UK CFD AND FX ASSOCIATION FIRMS RESPONSE TO ESMA CALL FOR EVIDENCE ON POTENTIAL PRODUCT INTERVENTION MEASURES ON CFD AND BINARY OPTIONS TO RETAIL CLIENTS

5 February 2018

The CFD & FX Association is a trade organisation formed of the seven leading providers of contracts for difference, spread bets and rolling spot FX (collectively "CFDs") to retail clients in the UK.

The Association firms listed on the last page of this document (the "Association firms" or "we") are authorised and regulated by the Financial Conduct Authority and collectively account for approximately 64% of the UK CFD market.

The Association firms welcome the opportunity to respond to ESMA on this matter. We would like to present our joint view on questions B, C, D and I.

B: What impact do you consider that the introduction of leverage limits on the basis described (applying to retail clients only) would have on your business? Please describe and explain any one-off or ongoing costs or benefits.

The Association firms support the introduction of proportionate leverage restrictions.

However, the Association firms are of the view that the suggested restrictions are far in excess of those necessary to protect clients from market volatility or from any other risk specific to CFDs. We think ESMA has materially underestimated the strong negative reaction of retail clients to this issue (and the related strong interest that clients have for trading with leverage) and the consequent potential for counterproductive results from imposing these restrictions.

Over the last few days, the Association firms have received feedback from clients on ESMA's proposed measures. This feedback has focused almost entirely on the suggested leverage restrictions and has been almost universally against ESMA's proposals.

The level of client disillusionment on this issue is such that we believe the principal impact on Association firms will be the migration of a very significant proportion of firms' clients to providers outside the EU, where such aggressive restrictions will not apply.

These far-reaching and disproportionate restrictions will impact on the marketing effectiveness of Association firms in the EU and will create a regulatory arbitrage in the industry. We expect to see a significant change in the balance of marketing where lightly regulated, or completely unregulated, non-EU providers will take a much increased share of online marketing voice within the EU. We expect the net result of this proposal to be a diversion of tens of thousands of new retail clients away from Association firms, and towards unregulated or lightly regulated non-EU competitors each year.

This will result in a reduction in investor protection and is directly contrary to ESMA's objectives.

C: What impact do you consider that the introduction of a margin close-out rule on a per-position basis (applying to retail clients only) would have on your business? Please describe and explain any one-off or ongoing costs or benefits.

The Association firms are of the view that this proposal is overcomplicated to the point of being largely unworkable and, even after the further clarification issued by ESMA, none of the Association firms are confident that they fully understand the way in which the rule is intended to operate in practice.

The proposed rule is not the current industry standard, nor is it the standard for other margined trading products, such as futures or options, resulting in an inequitable and unlevel playing field across financial products.

We believe the imposition of this rule will have the following effects on Association firms:

1. Assuming Association firms ultimately understand how the rule is intended to be implemented, it will require firms to make a significant IT investment in the redesign of their back offices, their margining systems and, most importantly, of the front end platforms and trade reporting systems relied upon by clients. It is likely to take a period of several months to implement as described.

2. It will act as an additional powerful factor forcing the migration of clients away from Association firms and toward non-EU competitors. This is because the rule is needlessly complex and difficult to understand, requires clients to trade in a manner they are not accustomed and that is different from other financial products, and also because the per-position approach, which prevents the offset of variation margin between positions, will make it very difficult for retail clients to use trading strategies (such as the hedging of a diverse investment portfolio) that rely on several CFD positions being open simultaneously. The majority of the retail clients of Association firms use such multi-position strategies from time to time.

D: What impact do you consider that the introduction of negative balance protection on a per-account basis (applying to retail clients only) would have on your business? Please describe and explain any one-off or ongoing costs or benefits.

The rule as described appears to require firms to isolate separate pools of client cash – margin, realised profits from closed CFDs and unencumbered, surplus balance, and to protect this last named pool of cash in the event of an unexpected market event triggering a no negative guarantee on an account.

We understand and respect ESMA's motivation for specifying the rule in this way, however ESMA should understand that this comes at a substantial cost in terms of speed of implementation. Just as in the case of the proposed per-position margin rule, this is not current market practice, either for CFDs or for other analogous margined trading projects, such as futures or options. This means firms will have to devote significant IT resources to the implementation of the rule in back offices, margin systems and, again, on the front end trading systems used by our clients. This is likely to take several months to implement in a way that is clear to retail clients.

I: What impact do you consider that the envisaged measures would have on retail investors?

Leverage

The leverage restrictions, combined with the proposed per-position margin close out rule, will effectively prevent European retail clients from using CFDs to hedge their investments in other instruments. This represents a significant negative impact on many tens of thousands of European retail clients.

However, we think a much larger negative impact will be the poor client outcomes resulting from the regulatory arbitrage created by the unnecessary severity of ESMA's leverage proposals.

As set out in answer to question B, we believe the extremely negative response of retail clients to ESMA's proposals will drive tens of thousands of existing clients, and tens of thousands of future clients, to trade CFDs with firms based outside the EU.

These firms will be based in jurisdictions generally chosen to allow the firms to operate without significant regulatory supervision and will be able to use their advantage in offering uncapped leverage to charge higher fees to clients. The retail clients who trade with these firms will do so without the consumer and investor protections they currently benefit from, and will be likely to suffer poor outcomes as a result of higher transaction fees, and of poor sales, marketing and trade execution practices.

We urge ESMA to consider the imposition of a more proportionate set of restrictions that would protect clients without triggering this kind of unintended and counterproductive result.

We believe that leverage restrictions of 80:1 on FX, 50:1 on equity indices, 20:1 on commodities and 10:1 on individual equities, combined with a simple to understand and operate, no-negative guarantee would effectively protect retail clients while greatly lowering the chances of provoking wide scale migration to non-EU providers.

Per-position margin close out rule and no negative per-account protection

ESMA is clearly of the opinion that it needs to exercise emergency powers with respect to CFDs; we therefore believe it must give appropriate weight to the practicality of its proposals, the consequent speed with which they can reasonably be implemented and the likelihood that the proposals will actually achieve ESMA's investor protection objectives for EU clients.

The Association firms are of the view that these proposals are an unnecessarily complicated way of achieving ESMA's declared client protection goals. The proposed approach has the potential to significantly and needlessly delay implementation. It may also lead to confusion for existing retail clients and, as already stated above, in light of strong negative reaction from clients to the proposals, there is a significant risk that the new measures result in a migration of clients away from the protections afforded in the EU, an outcome that is contrary to ESMA's objectives.

The suggested per-position margin close-out rule is different from current industry practice, and different from the practice followed by firms offering other margin trading products (futures, options) that CFD clients might already have encountered. It will therefore result in clients being stopped out regardless of the amount of equity held on their account in a way that many will find surprising and counterintuitive.

We expect a steep learning curve for retail clients as the impact of margin close out on a per position basis is more complex and significantly different to current industry practice, again potentially resulting in unfavourable outcomes for clients.

The proposed per-account no negative rule is complicated by the desire of ESMA to carve out surplus, unencumbered funds from the operation of the no negative guarantee. While we support ESMA's motivation, on a pragmatic level this requirement makes rapid implementation of the measure far harder for CFD firms.

Taken together, these measures will take firms months to implement in a way that would allow investors to effectively monitor and control the allocation of variation margin to each of their positions, and to understand the balance of their funds that is genuinely at risk. In addition to this, the lack of the ability to offset variation margin between positions will prevent clients from using multiple CFDs to hedge a diverse investment portfolio, or from pursuing many popular trading strategies where a portfolio of positions is held simultaneously.

The Association firms are of the view that the simplest and easiest way to ensure that clients are protected from losing more than their investment is to mandate firms to operate a conventional per-account margin close out rule of the kind that already exists (and is known and understood by CFD clients), in conjunction with a per-account no negative protection of the form already put into practice in Germany by BaFin. This solution could be rapidly implemented by the industry and would allow investors to continue to use CFDs to hedge their investment portfolios and to use multi-position trading strategies.

Alternatively, if ESMA is committed to the implementation of a per-position close out policy, we suggest the adoption of the solution already developed by AMF in France, where clients are required to leave explicit guaranteed stop orders against all positions. Such guaranteed stop orders fully protect these clients from the possibility of excessive loss and allow them to define the amount they wish to risk on each position in a clear and transparent manner.

Conclusion

This response is designed to provide ESMA with a joint view from the firms responsible for 64% of the CFD industry in the UK. We confirm that all Association firms listed below agree with the key points made in this response. In addition to this response, each of these firms will also respond with a detailed individual response to the questions raised in the ESMA's call for evidence.

Yours faithfully,

IG Index Limited ("IG")

Gain Capital UK Limited ("Gain Capital")

CMC Markets UK Plc ("CMC")

Spreadex Limited ("Spreadex")

Forex Capital Markets Limited ("FXCM")

Monecor (London) Limited ("ETX")