from any 'virtual' balances, such as bonus amounts or other trading benefits awarded on the client's account that do not equate to actual funds or instruments held for the client;<sup>55</sup>
  - e. Trading benefits being applied to a client's account as the default option or requiring the client to 'opt out' of receiving a trading benefit, such that the client may not be aware that he or she has received the trading benefit;
  - f. Firms not allocating profits generated from trades derived from a bonus to the client; and
  - g. Firms refunding sums owed to the client in the form of a bonus instead of in cash.
3. Especially in light of the above poor practices observed in this sector of the market, ESMA is of the opinion that it is unlikely that a firm offering bonuses that are designed to incentivise retail clients to trade in complex speculative products such as CFDs, binary options and rolling spot forex could demonstrate to its NCA that it is acting honestly, fairly and professionally and in the best interests of its retail clients, taking into account that the nature of the products means that they are not appropriate for a majority of retail clients. NCAs should therefore monitor that the practice of offering such bonuses is avoided in relation to these products.
4. Moreover, NCAs should monitor the offer of all types of trading benefits<sup>56</sup> by firms offering CFDs and other speculative products to retail clients, in order to ensure that such trading benefits are not designed to encourage behaviours that are not in the best interests of clients.

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<sup>55</sup> Article 16(1)(a) of the MiFID Implementing Directive requires investment firms to keep accounts and records as are necessary to enable them at any time and without delay to distinguish assets held for one client from assets held for any other client, and from their own assets.

<sup>56</sup> For example, this could include (but is not limited to): the offer of gifts (e.g. holidays, cars, electronic goods), trading tutorials or reduced costs (e.g. spread or fees).

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## Section 7: The withdrawal of funds from trading accounts when investing in CFDs or other speculative products

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### 1. Introduction

1. A firm offering CFDs or other speculative products to retail clients should enable its clients to withdraw funds from their trading account at any time, in order to comply with the MiFID conduct of business obligations, including the requirement to act honestly, fairly and professionally in accordance with the best interests of the client (Article 19(1) of MiFID) and to demonstrate **compliance** with the requirement to safeguard client assets (Articles 13(7) and 13(8) of MiFID).
2. It has been observed in this sector of the market that retail client complaints received by firms offering CFDs and other speculative products often mention delays withdrawing funds. Furthermore, delays in returning client funds could also be symptomatic of one or more other underlying issues that may require further supervisory attention. It is therefore important that NCAs, as part of their ongoing supervisory activity, consider the processes that firms have in place when responding to a request from a retail client trading in CFDs or other speculative products to withdraw funds from his or her trading account.

**Question 1 [last update 11 October 2016]: How long should it take for a firm offering CFDs or other speculative products to retail clients to process a client's request to withdraw funds from his/her trading account?**

**Answer 1:**

1. NCAs should monitor that firms offering CFDs or other speculative products to retail clients are able to, at any time and without delay, identify assets belonging to a particular client;<sup>57</sup> such that there should be no reason for the investment firm to delay the return of funds belonging to a particular client to that client.<sup>58</sup> Ordinarily, in the case that there is a positive cash balance in the retail client's trading account that is not committed margin supporting open positions, this should mean that a firm is able to process the client's request to withdraw funds (e.g. by sending payment instruction to the bank) on the same day that the request to withdraw funds was made, or the next working day if the client's request is received outside of normal trading hours.<sup>59</sup>
2. In the event that a client requests to withdraw funds from his or her trading account and it is not possible for the funds to be withdrawn without delay, the firm, in meeting its MiFID obligations to act in the client's best interest, should keep the client informed, including about the reasons for any delay and the expected timeframe before the funds will be withdrawn. Information provided to the client about any delays in withdrawing funds should be fair, clear and not misleading, in compliance with Article 19(2) of MiFID.
3. NCAs should also consider that delays in returning client funds, for example, where identified via client complaints or other supervisory activity, could be an indication of problems with the investment firm's compliance with its MiFID or other regulatory obligations. Especially where delays in returning client funds are identified on a widespread or systematic basis, this could indicate other underlying potential supervisory issues, for example relating to the safeguarding of client assets, anti-money laundering controls, or issues relating to the use of trading benefits (such as bonuses<sup>60</sup>).

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<sup>57</sup> Article 16(1)(a) the MiFID Implementing Directive requires investment firms to keep accounts and records as are necessary to enable them at any time and without delay to distinguish assets held for one client from assets held for any other client, and from their own assets.

<sup>58</sup> In some jurisdictions, the relevant NCA for the supervision of topics related to client money may be different from the relevant NCA for the supervision of other MiFID aspects. Other regulation may also be applicable to the process of withdrawing funds.

<sup>59</sup> This should be the case even when a firm in one jurisdiction is providing investment services and activities in another jurisdiction under Article 31 of MiFID (also known as passporting without a branch).

<sup>60</sup> Section 6 of this document also discusses the use of trading benefits observed in this sector of the market.



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## Section 8: The use of leverage when offering CFDs or other leveraged products to retail clients

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### 1. Introduction

1. CFDs and rolling spot forex are leveraged products. Leverage (also commonly referred to as the this sector of the market as margin<sup>61</sup>) offers a retail client the possibility to magnify the potential profits of a trade, however it also magnifies the possible losses. Because it is possible for the losses incurred to be higher than the sum originally invested, leveraged instruments such as CFDs and rolling spot forex are riskier than non-leveraged instruments. The leverage component also adds an additional level of complexity, which means that many retail investors would have difficulty understanding how leverage impacts the risks involved when trading CFDs or other similar leveraged products.
2. Moreover, the use of leverage may exacerbate the potential conflict of interests arising between the commercial interests of a firm offering CFDs or other similar leveraged products and the interests of a retail client (Article 21(a) of MiFID Implementing Directive), by increasing the sums of money at stake. This could be the case, for example, as a result of the firm dealing on own account and acting as the other side of the client's trade, or because the transactional costs payable to the firm that are based on the size of the position (e.g. fees and commissions) may multiply in relation to the leverage offered. This could incentivise behaviours that are not in the client's best interests.<sup>62</sup>
3. NCAs should therefore pay particular attention to the way that firms offering CFDs or other similar leveraged products determine the leverage levels offered to retail clients, in order to ensure that the MiFID requirement to act in the best interests of clients are met (Article 19(1) of MiFID).

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<sup>61</sup> If the value of a client's initial position in CFDs is 10,000 and the leverage ratio is 1:100, the initial margin requirement would be set at 1% (i.e. 100). Margin may also be referred to as collateral. A maximum possible leverage may be set for all opened positions in a client's account, or the leverage level available may differ for different positions (e.g. based on the underlying).

<sup>62</sup> Section 2 of this document discusses conflicts of interest in this sector of the market in more detail.

**Question 1 [last update 11 October 2016]: What aspects should NCAs consider when assessing the way that leverage is offered to retail investors?**

**Answer 1:**

1. NCAs have observed that firms offering leveraged speculative products, such as CFDs or rolling spot forex, to retail clients may determine the maximum available level of leverage based on their own discretion, and that the levels offered to retail clients are often very high, especially in cases where the underlying asset involves currency pairs. Leverage, whilst increasing the possible profit, also increases the risks involved because leverage significantly increases the possible losses, including the possibility for the client to lose more than the sum initially invested.
2. In theory the probability of realising a loss is equal (or very close) to the probability of realising a profit. However, in practice, when firms offer products such as CFDs or rolling spot forex to retail clients, the application of leverage may increase the probability of a larger loss for the client to a greater extent than the probability of a larger gain. This may be the case for the following reasons:
  - a. As the leverage levels increase the size of the client's position, this also increases the transactional costs incurred by the client. Because the transactional costs are usually deducted from the margin deposited by the retail client, as transactional costs increase this increases the risk of the automatic closure of the retail client's position (execution of stop-out<sup>63</sup>). Therefore, high leverage can lead to a situation when a retail client, at the moment of first opening a CFD position, observes a significant loss on the trading account, caused by the application of high transactional costs. In this case, even a small fluctuation in the price of the underlying to client's disadvantage would result in the remaining margin deposit being insufficient to absorb the market risk. The firm would thus automatically stop-out the client's positions, realising a loss for the retail client.
  - b. It is common for firms to set a margin call level. When a retail client's available margin is lower than or equal to the margin call level, the client is immediately requested to increase the value of margin deposit above the margin call level.<sup>64</sup> The margin call is not usually binding and the firm would not close the client's positions until the level of margin deposit reaches a lower stop-out level. However, a behavioural bias has been observed amongst retail clients, who may tend to increase the margin by depositing more funds (believing they can turn around their losing position), rather than wait for automatic closure of positions. Such behaviour

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<sup>63</sup> In order to reduce the client's maximum loss in the event that market conditions are unfavourable for the client, it is common for firms to set a stop-out level (i.e. a threshold of margin value, below which position is automatically closed). For example, if the stop-out is set at 30% of the margin, based on a margin of 100, the position would be automatically closed if the position reaches 30 or lower. The term "close-out" may also be used (usually in relation to a situation where all of the positions with a particular counterparty are closed).

<sup>64</sup> The margin call level is higher than stop-out level. For example, if a firm sets the margin call level at 70%, based a margin of 100, the client would be requested to place more money in the trading account once the balance falls to 70 or lower.

would result in the retail client ultimately losing a larger sum of money, in the case that a loss is realised.

3. The above factors are particularly important when considering the risks of trading CFDs for retail clients. Taking into account the volatility of the underlying market together with the extra leverage on the investment, this could result in rapid changes to the client's investment position, resulting in the client having to take swift action to manage the risk exposure by posting additional margin or the position being automatically closed out. In such instances, very high leverage would lead in many cases to a large loss for the retail client over a very short time span.
4. Furthermore, the impact of leverage on the risks of the product and service, including the risk of loss and the transactional costs involved, increases the complexity of the instrument. This means that it will likely be even more difficult for a retail client to understand the risks involved in trading a leveraged speculative product. For example, a retail client may consider his or her initial deposit (e.g. €500) as the sum that has been invested, whereas with a leverage of 1:100, this actually results in a trading position of €50,000.
5. NCAs should therefore pay particular attention to the use of leverage and consider the extent to which a firm offering leveraged speculative products such as CFDs can demonstrate that it is acting in the best interests of its retail clients.<sup>65</sup> A firm, in managing its own risks, may be incentivised to offer leverage limits that may not always be consistent with the best interests of its retail clients. For example, the firm may offer higher leverage limits to clients with smaller positions than those clients with larger positions in order to manage its credit risk, without taking into account the interests of the clients impacted.
6. An NCA should consider the extent to which a firm takes the following into account when determining the leverage available to its retail clients trading in CFDs or another leveraged speculative product:
  - a. Whether the firm establishes a level of margin deposit based on objective criteria that are verifiable and demonstrable to the NCA. Such criteria should reflect market conditions and risks of a given derivative (e.g. underlying instrument price volatility over a relevant reference period, liquidity, appropriate time for liquidation of client's position, risk of extraordinary market situations);
  - b. Whether the firm takes into account the conditions existing at the underlying exchange or market, in particular the underlying product features;
  - c. Whether the firm establishes a margin level that takes into account the client's knowledge and experience<sup>66</sup>; and

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<sup>65</sup> Even in cases where the national law of a jurisdiction where the firm offers CFDs or other speculative leveraged products specifies a maximum allowed level of financial leverage for retail clients (for example, in order to ensure the provision of services that are in the best interests of clients), NCAs, when assessing the level of leverage offered by firms they supervise, should nonetheless consider the content of this Q&A and whether a lower leverage limit than that prescribed by the relevant legislation may be appropriate, taking into account the best interests of the retail clients.

<sup>66</sup> Section 4 Question 3 of this document discusses one example of how a firm can take into account the client's knowledge and experience when determining the level of leverage available to that client.

- d. How the firm determines the level of margin at which margin calls and any automatic position closures (i.e. "stop-out" mechanisms) are triggered. These levels should be consistent with the client's best interests. When setting a stop-out level, the firm should in particular take into account the maximum effective leverage deriving from the stop-out level.<sup>67</sup>
7. It would be good practice for a firm offering CFDs to retail clients, when creating and marketing its product-offer, to:
  - a. Recommend that the client does not dedicate his or her entire deposit to meeting margin requirements, in order to protect the client against market volatility; and
  - b. Give clients the option to lower the leverage in order to limit their exposure. The maximum possible leverage limit should not be offered as the default offer to retail clients.
8. NCAs should also verify if and how investment firms target different leverage to different client groups, in particular to different groups of retail clients, to identify behaviours that may not be in the best interests of retail clients. NCAs should make sure that firms do not offer higher leverage to clients who do have less knowledge and experience<sup>68</sup> of trading CFDs and other leveraged speculative products or to clients who are worse performing traders.
9. When assessing the way an investment firm offers CFDs or other leveraged speculative products, NCAs should also take into account ESMA's Opinion on MiFID practices for firms selling complex products,<sup>69</sup> which states: "if following firms' due diligence, it appears that a particular complex product will never meet the best interests of their clients [...] NCAs should monitor that firms do not offer advice on that envisaged product, or sell it at all" (p.3). NCAs should therefore monitor that firms only sell leveraged products such as CFDs or rolling spot forex to retail clients if they can demonstrate that the offer of such products is in the best interests of retail clients.

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<sup>67</sup> When the margin deposited on the client's account is lower than the initial margin, the effective leverage increases. For example, when the margin deposited is 50 (compared to an initial margin of 100), the effective leverage is 1:200 (compared to an initial leverage of 1:100).

<sup>68</sup> Section 4 of this document discusses the requirement to assess appropriateness in more detail.

<sup>69</sup> ESMA/2014/146.

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## Section 9: Best execution obligations for firms offering CFDs or other speculative products to retail clients

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### 1. Introduction

1. MiFID requires investment firms to take all reasonable steps<sup>70</sup> to obtain the best possible result for their clients (Article 21 of MiFID and Article 44 of the MiFID Implementing Directive). In doing so, firms should first have a thorough understanding of their best execution obligations.
2. Any firm that executes orders for retail clients in CFDs or other speculative products is required to ensure that orders are executed on terms most favourable to the client (Recital 33 of MiFID). Firms that receive and transmit orders for retail clients in CFDs or other speculative products also have a corresponding duty to act in the client's best interests when placing orders with other entities for execution (Article 19(1) of MiFID and Article 45 of the MiFID Implementing Directive), although this section does not focus on reception and transmission activity.
3. Since firms in this sector of this market are executing orders with retail clients in complex OTC derivatives, NCAs should focus on how a firm's best execution arrangements ensure that the firm delivers the best possible result on consistent basis in terms of total consideration, i.e. the price of the financial instrument and the costs related to execution (Recital 66 and Article 44(3) of the MiFID Implementing Directive). NCAs should pay particular attention to how firms derive their pricing for CFDs and other speculative products, which will depend on the provider's selection of hedging venues or use of price sources to determine its own prices, depending on the business model adopted. These issues are discussed further in this section.

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<sup>70</sup> Article 27 of MiFID II will further enhance this standard by replacing "reasonable steps" with "sufficient steps".

**Question 1 [last update 11 October 2016]: What particular aspects should NCAs consider when assessing whether providers of CFDs and other speculative products are delivering best execution to their clients?**

**Answer 1a: Understanding the scope of best execution obligations**

1. NCAs should consider the applicable best execution obligations by first distinguishing between the main execution arrangements that are commonly used by firms offering CFDs or other speculative products to retail clients. Possible variations of these models may exist. It should also be noted that more than one execution model may be offered by the same firm. Two main examples are:
  - a. Firms dealing on own account: These firms deal on own account and execute orders on behalf of clients. This includes:
    - i. Firms dealing on own account as market maker and acting as the main execution venue (frequently as the sole execution venue) for their retail clients' orders. In such cases, the firm may take market risk from clients' transactions, depending on its hedging strategy; and
    - ii. Firms dealing on own account and executing orders on behalf of clients that hedge their positions with clients on a back-to-back basis with other execution venues (often using straight-through processing or STP technology).<sup>71</sup> In this latter example, the firm does not usually take any market risk as a result of its clients' transactions and the other execution venues selected by the firm for its hedging activity are used to determine the execution price for the firm's clients' orders.
  - b. Firms executing orders on behalf of clients: This includes firms that execute orders on behalf of clients with third party execution venues. In this case, the other execution venues selected by the firm are used to determine the execution price for the firm's clients' orders.
2. In all of the above models, NCAs should pay particular attention to how firms deliver best execution given they are dealing in complex OTC products with retail clients. In particular, for CFDs or rolling spot forex, once a client has opened a position with a firm, the client usually has to transact with the same firm to close a position, which effectively creates 'captive' trades for the firm. Binary options, as a derivative contract with a fixed expiry, will also be subject to the pricing arrangements used by the firm to ascertain the price when the option expires.
3. Firms are not exempt from providing best execution to retail clients relating to orders to trade in CFDs or other speculative products either because they are OTC instruments or based on their business model (for example if they deal on own account). The best

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<sup>71</sup> In this execution model, the firm has agreements in place with the other execution venues (i.e. market makers or other liquidity providers, such as an investment bank or another counterparty dealing on own account) it uses to hedge against its clients' orders.

execution obligations should be accurately reflected in the firm's execution policies and client disclosures.<sup>72</sup>

4. Poor practices observed in this sector of the market that would be considered a breach of MiFID best execution obligations include attempts by firms to exclude or limit best execution responsibilities, or to transfer best execution responsibilities to another party, through clauses in retail client agreements, contracts, or in the firm's execution policy. Any terms and conditions presented by a firm that would impact its execution policy should be strictly linked to objective and fairly determined thresholds or events. Firms should not use poorly defined clauses to arbitrarily cancel (usually profitable) client trades.
5. One example is the use of 'force majeure' clauses by firms, which should be linked to specified events and conditions and should not allow for significant discretion over when such terms may be invoked. If a 'force majeure' event does occur and this impacts a firm's ability to execute orders, the firm should continue to have regard to the best interests of its clients, since such clauses cannot waive regulatory obligations. NCAs should pay particular attention when firms use such clauses, and investigate further if a high number of cancelled trades are recorded by a firm.

#### **Answer 1b: Process for Delivering Best Execution**

6. The examination of the firm's policies and processes to deliver best execution should form a focal point of the NCA's supervisory work, with emphasis on the following processes:
  - a. The process for selecting and regularly reviewing<sup>73</sup> appropriate execution venues used for executing orders; the process for selecting and regularly reviewing independent price data providers (where applicable); and the process for selecting and regularly reviewing appropriate execution venues for hedging orders (where applicable);
  - b. The process for monitoring the quality of execution of client orders;
  - c. The process for selecting and monitoring the technology being used for execution of client orders;
  - d. The process for applying any mark-ups to derive prices offered to retail clients;
  - e. The management of potential conflicts of interest; and
  - f. The process of producing and providing clients with a written order execution policy and reviewing this on an annual basis or when material changes occur.

#### *Venue selection for firms executing orders*

7. The firm should have in place an internal process, available for inspection by NCAs, which describes the steps followed in practice for the selection of venues for the execution of

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<sup>72</sup> CESR Report 07-320, Best Execution under MiFID: Questions & Answers, May 2007

<sup>73</sup> Article 21(4) of MiFID and Recital 74 of the MiFID Implementing Directive



client orders (Article 21(3) of MiFID and Recital 66 of the MiFID Implementing Directive). The firm must also have sufficient expertise to be able to assess and select venues in a manner consistent with taking all reasonable steps. A firm may use external expertise to assist them in this process; however, the firm retains responsibility and cannot delegate its best execution obligations to another party.

8. NCAs should pay close attention to the risks arising in the case that a firm chooses to execute all client orders using a single venue. A firm using a single execution venue should be able to demonstrate it has selected that single venue based on a reasonable analysis of the order execution policies and arrangements at a range of other venues, and that it has determined that the selected venue will provide the best possible result for its clients, which is at least as good as the results it could reasonably expect from using other venues (Article 21(3) of MiFID and Article 44 of the MiFID Implementing Directive).<sup>74</sup>
9. When a firm executes orders on behalf of clients, the NCA should ensure that the firm can demonstrate that all different factors affecting the execution offered to the client have been fully considered and evaluated.
10. A firm would not be compliant with its best execution obligations if it chooses to execute orders with a venue solely based on the commercial benefit to the firm (e.g. to reduce its own costs) or without assessing its execution policy and arrangements to ensure it is acting in the best interests of its clients. A firm may also not be able to demonstrate it is acting in its clients' best interests if it is unduly reliant on a specific venue for the continuation of its own services. For example, a firm should not have binding contractual agreements or technology links to a venue that make it impractical for the firm to consider executing client orders using an alternative venue if execution quality deteriorates and/or when the firm undertakes its annual review of its policy.
11. Where the firm uses another execution venue to hedge client orders on a back-to-back basis, the selection of the firm's hedging venues is a major factor impacting the delivery of best execution. A firm may be incentivised to hedge with only one counterparty, for example, because the firm may incur additional costs for the technology required to establish additional connections with other venues for its hedging and pricing. In such cases, given the impact of the firm's hedging arrangements upon the execution offered to the retail client, the NCA should expect the firm to be able to demonstrate how its hedging arrangements enable it to consistently deliver best execution and to monitor this on an ongoing basis.
12. The financial strength, reputation, technology and capabilities of potential execution venues or hedging venues are important additional factors that should be considered by the firm as they can have a material impact on the execution offered to the client. Prior to the selection of its execution or hedging venues, the firm should request and obtain access to prices in order to perform demo and/or actual testing of trading conditions, for the

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<sup>74</sup> Recital 66 of the MiFID Implementing Directive and CESR's Question & Answers on Best Execution under MiFID: May 2007 (CESR 07-320).

purposes of assessing the expected quality of execution of each venue for each different instrument offered.

13. NCAs should pay particular attention to arrangements where a firm uses or proposes to use another party that is based in a non-EEA jurisdiction to execute its clients' orders. In these cases, the NCA should require the firm to demonstrate that it has properly assessed the execution policies and quality of the execution venue, assuming it is subject to similar regulatory requirements in the third country jurisdiction. If the venue is not subject to similar regulatory requirements, the NCA should consider how the MiFID authorised firm will be able to ensure that the other party provides sufficient execution quality and information to allow them to monitor ongoing performance (e.g. based on clear contractual terms). Similarly, if a firm dealing on own account and executing client orders that is hedging on a back-to-back basis uses an execution venue based in a non-EEA jurisdiction for its hedging activity or to derive prices for its clients' orders, the NCA should require the firm to demonstrate how this enables it to comply with its best execution obligations and to monitor this on an ongoing basis.
14. If an NCA is not satisfied the firm will be able to meet its MiFID obligations using a non-EEA venue for the execution of client orders or as a venue for the firm to execute its hedge orders, the firm should not use it.<sup>75</sup>

#### *Price data selection for firms dealing on own account*

15. When a firm deals on own account as the main or only execution venue for its clients' orders in CFDs or other speculative products, the NCA should expect it to be able to demonstrate how it derives its prices and ensures the quality of execution delivers the best possible result for its clients on a consistent basis that is at least as good as could be achieved on other venues (Article 21(1) of MiFID). In order to do so, the NCA should expect a firm to use independent price sources or liquidity providers to derive or benchmark its prices, and be able to demonstrate a rigorous process for how it selects, blends and monitors its price sources. The firm should review its arrangements, including price sources, on at least an annual basis.<sup>76</sup>
16. Where CFDs or other speculative products are based on liquid underlying markets, for example equities, NCAs should expect firms to base their prices on externally verifiable prices that reflect actual underlying pools of liquidity or a public reference price, for example where the underlying is a mainstream index of shares (FTSE 100, CAC 40, DAX).<sup>77</sup> For example, relevant benchmark prices may include:
  - a. For CFDs on equities, the best bid offer prices on the primary exchange (sometime referred to as PBBO) or another venue that has sufficient liquidity to consistently reflect the market price;

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<sup>75</sup> See also Q22 in CESR's Report, *Best Execution under MiFID: Questions & Answers*, May 2007.

<sup>76</sup> MiFID II, when it enters into application, will strengthen the existing best execution standards in relation to OTC products in relation to the fairness of price. ESMA is presently also working on Level 3 material on the topic of best execution under MiFID II.

<sup>77</sup> Please also refer to Section 2, Question 1 of this document.

- b. For CFDs on indices (which could include commodities), prices provided on the nearest equivalent futures contracts on an exchange or liquidity provider platform, or a public, recognised external benchmark price provider;
  - c. For CFDs on FX or commodities, futures contracts quoted on an exchange, or spot or futures prices provided by liquidity provider platforms (such as a large investment bank), or an external benchmark price provider.
17. Where a firm could hedge a transaction in the market, it should ensure it provides a price to the client that is not worse than the hedge transaction the firm could carry out, plus any mark-up applied by the firm. The firm should disclose to the client both the 'core' price and the mark-up value applied by the firm (see also paragraphs 29-32 below).
18. The firm should take all necessary measures to ensure the prices used are the most appropriate for the type of orders being received from its retail clients. As such, the firm should monitor systemically the quality of prices it receives from a sufficient number of independent data providers or other liquidity providers and compare them with other independent sources. If a preferred price source used by a firm offering CFDs is temporarily unavailable during normal trading hours, good practice may include executing the CFD trade based on applying a transparent spread to the last trade executed in the underlying instrument, or seeking a price from another market maker known to offer consistent pricing in an instrument.
19. A firm should not construct its own benchmark price if there is a relevant public reference price available. In cases where directly relevant pricing data (e.g. as discussed in paragraph 16) is temporarily not available, for example where prices on the underlying assets are not available or orders are placed outside of normal trading hours, the firm's order execution policy should clearly document precisely whether the firm will offer execution services and, if so, how the price will be determined (e.g. whether another correlated public reference price can be used as the reference price). NCAs should carefully consider whether a firm is acting in the best interests of clients in the event that a firm's execution policy allows it in some cases to determine a benchmark price that is not based on a directly relevant public reference price, in particular given the conflicts of interest that may arise in such a situation.<sup>78</sup> If the firm's pricing methodology cannot consistently deliver fair execution prices for its client, in the view of the firm or the NCA, then execution services should not be offered when relevant public prices or liquidity sources are unavailable. The firm's approach should be documented and should reflect its obligations to act in the client's best interest and avoid creating a conflict of interest. A firm should regularly test and review any pricing methodology used, and keep records of its monitoring to allow NCAs to verify the fairness of any constructed price.

#### *Execution arrangements involving connected parties*

20. NCAs should carefully consider situations where a firm's order execution arrangements include connected parties (e.g. entities within the same group), to ensure that the firm

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<sup>78</sup> Section 2 of this document also discusses conflicts of interest.

remains responsible for delivering best execution to its retail clients. This applies in the case of firms executing client orders with connected party execution venues and in the case of firms dealing on own account that execute hedge trades with a connected party, which could impact the quality of the execution offered by the firm to its client. In particular, the firm should ensure any such arrangements with a connected party, such as an intra-group counterparty:

- a. are made on an arm's-length basis, such that the connected party execution venue is considered alongside other **third party** venues and is selected because it allows the firm to deliver the best possible result to its clients on a consistent basis;
  - b. allow the firm to have sufficient, **independent oversight** of its execution arrangements (i.e. that **oversight** is not performed by the connected party);
  - c. ensure sufficient and free access to information to ensure the firm can effectively monitor and challenge execution prices provided by the counterparty;
  - d. are disclosed to the client in initial disclosures and in the firm's order execution policy; and
  - e. where a connected party execution venue is selected by a firm on the basis that it offers reduced execution costs, it should be clear that this results in a benefit to the client.
21. The firm should ensure that no commercial dependencies impede its ability to act in the best interests of its clients, and that it can consider alternative execution venues if the execution quality of a connected party execution venue is not helping the firm to consistently deliver the best results for its clients.
22. If a firm's execution policy lists several execution venues, one of which is a connected party, the **NCA** should examine the actual order routing carried out by a firm to **identify** if, in practice, the firm executes all or a significant proportion of client orders, or specific groups of client orders, with the connected party, which may suggest possible best execution issues or conflicts of interest.
23. When firms use a connected party venue to execute orders on behalf of clients, they must ensure that by doing so, the firm's own costs and the costs incurred by the client are not **higher** than if the firm dealt directly with external parties (Article 21(1) of MiFID and Article 44(3) of the MiFID Implementing Directive). In practice, if a firm has selected a connected party (such as an intra-group entity) as the execution venue on the basis of a reduction in the firm's own costs or other benefit to the firm, the **NCA** could expect the firm to offer the same cost saving or benefit to the client.
24. A firm's hedging arrangements with a connected party may also impact its ability deliver best execution. For example, a firm offering rolling spot forex may use multiple price feeds, but only execute orders from a particular **group** of clients based on matching hedge trades with an intra-group counterparty (potentially due to a commercial incentive in their

agreement).<sup>79</sup> In such a case, the firm may be effectively accepting a quality of price that does not enable it to consistently provide best execution, where using other venues for hedging and pricing could achieve better results for its clients.

#### *Monitoring of venues or price sources*

25. All firms executing orders should have the internal capabilities and tools to assess the quality of execution and pricing being offered by another venue or the ability to perform self-assessment of their own execution quality vis-à-vis their benchmark price source(s), including compared to other venues.

26. Practical ways for a firm to monitor execution quality include:

- a. systematically comparing prices provided by its execution venues against external price sources or other venues to ensure that there are no significant or systematic deviations in the pricing provided to its clients;
- b. monitoring quality of execution by reviewing statistics related to frequency of rejections and re-quotes, as well as the symmetry of any observed slippages (positive vs negative). This monitoring should be supplemented by sample checks that include a reasonable proportion of orders, both in terms of numbers and values, and ensure that all relevant types of clients and orders are represented. In addition, firms should monitor statistics around speed of execution (order execution timeframes, i.e. average % of orders being executed within certain timeframes both in numbers and in values). Any tolerances or thresholds used to monitor execution performance systemically against benchmark prices or other statistics (such as execution speed or costs) should be set at meaningful levels to ensure poor executions are captured; and
- c. monitoring any complaints related to the quality of execution in order to ensure that any deficiencies are improved. However, it is important that firms do not seek to rely solely or heavily on clients identifying poor execution outcomes – this remains the obligation of the firm, and the absence of client complaints does not mean that best execution can be assumed.

27. Firms may opt to use independent third party tools or services to analyse execution quality, although the firm remains responsible for ensuring that best execution is delivered. The firm must be capable of reviewing the outputs of any external tools where used and be able to take the necessary steps to identify and rectify any issues identified in its execution policy or arrangements.

#### *Technology selection and monitoring process*

28. NCAs should examine how firms have tested technology and trading platforms under stressed conditions that will be relevant during volatile markets, including high numbers of

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<sup>79</sup> Section 2, question 1 of this document discusses in more detail the conflicts of interest arising when the firm is dealing on own account and acting as the other side of the client's trade.

concurrent online users, high volumes of client orders, and high numbers of price ticks imported, to ensure that all reasonable steps have been taken to ensure continuity and regularity in the performance of investment activities (Article 13(4) of MiFID). The performance and capacity of the trading platform should be continuously monitored and all necessary upgrades (software, servers, etc.), should be carried out and tested in a timely manner. Firms should inform their clients of any incidents or systems outages in a timely manner and accordingly reflect this in their execution policy, as necessary.

#### *Applying spread mark-up / mark down for retail clients*

29. In the vast majority of the cases where CFDs or rolling spot forex products are offered, clients are charged a spread on the transaction. This spread includes a mark-down on the bid price and a mark-up on the ask price the firms receive from their price source and/or the prices firms receive from their selected execution venue(s). Since firms are required to provide appropriate information to clients on its order execution policy “in good time” prior to the provision of the service such that they can make an informed decision regarding the firm and its services, it would be relevant for a firms to disclose in its execution policy the general methodology applied by the firm in calculating mark-ups.<sup>80</sup>
30. In general, the term “spread” in relation to CFD products often encompasses two layers of costs, since firms apply a mark-up to a reference price, but that reference price is also derived from a market price with an accrued ‘core’ spread already factored in. NCAs should monitor that the mark-up and mark-down applied by the firm is clearly disclosed to the clients separately to the ‘core’ spread set by the liquidity provider, in order to allow the client to assess the costs of the venue and the costs charged by the firm (Article 19(3) of MiFID and Article 33 of the MiFID Implementing Directive). Any mark-up applied by the firm should be symmetrical to either:
- a. the data received from independent market data providers or publicly available sources (for firms dealing on own account), or
  - b. the price provided by the selected execution venues or liquidity providers.<sup>81</sup>
31. It would be poor practice if a firm applies an asymmetrical or inconsistent mark up to core spreads. This may indicate that the firm has a conflict of interest with its clients, for example the asymmetric spread may reflect an attempt by the firm to balance its own market position and risk.<sup>82</sup>
32. NCAs should remain aware of the risk that disclosure of mark-ups might not necessarily contribute to transparency as venues may be provided with different raw prices from various price sources or liquidity providers, making comparisons of mark-up challenging.

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<sup>80</sup> Please also refer to Section 3, Question 1 of this document, which discusses the information that should be provided to clients about costs and charges.

<sup>81</sup> This is also applicable to firms dealing on own account and executing client orders that derive their prices based on the prices received by their hedging counterparties.

<sup>82</sup> Section 2, Question 1 of this document also discusses asymmetric slippage and conflicts of interest. As part of that section, ESMA notes that a firm operating a business model whereby it does not hedge any client positions is in all likelihood a conflict of interest that cannot be managed and should therefore be avoided.



The quality of end prices provided to the retail client net of costs (total consideration) is the most important measure to consider (Article 44(3) of the MiFID Implementing Directive).

### *Management of conflicts of interest related to best execution and client order handling*

33. Section 2 of this document discusses some conflicts of interest aspects that relate to the execution of client orders.<sup>83</sup> One area mentioned in Section 2 that NCAs should focus on is the **risk** that a firm's execution arrangements may allow it to systematically benefit from asymmetric slippage, to the detriment of its clients.<sup>84</sup> A firm may be incentivised to unfairly use asymmetric slippage when it guarantees order execution at specified prices, by seeking to reject or re-quote orders when the actual price differs from the guaranteed order price by certain amount. Such behaviour would breach the firm's best execution obligations to provide the best possible result for its clients on a consistent basis.
34. In order to be able to monitor the **risk** of asymmetric slippage, a firm's execution arrangements should include a record of all time stamps, from order reception, intra-trade benchmark shifts, hedging of the trade, and client execution. Asymmetric slippage should also be considered as part of the firm's internal **controls** over best execution.
35. For example, it is common for CFD firms to use technology or software, such as bridges and plugins, that process client orders using pre-defined and/or configurable rules and settings that allow the firm to define under which conditions a client order can be confirmed and even what will be the firm's possible profit from it. NCAs should **assess** the firm's use of technology or software and evaluate the settings and parameters used by the firm to ensure that they are not used by the firm in any way that negatively affects the quality of execution of clients' orders, discriminates certain clients, or treat clients' orders unfairly. A firm should ensure that all order types are subject to its order execution policy and client order handling arrangements, including stop loss orders, take profit orders, other limit orders, or in cases of trades being executed in order to close a position due to the client's account falling below a required margin level (e.g. automatic margin close out). Automatic margin close-out trades should still be treated as orders executed on behalf of a client and are therefore subject to best execution obligations.
36. The following examples are unacceptable practices given firms' best execution obligations and client order handling requirements to have arrangements for the prompt, fair and expeditious execution of client orders, relative to other client orders or the trading interests of the investment firm (Article 22 of MiFID):
- a. Restrictions on stop loss and take profit orders (e.g. freeze orders within certain levels; guaranteeing stop loss within a specified spread);

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<sup>83</sup> See also Section 2, Question 1, paragraphs 9-11 of this document.

<sup>84</sup> Asymmetric slippage involves a firm passing on negative price movements to the client, but seeking to capture positive slippage itself by only giving the client the original quoted price where a positive movement has occurred in the intervening time between a quote being provided and the execution of the order. Slippage naturally occurs due to the time lag arising between a firm providing a quote to its client, which may be based on prices streamed from a venue with whom the firm will execute client orders or execute a hedge trade on a back-to-back basis at the moment at which the client confirms they wish to execute the order, and the moment at which the firm completes the trade by executing the client's order. During this time lag, the price may have moved away from the original quoted price.



- b. Restrictions on pending orders (e.g. during news);
  - c. Association of single or group of clients with a specific hedging strategy and/or execution behaviour (i.e. categorisation into 'more profitable' or 'less profitable' clients with a particular percentage hedging/covering);
  - d. Limiting the maximum positive price slippage possible in favour of the client (e.g. 0%, 25%, 75%) or assigning a maximum positive slippage per volume for market or pending orders, effectively disadvantaging the client vis-à-vis the firm; and/or
  - e. Asymmetric limitations to the maximum positive and negative price slippage (in favour of the client and to client's disadvantage), above which client orders will be rejected or re-quoted.
37. Applying different prices or spreads, or applying a longer latency than is necessary before an order is executed (which has the potential to increase potential consumer detriment resulting from the application of asymmetric slippage) to similar client orders would not be compatible with MiFID best execution obligations. Firms should not seek to apply different treatment to different groups of clients based on the clients' trading profitability or based on the firm's own hedging arrangements.<sup>85</sup>

#### **Answer 1c: Governance and oversight of best execution**

38. NCAs should ensure that firms can clearly demonstrate who within the firm has responsibility and accountability for ensuring that its execution arrangements and policies meet MiFID requirements (Article 13 and Article 21 of MiFID and Article 5 of the MiFID Implementing Directive). A firm offering CFDs or other speculative products must ensure that its front office/ trading desk staff, including any individuals responsible for overseeing trade processing via software tools, fully understand their best execution obligations, and that best execution is appropriately reviewed by compliance and other control functions (such as risk and internal audit). The firm should provide adequate training as necessary to ensure that all relevant staff are aware of their best execution obligations.
39. One example of poor practice is where front office staff incorrectly believe that best execution obligations do not apply when offering CFDs or other speculative products to retail clients. It would be good practice for a firm to conduct real-time front office monitoring of its systems to promptly detect any anomalies in executed trades (e.g. where executed outside a normal spread limit) or underlying issues, such as the loss of connection to a price feed or liquidity provider, and taking prompt action to investigate and rectify issues if necessary.
40. The compliance function should ensure that meaningful benchmarks are set against which to assess execution quality achieved (for example, using external reference data providers

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<sup>85</sup> Notwithstanding that the firm retains the discretion as to how it chooses to hedge its trades, any commercial decision by the firm in this regard should not impact the execution quality provided to client or impede the firm's ability to act in the best interests of its clients. The only exception would be if the firm could show that a given order was treated differently for a legitimate reason, for example if a trade was large in size (above a pre-defined threshold), which meant it was appropriate to prioritise different execution factors to obtain a more favourable execution for that client. This would need to be documented by the firm.

or reports from venues that are representative of the underlying market prices, spreads and volumes for relevant types of CFDs) and that any tolerances or alert settings used to identify potential poor execution are not so wide as to be ineffective.

41. A firm should also ensure that significant or persistent issues are escalated to senior management, in order to consider whether changes to the firm's execution policy or arrangements are needed (Article 21(4) of MiFID).

**Question 2 [last update 11 October 2016]: What disclosures related to best execution should firms offering CFDs or other speculative products provide to their clients?**

**Answer 2a: Order execution policy**

42. NCAs should monitor that firms offering CFDs or other speculative products to retail clients provide details on their order execution policy in good time prior to providing the service, which should include details on the relative importance a firm assigns to execution factors. The policy should note for retail clients the prioritisation of price and cost, a list of execution venues on which the firm places significant reliance to meet the best execution obligations, and a warning that any client-specific instructions will take precedent over the firm's execution policy, although only for those elements to which instructions apply (Article 21(3) of MiFID and Article 46(2) of the MiFID Implementing Directive). This must be provided in a durable medium or by means of a website (subject to Article 3(2) of the MiFID Implementing Directive). Firms must also seek a client's explicit consent to his or her orders being executed outside a regulated market or multi-lateral trading facility (MTF), which will always be the case for OTC instruments such as CFDs and other speculative products.
43. A firm should provide clear links to its order execution policy on its website. The policy should be written and set out in a way that is appropriate and understandable for retail clients. The firm should clearly explain its execution model and how this impacts the execution process for the client. The firm should specifically identify the execution venue(s) on which it places reliance when executing client orders, or the sources from which they derive a price if dealing on own account (for example, naming the actual exchanges, MTFs or brokers used for price benchmarks).<sup>86</sup> The firm should also indicate in its policy the different approaches, including venues or pricing sources used, by type of instrument and underlying asset. For example, a firm's execution arrangements for CFDs on currency pairs are likely to be different for CFDs on shares, indices or commodities. The execution policy should not be generic, e.g. it should not state that a range of venues may be used without specifying them.
44. The firm's order execution policy disclosed to its clients should also include clear explanations of other key aspects of the firm's execution arrangements as discussed in Question 1 in this section.
45. For CFDs, rolling spot forex and binary options, this should include:

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<sup>86</sup> Section 3 of this document discusses in more detail, inter alia, the information that should be presented to clients about the firm and the service performed and about the price and the pay-out.

- a. Explaining the potential for latency between a quoted price and the executed price, what factors may impact latency, and possible risks to the client. In particular, the firm should explain that this can lead to price slippage, and explain how the firm will handle positive and negative price changes. As part of this disclosure, the firm could include information on the standard or average time it typically takes under its execution arrangements from the moment a client's order is first registered in the IT system of the firm, to when execution is confirmed, under standard market conditions (see below);
- b. If the firm offers execution in a market outside normal trading hours, how it constructs a price and executes orders in that instance;
- c. How the firm will apply its execution policy in certain events, for example in volatile markets. This should include an explanation of the steps that may be taken including whether the firm could cease to quote prices, use other venues or price sources, widen spreads, or execute orders on the next available price, and the possible implications for the client; and
- d. Specifying when any relevant clauses may result in the cancellation of trades or closure of positions. Such clauses should be as clearly defined as possible to limit the firm's discretion and should remain consistent with the firm's duty to act in the best interests of its clients.<sup>87</sup>

46. For binary options, the execution policy should also include:

- a. An adequate explanation of the strike price, the methodology of its calculation and the factors affecting its price. In the case that this differs/deviates from  $(bid+ask)/2$ , the circumstances under which this is possible should be adequately explained and disclosed to the client. A good practice example is when a firm provides to clients a continuous (e.g. per second) presentation of the flow of the bid/ask prices of the underlying asset of the binary option throughout the lifetime of the option, as received by the feed provider; and
- b. An adequate explanation of the expiry price (including the reference value of the expiry price per different underlying asset of the binary option) and the methodology of its calculation. A good practice example of the disclosure of the methodology used to determine the expiry price in the case of binary options is when the firm:
  - i. Makes reference to the relevant mathematical equation for the calculation of the expiry price, e.g.  $(bid + ask / 2)$ ,  $(last + bid + ask / 3)$ ;
  - ii. Explains the prices that constitute the expiry price (e.g. bid, ask, last). Where more than one price is obtained by the feed provider at the second of the expiry of the binary option (e.g. 1/16/2015 10:11:01.424 am, bid

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<sup>87</sup> Question 1 in this section states that broad or poorly defined clauses in the execution policy or other contractual documentation should not be used as a means to circumvent best execution obligations.

1.16394 ask 1.16404, 01/16/2015 10:11:01.885 am, bid 1.16395 ask 1.16404), the exact selection of data used is clarified;

- iii. Explains any rounding of the expiry price of the binary option;
- iv. Makes reference to the feed provider details;
- v. Maintains historical records with the bid/ask, and/or last prices at the expiry of the binary option, which are accessible by clients for the trades they executed;
- vi. Adequately explains the circumstances/conditions under which a binary option might not be available; and
- vii. Provides an adequate explanation of the methodology/calculation of the possibility for a buyout of a binary option by the firm, where relevant.

#### **Answer 2b: Disclosure of spreads**

47. Many firms in this sector disclose minimum spreads. However, a firm would not be considered to be in compliance with its best execution obligations if the minimum spreads that are marketed are in practice only available for a limited time during a day and/or for a limited number of transactions, while for the rest of the time the spreads offered are well above those being marketed. A firm should give clients sufficient information about the expected spreads throughout their trading experience, including busy hours and volatile periods (e.g. around news and announcements).<sup>88</sup>
48. A good practice example would be a systematic update and disclosure to clients of the time weighted average spreads over a sufficient period of time (e.g. over 1-4 weeks, disclosure of the total no of ticks for €/ \$ of 500,000, 100,000 with spread 1.5 pips, 300,000 with spread 1.6 pips, 100,000 with spread 1.4 pips, calculated weighted spread over period was 1.54), as well as the maximum spreads (monitored over same period and reporting the maximum spread provided by the platform).

#### **Answer 2c: Disclosure of data relating to execution quality**

49. NCAs should encourage firms to disclose data relating to the quality of execution of transactions to their clients. This information could include execution statistics such as:
- a. speed of execution;
  - b. positive/negative/zero slippage ratios; and
  - c. requotes/rejection rates.

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<sup>88</sup> When a firm has carried out an order, it should also disclose to the client the actual applied spread for each order executed as part of the information provided about the execution of the order (Article 40 of the MiFID Implementing Directive).

These could be provided per different account types, execution platform/ software used, order types, order sizes and markets or products (instrument type and underlying asset).

50. Metrics on order latency, which is relevant to the speed of execution, are particularly important for CFDs and speculative products on underlying assets such as currencies, where there is often extremely high liquidity and sensitivity in price changes due to the small size of price ticks and accuracy of quotes (typically going down to five decimal points), and as a result of the impact of leverage (where applicable) on the client's exposure. Any delays in executing marketable orders<sup>89</sup> may undermine the client's investment outcome and fairness of price received. Firms should consider publishing standard or average latency statistics for normal trading conditions, and explain specific circumstances in which the timeframes in which orders are executed may be extended, so that a client can easily and objectively verify if a given order execution took longer than standard or average, and if so whether this was justified. These should be based on the parameters of the IT systems<sup>90</sup> used and transactions concluded over a previous period, providing the standard or average time elapsing from the moment of an order being registered in the IT system to its execution.
51. By contrast, poor practice examples of execution disclosures, which may not be meaningful or could even be misleading, include the following:
- a. A firm discloses only the effects of positive slippage on the execution of client orders, without disclosing similar information in relation to negative slippage, e.g. "Over the last quarter, our clients' orders benefited from positive slippage of total value in excess of EUR5m", or the firm provides statistics on positive slippage only on limit orders but not other types of orders, such as stop orders and market orders, which are less likely to have positive slippage;<sup>91</sup> and/or
  - b. A firm discloses its slippage statistics on market orders without any indication of the volume and value of those orders and corresponding slippage, e.g. "Over the last quarter 60% of market orders were executed at the quoted price with no slippage, 30% with positive slippage (price improvement for the client) and only 10% of orders executed with negative slippage." This information is not sufficient for clients to evaluate and could be misleading, as it is not clear if the disclosed rates relate to volume weighted percentages, or per number of trades. If this statistic is calculated based only on the total number of orders, the asymmetry of positive and negative slippage might be a result of firm's execution model, whereby it favours smaller size orders versus larger size orders and the impact of negative slippage might be higher in value per order slipped, than the impact of positive slippage, and overall outcomes may not be favourable to clients.

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<sup>89</sup> A 'marketable' order in this context is an order to execute immediately at the current quoted market price, i.e. based on the bid/ask spread (for example, as opposed to a limit or stop-loss order, which are used to execute a trade at a pre-set price).

<sup>90</sup> The specified value should be given with highest precision possible based on the capacity of IT systems used by the firm (e.g. some platforms allow the time of execution of the orders to be measured with accuracy up to a 1/1000 of a second (1 millisecond)).

<sup>91</sup> Limit orders tend to be executed at the client requested price (no slippage) or better (positive slippage). On the contrary, when stop orders are executed they are usually executed at requested price (no slippage) or worse (negative slippage).

## **Annex 1: Questions NCAs could ask when assessing firms' compliance with best execution and client order handling requirements under MIFID<sup>92</sup>**

### **1. Understanding and scope of best execution:**

- a. Does the firm fully understand its best execution obligation, including which activities are covered by the obligation to deliver best execution?
  - i. Does the firm seek to limit the scope of the obligation, for example through the use of carve outs?
  - ii. Does the firm rely on the assumption they provide best execution solely because they are the 'only execution venue' for bespoke OTC transactions?

### **2. Process of delivering best execution:**

- a. Is the firm providing best execution consistently and applying the same treatment to all clients?
- b. Does the firm have a clear process for deriving a price?
  - i. Including execution of orders where pricing is not available and where pricing may differ from the disclosed market price?
  - ii. Is the same process used for all clients?
  - iii. Does the firm apply a transparent mark up to an instrument where the firm has manufactured the price using external benchmarks or similar approaches?
  - iv. Does the firm set and disclose a max spread?
- c. How does the firm select the execution venues (EVs) and liquidity providers (LPs) it uses?
- d. How does the firm ensure that its choice of EVs and LPs delivers best execution?
  - i. Does the firm review and compare a sufficient number of EVs and LPs?
  - ii. What are the factors contributing to the selection of the EVs and LPs?
  - iii. Is the firm is 'locked' to a particular EV/LP due to its dependence on technology: e.g. the LP provides the trading platform and the 'omnibus account' business model is followed?
- e. How does the firm deal with price slippage?

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<sup>92</sup> This list is not exhaustive. It is intended as an aide for supervisors or those involved in the review of best execution arrangements in firms offering CFDs or other speculative products to retail clients.

- f. How does the firm ensure that it complies with the best execution obligation when dealing on own account?
  - g. What technology or tools does the firm use to assist in executing client orders?
    - i. Does the firm use such technology or tools in a manner that infringes its best execution obligation?
    - ii. Does the firm use tools that allow systematic asymmetric slippage?
    - iii. Does the firm disclose execution features / settings of the trading platform/ system?
3. Review and monitoring of best execution:
- a. Is the firm effectively monitoring the delivery of best execution?
    - i. Is the monitoring capable of identifying best execution failures and poor client outcomes?
    - ii. Does the firm undertake independent monitoring of the execution quality of orders performed by the execution venue/ liquidity provider used (e.g. with the help of purpose build software)?
    - iii. If monitoring is automated using statistical thresholds and tolerances, are these set at appropriate and realistic levels to systematically detected poor executions?
  - b. What form does the monitoring take (e.g. bulk review of trades or manual review of individual trades)?
  - c. Does the monitoring cover all relevant instruments, reflect all of the execution factors that the firm is required to assess and include adequate sample sizes of transactions?
  - d. What are the second and third line of defence doing to review whether best execution is consistently achieved and whether there are any anomalies?
  - e. Does the firm carry out stress tests on its systems and trading platforms?
  - f. Does the firm perform regular comparisons of prices provided by its execution venue/ liquidity provider with other providers of independent price sources?
  - g. Is the monitoring of best execution captured in management information and used to inform action to correct any deficiencies observed? If so, how?
4. Connected parties and intra-group arrangements:
- a. Does the firm ensure it delivers best execution where it relies on connected parties and intra-group arrangements for pricing or hedging?



- b. Does the firm separate costs incurred on behalf of clients from its own internal costs when assessing best execution?
- c. If the firm cites lower execution costs as a reason for using a connected party or intra group entity in its execution arrangements, are these benefits passed onto the client?

5. Execution policy and other relevant disclosures:

- a. Is the policy clear about how the firm's arrangements achieve best execution and deliver outcomes that are in the client's best interest?
- b. Does the policy specify how best execution is delivered for all different types of instruments the firm offers?
- c. What are the best execution factors that the firm takes into account in order to deliver best execution? How is the relative importance of the different factors determined?
- d. What is the pricing methodology the firm uses?
- e. Is the firm clear about the venues it uses?
- f. Is the firm's policy and/or other relevant disclosures clear about what may constitute as exceptional trading conditions?
- g. Is the policy and/or other relevant disclosures clear about the circumstances under which the timeframe for executing orders could be extended?
- h. Can the firm evidence that it undertakes a regular review of its order execution policy and disclosures, and updates these policies and its clients if material changes have occurred, e.g. the addition or removal of an execution venue?

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**\*\*\*New\*\*\* Section 10: Passporting and the cross-border provision of services by investment firms offering CFDs and other speculative products to retail clients outside the home Member State without the establishment of a branch or tied agent**

**\*\*\*New\*\*\* Introduction**

1. A core principle of MiFID permits investment firms authorised in home Member States to provide any or all of the investment services for which they have received authorisation into other Member States (under Articles 6 (3) and 31 of MiFID) together with any ancillary service.
2. MiFID investment firms offering CFDs and other complex products to retail clients often operate an online business model in which investment services are offered on a cross-border basis, in multiple other Member States, without the use of branches or tied agents and with firms having only a limited physical presence outside the home Member State.
3. When a physical presence is established, NCAs note that in some cases this is through the establishment of representative offices. Representative offices are only permitted to conduct market research and promote the brand of the firm and cannot provide any MiFID services. NCAs however have observed incidents of representative offices acting unlawfully by providing regulated services.
4. As representative offices are not subject to the freedom of establishment rules under Article 32 of MiFID, the host **NCA** has no supervisory **oversight** of their activities or access to information in relation to the representative office. This places a greater emphasis on the home NCA's supervision of the investment firm's cross border activities and also on the sharing of information between home and host NCA.
5. Third parties, also referred to in the industry as introducing brokers or affiliates, ("third parties"), are widely used to facilitate the cross border distribution of CFDs and other speculative products. Third parties have been observed carrying out a wide range of promotional, marketing and client services activities on behalf of investment firms. In many cases these activities overlap and it can be difficult to distinguish between the marketing of the firm/brand, the provision of customer support services and the provision of investment services. Given the extensive use of third parties in the industry, it is critical that authorised firms have robust **controls** in place to ensure the effective **oversight** of these relationships.
6. Under MiFID, the home competent authority is responsible for assessing how a firm authorised in its Member State which is providing investment services in another Member State without a branch or tied agent, complies with its MiFID obligations. The online nature of this industry and the extensive use of third parties located outside the home jurisdiction increases the need for robust **oversight** of the distribution arrangements of authorised firm's and highlights the need for open communication between home and host NCAs.

7. This section identifies certain key aspects that NCAs should take into account as part of their supervisory responsibilities under, inter alia, Articles 13, 16 and 17 of MiFID when considering the activities of firms providing services under Article 31. The section also identifies how NCAs can ensure better cooperation between home and host authorities in order to enhance such supervision.

**\*\*\*New\*\*\* Question 1 [last update 31 March 2017]: Where an investment firm establishes a representative office in a host Member State, what factors should the home NCA take into account when assessing whether the investment firm complies with the MiFID provisions on cross border services?**

**\*\*\*New\*\*\* Answer 1**

1. The authorised firm must qualify the nature of the activities performed by a representative office established in another Member State. If the office in practice provides investment services or activities, it must be considered a branch.
2. A representative office is an office that represents the head office of an investment firm in another Member State and does not itself provide investment services or activities. Representative offices<sup>93</sup> can only carry out activities such as market research and promoting the brand of an investment firm.
3. As stated in the Recommendation 13 in the CESR document CESR/07 337b, in practice, firms should notify under Article 31 where they establish a representative office to enable the home NCA to inform the host of the possibility that they might be conducting cross-border business.
4. When such a notification is received by the home NCA or when a home NCA becomes aware of the existence of a representative office, it should inform the host NCA without delay.
5. The specific activities, governance arrangements and internal controls in respect of the representative office should be clearly understood and assessed (on a regular basis) by the home NCA. The home NCA should request supplementary information, such as:
  - a. Board minutes evidencing formal approval of the establishment of the representative office and also outlining the business case for its establishment and the activities to be provided;
  - b. Detailed roles and responsibilities of staff of the representative office;

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<sup>93</sup> The concept of representative office comes from banking legislation as such offices were mainly a feature of credit institutions.

- c. A revised **compliance monitoring** plan outlining the **oversight** to be provided of the representative office.
6. The home **NCA** should consider whether the establishment of the representative office signifies a material change of business strategy that may require additional systems and **controls** to be put in place by the investment firm. The home **NCA** should also consider whether investment firms which provide services in other jurisdictions without the establishment of a branch or tied agent should be assigned a **higher risk** rating than other similar firms.
7. The home **NCA** should ensure that the **oversight** arrangements in place between the authorised firm and the representative office are sufficiently captured within the firm's **internal control** framework. Consideration should be given to challenges relating to the geographic distance between the firm's headquarters and the representative office and the potential for language barriers or cultural differences between staff at the authorised firm and the representative office. As a consequence, the home competent authority's assessment of the firm's policies, **procedures** and **controls** over the representative office will be particularly important in cross-border arrangements of this nature.
8. The home **NCA** should check that an investment firm ensures that individual staff members in the representative office are sufficiently informed and have been provided with adequate training so as to understand the relevant regulatory obligations and the strict limitations in respect of the activities of the representative office.
9. Where a home **NCA** concludes that it cannot **rely** on the authorised firm's **internal control** framework, or where specific supervisory concerns arise, for example, as a result of client complaints, it may be necessary to interview staff of the representative office or to carry out inspections of the operations of the representative office. NCAs may seek to review phone calls, email records or financial transactions to gain comfort over the nature and scope of the activities carried out. Host NCAs should also share information with a home **NCA** if they **suspect** a representative office in their jurisdiction may be providing investment services or carrying out investment activities.
10. Poor practices observed in this sector of the market include:
  - a. Authorised firms being unable to demonstrate any meaningful **oversight** or **compliance monitoring** of the activities of the representative office;
  - b. Representative offices directly providing clients with investment advice or other investment services;
  - c. Representative offices entering into bilateral relationships with clients of the investment firm. Where this is the case, it is likely that the representative office is engaging in activities that would lead to it being qualified as a branch;
  - d. Staff of representative offices remunerated either partly or fully on the basis of the value of transactions entered into by acquired client(s) or the value of client deposits;

- e. Representative offices publishing contact details to encourage clients or prospective clients to call the office to discuss opening trading accounts, trading strategies, open positions or technical issues, sending trading signals etc.

11. The home NCA should, both at the authorisation stage and as part of its ongoing supervision, request all necessary information from the firm to enable it to understand how the representative office will make use of, or engage with, other local third parties who may act as intermediaries, introducing brokers or affiliates and who may be involved in hosting the firm's promotional material, directing web traffic to the firm's website, or directly introducing individual clients to the authorised firm.

**\*\*\*New\*\*\* Question 2 [last update 31 March 2017]: What should home NCAs consider when assessing the use of third parties by investment firms to acquire retail clients under the provisions of Article 31 or 32 of MiFID?**

**\*\*\*New\*\*\* Answer 2**

1. Investment firms operating in this sector often engage with third parties across multiple jurisdictions who operate on behalf of, or for the benefit of, the investment firm. Such third parties have been observed engaging in a range of activities including: (i) promoting the brand of the authorised firm online or through other media outlets, (ii) hosting marketing material and directing web-traffic to the authorised firm's website, (iii) increasing the online profile of the firm through search engine optimisation, (iv) providing customer support services, and (v) directly introducing clients or other third parties to the investment firm.
2. In some instances, third parties have been found to be unlawfully providing regulated services such as investment advice or portfolio management.
3. The use of third parties can create ambiguity for retail clients who may not be able to understand or delineate between the activities performed by the unregulated third party and the activities of the authorised firm. It can also make it more difficult for clients to contact the authorised firm directly to raise queries or complaints as clients may not be familiar with the applicable home state regulatory complaints regime or resolution process for complaints.
4. Third parties are often remunerated on the basis of client trading volumes or net client losses, creating a potential material conflict of interest which it is unlikely the investment firm can effectively manage in an objective and demonstrable manner. Additionally, third parties may also be clients of the authorised firm which can create a further conflict of interest.
5. The home NCAs should be aware of an investment firm's third party arrangements and should consider whether these arrangements equate to the outsourcing of critical or important operational functions, which therefore must comply with the MiFID outsourcing

provisions<sup>94</sup>. In the context of the business models of investment firms which distribute CFDs and other complex financial instruments to retail clients online, non face-to-face activities in relation to marketing, customer support and IT would typically be deemed to be of critical importance<sup>95</sup>.

6. The home NCA may also request supplementary information to understand the relationship with the third party. The specific activities, governance arrangements and internal controls in respect of the third party should be clearly understood and assessed (on a regular basis) by the home NCA. The home NCA should consider whether the following information is required, such as:
  - a. Board minutes evidencing formal approval of the establishment of the third party arrangement and also outlining the business case for its establishment and the activities to be provided;
  - b. Detailed roles and responsibilities of staff of the third party;
  - c. A revised compliance monitoring plan outlining the oversight of the third party.
7. The home NCAs should also consider where the establishment of the third party arrangement, such as a call centre, represents a material change of business strategy that might necessitate a reconsideration of the firm's authorisation.
8. Customer support functions, such as call centres or agents operating live online chat services, are widely used by investment firms in this sector to address standard client queries, for example, in relation to initial account set-up or platform functionality.
9. A third party customer support function, which is not acting as a branch or tied agent, cannot provide any form of investment advice or issue opinion on any investment services or products or provide any trading strategies or send trading signals. In the case where a firm engages with a third party to provide customer support, the home NCA should require that the investment firm has in place effective internal controls which ensure these activities are adequately monitored. For example, in order to gain satisfaction that no investment services are being provided, the investment firm should have access to recordings/transcripts of all phone calls and/or live online chat discussions and should conduct regular monitoring of the content of client interactions. Access rights to the relevant records of the third party, including telephone recordings, should be incorporated into the written outsourcing agreement between the investment firm and the third party. Call centre staff should operate in accordance with a written manual or Q&A document, formally approved by the investment firm, which outlines suitable standard responses to typical client enquiries<sup>96</sup>.
10. In cases where the third party solely acts as a platform through which the firm presents advertising or promotional content (e.g. newspaper, TV channel, magazine), the investment

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<sup>94</sup> See inter alia, MiFID Implementing Directive Articles 13, 14, 15.

<sup>95</sup> For firm's operating such business models, a defect or failure in the performance of these functions would materially impair the soundness or continuity of the investment firm's investment services or activities (Article 13(1)).

<sup>96</sup> In general call centres should only receive incoming calls. Outbound calls may be appropriate in limited circumstances such as when a client has expressly requested a call-back.

firm must ensure that the content of the marketing material is clear, fair and not misleading in accordance with the requirements of MiFID and that it is subject to pre-approval and on-going monitoring by the investment firm.

11. In cases where the investment firm has entered into an agreement with a third party to use its website as a portal for displaying promotional and advertising content, the investment firm should regularly verify that the third party does not use this information to encourage users of its website and prospective clients of the investment firm to entrust the third party with funds for management, or does not in any way offer investment advisory services to prospective clients on behalf of the firm.
12. In other cases, third parties have been observed as being involved in active client acquisition on behalf of the investment firm through means such as direct telephone calling<sup>97</sup>, personal meetings, sending emails, and contacting prospective clients through social media or internet chat rooms. These activities may involve the provision of investment services such as reception and transmission of orders or investment advice. For example, there is a risk that a third party entity carrying out active promotion of financial instruments and client acquisition may, either in an explicit or in an implicit form, recommend financial instruments such as CFDs or other speculative products as suitable for the investor and so could be regarded as providing investment advice. Where a third party is providing investment services in a host Member State, they can only do so if they are either a tied agent or a branch of an investment firm, or are independently authorised as an investment firm.
13. In assessing whether the use of third parties by authorised firms is in compliance with the MiFID requirements and to ensure third parties perform tasks entrusted to them with due care and in the clients' best interests, home NCAs may inter alia consider the following points:
  - a. Does the investment firm maintain a register of all third parties with a description of the activities carried out by each entity?
  - b. Does the investment firm maintain a register of sub-affiliates which arise when a chain of third party relationships exist as a result of a third party further contracting with another entity to carry out all or a portion of a particular activity?
  - c. Is the third party acting in an active or passive capacity? Where third parties are actively involved in client acquisition or managing client relationships on behalf of the firm (as described in paragraph 12) it should be considered whether they should have their own independent authorisation or be established as a branch or tied agent of the investment firm.
  - d. Does this register identify which clients are associated with each third party and any interconnectedness between different third parties or sub-affiliates?

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<sup>97</sup> Direct marketing including direct telephone calling is not permitted in France in relation to CFDs, Rolling Spot Forex and Binary Options. Unsolicited 'cold call' promotions are also prohibited in the UK in relation to CFDs.



- e. Are **third party** arrangements documented through formal contracts?
  - f. Is a robust process of due diligence undertaken by the investment firm of all third parties prior to any formal arrangement commencing and on an on-going basis thereafter, and does the investment firm maintain adequate **oversight** of the third party?
  - g. Are the **third party** remuneration arrangements adequately documented and structured in such a manner which does not create a material conflict of interests<sup>98</sup>?, and
  - h. Does the investment firm provide third parties with appropriate and effective training?
14. **Third party** arrangements may be structured in such a way that formal agreements are entered into between the **third party** and another (possibly unregulated) **group** entity and not directly with the authorised firm. This may obscure the direct relationship and transaction flows between the **third party** and the authorised investment firm. However, where a **third party** is involved in promoting the brand of a regulated entity within any Member State, the authorised firm must maintain adequate **oversight** of its activities regardless of the contractual relationship between the **third party** and the investment firm's wider group.
15. Third parties may also be clients of the authorised firm and the home **NCA** should ensure that the firm assesses if there is any conflict of interest as a result of these bilateral relationships and where necessary, that the firm has put appropriate mitigating **controls** in place to remove such conflicts.
16. The complex and varied nature of the **third party** relationships evident in this sector places increasing importance on the open cooperation and communication between home and host Member States in relation to issues or concerns arising in respect of **third party** activities. Such information sharing will inform home Member States in their on-going supervision of authorised firms and also may enable host Member States to **identify** unregulated service providers operating in their jurisdiction.

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<sup>98</sup> See also question 3 of section 2 of this Q&A document.

**\*\*\*New\*\*\* Question 3 [last update 31 March 2017]: What examples of poor practice have been observed by NCAs in respect of the use of third parties by investment firms offering CFDs and other speculative products to acquire retail clients on a cross border basis?**

**\*\*\*New\*\*\* Answer 3**

1. Poor practices observed in this sector which are considered unacceptable and which would indicate that the third party (including call centres) should be authorised in its own right or face charges of providing unauthorised investment services, include (inter alia):
  - a. Third parties carrying out active promotion of financial instruments and client acquisition that can involve the provision of investment advice, portfolio management or other MiFID investment services or ancillary services;
  - b. Third parties misleadingly referring on their website or social media pages (Facebook, LinkedIn etc.) to themselves as being employees of an authorised investment firm or to themselves being authorised, regulated or supervised by a NCA;
  - c. Investment firms referring to third parties as “advisors”, thus indicating to prospective clients that the third party is providing advice in relation to the investment services offered;
  - d. Third party introducing brokers also engaging in automated trading arrangements whereby the third party both introduces clients to the investment firm and acts as a signal provider to those clients;
  - e. Third parties entering into bilateral relationships with clients of an investment firm whereby the third party acts as a money manager and operates a “master” or “percentage management” account on behalf of a single client or multiple clients;
  - f. Third parties acting as “recovery managers” who specifically engage with clients that have suffered losing trades and claim to assist in recovering losing positions by unlawfully providing investment advice or portfolio management services.
2. Poor practices observed in this sector which would require greater scrutiny by the investment firm of the third party’s activities include, inter alia;
  - a. Authorised firms being unable to demonstrate meaningful oversight or compliance monitoring of the activities of third parties, including call centres and sub-affiliates;
  - b. Arrangements with third parties not being documented by way of a formal agreement setting out the parameters of the arrangement, the services to be provided and the payment details;

- c. Third parties being contracted to a separate unregulated related party of the investment firm. In such instances, payments to third parties may not be visible in the accounts of the regulated entity but will typically be captured through inter-group transfer pricing arrangements. Such an arrangement can impede the ability of the home NCA to effectively assess the risks associated with an investment firm's third party arrangements;
  - d. Authorised investment firms failing to maintain sufficient records of their engagements with third parties, such as meetings, phone calls, emails, etc.;
  - e. Third parties remunerated on the basis of the number of clients introduced, the volume of client trading or the value of client deposits<sup>99</sup>;
  - f. Third parties misleading clients of investment firms by using false personal information (e.g. third parties using false names and postal and email addresses);
  - g. Contacting the same client using different email addresses or phone numbers;
  - h. Following regulatory sanction, third parties establishing new entities which are controlled by the same individuals and engage in the same activity; and
  - i. Customer support or call centres adopting retention strategies aimed at encouraging existing clients to keep their trading accounts open or placing restrictions on clients seeking to close accounts or withdraw funds.
3. Where home NCAs identify firms with third party arrangements which are not subject to effective and rigorous oversight and/or where evidence of any of the above practices exist, consideration should be given to appropriate supervisory measures which may be necessary to ensure the investment firm authorised in its Member State is compliant with its MiFID obligations. This may include consideration of the location of the third party and whether the host NCA in that jurisdiction should be notified of practices, which may constitute the unlawful provision of MiFID services by an unauthorised entity.

**\*\*\*New\*\*\* Question 4 [last update 31 March 2017]: What cooperation should take place between NCAs?**

**\*\*\*New\*\*\* Answer 4**

1. Supervisory cooperation between competent authorities of home and host Member States is an important element for ensuring safeness and soundness of the Single Market and protecting the interests of clients across the Union. The importance of appropriate exchange of information and cooperation between the competent authorities supervising investment firms operating in this sector through the freedom to

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<sup>99</sup> See also question 3 of section 2 of this Q&A document.

provide services in one or more Member States should be of a sufficient scope and nature to allow competent authorities to discharge their supervisory duties and functions effectively.

2. Due to the cross-border nature of this activity itself, a proactive and agile cooperation between home and host authorities is essential in order to duly protect the interests of the clients.
3. ESMA believes that in order to ensure efficient cooperation between competent authorities of home and host Member States information exchange should be two-way, provided through clearly established channels of communication and dealt with promptly. In this context:
  - a. The home NCA should promptly advise the host authorities of the Member States in whose territories an investment firm carries on activities under Article 31 of any decision by the home NCA to withdraw or to suspend the authorisation of that firm, or any other important fact that could affect the provision of investment services by the firm.
  - b. The home NCA should promptly respond to the host NCA or vice versa, when a request for information is made. Where such a request cannot be responded to promptly the receiving NCA should promptly inform the requesting NCA of the estimated date for provision of the requested information. Where the receiving NCA is aware there will be a delay in providing the requested information it should promptly inform the requesting NCA of the delay and the new estimated date.
  - c. The host NCA should be promptly provide any relevant information to the home NCA when it becomes aware the home NCA is investigating in a firm issues related to the provision of activities under Article 31.
  - d. The home NCA may consider the reasons why the authorisation is requested in their Member State when the activity is planned to be exclusively or mainly carried out in other Member States particularly to identify cases where the applicant may have previously sought authorisation in one or more of those Member States without success. In this context, close cooperation between the host and home NCAs is crucial, in particular with the experience, if any, of the host NCA in relation to the firm itself or its promoters.<sup>100</sup>
  - e. The home and host NCAs establish clear lines of communication with designated contact persons within the home and host NCAs to address supervisory issues related to firms providing services in Article 31.
4. Good practices, without prejudice to the above mentioned general aspects, include:

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<sup>100</sup> See also section 1 of this Q&A document.

- a. Regular information sharing between home and host NCA designated contact persons to discuss issues relating to firms providing services under Article 31,
  - b. The host NCA transmits complaints information relating to services provided by firms providing services in their Member State under Article 31 that they have received from clients in their Member State to the home NCA, in order to allow home NCAs to further investigate if there are any supervisory issues to be addressed. It would also be considered a good practice for the host NCA to summarise the complaints into English before sending them to the home NCA.
  - c. The Home NCA promptly communicates with the host NCA about any possible problems relating to an investment firm providing services in that Member State it has been made aware of through any complaints received.
  - d. Where a procedure for settlement of disagreements in relation to cross border situations between NCAs of different Member States has been initiated<sup>101</sup>, the NCA of the home Member State should inform relevant investment firms that a decision concerning the passport notification is deferred pending resolution.
  - e. The home NCA informs the host NCA of any issues related to the purchase, acquisition, liquidation or bankruptcy of the firm providing services under Article 31.
5. Poor practices observed in this sector of the market include:
- a. Unjustified delays from the home NCA in answering to questions/requirements of the host NCA.
  - b. Lack of cooperation from the home NCA when information is required from the host NCA as a consequence of a supervisory process, bankruptcy or any other circumstance that could affect the passport.
  - c. Lack of action/reaction from the home NCA when the host NCA communicates a non-compliant behaviour or any other breach of MIFID rules.

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<sup>101</sup> See Article 19 of Regulation (EU) No 1095/2010

**\*\*\*New\*\*\* Question 5 [last update 31 March 2017]: An investment firm offering financial contracts for difference (CFDs) or other speculative products communicates to its home competent authority its intention to provide services in other jurisdictions under Article 31 of MiFID, in order to market speculative products to retail investors across Europe online. What particular factors should the home competent authority take into account when considering this information?**

**\*\*\*New\*\*\* Answer 5:**

1. Many firms offering CFDs and other speculative products to retail clients operate an online business model which is based on the cross-border provision of such products to the retail mass market without branches, pursuant to Article 31 of MiFID. In the life cycle of supervision, one key check point indicating a potential change in the business model of an investment firm can be when a notification is made by the firm about its intention to provide MiFID investment services and activities in another Member State (also known as 'passporting'). Taking into account the scale of planned expansion of activity, a passport notification is an opportunity for the home competent authority to consider its assessment of the business model, organisational arrangements and practices of the firm.
2. In particular, on receiving a request from an investment firm to provide services under Article 31 the home competent authority should consider the planned business model compared to the existing business model of the investment firm, in order to assess whether the planned expansion could present any new regulatory risks or otherwise change the existing risk profile of the investment firm. For example, the home NCA should check for any existing supervisory or enforcement investigations or actions against the firm in order to assess whether the planned expansion could present any regulatory risks. Some or all of the information necessary to make such an assessment may already be known to the home competent authority, as a result of other ongoing supervisory activity or from the contents of the passport notification.<sup>102</sup> If information provided in a passporting notification is incomplete, further necessary information should also be requested from the investment firm notifying its intention to passport.
3. The following business model aspects are likely to be particularly relevant for home competent authorities to consider if follow up work with a firm following a recent services passport request should take place, given that in this example firms offering CFDs and other speculative products (such as binary options and rolling spot forex) are almost exclusively marketed to retail clients online on a cross-border basis:
  - a. The planned scale and nature of the business activity in the proposed host Member State(s) compared to the activity presently conducted in the home Member State

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<sup>102</sup> It should be noted that part of the MiFID II package, which enters into application in January 2018, includes regulatory technical standards and implementing technical standards specifying and standardising the information to be notified by investment firms, market operators and credit institutions when notifying the competent authorities of their home Member State in the event that they wish to provide investment services or perform investment activities as well as ancillary services in another Member State.

and any other Member State(s) in which the firm is already providing investment services or activities;

- b. The distribution channels to be used in the host Member State(s) and the relevant controls in place to ensure that the investment firm is meeting its MiFID obligations in the home Member State(s). This should include, where applicable, information on whether and how the firm intends to use any third parties located in the host Member State as part of its business model to distribute CFDs or other speculative products in the host Member State; and
- c. The proposed marketing and promotional activity in the host Member State(s). This may include whether and how the investment firm plans to issue marketing communications in the language of the host Member State(s) (see also Section 3 on information to clients, Question 1).

**\*\*\*New\*\*\* Question 6 [last update 31 March 2017]: An online business model is often used by investment firms to offer financial contracts for difference (CFDs) and other speculative products in other jurisdictions under Article 31 of MiFID, without branches. Where an investment firm is adopting this type of online business model and offering information to clients and potential clients in multiple languages, what factors should the home competent authority take into account to ensure the firm complies with its MiFID requirements relating to information provided to clients or potential clients?**

**\*\*\*New\*\*\* Answer 6**

1. Although speculative products such as CFDs, binary options and rolling spot forex are complex products and it may be difficult for a majority of retail investors to understand the risks involved, these products are widely advertised to the retail mass market, often via online platforms. National Competent Authorities (NCAs) should therefore pay particular attention to the information and marketing communications issued by firms offering these products, to ensure that information provided to clients and potential clients is fair, clear and not misleading, and that marketing communications are clearly identifiable as such.
2. Home competent authorities are responsible for the supervision of information and marketing communications provided by firms authorised in their Member State, including when such information is provided on a cross-border basis in other Member States without a branch. Methods that home competent authorities should make use of to monitor information and marketing communications include: the ex-ante or ex-post review of information and marketing communications<sup>103</sup>; thematic reviews of information and marketing material on a periodic basis (e.g. "surfing days"); and mystery shopping exercises<sup>104</sup>). Where information or marketing communications are reviewed on an ex-post basis, competent authorities should ensure that their monitoring is sufficiently

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<sup>103</sup> Without prejudice of the existence of the additional domestic requirements that may be applicable.

<sup>104</sup> Where legally possible.



timely to enable them to react, to ensure that investors are not misled by information or marketing communications that are misleading and not fair or clear. Home competent authorities should also ensure that their monitoring enables them to identify whether a particular firm is consistently producing unclear or misleading communications, which may warrant further investigation into the firm's processes and controls.

3. It is common in this market for information and marketing communications to be offered on a cross-border basis in languages other than the language(s) of the home Member State. As this may pose some practical challenges for the home competent authority, cooperation between home and host competent authorities is particularly important in these cases. Where a host competent authority identifies an issue relating to the information or marketing communications provided by a firm that is operating in its jurisdiction without a branch, as part of its obligation to cooperate (Article 56 of MiFID), the host competent authority should proactively notify the home competent authority, to enable the home competent authority to take the information into account as part of its supervisory activity.
4. The home competent authority should request necessary information from investment firms and, where relevant, host competent authorities, to facilitate the ongoing review of information and marketing communications, including those provided in other languages or other jurisdictions<sup>105</sup>. Whilst on a practical level, it may not always be feasible for a home competent authority to monitor every communication by every firm in every language, competent authorities should, at a minimum, adopt a risk-based approach taking into account available intelligence and other relevant information to ensure that firms are complying with the MiFID requirements relating to information and marketing communications to clients and potential clients in all Member States in which they provide investment services and activities, without branches.
5. The home competent authority has a number of tools at its disposal to facilitate the review of information and marketing communications in other languages. For example, it could require a firm to make its marketing communications available in the language of the home regulator; and/or request the assistance of NCAs in the host Member State(s) to provide details of the marketing communications available in their jurisdictions. As one example of a risk-based approach, where similar information is provided in more than one host Member State(s), it would be logical for the home competent authority, before determining its review approach, to first ascertain the extent to which the information and marketing communications provided to clients and potential clients in other Member States is based on the same 'base' information that is translated into multiple languages.

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<sup>105</sup> Please also see paragraph 24 of Q2 of Section 3, which refers to the need for firms to translate marketing materials used cross border into the language used by the home NCA.