European Securities and Markets Authority

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)[1] 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/EC2 and Implementing Regulation 1287/20063 (the Level 2 legislation).[2]

3. In June 2014, the final legislative texts of the new Markets in Financial Instruments Directive (MiFID II)[3] and the Markets in Financial Instruments Regulation (MiFIR)[4] 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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[1] 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.

[2] 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.

[3] 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.

[4] 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.[5]

6. CFDs, binary options and rolling spot forex[6] 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[7] 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

[5] 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.
[6] 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.
[7] 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.[8]

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.

[8] 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.

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

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.[9]

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

[9] 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[10] 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.[11] 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,[12] 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

[10]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.

[11] 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.

[12] 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).

the firm can monitor, on a regular basis, the adequacy and effectiveness of the policies 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 it 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 comply with all its regulatory requirements, whether it has due regard to the interest of its clients, and whether it is commit-ted to carry on business with integrity. In doing do, 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 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).[13] 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

[13] 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.

Member State, for example it may wish to move certain management[14] 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.

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).

[14] Article 9(2) of MiFID requires an 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.

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

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).[15]

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.[16]

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[15] 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."*

[16] 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[17] 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

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.

[17] 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.[18]

18. The design of remuneration policies and practices is discussed in more detail in ESMA's guidelines on remuneration policies and practices under MiFID.[19] 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. [20]

    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. [21]

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

[18] Paragraph 26 of ESMA's guidelines on remuneration policies and practices (MiFID) (ESMA/2013/606).
[19] ESMA/2013/606.
[20] 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. […]"*
[21] 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).[22]

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 on-boarding 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

[22] 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.

entering into an outsourcing arrangement exercises due skill, care and diligence and avoids undue operational risk.[23]

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

[23] 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.

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. [24]

    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

[24] 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.

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) [25] 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 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.[26]

[25] ESMA/2013/606.

[26] 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.

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

1. ***New*** 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.[27]

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.

[27] 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.

New **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?**

New **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.[28] 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;

[28] 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);[29] 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).[30]

Information regarding the market and the product:

[29] Section 3, Question 2 in this document discusses controls over marketing communications in more detail.
[30] 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.[31] 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

[31] 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.[32] 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

[32] 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.[33]

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.

<u>Presentation and timing of information</u>

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

[33] 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).

complexity of the product, i.e. the more complex the product, the more detailed the 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."[34]

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.

*****New*** 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?**

*****New*** 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)." [35]

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

[34] ESMA's Opinion on MiFID practices for firms selling complex products (ESMA2014/146) (p.7).
[35] ESMA/2014/146 (p.3).

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 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 all 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;[36] 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[37] 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.

*****New*** 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?**

*****New*** 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

[36] 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.
[37] ESMA/2014/1485.

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.

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.[38] 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.

[38] 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.

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

1. ***New*** 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.

New **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?**

New **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.[39] 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.

[39] 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.

*****New*** 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?**

*****New*** 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[40] 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.[41] 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

[40] CESR/09-697.

[41] 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.

*****New*** 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?**

*****New*** 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.[42]

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),

[42] 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.[43] 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.

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

*****New*** 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:[44]

    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?);[45]

[43] Section 4, Question 1 discusses the content of the appropriateness test in more detail.

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

[45] Section 4, Question 1 considers the content of the appropriateness test in more detail.

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 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?);[46] 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.[47]

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[48] 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

[46] Section 4, Question 2 sets out the steps that a firm should follow in such cases.
[47] Section 4, Questions 2 and 3 consider such cases.
[48] ESMA/2014/146.

appropriateness; records of other measures adopted by the firm when the client has not demonstrated sufficient knowledge and experience in CFDs or other speculative products; and relevant voice recordings.[49]

[49] 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."

New 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

1. ***New*** 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.

New **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?

New **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.

<u>Firm B</u>

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).[50]

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

[50] 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.

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:

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.[51]

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

[51] Section 4 discusses the assessment of appropriateness when offering CFDs or other speculative products to retail clients in more detail.

relation to CFDs or other speculative products, including in the event that a client complains to Firm B.

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.

*****New*** 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[52] arrangement?

*****New*** Answer 2:**

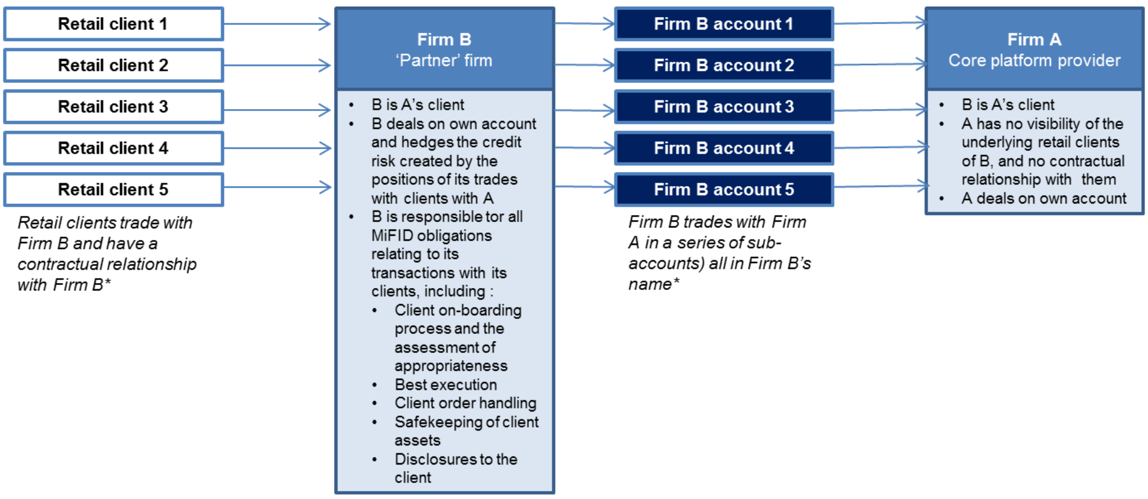
[52] Such trading omnibus accounts should be clearly distinguished from an omnibus account maintained by a third party and used to hold financial instruments on behalf of the client, as discussed in relation to securities financing transactions in Article 19(2) of the MiFID Implementing Directive, and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

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 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.[53]

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 a 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

[53] 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 the assets or funds of a retail client to conclude its transaction with Firm A.

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 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).