Report on Retail OTC Leveraged Products

Consultation Report

OICU-IOSCO

The Board
OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

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Foreword

The Board of the International Organization of Securities Commissions (IOSCO) has published this Consultation Report with the aim to identify and promote regulatory approaches that can enhance the protection of retail investors who are offered retail OTC leveraged products. Following the publication of the December 2016 IOSCO *Report on IOSCO Survey on Retail OTC Leveraged Products* which was an initial fact-finding exercise, a mandate to more closely examine this area was agreed by the IOSCO Board in July 2017, focussing on the ongoing regulatory challenges and common concerns in relation to OTC leveraged products offered and sold to retail investors.

How to Submit Comments

Comments may be submitted by one of the three following methods **on or before 27 March 2018**. To help us process and review your comments more efficiently, please use only one method.

Important: All comments will be made available publicly, unless anonymity is specifically requested. Comments will be converted to PDF format and posted on the IOSCO website. Personal identifying information will not be edited from submissions.

1. Email

- Send comments to consultation-01-2018@iosco.org
- The subject line of your message must indicate IOSCO Consultation *Report on Retail OTC Leveraged Products*.
- If you attach a document, indicate the software used (e.g., WordPerfect, Microsoft WORD, ASCII text, etc) to create the attachment.
- Do not submit attachments as HTML, PDF, GIFG, TIFF, PIF, ZIP or EXE files.

2. Facsimile Transmission

Send by facsimile transmission using the following fax number: + 34 (91) 555 93 68.

3. Paper

Send 3 copies of your paper comment letter to:

Alp Eroglu
International Organization of Securities Commissions (IOSCO)
Calle Oquendo 12
28006 Madrid
Spain

Your comment letter should indicate prominently that it is a *Public Comment on IOSCO Consultation Report on Retail OTC Leveraged Products.*

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Chapter 1 - Executive Summary

In December 2016, IOSCO Committee 3 published a Report on Retail OTC Leveraged Products (December 2016 Report). The December 2016 Report described the activity in this particular off-exchange retail market sector explaining the types of relevant products offered; identifying the different types of firms and business models commonly seen in the sector; and outlining the different approaches taken by IOSCO member jurisdictions to regulate the distribution of the relevant products by firms. The December 2016 Report also described supervisory concerns and challenges arising in the sector. It further set out potential risks to investors and instances of misconduct by licensed firms, as well as growing concerns with activity by unlicensed entities predominantly offering the products online.

Following publication of the December 2016 Report which was an initial fact-finding exercise, a mandate to more closely examine this area was agreed by the IOSCO Board in July 2017, focussing on the ongoing regulatory challenges and common concerns in relation to OTC leveraged products offered and sold to retail investors. The overall goal for the new mandate is to identify and promote regulatory approaches that can enhance the protection of retail investors in this area. To help achieve this goal, IOSCO members are encouraged to consider, to the extent legally permissible in their jurisdiction, improving the practices of licensed firms in the sector, better informing investors about the features and risks of the products and the firms offering them, or restricting the marketing or sale of the products for example, as well as more effectively combatting illegal cross-border activity in this area.

Based on the concerns raised as part of the December 2016 Report, the new IOSCO mandate in this area proposes three complementary workstreams to address investor detriment in the sector:

i. Development of a toolkit of policy measures with guidance for the regulation of the offer and sale of the relevant products by intermediaries;

ii. Development of a toolkit of investor education material with guidance about the relevant products and firms; and,

iii. Development of a toolkit of enforcement approaches and practices to address and mitigate the risks posed by unlicensed firms offering the relevant products to retail investors.

The final report for the mandate will incorporate all three of the toolkits, as set out above.

This consultation report includes the first of the toolkits. It sets out for comment policy measures that are designed to help reduce the risks to investors caused by certain features of these products, improve the practices of licensed firms that sell them, improve the likelihood that the products are sold to an appropriate target market and reduce the likelihood that the products are sold without the firm holding the necessary license to do so.

The first toolkit will describe a range of policy measures that may be adopted by IOSCO members to address the specific risks arising from the offer and sale of the relevant products by intermediaries. These vary from leverage limits and pricing methodologies to restrictions on certain marketing activities and a prohibition on the sale and/or distribution by intermediaries of the products to retail investors. The toolkit describes how each of the measures addresses these risks as well as how different jurisdictions have implemented the measures for the purpose of providing directional guidance on possible ways to implement each measure.

IOSCO members are encouraged to consider adopting one or several of these measures, in accordance with their legal and regulatory framework and the specific risks they have identified, to help ensure an appropriately high level of protection for retail investors transacting in the relevant products. However, IOSCO members are not mandated to adopt the regulatory measures described in this toolkit and it is recognised that not every measure may be appropriate for, or permitted under, the specific legal and regulatory framework of each IOSCO member.

Chapter 2: Retail OTC Leveraged Products

The products

This report covers the offer and sale by intermediaries of the following categories of OTC leveraged products that are actively marketed and sold to retail investors in the majority of IOSCO member jurisdictions, both domestically and on a cross-border basis:

- Rolling-spot forex contracts, which are contracts where the pay-out is based on the fluctuation of foreign exchange rates and the initial maturity of two business days is automatically extended (by one business day at a time) if the contract is still open by the end of trading on the second business day. This product family includes economically equivalent leveraged forex contracts;
- Contracts for differences (CFDs), which are contracts where the pay-out is based on the fluctuation of any of a variety of underlying financial rates and prices and which stay open until closed by one of the parties;
- Binary options, which are contracts where the pay-out, based on any of a variety of underlying financial rates and prices, depends entirely on the outcome of a yes/no proposition (typically whether the price of the underlying will raise or fall below a specified level), and is either zero or a fixed amount or a specified percentage of the price (amount invested) of the option.[1]

The products are generally used by retail investors to speculate on the short-term price movements in a given financial underlying. Some investors, who are generally more sophisticated retail clients, may also use the products for hedging purposes.

The products are typically not listed on an exchange, but traded over the counter (OTC).[2] As such, the pricing and settlement as well as the trading terms of the products are not standardised. Typically, the products are offered through online trading platforms and are sold without the provision of investment advice. An increasing number of IOSCO members have reported that intermediaries active in these products are targeting the mass retail market.

In the case of rolling-spot forex contracts and CFDs, the products operate on margin, allowing retail investors to open a position by only depositing a small proportion of their overall exposure as collateral to support their position. Trading on margin amplifies even minor fluctuations in the value of the investor's position, exponentially increasing a client's losses and gains.

In the case of binary options, the investor commits funds to a position and in a typical scenario, if the financial underlying reaches a specified strike price at a specified time, the investor receives a pre-determined pay-out based on a fixed multiple of the initial payment. If the underlying does not reach the specified strike-price, the investor loses all or most of the initial payment. The investor sets the level of the initial payment or premium, which is not contingent on the value of the financial underlying.

[1] The pay-out in some binary options can also be based on a non-financial underlying, such as a weather event or the outcome of an election. In some jurisdictions, only binary options that are based on a financial underlying are classified as financial instruments.

[2] There are at least three jurisdictions where some of the relevant products are traded on venue or centrally cleared, including Romania, Japan, and the United States. The Australian Exchange formerly offered listed CFDs but the service is no longer available.

Firms and their business models

The December 2016 report describes how the number of market intermediaries offering these products has increased in several IOSCO member jurisdictions in recent years.

While a variety of business and trading models are observed in the sector, firms offering the relevant products to retail clients typically act as the counterparty to the client's trades. Some of these firms hedge their exposure according to their risk appetite or on a trade-by-trade basis, while others assume the full market risk against the client's position.

A significant proportion of firms offer services on a cross-border basis, often without a physical presence in many of the jurisdictions where the end-consumers reside. This presents specific challenges to regulators regarding the supervision of these firms.

Key risks of the products

As set out in the December 2016 Report, several IOSCO members have recently expressed concerns about the offer and sale of these complex and risky products to retail investors, in particular over the level of losses experienced by retail clients trading in them and the manner in which these products are mass-marketed to consumers. IOSCO members also raised concerns about the quality of disclosures provided by intermediaries offering the products to retail investors and about certain operational issues, such as concerns around quality of execution in the relevant products. These concerns are reflected in the number of investor complaints received by the relevant authorities in relation to the products (in some jurisdictions many more complaints arise in relation to firms that are operating illegally without licenses) as well as the enhanced supervisory focus on the sector across a number of IOSCO jurisdictions.

In addition to the concerns set out above, supervisory work across IOSCO member jurisdictions has identified several other risks arising from the sector. These risks are outlined in the below paragraphs.

Distribution risks

Several IOSCO member jurisdictions have indicated that firms in the sector are targeting the general public and in some cases have widened the target audience for the relevant products in recent years. As a consequence, the following risks have been seen to arise and become increasingly acute in relation to the distribution of the products:

- Firms adopting business models that rely on churning a high volume of inexperienced retail clients who are likely to lose money when trading in the products;
- Firms adopting aggressive marketing methods to attract new retail customers;
- Firms failing to undertake sufficiently robust on-boarding processes before allowing new clients to start trading;
- Firms using misleading marketing messages and making insufficient disclosures of risk to their retail clients; and,
- Firms using incentives, such as bonuses, to attract retail customers and that put the clients at risk of suffering higher losses than they otherwise would assume.

Risks arising from certain product features

As the December 2016 Report set out, rolling spot forex products and CFDs sold to retail customers are characterised by the ability of investors to trade these products on margin. In recent years, a number of IOSCO member jurisdictions have observed that the level of leverage offered by firms distributing the relevant products has substantially increased. For instance, while common leverage levels observed by national competent authorities have typically ranged between 10:1 and 200:1, some firms have recently been observed offering levels as high as 2000:1, depending on the underlying asset of the product and the firm offering the product.

High levels of leverage pose considerable risks to retail investors, including:

- exposing clients to a high probability and high value of losses, which can exceed their deposited funds;
- exacerbating the impact of costs and charges;[3]
- increasing the risk of conflicts of interest, particularly for firms who take the other side of their clients' trades and who therefore directly benefit from client losses;
- posing a credit risk to the firms themselves.

For binary options, the following risks can be seen to arise:

- Although the products appear simple and therefore attractive to retail clients, firms use complex probability methodologies to calculate pay-offs that ensure that on aggregate, the firm always profits from the trades. This also makes it difficult for clients to fairly value the product and make an informed investment decision;
- The lack of transparency in the price of the underlying asset makes it often difficult for a retail client to assess the fairness of the price at the start of the contract and at expiry;
- The very short duration of many binary option contracts exacerbates the above risks.[4]

Risks arising from the potential conflicts in the market intermediaries' business models and execution practices

Some of the business models of firms that offer and sell CFDs and rolling spot forex products to retail clients bear an inherent conflict of interest between the firm and the client. This mainly arises from when the firm acts as the counterparty to the client's trades and where it might be directly benefiting from the client's losses. In particular, the conflict is greater where the firm does not hedge or only partially hedges the client's trades.

Potential conflicts also arise from the lack of transparency in the pricing of the relevant products. Indeed, it is not always clear whether the pricing can be linked to an underlying market. In addition, firms may require the client to acknowledge that the reference prices used to determine the value of the underlying may differ from the price available on the market. As a consequence, clients often find it difficult to verify the accuracy of the price offered to them by the firm and will face information asymmetries when attempting to monitor performance.

In addition to these conflicts, several IOSCO members have expressed concerns over the execution practices observed in the sector. In particular, members have reported their concern that some firms selling CFDs and rolling spot forex products invoke contractual clauses to exercise discretion either cancelling a trade to avoid pay-out or closing trades to crystallise

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3 Costs for CFDs and rolling spot forex products sold to retail clients are typically based on the client's notional exposure and are calculated as a percentage of the notional exposure.

4 Some regulators question whether products such as binary options can ever fulfil a genuine investment need and are concerned that the short-term nature of these contracts may encourage repeated transactions that can present addiction-like risks leading to large losses.

client losses. Concerns have also been raised over firms engaging in asymmetric slippage practices.[5]

As set out above, binary options present significant information asymmetries, which are often exploited by firms to the detriment of the client, although they are sold as straightforward products and perceived as simple by retail clients.

Risks arising from unlicensed entities

In addition to issues relating to licenced firms offering the relevant products to retail clients, several IOSCO member jurisdictions have reported an increase in the number of unlicensed firms, who often hold themselves out as being licensed, and offer these products illegally.

The complexity and high-risk/high-profit nature of the relevant products makes them particularly attractive for unlicensed firms to use as tools for defrauding retail investors. As such, unlicensed firms distributing the products via online platforms pose a significant risk to investor protection. This has led to increased levels of consumer detriment and associated investor complaints and enquiries.

Some jurisdictions have set their regulatory perimeter to only require firms that market, offer or sell the products to residents of that jurisdiction to be licensed. In these jurisdictions, firms that offer the relevant products to non-residents are exempt from the requirement to be registered for the purposes of those activities, and are therefore not subject to any regulatory oversight in that "home" jurisdiction.

A number of firms in the sector have exploited this regulatory gap to target foreign investors, by locating in jurisdictions where they are not required to be licensed when offering and selling the relevant products to foreign investors only. As a result, it is difficult for "host" state regulators where the clients of these firms are located, to effectively take enforcement actions against these firms. It also creates practical hurdles around enforcement cooperation and information sharing between home and host state authorities.

IOSCO Committee 4 on Enforcement and the Exchange of Information is currently exploring issues and challenges raised by unlicensed retail business in OTC leveraged products with a view to producing a toolkit with guidance on different types of effective enforcement approaches and practices employed across jurisdictions. In light of this on-going work, and aside from recommending a licencing requirement for the relevant firms in the sector to address the specific issue of firms being able to avoid regulatory oversight simply by offering the relevant products to foreign investors alone, this toolkit will not focus on addressing the risks arising from the conduct of unlicensed firms and fraudulent activity.

Regulation

The regulatory treatment of retail OTC leveraged products differs across jurisdictions, as detailed in the December 2016 Report. The relevant products are typically characterised as OTC derivatives, although in some jurisdictions different regulatory requirements may apply based on the specific category of OTC derivatives involved (e.g. swaps, options).[6] Moreover,

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5 Asymmetric slippage involves a firm passing negative price movements to the client, but seeking to capture positive slippage itself by only giving the client the original quoted price where a positive movement for the firm has occurred in the intervening time between a quote being provided and the execution of the order.

6 In some jurisdictions the products may be traded on exchanges.

in a few jurisdictions, some of the products are legally deemed to be securities, implying potentially differing requirements and standards across the different products.[7]

In addition, the regulation applicable to the market intermediaries offering the relevant products is quite heterogeneous across different IOSCO member jurisdictions. This reflects the different regulatory frameworks in the different jurisdictions, as well as the various regulatory initiatives IOSCO members have undertaken in recent years in response to the risks identified in relation to the relevant products.

Nonetheless firms are typically subject to similar conduct rules in different jurisdictions, which generally include:

- Ensuring that the information provided to clients, including financial promotions and marketing materials, is clear, accurate and not misleading and that disclosures include appropriate risk warnings to enable clients to make informed investment decisions;
- Carrying out appropriate client on-boarding, including know-your-customer procedures and entering into a written agreement with the client as well as, in some jurisdictions, carrying out an assessment of the appropriateness of the products offered to the client (where no advice is provided);
- Assessing the suitability of any advice given to clients;
- Ensuring client orders are executed on the best terms available;
- Operating effective organisational arrangements that mitigate any conflicts of interest and ensure fair treatment of all clients; and
- Ensuring adequate safeguarding of client money and assets.[8]

In addition, various capital, liquidity and organisational requirements apply to the relevant firms across IOSCO member jurisdictions.[9] These include requirements relating to risk management, internal controls, business continuity and record keeping.

While the standard regulatory requirements mentioned above address some of the broader risks arising from the offer and sale of the relevant products to retail clients several IOSCO members have taken the view that they do not necessarily address the more specific investor protection risks arising from the distribution of the products to retail clients. As a result, some IOSCO member jurisdictions have adopted more specific regulatory measures to enhance investor protection in this particular area. These additional, targeted measures are the focus of the regulatory toolkit outlined below.

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[7] For example, the requirement to publish a prospectus may only apply to securities; or certain transaction reporting requirements may differ depending on whether the transaction involves a security or a derivative.

[8] These requirements reflect the IOSCO's Objectives and Principles of Securities Market Regulation, June 2010. Also see IOSCO's Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation; Suitability Requirements with respect to the Distribution of Complex Financial Products, January 2013; Guidelines for the Regulation of Conflicts of Interest Facing Market Intermediaries, November 2010; Recommendations Regarding the Protection of Client Assets, Report of IOSCO, January 2014.

[9] Also see Capital Adequacy Standards for Securities Firms. Report of IOSCO, October 1989.

Chapter 3: Regulatory toolkit to enhance conduct standards

Introduction and overview of the toolkit

This section of the report sets out the policy measures that IOSCO members may consider in their regulation of firms offering and selling retail OTC leveraged products. The purpose of the toolkit is to present IOSCO members with options for targeted regulatory measures that address the specific investor protection risks arising from CFDs, rolling spot forex contracts and binary options sold to retail customers.

The measures are designed to help reduce the risks to investors in these products, improve the practices of licensed firms that sell them, improve the likelihood that the products are sold to an appropriate target market and reduce the likelihood that these products are sold illegally by unlicensed firms.

This toolkit of policy measures with guidance includes:

i. A licensing requirement for all firms that sell the relevant products to retail investors either domestically or on a cross-border basis;
ii. Leverage limits or minimum margin requirements;
iii. Measures to address the risk of investors losing more than their initial investment;
iv. Measures to enhance the disclosure of costs and charges of the products;
v. Measures to improve the disclosure of risks of the products, including profit and loss ratios;
vi. Other focused requirements to enhance the quality of pricing and order execution; and,
vii. Measures to restrict the sale, distribution and marketing of the products with a view to addressing mis-selling risk.

Several of the measures in this toolkit have already been adopted by some IOSCO members who apply them alongside the standard regulatory framework governing the sale and offering of all investment products. Where this is the case, it has been indicated in the report. Other IOSCO members may wish to consider applying similar measures when determining their approach to regulating the intermediaries offering and selling OTC leveraged products to retail clients.

Licensing of intermediaries

Unlicensed firms avoid the regulatory requirements or standards that licensed firms are subject to when selling the relevant products to retail clients. As such, they pose considerable risk to retail investors.

A licensing requirement is an important tool to help ensure that firms are subject to certain minimum standards and regulations, that they can be effectively supervised, and be subject to enforcement actions in the event of non-compliance.[10] Licensing provides a critical safeguard that firms are appropriately managed, and that certain conduct and prudential standards are observed when undertaking business.

The IOSCO Principles state that jurisdictions should ensure that, as a condition of operating a securities business, market intermediaries are subject to minimum entry standards. IOSCO members are however ultimately responsible for determining the scope of their regulatory perimeter, and it is not the intention of this toolkit to suggest harmonizing licensing

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10 This requirement is outlined in Principle 29 of IOSCO Objectives and Principles of Securities Market Regulation, June 2016.Issues and challenges raised by unlicensed firms and enforcement against unlicensed entities are being addressed in the work undertaken by IOSCO Committee 4.

requirements beyond those standards that are strictly necessary to address significant investor protection concerns, in particular the concerns arising from unlicensed or illegal cross-border business with retail investors.

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

This measure would require market intermediaries to be registered and/or licensed by a relevant regulatory authority when physically based in and operating from that jurisdiction and offering the relevant products to retail investors, regardless of where the end-investor is located.

This measure will ensure that firms are subject to regulatory oversight regardless of where their end-customers are located, and that firms meet certain minimum standards when offering their services.

In particular, preventing a carve-out from the licensing requirement based on a client's location would ensure that all firms operating in the sector:

- are subject to certain regulatory requirements;
- can be supervised and inspected; and,
- can be held to account for their misconduct, including through effective enforcement actions.

A more common approach to licensing will help mitigate regulatory arbitrage in the sector which remains an ongoing problem. In particular, subjecting all firms offering the relevant products to retail clients to a licensing requirement in the jurisdiction where they are based will make it more difficult for firms to avoid meeting any regulatory requirements purely by marketing the relevant products outside of the jurisdiction where the firm is domiciled. It will also assist regulators in inspecting firms to ensure compliance with relevant conduct measures. In addition, such a measure will likely reduce the burden of taking action against unlicensed entities in jurisdictions where the investors reside since supervision by the home country authority would likely help deter illegal activity abroad.

Adoption of the measure by IOSCO member jurisdictions

In most IOSCO member jurisdictions, firms offering the relevant products are already regulated and required to be licensed regardless of the location of the end-customer. In addition, in the large majority of IOSCO member jurisdictions, the relevant products are considered to be financial instruments, i.e. either securities or derivatives and are accordingly subject to regulatory oversight.

Recently, a number of jurisdictions have taken steps to amend their regulatory perimeter to bring the relevant products within the scope of local financial services regulation, and to subject firms offering them to a licensing requirement. For example in the UK binary options, unlike CFDs, are currently treated as gambling products subject to regulation by the Gambling Commission. The UK Parliament has, however, recently amended primary legislation in order to bring binary options within the regulatory perimeter of the Financial Conduct Authority (FCA) with effect from January 2018.[11] Israel also recently passed legislation to ban online trading companies operating from Israel from offering binary options to customers in Israel and abroad.

11 The UK's recent amendment, treating binary options as financial instruments reflects the European Commission's revised guidance on binary options treatment under European law, which had not originally considered the products as financial instruments for the purposes of MiFID. Other European jurisdictions had taken a similar approach as the UK before the revised guidance from the European Commission.

Guidance on applying the measure

One of the most effective measures to address this serious investor protection issue is through licensing requirements. It is acknowledged that the scope of the licensing requirement in different IOSCO member jurisdictions is likely to be determined under the relevant statutory law. While there may be challenges in adopting this measure as a result of this, the relevant jurisdictions are encouraged to adopt this measure in order to address any existing gaps in the regulation of the firms offering the relevant products.

Given the evident risks attached to trading these products for retail clients, to help provide a consistent level of investor protection, jurisdictions would need to characterize these products as financial instruments to ensure that firms offering the relevant products are licensed as financial intermediaries and that the measures outlined in this toolkit can be applied to them.

To avoid regulatory arbitrage and to help ensure that retail investors are afforded sufficient protections when dealing with firms offering the relevant products, regardless of where the clients are located, IOSCO member jurisdictions may wish to consider the following approaches when establishing a licensing regime in respect to the relevant firms:

- Requiring all intermediaries physically located in their jurisdiction and who deal with retail clients residing either in the local jurisdiction or abroad to obtain the necessary local license; or,
- Requiring all intermediaries physically located in their jurisdiction and who deal with retail clients residing in the same jurisdiction to obtain the necessary local license, while prohibiting any such local intermediary from dealing with retail clients residing in other jurisdictions.

Leverage limits or minimum margin requirements

Leverage alters the client's financial exposure to the underlying. It allows the client to enter into trades by only posting a small proportion of the total notional investment to support the trading position. This increases the client's exposure to the volatility of the underlying asset and typically increases the client's notional investment. As such, leverage magnifies the risk and potential size of losses for clients, including the risk that client losses can exceed the initially deposited client funds.

The below measure seeks to ensure that the levels of leverage that firms offer to their retail investors trading in the relevant products are limited, thereby contributing to provide an appropriately high level of protection for these investors.

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

This measure would require market intermediaries to comply with minimum margin requirements when transacting in CFDs or rolling spot forex contracts, ensuring that they collect from their clients a certain margin amount as collateral before opening a position. The measure can also be applied so that it requires a certain level of margin to be maintained to support a position over the course of the trade.

Setting a minimum margin requirement on CFDs and rolling spot forex contracts reduces the risk of losses to clients trading in these types of products. By limiting the client's exposure, the measure reduces the likelihood and volume of potential client losses. Limiting the leverage available in the products also helps firms mitigate potential conflicts of interest arising from situations where they act as the counterparty to the client's trades and where they directly benefit from the client's losses. Furthermore, the measure also mitigates the counterparty credit risk that the firms offering the products can present when offering the products to retail customers at excessive levels of leverage.

Adoption of the measure by IOSCO member jurisdictions

Several IOSCO member jurisdictions have decided to apply minimum margin requirements to CFDs and rolling spot forex contracts as a measure to mitigate investor detriment arising from the relevant products.

The measures adopted by different IOSCO member jurisdictions include:

- Firms being subject to different levels of initial margin and maintenance margin requirements for rolling spot forex contracts and CFDs;
- Firms being subject to the same leverage limits as firms offering exchange-traded futures contracts on the applicable underlying interest; and,
- Firms being subject to different minimum margin requirements or leverage limits depending on the relevant product and underlying.

Guidance on applying the measure

When considering the appropriate level of minimum margin for the relevant products, IOSCO member jurisdictions will need to carefully balance the need to ensure robust investor protection while allowing customers who sufficiently understand the products and their risks and are able to bear any associated losses to continue to trade these products.

In designing the measure, IOSCO members may wish to consider setting the minimum margin requirement for the products taking into account one of more of the following factors:

- according to the riskiness and volatility of the underlying;
- according to the sophistication and experience of the client; or
- based on other comparable, or economically equivalent products (such as futures).

IOSCO members may also wish to consider their approach for requiring firms to maintain a prescribed margin level supporting their client's position. Some jurisdictions require firms to collect and maintain a minimum margin from the client over the course of the transaction. Others apply the minimum margin requirements for clients only to the client's initial position, allowing the margin to be eroded over the course of the trade.

Firms in jurisdictions without the requirement to maintain the margin at a pre-determined level typically adopt a margin close out feature for the relevant products. This feature closes out the client's position as soon as market conditions allow once the client's margin has fallen below a pre-determined proportion of their notional exposure. In practice, the feature provides a set limit for leverage available to the client during the course of the trade. However, because the level of margin at which the close out is effected is set as a proportion of the initial margin posted, such a feature makes available higher levels of leverage to the client during the course of the trade than that available to the client when opening the position.

Taking into account the above considerations, where there is no regulatory requirement for a maintenance margin, IOSCO members may wish to consider applying the margin close out feature as a formal requirement for the relevant products.

Measures for intermediaries that counter the risks of investors losing more than their initial investment in the relevant products

The leveraged nature of the relevant products means that retail clients trading in them can be exposed to losses exceeding their deposited funds. Depending on the leverage used and the volatility of the underlying, the speed and volume of the losses can be significant.

Set out below is a policy measure that mitigates the risk of clients losing more than their initial deposits when investing in the relevant products.

Measure 3: Negative balance protection

This measure would require market intermediaries to limit retail clients' losses in CFDs and rolling spot forex contracts to their deposited funds or their funds invested for each trade, thereby preventing firms from recovering any losses that exceed the clients' deposited funds or funds invested for each trade.

A measure limiting client losses to their deposited funds or funds invested for each trade in CFDs or rolling spot forex contracts provides a high level of protection to clients by guaranteeing a certain floor for the losses clients may be exposed to. It addresses the risk that a significant change in the price of the underlying can subject the client to considerable, in some cases even unlimited losses. It provides a level of certainty to the client of possible investment outcomes when trading in CFDs or rolling spot forex contracts.

While a minimum margin requirement addresses some of the risks of retail clients investing in the products, a requirement for firms to cap retail client's losses provides a guaranteed backstop to the level of losses retail clients can be exposed to. As such, the measure provides a high level of protection for clients against potential losses, including during periods of significant market volatility.[12]

Application of the measure by IOSCO member jurisdictions

Measures adopted by IOSCO member jurisdictions include:

- A restriction on the marketing, distribution and sale of CFDs that do not limit the client's losses to the balance on the client's trading account.
- A prohibition on electronic advertising of all retail OTC derivatives that do not limit the client's losses to the initial investment made to create any relevant client position (thereby prohibiting firms from making a subsequent margin call or clients from posting additional margin to maintain an open position).
- A requirement for firms offering rolling spot forex contracts to agree and set an individual loss limit for their client transactions and terminate the client's trade when it reaches the agreed limit.

Guidance on applying the measure

The primary consideration for IOSCO members when designing this measure is whether to apply it on a per position or per account basis. If applied on a per position basis, the client's losses in a particular position are limited to the funds held to support that particular position. If

12 When implementing the measure, IOSCO members should consider the impact the measure has on the capital standards and prudential requirements for the firms and ensure that these are revised accordingly and in a manner that, together with the negative balance protection measure, ensures an appropriately high level of protection to investors.

applied on a per account basis, the client's losses on one or multiple positions are limited to the total equity in the client's account.

Applying the measure on a per position basis provides the most comprehensive level of protection to the client. However, it restricts certain client trading strategies and is likely to be costly for firms to provide, therefore likely leading to higher transaction costs for retail clients when trading in the relevant products. Applying the measure on a per account basis allows more flexible trading strategies by investors trading in the products and is less costly for firms to offer. However, it allows the firms to use profits across the client's trading account to cover losses on individual positions.

IOSCO members may also wish to consider adopting the measure requiring firms to agree and set the level of the loss limit separately with each client.

Measures to enhance the disclosures of costs and charges by intermediaries

As set out in the December 2016 Report, several IOSCO members have raised concerns that there is a lack of transparency around the different costs and charges that market intermediaries impose on the sale of the relevant products and that many retail clients may find it difficult to understand which costs are applicable and how the application of the various costs affects the returns on the product.

Standardised cost disclosures are designed to ensure that firms accurately describe the costs arising from trading in the products.

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

This measure would require market intermediaries to provide a standardised disclosure that clearly sets out the total costs and charges charged by intermediaries relating to the product before it is sold to retail clients.

This measure promotes transparency of the information available to clients on the costs and charges of the product. In addition, the measure helps clients compare the different products, helps them to better assess value for money and the impact of costs on the expected performance of the product, and ultimately assists them in making an informed investment decision.

Adoption of the measures by IOSCO member jurisdictions

In Europe, firms will be required to disclose to the client the total cost of the product as part of enhanced disclosure requirements stemming from the MiFID 2 legislation.

In addition, firms offering the relevant products will be 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).[13]

Guidance on applying the measures

Should this measure be adopted by IOSCO members, regulators may wish to require that firms ensure that at least the following costs and charges are included in the enhanced disclosure:

- The spread;
- The various other costs and charges applied, including:

13 Both EU legislations mentioned will come into effect in January 2018.

- Any financing charges to keep the position open, such as daily or overnight
- charges;
- Commissions, e.g. general commission, commission on each trade, or commission on opening and closing an account;
- A mark-up to the market prices[14] the firm receives from an external source;
- Any costs or charges applicable if a client closes a position;
- Account management fees.

Where an exact cost for the product cannot be indicated at the outset, IOSCO members may wish to require a firm to make this clear and disclose to their client how those costs will be calculated and applied.

IOSCO members could also consider requiring firms to make estimations of the expected costs and charges for any costs that cannot be indicated at outset. For example, firms could be required to use incurred costs as a proxy for expected costs and charges. Firms should be expected to make reasonable assumptions and take into account any factors that can impact the costs, such as the type of products and the underlying, the expected holding period and/or expiry of the product. In addition, firms could be expected to regularly review any ex-ante assumptions they have made based on actual outcomes and make amendments to the disclosures where appropriate.

In designing the measure, IOSCO members may want to consider the following aspects:

- The timing of the disclosure;
- The medium for the disclosure;
- The scope of application of the measure, including whether it would apply to licensed firms offering the relevant products outside their home jurisdiction;
- Whether, aside from total cost of the product, any other key information should be included in the disclosure;
- The level of granularity and format for disclosing the methodology the firm uses to calculate and apply the costs;
- Whether the impact of costs and charges on the performance of the product should be included as part of the disclosure.

Measures to improve the disclosure of risks of the products

Firms in the sector are commonly observed using misleading marketing messages when promoting their products to retail clients, focusing on the benefits and ease of trading in the relevant products and emphasising the potential of significant profits, while playing down the risks and potential for rapid and potentially unlimited losses.

The below measure is designed to help ensure that firms offering the relevant products adequately describe the risks arising from the products when offering them to retail investors.

Measure 5: Disclosure of investor profit and loss ratios

This measure would require market intermediaries to disclose to their clients the percentage of client accounts that made a net profit or loss during a certain period of trading activity.

Given that several IOSCO members have found that a majority of clients lose money on these products, this measure provides a simple, firm-specific figure highlighting actual client trading outcomes. It helps to ensure that clients are better informed of the risks associated with the

14 These market prices may already include a spread by an external source.

relevant products and that firms communicate certain key messages in a clear and understandable way. While disclosures alone have some limitations in impacting investor behaviour, the measure helps offset the tendency of firms and clients to focus on the potential for profits rather than losses, and supports 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.

Adoption of the measures by IOSCO member jurisdictions

Similar measures adopted by IOSCO member jurisdictions include:

- A requirement for firms offering the relevant products to disclose data on loss-making and profit-making accounts at firm level for the last calendar quarters.
- A competent authority publishing monthly, firm-level statistics on profit and loss ratios of the clients trading in the products.
- A requirement for firms that offer CFDs with leverage in excess of a specified level to provide an express warning to investors on the complexity, risk and likelihood of losses.

Guidance on applying the measures

In addition to the considerations set out for IOSCO members when designing the requirement for firms to disclose the total costs of the product as set out under Measure 4, members may want to set out specific instructions to firms for calculating the profit-loss ratio. This would help prevent firms from using a methodology that is designed to produce an attractive marketing message and ensure that the methodology firms use to calculate the ratio accurately reflects genuine client outcomes For example, the instructions could include the following:

- The percentage of profitable versus loss-making accounts should include the realised and unrealised gains and/ or losses on all relevant contracts for each retail client.
- The calculations for the profit and loss ratios should be inclusive of all fees, commissions and any other charges.
- The calculations for the profit and loss ratios should be exclusive of all deposits of funds, all withdrawal of funds and all accounts that have not entered into a single trade over the relevant period.

IOSCO members could also consider other alternatives when designing requirements for firms to disclose the actual outcomes of clients who trade in the relevant products. These could include, for example, firms disclosing the actual average losses experienced by clients. When considering such measures, IOSCO members may wish to test different approaches for their impact on retail investor behaviour.

Measures to improve the quality and integrity of pricing and order execution

Several IOSCO members have raised concerns over execution practices of firms offering the relevant products to retail clients, stating that the products present challenges to regulators to ensure that the firms are delivering the best possible execution outcomes to their clients.

Below are measures that IOSCO members can adopt in an effort to improve the integrity of pricing of the relevant products and to enhance execution quality in the sector.

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

This measure would require market intermediaries to be able to demonstrate a clear pricing methodology for the relevant products and to use independent and externally verifiable price sources and liquidity providers to derive their prices.

To increase the transparency in the pricing of the relevant products, IOSCO members may wish to require that firms be able to demonstrate how their prices are constructed and how they apply a spread or a mark-up to the reference prices used. Furthermore, IOSCO members may wish to consider mandating firms to use externally verifiable price sources and liquidity providers to derive their prices as a way of ensuring fair pricing.

This measure helps to ensure that firms are clear about how they construct the prices for the relevant products and that the firm's pricing methodology supports quality outcomes for its clients.

Improving price transparency in the relevant products also makes it easier for clients to compare the quality of the firm's service offering, to make informed investment decisions and to assess value for money.

Adoption of the measures by IOSCO member jurisdictions

In Europe, investment firms will be required to demonstrate fairness in pricing when executing in OTC products and increase transparency around execution processes as part of the best execution requirements arising from MiFID 2, which will come into effect in January 2018.

In the US, broker-dealers are required to ensure that the prices they offer bear a 'reasonable' relationship to prevailing market prices. FINRA rules also address both reasonable mark-ups and potentially conflicted fee structures for securities.

Guidance on the application of the measures

Firms could be expected to demonstrate that their pricing methodology supports quality outcomes for clients, for instance, by:

- Referencing the price they offer to their clients to market data used in the estimation of the price of the product;
- Using independent and externally verifiable price sources and liquidity providers to derive their prices; and
- Comparing their pricing with that of similar or comparable products.

As part of the measure, IOSCO members may wish to require firms to disclose their pricing methodology to their clients, as suggested under Measure 7. To ensure that firms continue to deliver quality outcomes to their clients on a consistent basis, IOSCO members may wish to require firms to review their pricing methodology at regular intervals.

Measure 7: Enhanced disclosures about order execution quality

This measure would require that market intermediaries provide clear and effective disclosures to their clients about how their orders are executed.

Increased transparency around order execution helps clients to better understand and to evaluate the quality of the firm's execution practices and thus to better assess the quality of the overall service provided to them. In addition, improved information on how the firm prices its products assists clients when monitoring the prices they have been offered by the firm and helps them better look after their own interests.

Adoption of the measures by IOSCO member jurisdictions

In Europe, 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 2 will also 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 will also be required to make public detailed data relating to the quality of execution of transactions on that venue.

In addition to the requirement to ensure that the prices broker-dealers offer bear a reasonable relationship to prevailing market prices, in the US, the NFA requires forex dealer members to provide their customers, upon request, with certain transaction execution data. This includes price data for the 15 transactions in the same currency pair that occurred immediately before and after the customer's transaction.

Guidance on the application of the measures

IOSCO members have different requirements for firms to inform their clients about how their orders are executed. Taking into account the diverging national requirements in this area, IOSCO members may wish to require firms to provide at least the following disclosures to their clients in respect of the way they execute their client orders:

a) Order execution policy explaining the methodology the firm uses to deliver the best possible outcome to their clients when executing their orders;
b) The firm's pricing methodology;
c) Any other data relating to execution quality, such as slippage ratios or re-quote and rejection rates, which clients can use to better evaluate the quality of execution delivered by the firm.

Firms should ensure that the disclosures to clients are clear and allow the clients to readily understand how their orders are executed by the firm.

As part of this measure, IOSCO members may expect firms in the sector to include the following considerations in their execution policy:

- The process followed for selecting the execution venue and price sources used by the firm;
- The process for selecting the hedging venue for the client's trades;
- The process for selecting and monitoring the technology used for executing client orders; and,
- How the firm manages any potential conflicts of interest arising when executing client orders.

Measures to restrict the sale and marketing of the relevant products

As set out in the December 2016 Report, OTC leveraged products are increasingly being marketed and sold to the mass retail market, despite the fact the products are unlikely to be appropriate for most ordinary retail investors.

Given that the products are complex and highly risky, presenting their investors with a high probability of losses, they are likely to be appropriate only for a relatively small number of sophisticated retail investors who understand the products and their risks and are financially capable of absorbing the potential losses.

As pointed out previously, some IOSCO members consider that the general regulatory requirements applicable to market intermediaries, or the enhanced regulatory requirements above, do not sufficiently address some of the specific risks arising from the relevant products. To mitigate the high risk of mis-selling in the sector, a number of jurisdictions have adopted more stringent measures, ranging from a full ban on intermediaries either marketing or selling the relevant products to retail investors, to more targeted measures prohibiting certain forms of aggressive sales or marketing techniques.

The different options for IOSCO members to consider are set out below.

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

This measure would involve placing restrictions on certain forms of marketing or sales techniques used by market intermediaries offering some or all of the relevant products to retail investors.

This measure seeks to ensure that the relevant products to be offered to retail investors are appropriately marketed and/or distributed. It addresses the risk of mis-selling the relevant products. It is intended to help prevent indiscriminate and inappropriate mass marketing of the products and prevent pressure sales to retail clients.

Adoption of the measures by IOSCO member jurisdictions

The restrictions on certain types of marketing and sales techniques adopted by IOSCO member jurisdictions include:

- A ban on advertising of all binary options and of certain types of CFDs and rolling spot forex products with specified product features (i.e. CFDs and rolling spot forex products that may give rise to a loss greater than the initial amount invested by the retail client) . The ban covers all forms of electronic advertising, promotion and marketing, including emails, internet pop-up banners, mobile apps, social media postings, radio and television. The ban also prohibits sponsoring by the relevant firms, for example of sports teams. In addition to prohibiting financial sector firms from issuing such marketing material the ban extends to prohibiting advertising sector firms from issuing the relevant material. The ban does not apply to information provided by financial firms directly on their websites provided that the firm is acting legally in the jurisdiction.
- Another jurisdiction has prohibited certain distribution techniques with respect not only to these particular products but to all OTC derivatives that may be offered to consumers. The prohibition includes a ban on the use of call centres to market the products, preventing the use of credit cards to make payments to the relevant firms and restricting the use of promotional cash bonuses.

In Europe, MiFID 2 legislation will require product manufacturers to identify an appropriate target market for their products; to ensure that the products are designed to meet the needs of the target market and distributed accordingly. Distributors of products will be required to use the target market information from product manufacturers and take account of the target market in designing their distribution strategy.

Guidance for applying the measures

Ways for IOSCO members to limit the marketing and distribution of the products could include:

- Prohibiting or restricting electronic advertising of the products, with a focus on media such as web-based marketing and mobile apps used by firms to reach customers;
- Prohibiting or restricting unsolicited promotions and intrusive sales techniques for the products, including cold calling;
- Prohibiting or restricting bonus promotions to market the products;
- Prohibiting or restricting the payment of compensation to clients to introduce new clients;
- Requiring firms to undertake target-market assessments and use an accordingly tailored distribution strategy for the products; or
- Limiting the use of third parties, such as call centres, by firms to promote the products and to introduce clients to the firm selling them.

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

This measure would prohibit or restrict the sale and/or distribution of some or all of the relevant products to retail investors by market intermediaries, or require transactions on the relevant products to take place on exchanges.

Banning the sale and/or distribution of any of the relevant products, or requiring such transactions to take place on exchanges, could be used in scenarios where IOSCO members consider that other measures may be insufficient in mitigating the investor protection risks arising from the products. Such measures help ensure that products that pose a significant risk of investor detriment cannot be sold off-exchange and/or distributed to retail clients.

Monitoring compliance with a ban or restrictions on sales and/or distribution of the products may be less resource intensive for the relevant regulatory authorities than monitoring compliance with the other suggested measures.

Adoption of the measures by IOSCO member jurisdictions

The following approaches have been applied by IOSCO members that prohibit or otherwise restrict the distribution of some (or several) of the relevant products:

- Some jurisdictions prohibit the sale and/or distribution of some or all of the relevant products to retail investors either off-exchange or via any electronic trading platform;
- Some jurisdictions have adopted or consulted on a prohibition on the sale of some or all of the relevant products regardless of whether they are sold on exchange while other jurisdictions require such transactions to take place under a regulatory regime specifically tailored to such products;
- Some jurisdictions have taken the approach not to authorise any firms offering binary options to retail clients.

Guidance for applying the measure

IOSCO members may wish to consider this measure alongside other measures set out in this toolkit that address the offering of sale of the products with certain features. In particular, where those measures require the products to incorporate certain features, they can also be considered as restrictions on the distribution of the relevant products that do not incorporate such features.

Before applying this type of measure, it may be helpful for IOSCO members to consider whether applying any of the measures set out previously, or a combination of them, could sufficiently mitigate the investor protection risks arising from the relevant products. For example, because of their inherent complexity and the lack of transparency in their pricing, IOSCO members may consider that there are inherent flaws in binary options as products that render them unsuitable for sale to retail clients by intermediaries. In addition, the product features of binary options may mean that some of the measures presented in this toolkit have little impact on addressing the risks arising from binary products. Therefore, IOSCO members may choose to adopt the measure restricting intermediaries from selling these products as a proportionate measure to help ensure a sufficient level of protection for retail clients.

When applying this measure, IOSCO members may also want to decide whether reverse solicitation of the relevant products should be allowed.[15]

Finally, as this measure may heighten the risk that retail investors are targeted by unlicensed entities, which become the sole provider of these products, IOSCO members adopting this measure may wish to consider appropriate enforcement approaches that can be adopted alongside this measure and that can help to mitigate the risk of unlicensed entities offering the products illegally.

Question: Do market participants agree that the measures included in this toolkit are appropriate for addressing the specific risks arising from the offer and sale of OTC leveraged products to retail clients?

15 In this context, reverse solicitation is taken to mean an offering or sales process that is initiated by the customer.

Chapter 4: Conclusion and next steps

This toolkit proposes a variety of policy measures that IOSCO members are encouraged to consider when determining their approach to address the specific risks arising from the offer and sale of OTC leveraged products to retail clients. The measures vary in their intrusiveness and range from a licensing requirement, which is a prerequisite for the adoption of the other measures included in the toolkit, to measures involving certain specific product features and to restrictions on intermediaries from offering the relevant products to retail clients, including a prohibition on such offers.

The tools presented are intended to allow for flexibility in the different jurisdictions that choose to implement them.

No regulatory action is mandated by the toolkit described in this report. It is acknowledged that not every tool or measure described would be appropriate in all IOSCO member jurisdictions and that the use of any tool or measure is dependent upon the capacity of the relevant IOSCO member under its legal and regulatory framework to implement it. In addition, implementation of the measures should be done in light of the specific risks and sources of harm that have been identified in the respective jurisdiction. Implementation of the different tools and measures may therefore vary across IOSCO jurisdictions. As such, IOSCO members may choose to implement the measures selectively, in a manner best suited to their legal and regulatory framework, market environment and investor base.

IOSCO is seeking feedback on the tools and measures proposed in this report. After consideration of comments received from the public, IOSCO will prepare a final report, incorporating all three toolkits envisaged by the mandate, as set out in the introduction.