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International Organization of Securities Commissions
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Attention: Alp Eroglu

By email: consultation-01-2018@iosco.org

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Public Comment on IOSCO Consultation Report on Retail OTC Leveraged Products

Dear Sir or Madam,

Please find below our response to the aforesaid Consultation Report.

As an association of 12 leading providers offering contracts for difference ("**CFDs**") in Germany, who represent a significant portion of the German overall market, potential product intervention measures may affect the economic and legal interests of our members.

The members of the German association Contracts for Difference Verband e.V. ("**CFD Association**") are regulated by various European supervisory authorities, have various business models and offer their clients various types of CFDs. This is why individual members reserve the right to submit their own statements in response to the Consultation Report.

In this response we firstly set out some general observations in respect of the regulation of retail OTC leveraged products, particularly CFDs, before providing specific feedback on the suggested policy measures set out in the Consultation Report.

Investor protection is a major objective of the CFD Association

One of the major objectives of the CFD Association is investor protection. As a rule, the CFD Association and its members welcome measures to improve investor protection while maintaining the freedom for investors to choose from a wide range of products with different risk profiles.

Regulation to focus on providing investor with all relevant information to make an informed investment decision

Investor protection should primarily aim at providing investors with all relevant information in order to make an informed decision rather than prohibiting products or limiting access to certain investment opportunities.

CFD is an established product and the CFD market is, in general, well-functioning. In order to provide CFD investors with improved protection without curtailing their freedom to make informed investment decisions, the CFD Association supports regulatory intervention focussed not on the structure of CFD as a product but rather on the advertising / distribution of CFDs, particularly by unregulated / less regulated providers. In order to maximise the impact of such regulatory intervention and avoid regulatory arbitrage, relevant measures should be adopted and enforced consistently by all IOSCO members.

Significant investor protection concerns arising from unregulated providers

From the CFD Association's perspective, significant investor protection concerns essentially exist almost exclusively due to the existence of unregulated CFD providers and the misleading advertising promises by these unregulated CFD providers or by CFD providers regulated by supervisory authorities in jurisdictions with lower regulatory standards compared to those maintained by the German Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht, "**BaFin**"), such as Cyprus.

For example, in its warning of 25 July 2016, the European Securities and Markets Authority ("**ESMA**") (cf. ESMA: Warning, 2016/1166, dated 25 July 2016; pp. 2 et seq. with a reference to Cyprus-based CFD providers) criticised the misconduct of Cyprus-based investment companies offering CFDs and binary options. In the context of its supervisory action plan, the Cyprus Securities and Exchange Commission has imposed administrative fines and reached settlement agreements with a number of investment firms. It has also suspended the licence of at least one firm due to suspicions of an alleged violation of the Investment Services and Activities and Regulated Markets Law of 2007 in respect of the terms of such firm's authorisation and the conduct of business obligations when providing investment services to clients.

For France, evaluations carried out by the French securities supervisor Autorité des marchés financiers ("**AMF**") showed that out of a total of 1,617 complaints made by clients with regard to foreign-exchange products and binary options in the year 2015, about 1,478 cases were attributable to providers operating without a licence from a supervisor or without notification in France (cf. AMF: Rapport Annuel 2015 de l'AMF, p. 8, and Rapport du Médiateur de l'AMF, p. 19). Out of the remaining 139 complaints, 118 concerned providers with a licence issued by the Cyprus Securities and Exchange Commission ("**CySec**") and only 21 concerned providers with a licence from a supervisory authority in another EU Member State. This means that about 98% of all complaints made concerned unregulated providers or providers regulated (insufficiently, as it appears) by the Cypriot CySec.

In Germany, too, the risks to investor protection arise from unregulated CFD providers. Only a small number of the complaints made to BaFin concerned regulated CFD providers. According to information from BaFin, about 100 complaints were made in 2015 with regard to providers regulated by a supervisory authority in another EU Member State (cf. Report on the IOSCO Survey on Retail OTC Leveraged Products, dated December 2016). Furthermore, according to an internal survey conducted by the CFD Association, the number of complaints concerning members of the CFD Association was less than 30 in 2016, for example. In this respect, the situation in Germany is similar to that in France, with regard to regulated providers.

Based on the evaluations carried out by AMF and the above-quoted ESMA warning, it can be assumed that most of the examples of misleading advertising promises quoted by ESMA in the Q&A document (cf. ESMA: Q&A, 2016/1165, dated 11 October 2016, p. 36) are likewise attributable either to CFD providers who have been licensed by a supervisory authority in a jurisdiction with lower regulatory standards or to CFD providers operating without a licence from a supervisory authority or without notification.

Existing regulation should be applied consistently by all IOSCO members

Since beginning of this year with the introduction of MiFID II and PRIIPs legislation in Europe CFD providers had to adopt these new rules. This regulation is already aiming at enhancing investor protection. It is the view of the CFD Association that the impact of such new regulation should be assessed first before introducing new regulations. Furthermore, the existing regulation should be applied consistently by all IOSCO members in order to avoid regulatory arbitrage by CFD providers.

The term "retail investors"

The CFD Association is supportive of a clear distinction between sophisticated clients and those with less experience. However, the CFD Association is concerned that the broad use of the term "retail investors" in the Consultation Report negates differences between sophisticated and un-experienced investors and may risk the potential for inappropriate / excessive regulatory inter-vention. The main objective of any regulation should be to enable investors to make an informed investment decision based on such investor's knowledge and experience.

The average CFD investor is not a typical retail investor and this should be taken into account when considering the Consultation Report. The average CFD client has a wealth of experience in trading and has been trading in CFDs for several years. A market survey published by the CFD Association (CFD-Marktstudie: Typologisierung von CFD-Investoren, November 2016 and December 2017) arrives at the conclusion that the average CFD investor has been trading in CFDs for about four and a half years. 39.8% of CFD investors have been trading in CFDs for three to five years. 24.8% of CFD investors have even been trading in CFDs for six to ten years. In addition, the average CFD client spends several hours a day carrying out CFD trades. The average CFD trading time is about 3.3 hours a day and the average number of trades carried out per year is 2,190. Furthermore, 67% of the interviewed clients stated that they obtained compre-hensive information before making their decision to invest. For 73.3% of the interviewed clients, the objective of trading in CFDs is to obtain an above-average return. As such, the average CFD investor's experience in trading is far greater than that of a typical retail investor. Consequently, a distinction in regulation should be made to cater for respective differences in the type of retail investors active in the CFD market.

Comments in respect of suggested policy measures in Consultation Report

Based on the CFD Association's view that regulation applied consistently by IOSCO'S members should focus on the distribution and marketing of CFD's rather than the economics and the design of the product itself, please find below our comments in respect of the suggested policy measures set out in the Consultation Report.

Measure 1: Requirement for firms offering the relevant products to retail investors to be licensed

The CFD Association fully supports this measure.

As mentioned above under ‘Significant investor protection concerns arising from unregulated providers’, from the CFD Association’s perspective, significant investor protection concerns essentially exist solely due to the existence of unregulated CFD providers and the misleading advertising promises by these unregulated CFD providers or by CFD providers regulated by supervisory authorities in jurisdictions with lower regulatory standards compared to those maintained by the BaFin.

The CFD Association and its members attach great importance to improving investor protection. The CFD Association and its members support clear action against unregulated or insufficiently regulated CFD providers and against misleading advertising promises by CFD providers. Such action would lead to more investor protection and would make it more difficult for less professional providers to act on the market.

The Consultation Report acknowledges that ISOCO members are ultimately responsible for determining the scope of their regulatory perimeter and that it is not the intention of the regulatory toolkit proposed in the Consultation Report to suggest harmonising licensing. However, while the CFD Association understands this, it has some concerns regarding the potential for clients moving to unlicensed firms or to jurisdictions where the licensing requirements or oversight are less strict. As such, to the extent possible, the CFD Association would urge a more common approach to licensing in order to mitigate regulatory arbitrage in the sector, which remains a serious ongoing problem.

Measure 2: Requirement for firms to incorporate a prescribed minimum margin requirement for retail investors

The measure seems to address two different risks:

(1) Firms shall establish the requirement for a minimum margin by retail investors in order to reduce the risk for investors to lose their investment; and

(2) Firms shall limit the applicable leverage in a product in order to reduce the volume of potential losses.

Generally, the CFD Association supports measures with a view to limit the risk of losses for retail investors. However, in the CFD Association's opinion a minimum margin requirement is not needed, if the loss of investors is already limited to the balance on an investor's trading account (see Measure 3 below on negative balance protection). This is the case in Germany: Prior to opening a new position the margin will be calculated in order to allow such trade in light of the current balance on the account. Consequently, it is suggested to take into account the following considerations when suggesting this measure.

- A minimum margin requirement is not needed if the loss of an investor is already limited to its balance on the account.
- A minimum margin requirement is static and non-flexible and ignores the fact that an investor is already fully aware of its maximum loss (assuming a negative balance protection).
- Regulation should focus on investor protection rather than changing the economics of a financial product by introducing, e.g. minimum margin requirements which result in a more expensive and less attractive product for investors.
- Any margin provided by investors is for the benefit of the CFD provider. If CFD providers calculate the margin according to the valued risk, why should regulation force CFD providers to request more margin?

Further, the CFD Association supports restrictions on excessive leverage which exceeds a leverage of 200:1. Nevertheless, the level of leverage is a product feature relating to the economics of the product. Any regulation should not target the economics of a product, but rather enhance the information of and disclosure to investors.

Firstly, the effect of leverage is not limited to the types of OTC leveraged products identified by the Consultation Report. The effect of leverage also exists with numerous other packaged retail investment and insurance products ("**PRIIPs**") (e.g. warrants, turbo-warrants, options, futures, margin loans and securities lending), which are popular and have been frequently traded for decades. Further, the concept of unlimited personal liability is embedded in many other products like options and futures. This even extends, for example, to mortgages, where the liability may exceed the value of the underlying object. Product intervention measures in relation to CFDs would place CFDs at a disproportionate disadvantage, compared to similar financial instruments. From the CFD Association's perspective, the risk of loss involved in trading in CFDs is comparable to the risk of loss involved in trading in other leveraged products, such as knock-out warrants.

Secondly, while the CFD Association would see the one-off cost of implementing a leverage limit as rather low, it is concerned that, as a result of leverage being limited, there would subsequently be a very significant fall in returns. Providers and brokers of the CFD Association expect that if leverage were reduced, up to 80% of clients would stop trading in the products with reduced leverage. Such a loss of clients could jeopardise the continued existence of providers offering CFDs and of CFD brokers, in particular in cases where the trade in CFDs accounts for a large portion of their business. For the firms concerned, this would therefore constitute a significant interference with the fundamental right to carry on an established business (protected fundamental rights: freedom to choose an occupation, freedom to conduct a business and right to property).

Just the UK Financial Conduct Authority's announcement to reduce leverage to a maximum of 40, led the share prices of CMC Markets plc and the IG Group plc to drop drastically by 36% and 38%, respectively, on 5 December 2016. The imposition of even more strict margins could result in even worse drops of shares prices of listed companies. For smaller providers such measures could be existence-threatening.

The CFD Association expects that in such scenario its clients would turn to unregulated / less regulated providers outside the EU. Individual members have conducted a survey among their clients. This survey clearly confirms the expected behaviour: the clients have moved, or will move their accounts to Australia, Switzerland and Dubai and many of them are waiting for the UK to Brexit, as they are convinced that the UK financial services sector will be endeavoured to position itself very attractively. In addition, there is a substantial risk that the providers and brokers concerned, too, will relocate to non-EU-countries.

Any investors who would stay with EU regulated distributors despite the burden of the measures and wishing to achieve an equivalent trade volume upon leverage being limited, would have to invest a multiple of the capital currently invested, which would have to be withdrawn from other types of investment, such as savings accounts. Furthermore, investors trading in CFDs cover a large number of underlying assets, also for hedging purposes. Due to of the larger amount of capital invested, they would now be forced to invest their capital using only one strategy or only few different strategies, which would give rise to a higher risk of loss.
There are also other products that provide for high leverage, for example, warrants or knock-out warrants offered by banks, which are often positioned to compete with CFDs. Warrants with leverage above 100:1 are not rare. Such products would then, unjustifiably, be preferred over CFDs.

Thirdly, as mentioned above under 'The term "retail investors"', the average CFD investor's experience in trading is far greater than that of a typical retail investor. The market study published by the CFD Association has additionally shown that CFD investors have a very high level of skill and education. According to said study, 49.9% of CFD investors have a university degree. Furthermore, the economic situation of clients is good. The average CFD investor has assets of € 50,000 to € 150,000, again according to the published market study. As such, the CFD Association questions whether such a protection is necessary for CFD clients who have deliberately decided to trade in CFDs and have comprehensive knowledge in this field.

Measure 3: Negative balance protection

The CFD Association is of the view that negative balance protection on a per account basis (applying to retail clients only) is the measure providing the best level of protection for clients as unlimited losses are avoided. It is sensible to calculate the balance at risk on a gross basis, i.e. across all positions of an investor. Negative balance protection on a per account basis (applying to retail clients only) has already been implemented in Germany.

Measure 4: Prescribed disclosures setting out the total costs of the product

The CFD Association is supportive of such measures.

As mentioned in the Consultation Report, firms in Europe are required to disclose to the client the total cost of the product as part of enhanced disclosure requirements stemming from the

MiFID II legislation. In addition, firms offering the relevant products are required to provide other standardised disclosures to their clients, including information on the objectives of the product, target market and costs and charges as set out in the Regulation on Key Information Documents for Packaged Retail and Insurance-based Investment Products (PRIIPs).

Providers of the CFD Association supply investors with comprehensive information about costs of CFD (MiFID II) and comprehensive information about the risk and performance of each CFD (PRIIPs KIDs). In order to mitigate regulatory arbitrage in the sector, the CFD Association would support the extension of the MiFID II and PRIIPs KIDs regulations globally.

Measure 5: Disclosure of investor profit and loss ratios

The CFD Association is fully supportive of the full disclosure of the risks associated with such products. However, the CFD Association would make the following observations in respect of any proposal to require the disclosure of profit and loss statistics for CFD investors.

Firstly, the Consultation Report states that the provision of such information would support clients in making an informed decision about whether they wish to proceed with a high-risk product that, statistically, is more likely to result in a loss than a gain. In this regard, the CFD Association is aware of studies conducted by the Central Bank of Ireland and AMF showing that between 74 and 89% of clients trading in CFDs lose money. However, in the opinion of the CFD Association, the aforesaid studies are not applicable to Germany, as the German market is dominated by highly regulated providers and has a much smaller number of unregulated providers. The CFD Association, together with the CFin Research Center for Financial Services, has conducted its own comprehensive profit and loss study for the trade in CFDs in Germany (CFD Gewinn- und Verluststatistik, November 2016). This study has also been presented to BaFin and is available to the latter. According to said study, only 62.7% of clients lose money when trading in CFDs.

Secondly, the CFD Association would be wary of requiring the disclosure of profit and loss ratios solely in the case of the products on which the Consultation Report focusses. From the CFD Association's perspective, the risk of loss involved in trading in CFDs is comparable to the risk of loss involved in other trading products, such as knock-out warrants, and even day trading shares, options and futures. The Consultation Report also focusses on the complexity of the products. The CFD Association would argue that CFDs are not complex products; or rather the performance calculation for CFDs is not a complex issue. There is a 1:1 relationship between the performance of the CFD and the underlying price. An investor who trades a large volume can expect that the risk involved corresponds to the volume traded. Therefore, applying additional disclosure requirements to CFDs as compared to its competitor products would put it an unnecessary competitive disadvantage.

Thirdly, as mentioned above under 'The term "retail investors"', the average CFD investor's experience in trading and knowledge of the product is far greater than that of a typical retail investor. As such, requiring such specific disclosure for CFD investors may be regarded as a disproportionate response for investors who have deliberately decided to trade in CFDs and have comprehensive knowledge in this field.

Measure 6: Adoption of a fair pricing methodology and use of externally verifiable price sources

The CFD Association is supportive of a fair and transparent CFD offering.

As the Consultation Report states, European investment firms are required to demonstrate fairness in pricing when executing in OTC products and have increased transparency around execution processes as part of the best execution requirements arising from MiFID 2. Providers of the CFD Association supply investors with comprehensive information about costs of CFD (MiFID II) and comprehensive information about the risk and performance of each CFD (PRIIPs KIDs). As mentioned above, in order to mitigate regulatory arbitrage in the sector, the CFD Association would support the global extension of regulations equivalent to MiFID II and PRIIPs KIDs regulations.

Measure 7: Enhanced disclosures about order execution quality

The CFD Association is supportive of a fair and transparent CFD offering.

As the Consultation Report states, European firms are required to disclose their order execution policy to their clients as part of their best execution requirements. The requirement for firms to disclose their pricing methodology is also consistent with the spirit of the legislation.

The enhanced best execution requirements in MiFID II require investment firms, including brokers, to make public the top five execution venues where they execute client orders and information on the quality of execution obtained. Execution venues are also required to make public detailed data relating to the quality of execution of transactions on that venue. As mentioned above, in order to mitigate regulatory arbitrage in the sector, the CFD Association would support the global extension of regulations equivalent to MiFID II.

Measure 8: A ban or restrictions on certain forms of marketing and sales techniques for the relevant products

The CFD Association is supportive of improved restrictions on aggressive marketing practices.

However, as noted above, most of the examples of misleading advertising promises quoted by ESMA in the Q&A document (cf. ESMA: Q&A, 2016/1165, dated 11 October 2016, p. 36) are attributable either to CFD providers who have been licensed by a supervisory authority in a jurisdiction with lower regulatory standards or to CFD providers operating without a licence from a supervisory authority or without notification. Most jurisdiction have already regulation in place (like MiFID II legislation) or apply the general rule against unfair competition (e.g. in Germany under the Act against Unfair Competition)

Accordingly, while the CFD Association is supportive of improved restrictions on aggressive marketing practices, it believes that such improved restrictions will be most effective if targeted specifically at unregulated or insufficiently regulated providers.

Measure 9: A ban or restriction on the sale and/or distribution of the relevant products by intermediaries

The CFD Association would always vote against a product prohibition in favour of (i) better client education and information, (ii) improved restrictions on aggressive marketing practices, (iii) a correct assessment of the appropriateness of a specific product for a specific client and (iv) a more accurate distinction between sophisticated clients and those with less experience / knowledge.

As mentioned above under ‘The term “retail investors”’, the average CFD investor’s experience in trading and knowledge of the product is far greater than that of a typical retail investor. An outright ban or restriction on the sale and/or distribution of CFDs would not be well received by CFD investors who would likely view such product intervention measures as an interference with the economic freedom of action of private investors and an act of patronising “responsible” citizens.

Regards,

Niklas Helmreich
Chairman of the Management Board