European Securities and Markets Authority

Questions and Answers

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

8 April 2016 | ESMA/2016/590

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Contents

I. 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 2017 (unless a new application date is established by the legislation).

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.

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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.

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 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 short term 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.

II. 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.

[5] ESMA 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.

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.

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

III. 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.

IV. 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 holders, 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 mode, 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

[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).

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 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.

[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.

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 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 author-

[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).

isation 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 committed 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 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).

[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.

[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:

    i. 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;

    ii. Firm dealing on own account and acting as the client's counterparty, without hedging against client orders; and

    iii. 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 pro-

[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."*

vider 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]

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

[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 obligation 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 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.

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 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

[17] ESMA/2013/606.
[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. […]"*

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 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.

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[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."*

[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.