

## FCA Cracks Down on Retail CFDs in Consultation Paper

The Financial Conduct Authority's (the "FCA's") recent [Consultation Paper 16/40](#) ("CP16/40") outlines policy proposals designed to boost investor protection measures available for retail contracts for differences ("CFDs"), including spread betting and rolling spot foreign exchange products. This follows the FCA's [thematic review](#) and its supervisory work carried out within the sector which highlighted a number of concerns for the FCA, in particular, that investor protection measures were not robust enough. It also sets out the FCA's plan to review binary bets ahead of these products being brought under the FCA's umbrella. These changes, once implemented, may not just leave firms vulnerable to action from the FCA, they could also result in investors mounting their own legal actions, claiming that losses were caused by firms not complying with the requisite conduct of business standards and financial promotion rules.

### Why is the FCA proposing such measures?

The FCA has decided to enhance conduct of business standards for CFD providers to limit the risk of retail CFDs to investors and bring the UK in line with measures proposed or in place in other EU jurisdictions, such as Belgium, France and the Netherlands. In its most recent [thematic review](#) of the sector, the FCA said that it identified what it described as "shortcomings" in relation to these products, particularly regarding firms' considerations of how appropriate such products are for investors, use of risk warnings and anti money laundering ("AML") checks.

The FCA noted that this change is particularly marked because the CFD sector has changed significantly, with the number of active clients in retail CFD products in the UK estimated at around 125,000, doubling since 2010. With an increasing number of firms also offering CFDs to retail customers, the retail market is expanding beyond the initial limited target market and highly complex, leveraged derivative

products are now being targeted at a broader range of retail investors, whereas previously they were typically marketed to more financially sophisticated retail investors. The policy proposals that the FCA intends to put in place seek to remedy any investor harm that may result from this change.

However, this is not the first measure that the FCA has taken in relation to the CFD sector. In particular, in the [Dear CEO letter in February 2016](#), the FCA outlined its expectations for CFD firms with regards to adequate standards relating to appropriateness assessments, AML controls and client categorisation, indicating that closer scrutiny of the sector is firmly on the FCA's agenda, as well as being a key topic of interest for other EU regulators.

### What is the FCA proposing for CFD firms?

The FCA's package of reforms has three distinct elements:

#### 1. *Enhanced disclosure requirements*

All retail CFD firms will be required to provide a standardised risk warning which discloses "sufficient and more effective information" to retail clients and mandatory profit-loss disclosures so investors have a better understanding of the risks of investing in CFD products.

Firms will be required to set out the percentage of client accounts that made a net profit or loss in both the previous calendar quarter of trading activity and over the last 12 months. This information can be displayed on any website page or mobile application that discusses the benefits of investing in retail CFD products. The disclosure must also include the actual profits or losses and the current level of profit or loss from equity in open trading positions.

While firms that offer CFDs into the UK on a cross-border services passport from another EU member state will not be directly subject to this measure, the FCA is proposing to restrict financial promotions for firms that do not adopt a proposed enhanced disclosure requirement.

## 2. *Leverage limits (minimum margin requirements)*

To limit the risk to investors of investing in highly leveraged products, firms will need to apply:

- a) lower leverage limits or initial margin requirements and margin close-out requirements for inexperienced retail clients (less than 12 months of active trading experience) in relation to CFD products or other relevant margined products.

The firm may allow the client to maintain their open position(s) until their net equity falls below 50% of the initial margin required to establish their open position(s). Once this happens, the firm must close out the client position(s) as soon as market conditions allow.

The FCA hopes that this measure will reverse the current market practice of firms offering the highest leverage to small accounts and will require firms to request information to establish a client's knowledge and experience to deem if products are appropriate.

This is a marked diversion away from the FCA allowing clients to self-certify that they understand the risks or firms relying on assessments of 'knowledge' to deem if CFD products are appropriate for a client and instead places emphasis on actual, evidenced client experience of trading leveraged instruments.

- b) higher leverage limits for experienced retail clients determined by volatility of the underlying asset.

The FCA said that such limits still reflect the risk and relative volatility of each of the underlying assets and are in line with

international practices, reducing risks to investors. The FCA is also proposing the same 50% margin close-out requirement for experienced retail clients as for less experienced clients.

## 3. *Prohibition of bonus promotions and other incentives*

This bans all financial promotions offering introductory or trading 'bonuses' or benefits to promote certain retail CFD products and platforms as the FCA said that such incentives are "inappropriate" and can draw in inexperienced retail clients and not make investors fully aware of the risks of investing in a product. The FCA said that it identified that clients were often unaware of the terms and conditions associated with access to bonus funds, e.g. these depended on a specified volume of trades while others reported difficulties in withdrawing funds when trying to use bonus promotions.

## 4. *Restriction on financial promotions for incoming EEA firms*

As well as the three measures detailed above, the FCA is also proposing to restrict financial promotions for incoming EEA firms that do not adopt comparable conduct of business standards when offering retail CFD products to UK clients, such as the enhanced disclosure requirement. The FCA said that such a measure will ensure that UK investors receive a consistent level of consumer protection when dealing with UK and incoming EEA firms.

## What are the plans for binary bets?

Binary bets involve clients 'betting' on whether the price of a financial instrument will be higher or lower than a fixed threshold at a future point in time using complex probability methodologies and with firms having greater information than the consumer, making it harder for retail clients to make an informed investment choice. The FCA has included binary proposals alongside those for CFDs as it considers these products to be marketed in a similar way.

The regulatory landscape for binary bets is changing. While binary bets are currently considered gambling products in the UK and providers are currently licensed under the Gambling Commission rather than being FCA regulated, the Treasury has consulted on bringing binary bets into the scope of FCA regulation as part of the transposition of Markets in Financial Instruments Directive (“**MiFID**”) II and the FCA intends to create a new permission category of binary bets to supervise firms conducting this type of business.

The FCA is particularly concerned that the “inherent features” of binary bets may make them inappropriate for retail investors as it is difficult for retail clients investing in such products to judge the value of the bet, making them less able to make an informed decision. Investments in binary bets may also cause the investor to develop addictive behavioural patterns because such products are similar to gambling products. The FCA also said that binary bets may present best execution obligation concerns because they lead to conflicts of interest as the firm takes the other side of the client’s bet, with the firm possessing far more information than the investor. The FCA particularly has significant concerns over the conduct of binary bet firms in other EEA jurisdictions and elsewhere and the impact on UK consumers.

The FCA is therefore considering a restriction on the marketing of binary bets to certain retail clients, using product intervention powers under MiFID II which will allow the FCA to ban or restrict specific product features of binary bets where there is a significant risk to investor protection. The FCA said it will also consider other approaches to ensure that binary bets are designed to meet the needs of the target market and serve the best interests of investors.

The FCA said that any potential measures will be subject to the government’s final legislative changes to bring binary bets within the scope of the FCA’s regulatory power and that the FCA will consult on formal proposals once such legislation has been finalised and once it has received responses from CP16/40.

## What is happening in other jurisdictions?

The UK is not the only jurisdiction to introduce measures to address the potential risks of CFDs to investors. The European regulator, the European Securities and Markets Authority (“**ESMA**”), has introduced measures that will harmonise the application of the MiFID standards across the CFD sector and a number of EU member states have already introduced or plan to introduce financial promotion bans on CFD retail products and implement specific conduct requirements designed to improve consumer understanding of products.

EU legislation is also increasingly focusing on investor protection with the Packaged Retail and Insurance-based Investment Products Regulation introducing Key Information Documents to increase disclosure to clients and MiFID II enhancing conduct and organisation requirements that apply to investment firms offering retail CFD products. The FCA therefore considers that its proposed measures will bring its policy in line with a number of other jurisdictions.

## What’s next?

Clients and potential clients in retail CFDs, providers and distributors of retail CFD products and binary bets and associated trade bodies should submit comments to the FCA by 7 March 2017.

The FCA aims to publish feedback and a Policy Statement confirming final FCA Handbook rules for retail CFDs in spring 2017 with the rules coming into force shortly afterwards. The FCA will also use feedback on binary bets to assess whether further policy measures are necessary and will aim to publish a Consultation Paper in spring 2017.

Interested parties should therefore look at expressing their views on the proposals by the 7 March 2017 deadline. CFD providers should also ensure that they are complying with existing rules on CFD products, in particular with the current investor disclosure requirements related to risk warnings.

Given that there has been increased regulatory

activity at both UK and international level aimed at addressing concerns regarding investor protection within the CFD sector, CFD firms should also consider how the proposals may affect their business long-term and start planning accordingly. Firms should also ensure that staff are fully trained so that they are aware of the FCA's main concerns in this area and are implementing the current conduct of business requirements effectively.

This is particularly important given that it is not just the FCA who could pursue legal action against firms deemed to be in breach of these rules. Once the rules come into force, there is also a potential for investors who have lost money on CFD investments to mount legal action against firms, claiming that their losses were the result of firms' failure to comply with conduct of business standards and financial promotion rules.

For more information on this update please contact:

***Lauren Smith***

Associate

T: +44 20 3130 3134

E: [lsmith@mayerbrown.com](mailto:lsmith@mayerbrown.com)

***Guy Wilkes***

Partner

T: +44 20 3130 3355

E: [gwilkes@mayerbrown.com](mailto:gwilkes@mayerbrown.com)

***Mark Compton***

Partner

T: +44 20 3130 3388

E: [mcompton@mayerbrown.com](mailto:mcompton@mayerbrown.com)

***Dominic Griffiths***

Partner

T: +44 20 3130 3292

E: [dgriffiths@mayerbrown.com](mailto:dgriffiths@mayerbrown.com)

***Chris Arnold***

Partner

E: [carnold@mayerbrown.com](mailto:carnold@mayerbrown.com)

T: +44 20 3130 3610

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