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Hearing: General Administrative Act pursuant to section 4b (1) of the German Securities Trading Act (Wertpapierhandelsgesetz – WpHG) regarding contracts for difference (CFD)

Dear Sir or Madam,

I intend to order a measure pursuant to section 4b of the German Securities Trading Act (Wertpapierhandelsgesetz – WpHG). Before I do so, I hereby give you the opportunity pursuant to section 28 of the German Administrative Procedure Act (*Verwaltungsverfahrensgesetz – VwVfG*) to comment on it in writing by

[20 January 2017] (receipt by BaFin).

The intended measure reads as follows:

"The following is ordered:

General Administrative Act

1. I order the limitation of the marketing, distribution and sale of financial contracts for difference ("CFDs") within the meaning of section 2 (2) no. 3 of the WpHG. The marketing, distribution and sale of CFDs to retail clients within the meaning of section 31a (3) of the WpHG shall be prohibited insofar as they may give rise to an additional payments obligation. This limitation is to be implemented [within three months of the date on which the General Administrative Act is deemed announced].
2. The General Administrative Act shall be deemed announced on the day following the public announcement.

Grounds:

A. Facts

Financial contracts for difference are arrangements between two parties who speculate on the price performance of a certain underlying asset. CFDs are used for short-term speculation and are offered over the counter. They are leveraged contracts characterised by a high risk of loss for the investor. The client's risk of loss is not limited to a particular margin payment but instead may encompass the entirety of the client's assets. If the client's loss exceeds the balance on their account for the purpose of CFD trading, they must pay for the loss from their other assets (additional payments obligation). The CFD providers who are the retail investor's contractual partner take on the risk inherent in the CFD into their books and so act as a market maker, or hedge against that risk by transferring it to other market players.

CFDs were developed in the 1990s in investment banking in order to bypass stamp duty to be paid in the United Kingdom when trading in shares at the London Stock Exchange. CFDs enable retail investors to use a relatively small margin (deposit) to speculate on the performance of currency pairs, shares, indices, commodities, bonds and other underlying assets without having to invest in the underlying asset directly. In a CFD transaction, no underlying assets are therefore ever purchased or traded. By opening a share CFD position, the retail client never participates in financing a company through the capital market.

In CFDs, the contractual partners agree to settle the difference between the price of an underlying asset at two different points in time (t and $t+n$). The result of the speculation is calculated as the difference between the opening and closing price of the underlying asset. For example, if an investor speculates on the price of a share going up, a CFD provider, who acts as the contractual party in this CFD and does not hedge against market risk, speculates on the price of the share going down. When the price of the underlying assets changes, the corresponding price gains or losses are mirrored by the CFD. If the difference is positive, the retail investor is paid the difference by the CFD provider; if, however, the difference is negative, it is the investor who must pay the difference to the CFD provider.

Example¹:

The retail investor opens a CFD position in order to speculate on the performance of the price of Share A. The CFD position is 4,000 Shares A at EUR 10 each, totalling EUR 40,000. The CFD provider offers the retail investor a leverage of 20. This means that the margin required for the entire position is EUR 2,000 (or 5% of the entire position). The effects of the changes in value of the underlying asset on the profit/loss from the CFD are as follows:

"Share A" price	"Share A" price performance	Profit/loss from the "A CFD"	"A CFD" price performance
€7.50	-25%	€-10,000	-500%
€9.50	-5%	€-2,000	-100%
€9.90	-1%	€-400	-20%
€10.00	0%	€0	0%
€10.10	1%	€400	20%
€10.50	5%	€2,000	100%
€12.50	25%	€10,000	500%

The price of the underlying asset when opening the CFD position (opening price) and when closing the CFD position (closing price) determines the amount of the difference due. The opening and closing of a CFD position is based on prices determined by the CFD provider. The client thus speculates on the development of prices that are determined and set by the CFD provider. These prices may generally mirror the available market prices such as stock market prices or underlying asset prices available on reference markets. However, CFD providers have scope for discretion in determining the price difference that is contractually due and may therefore set the relevant price at their own discretion in compliance with the opening clauses agreed with the retail investor, e.g. in the event of particularly high volatility of the underlying asset or in the case of market turbulence.

In addition, a phenomenon called "price gap" frequently occurs when the price is determined. A price gap occurs when the price of the underlying asset as determined by the CFD provider for the retail investor abruptly

¹ Simplified example, not considering any potential transaction costs.

"jumps" to a different level. Such price jumps may follow the publication of economic data or significant economic events that lead to major price fluctuation of the underlying asset. If a price gap occurs when the price of the underlying asset develops in a way that is unfavourable to the retail investor, they may not always have the opportunity to close their open CFD position between the two price levels in order to minimise their losses. Instead, they are only able to close their CFD position at the next price as determined by the provider. This price, though, may differ significantly from the previous one.

The key characteristic of CFDs is their leverage. If a retail investor opens a CFD position, they do not need to have sufficient balance on their trading account with the CFD provider that corresponds to the current price of the underlying asset of the CFD position. Rather, CFD providers only require the retail investor to put down a small fraction of the price of the underlying asset on their trading account (what is known as a "margin"). The investor can thus speculate with a larger amount (mathematical value of the corresponding position in underlyings) than they have actually put down as margin. The mathematical value of the corresponding position in underlyings can even exceed the value of the investor's existing assets. Such an arrangement enables the investor to participate in the price changes of the underlying asset (both upwards and downwards) to a disproportionate extent. For every open CFD position, the retail investor must put down a margin that is calculated as a percentage of the price of the underlying asset. If the margin on an underlying asset is 1%, the retail investor can open a CFD position whose underlying asset may be worth 100 times more than the margin. The margin amount is determined in detail for every underlying asset by the CFD provider. Since the value of the underlying asset varies depending on its price performance, the amount to be maintained as margin on the CFD account does not remain constant but instead fluctuates in line with the price performance of the underlying asset. If, as a result of the price performance of the underlying asset, the amount paid into the trading account is utilised in full by the amount to be maintained as margin, the investor can deposit more money on their trading account; otherwise, the CFD position will be forcibly closed by the provider.

The investor therefore does not have to have the entire contract amount on their CFD account when opening a CFD position. Instead, the CFD provider accepts the investor putting down only a fraction of this amount. In this way, the retail investor's willingness to speculate is purposefully encouraged. In economic terms, this type of trading is a form of speculation on credit.

The amount of the margin held for the CFD position in a certain underlying asset plays a key role in determining how high the leverage is with which the retail investor can participate in the price developments of the underlying asset. The lower the margin that the retail investor has on their CFD account as compared with the value of the underlying asset, the higher the leverage. The smaller the fraction of the underlying asset held as margin, the higher impact both positive and negative price changes of the underlying asset of the CFD have as compared with the retail investor's margin.

If the price of the underlying asset of a CFD shows significant fluctuation within short periods of time (high volatility) and if the CFD provider requires a minimum margin for that underlying asset that is similar to the fluctuation range of the underlying asset, the retail investor has the opportunity to quickly multiply the margin. The drawback of leverage, however, is that there is a corresponding risk of the retail investor's losses reaching levels many times the amount of the margin. If, for instance, the price moves significantly in a direction that is unfavourable to the retail investor, the difference between the opening and closing price they have to pay may be many times the amount they have as margin on their account.

If the margin held on the client's CFD trading account is insufficient to pay for the losses incurred, the client must pay for the losses using their other assets (additional payments obligation).

It must be noted that the leverage produces a particular scaling impact in connection with the potential extent of the additional payments obligation. This is because the leverage increases the potential loss in proportion to the margin put down. In certain cases, this loss can exceed the margin held on the client's trading account. The higher the CFD's leverage, the higher the potential loss and the higher the probability that the margin held on the client's trading account will not be sufficient to pay for the losses incurred, which means that the client will be obliged to make additional payments.

Example:

If the price of Share A from the example above decreases from EUR 10 to EUR 7.50, the retail investor who put down EUR 2,000 as margin loses EUR 10,000. With a greater number of contracts traded, the potential extent of any loss also increases. If the client has no more balance than the amount of the margin on their CFD account (total capital on the account minus margin), the in-

vestor then has to pay the remaining difference of EUR 8,000 using their other assets. The CFD provider would then prompt the client to make an additional payment without delay.

In principle, CFDs have no length limit. However, this only applies as long as the retail investor fulfils the minimum margin requirements set by the individual CFD provider. If the retail investor's balance (margin plus free capital on the CFD account) is no longer sufficient to fulfil the margin requirements set by the CFD provider, the latter will issue a margin call. Depending on the provider, such margin calls may reach different escalation steps and involve, for instance, notifying the retail investor when a certain threshold has been exceeded (e.g. loss of 80% of balance). If the retail investor's balance is no longer sufficient to fulfil the CFD provider's margin requirements, the CFD position is automatically closed. However, such force closing does not guarantee that the retail investor's losses will be limited to their balance with the CFD provider. Instead, abrupt price fluctuations of the underlying asset or the price gaps result in the retail investor's losses amounting to multiples of their original margin payment. These must then be paid for using the investor's other assets.

A CFD position is typically closed by clients on the same day that it is opened. If CFD positions are kept open overnight, however, the retail investor is usually charged an overnight fee. The short-term character of trading also manifests itself in the design of the CFD providers' trading platforms. These platforms typically include a whole range of visual signals, the intention of which is to indicate the relevant price developments to the client. These indicators are intended to support the clients when estimating price developments. The flashing price information and visual effects indicating possible price developments are designed in such a way as to encourage the retail investor to open CFD positions.

Based on the observations made by the Federal Financial Supervisory Authority (BaFin) in the course of its supervisory duties, CFD providers target almost exclusively retail clients within the meaning of section 31a (3) of the WpHG. A typical CFD client is a retail investor. According to a market survey conducted on behalf of the CFD association *CFD Verband e.V.* by the Research Center for Financial Services, there were around 127,137 CFD client accounts in 2015.² The number is approximately representative of the number of clients affected.

² http://www.cfdverband.org/wp-content/uploads/2014/03/CFD_Jahresstatistik_2015.pdf

The average period of time spent as a client of a CFD provider is approximately 6 months. In that time, as observed by BaFin and other European supervisory authorities, the majority of retail investors lose the money they have invested. These prudential observations have also been confirmed by various studies conducted by European supervisory authorities.

The Central Bank of Ireland in its study published on 23 November 2015 concluded that around 75% of all active CFD clients lose their money.³ In the study, the Central Bank of Ireland states that these CFD clients (39,000 retail clients, 5,000 of whom are domiciled in Ireland) suffered an average loss of EUR 6,900 in the years 2013 and 2014.

The French securities supervisory authority *Autorité des marchés financiers* (AMF) in its study entitled "Study of investment performance of individuals trading in CFDs and forex in France" of 13 October 2014 concluded that 89% of all active CFD clients lose their money.⁴ In the study, the AMF found that these CFD clients (14,799 clients) suffered a loss between 2009 and 2013, losing on average EUR 10,887 (median of EUR 1,843; aggregated losses of all clients total EUR 161,115,493).

The aggregated client losses feed into the CFD providers' profits. This includes CFD providers who take on the risks inherent in the CFD (e.g. market risk) onto their books and so participate in both the advantages and disadvantages of the CFD trades together with retail investors. These CFD providers carry out proprietary trading within the meaning of section 2 (3) sentence 1 no. 2 (c) of the WpHG and are called market makers or liquidity providers.

Another group accounting for the above-mentioned aggregate sum is the CFD providers who act as intermediaries between these market makers/liquidity providers and retail investors. Such CFD providers typically carry out principal broking services within the meaning of section 2 (3) sentence 1 no. 1 of the WpHG as they enter in CFDs with a market maker/liquidity provider that is prepared to carry the risks resulting from the CFD in their own name for the account of their clients. These providers make their profit from the fees charged to the clients for order execution, either determined as a fixed fee or calculated as a percentage markup. These costs also increase the threshold beyond which a retail investor may make a profit from their original investment (break-even point).

³ <https://www.centralbank.ie/press-area/press-releases/Pages/CentralBankinspectionfinds75percentofCFDclientslostmoney.aspx>

⁴ http://www.amf-france.org/en_US/Actualites/Communiqués-de-presse/AMF/annee_2014.html?docId=workspace%3A%2F%2FSpacesStore%2F96c52a14-3900-464f-8fff-7d4700ff37e3

In their investor warning issued as early as 28 February 2013, The European Securities and Markets Authority (ESMA) and the European Banking Authority (EBA) warned that purchasing CFDs may result in losses significantly exceeding initial investment. On 25 July 2016, ESMA published another warning on CFDs and other speculative products.⁵ In it, ESMA again warned against major risks resulting from, i.a., CFDs' leverage. ESMA pointed out that the providers in their advertising often presented an unbalanced picture of the opportunities and risks of these products. Moreover, ESMA remarked that the commercial interests of providers of CFDs and the other above-mentioned products often conflicted with the interests of the investors. According to ESMA, these conflicts of interest were particularly apparent in business models of the providers whose profits directly correlate with the investors' losses.

In international comparison, the following trend has been found regarding the treatment of leveraged products with a structure similar to CFDs:

In the US, similarly to Europe, CFDs are not traded on the stock exchange. However, in the US, over-the-counter CFD trading is prohibited for retail clients unless the investor has a minimum investment capital of USD 10 million and USD 5 million solely for hedging purposes in CFD trading.

Moreover, a leverage limit of 50 for leveraged forex products (products similar to a CFD from a commercial point of view, where a currency pair acts as underlying) is in place in the US. On behalf of the Commodity Futures Trading Commission (CFTC), the National Futures Association (NFA) has additionally limited the permissible leverage for forex products with particularly volatile underlying assets to 20.⁶

In addition to ESMA's warning, the following member states of the European Union and European Economic Area have so far taken measures to counter the risks posed by CFDs: Poland, France, Belgium and Malta.

In Poland, a ban on the execution of client orders regarding margin-based financial instruments, including CFDs, was issued on 5 December 2014.⁷ The ban applies as soon as the margin put down by the client

⁵ <https://www.esma.europa.eu/press-news/esma-news/esma-issues-warning-sale-speculative-products-retail-investors>

⁶ <https://www.nfa.futures.org/news/newsComment.asp?ArticleID=2459>

⁷ https://www.knf.gov.pl/en/Images/KNF_Office_Statement_Forex_EN_tcm81-42560.pdf

falls below the threshold of 1% of the nominal value of the financial instrument. This measure de facto means a ban on the sale and purchase of CFDs with a leverage exceeding 100.

On 1 August 2016, the French supervisory authority AMF published a consultation paper on a regulation regarding an advertising ban for CFDs and other speculative financial instruments.⁸ The planned regulation sets out a ban on advertising regarding the offer of CFDs and binary options. With regard to CFDs, the ban is intended to apply to all that have a leverage higher than 5.

The Belgian Financial Services and Markets Authority (FSMA) follows a similar approach. On 8 August 2016, it announced that a regulation on limiting the distribution of CFDs was coming into force. This regulation prohibits the distribution of CFDs which are not included in trading on the regulated market or multilateral trading facilities.⁹

The Malta Financial Services Authority (MFSA) on 17 October 2016 published a consultation paper on CFDs and rolling spot forex contracts.¹⁰ In it, the MFSA announced limiting CFD leverage to 50. In the MFSA's view, this measure takes account of the supervisors' observation that some CFD providers predominantly offer the highest possible leverage to retail investors, which poses significant risks to the investors affected.

B. Legal assessment

The General Administrative Act is based on section 4b (1) no. 1 (a) and (2) of the WpHG. Pursuant to its provisions, BaFin may limit the marketing, distribution and sale of specific financial instruments where there is evidence to suggest that a financial instrument, activity or practice gives rise to significant investor protection concerns, the investor protection concerns can be remedied by limiting the distribution or sale and the measure is adequate considering the risks and level of expertise of the investors in question or market participants and the likely ramifications of the measure for investors or market participants.

In this case, these conditions are met.

⁸ http://www.amf-france.org/en_US/Actualites/Communiqués-de-presse/AMF/annee-2016.html?docId=workspace%3A%2F%2FSpacesStore%2Fad42eccc-9720-49da-82a8-2ddcb72fbf1d

⁹ http://www.fsma.be/en/Site/Repository/press/div/2016/08-08_banning.aspx

¹⁰ https://www.mfsa.com.mt/pages/readfile.aspx?f=/files/Announcements/Consultation/2016/20161017_CP_ForexandCFDs_final.pdf

I. Requirements for the above-mentioned legal competence

1. Financial instruments

The subject of this Administrative Act is contracts for difference (CFDs) within the meaning of section 2 (2) no. 3 of the WpHG. According to Article 4(2) of the Markets in Financial Instruments Directive (MiFID) and MiFID Annex 1 Section C point 9 and the provisions transposing these MiFID rules into German law, i.e. section 1 (11) sentence 3 no. 3 of the German Banking Act (*Kreditwesengesetz* – KWG) and section 2 (2) no. 3 in conjunction with subsection 2b of the WpHG, CFDs are deemed financial instruments. The German legislators treat CFDs as a subgroup of derivatives.

2. Significant investor protection concerns regarding CFDs with additional payments obligation

The marketing, distribution and sale of CFDs with additional payments obligation to retail clients raise significant concerns with regard to investor protection within the meaning of section 4b (2) no. 1a of the WpHG. The significant investor protection concerns result from the characteristics inherent to CFDs as products.

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 ("MiFIR")¹¹ will introduce a directly applicable product intervention right in the member states. The Regulation is not applicable yet.¹² The authorisation for product intervention was introduced early at the national level in the German Retail Investor Protection Act (*Kleinanlegerschutzgesetz*).¹³ The legal basis for authorisation in section 4b of the WpHG is thus based on the wording of the European Regulation. On 19 December 2014, ESMA published Technical Advice¹⁴ on the conditions for a product intervention measure. These criteria have now been included in a draft delegated regulation of the European Commission.¹⁵ It provides that the existence of significant investor protection concerns must be assessed using criteria including the following:

¹¹ OJ L 173 of 12 June 2014, p. 84.

¹² The Regulation will apply in all Member States from 3 January 2018.

¹³ Legislative intent of the draft German Retail Investor Protection Act, Bundestag printed paper, 18/3994, p. 53.

¹⁴ Final Report, ESMA's Technical Advice to the Commission on MiFID II and MiFIR (ref. no.: 2014/1569), p. 190 et seqq., available under: www.esma.europa.eu

¹⁵ Delegated Regulation (EU) No 600/2014 of the European Parliament and of the Council (MiFIR) with regard to definitions, transparency, portfolio compression and supervisory measures on product intervention and positions.

- The complexity of the calculation of the financial instrument's price development;
- The nature and scope of the risks inherent in the financial instrument;
- The lack of transparency of the financial instrument's price development;
- Unforeseeable risk for the retail investor.

In this context special consideration is to be given to the question whether a leverage effect inherent in the product or relating to financing is characteristic of the financial instrument and the value of its underlying may no longer be available or determined in a reliable manner in the short term. Moreover, the type of client targeted by the financial instrument's marketing or sale is to be taken into account. Specifically, it should be taken into consideration whether a typical client is a retail investor and what sort of qualifications, skills and experience such client typically has.

In the case of CFDs there are significant investor protection concerns as the purchase of CFDs that may give rise to an additional payments obligation results in unforeseeable risks of loss arising for the investor. The risk of loss encompasses not only the margin that the investor has put down, but also their other assets. If the difference to be settled by the retail client exceeds their initial margin payment, the resulting difference amount must be paid using the retail client's other assets. It is an uncontested fact in the CFD sector that the extent of the retail client's possible additional payments obligation when purchasing a standard CFD may not be calculated ex-ante.

2.1.1. Complexity of performance calculation

The significant investor protection concerns in the case of CFDs with an additional payments obligation result first and foremost from the complexity of calculation of their performance. In the case of CFDs, leverage quickly results in losing control over market developments and makes it all but impossible for an average retail investor to anticipate the likelihood of losses and, consequently, chances of success.

To avoid losses from an opened high-leverage CFD position, the retail investor must be able to reliably assess the price fluctuation range of the selected underlying asset and project the price moves of the underlying within that price fluctuation range (multiplied by the applied leverage)

on the margin they have put down. Unlike in the case of direct investment in the underlying assets such as shares, bonds, currency pairs or commodity futures, in these cases the retail investor is exposed to an exponentiated market risk; controlling such risk requires the kind of expertise and trading experience mostly possessed only by professional clients.

The margin held by the retail investor on their CFD account amounts to just a fraction of the value of the corresponding underlying asset of the CFD when high leverage is applied. The higher the leverage, the smaller the fraction of the underlying asset's value to be put down and the smaller the part of the underlying's price fluctuation range covered by the retail client's margin. Because the client only has to put down a fraction of the contract value as a margin in relation to the concluded contract, there is a danger that they are not aware of the extent of the risks of loss they are entering into. In this respect, it is not clear to the client what amount of money is actually at risk.

The effects of the leverage described above are all the more problematic because they are not limited to the margin put down by the client for trading purposes. Instead, the leverage can constitute a risk of loss associated with an additional payments obligation, the extent of which is incalculable for the retail client. Within the CFD sector, it is undisputed that the extent of the possible additional payments obligation cannot be determined at the outset in the case of these leveraged financial instruments.

This became particularly apparent on 15 January 2015 after the decision of the Swiss National Bank (SNB) to decouple the Swiss franc from the euro. On that day, some retail investors suffered losses a thousand times higher than the original amount invested. In one instance, an investor lost EUR 280,000 after a margin payment of around EUR 2,800.¹⁶ In this case, too, high leverage was applied (1:400) in order to speculate on exchange rate fluctuations in the aforementioned currency pair. This shows that the purchase of a CFD which establishes an additional payments obligation can drive a retail investor to economic ruin.

Even the CFD providers themselves often describe their clients' risk of loss as indeterminable. One CFD provider even explains on its website that, in the case of CFDs, the maximum loss cannot be determined at the outset. It may far exceed the client's initial margin payment and does not have any upper limit. The client's risk of loss is therefore not limited to their initial margin payment but instead may extend to cover

¹⁶ <http://www.spiegel.de/wirtschaft/unternehmen/franken-kurs-ingenieur-setzt-2800-und-verliert-280000-euro-a-1023799.html>

the entirety of their other assets. According to this particular CFD provider, forced closure of CFD positions in the event of an insufficient credit balance in the CFD account is undertaken solely in the provider's interest and the client cannot infer any rights from the possibility of such a forced closure. Another CFD provider explains on its website that the loss associated with a trade, even within a short period of time, may be considerably higher than the deposit and may even exceed it, with there being no upper limit on the potential loss. It goes on to say that this is a feature of leveraged instruments. According to this CFD provider, during market fluctuations leverage means that the client can share in the losses of the underlying to a disproportionate extent. If the client applies a leverage of 10, the effects of market fluctuations are ten times greater than if the client had traded without leverage or had invested directly in the underlying. Accordingly, the greater the leverage the greater the risk. The CFD provider goes on to say that the effect of price movements on the client's trades depends on the size of their position in the respective CFD, on the leverage of their trade as well as on the size of their margin rates rather than on their account balance when they enter into the position. Small price fluctuations could therefore have a major impact on the client's trades and on their account if they execute large trades on margin.

This has been confirmed by European supervisory authorities in their studies on retail clients' profit and loss ratios conducted in recent years. The study published by the Central Bank of Ireland on 23 December 2015 showed that around 75% of all active CFD clients lose their money.¹⁷ The study undertaken by the French securities supervisory authority AMF concluded that 89% of all active CFD clients lose their money.¹⁸ The losses suffered by retail investors show that the representatives of this investor group are unable to control the risks inherent in CFDs' leverage in a way that would limit their losses. Rather, leverage is often the key reason why retail investors trade in CFDs in the first place. However, the above-mentioned studies show that the average retail investor is unable to adequately assess the effects of the high leverage associated with CFDs. Although retail clients using the services of CFD providers are advised of the unforeseeable risks of loss associated with CFDs, the efforts to explain the risks to retail investors have so far done nothing to change the loss-making of this client group. This is due to the fact that a retail investor with average expertise lacks the trading experience necessary to realistically assess the likelihood of loss inherent in this financial instrument. Instead, the relevant risk advice is seen by the

¹⁷ <https://www.centralbank.ie/press-area/press-releases/Pages/CentralBankinspectionfinds75percentofCFDclientslostmoney.aspx>

¹⁸ http://www.amf-france.org/en_US/Actualites/Communiqués-de-presse/AMF/annee_2014.html?docId=workspace%3A%2F%2FspacesStore%2F96c52a14-3900-464f-8fff-7d4700ff37e3

retail investors as a purely hypothetical scenario. The typical retail client lacks the experience required to realistically assess the likelihood of losses materialising and their extent.

2.1.2. Speculation (more or less) on credit

In economic terms, a CFD provider allows retail investors to speculate on credit by way of leverage. This results from the fact that, for each CFD position, the investor only has to put down a fraction of the contract value as a margin on their CFD trading account. The investor is therefore exposed to the financial consequences of the speculation with an investment amount, of which they actually only have to put up a small percentage themselves. This is made clear using the example cited at the beginning: the underlying position, the risks of which the investor is exposed to there, is worth EUR 40,000. The amount which must be held available by the investor, however, is only EUR 2,000. In economic terms, therefore, the investor is in the same position as if they had bought the underlying asset on credit to the amount exceeding the margin.

In the field of financial theory, a credit-financed investment strategy is considered particularly risky. If a retail investor speculates with money which does not belong to them, speculative losses will affect them particularly hard. A credit-financed speculation, where a retail investor only has to provide a fraction of the actual speculative value, is often even associated with existential risks for the investor concerned.

Legislators, too, consider credit-financed speculation to carry a particularly high potential for risk. This is shown for example by the special reporting obligation for asset managers of credit-financed portfolios established in section 31 (8) of the WpHG in conjunction with section 8 (6) of the German Investment Services Conduct of Business and Organisation Regulation (*Wertpapierdienstleistungs-Verhaltens- und Organisationsverordnung – WpDVVerOV*). If an investment services enterprise enters into a transaction which includes an uncovered position in a transaction with contingent liabilities, it must also inform the retail client about the uncovered (or not fully covered) losses arising from contingent liabilities. In addition, under section 2 (3a) no. 2 of the WpHG the legislators categorise the granting of credits or loans to others as an ancillary investment service requiring supervision provided such credits or loans are granted for the carrying out of investment services in which the enterprise granting the credits or loans is itself involved.

This makes it clear that legislators view credit-financed speculation practised by retail clients as an exceptional phenomenon which necessitates

the creation of special provisions to protect retail clients. These assessments made by the legislators justify protecting the, in this respect, economically equivalent CFD investor from those losses which exceed the amount paid into their CFD trading account and therefore encroach on the investor's other assets.

2.1.3. Lack of transparency in the calculation of underlyings where there are price gaps

In the case of financial contracts for difference, the CFD provider is often a counterparty to the retail client. In its role as a market maker or liquidity provider, the CFD provider has extensive discretionary powers when it comes to setting prices once markets become turbulent. Whether or not the CFD provider exercises its discretion appropriately and in line with the market cannot be assessed by the retail investor. The retail client does not have any information at their disposal which allows them to assess if the price quoted by the provider is in line with market conditions or not.

The effects of a price set at a level which is not in the best interests of the retail investor is exponentiated by the respective leverage applied. If the CFD provider makes a misestimation of one euro when setting the binding price for an underlying, the leverage applied exponentiates the effects of this bad decision on the retail investor's capital many times over.

Since in all CFD transactions, a CFD provider acts as counterparty to the client in the chain of execution – which means that the client's losses correspond to the CFD provider's gains – this constitutes a major conflict of interest for the CFD provider in question. This conflict of interest becomes particularly evident if, during turbulent times on the market, the CFD provider exercises discretion when setting the price of the underlying, which is binding for determining the respective difference owed. The leverage exponentiates the effects of the misexercise of discretion on the client's risk of loss in a manner which is a cause of significant investor protection concern.

A slight deviation on the part of the CFD provider when setting the binding price for an underlying can, through the leverage applied, exponentiate the effects of such a bad decision on the retail investor's capital.

2.1.4. No limitation on the risk of loss through the margin call procedure

The extent of the retail client's risk of loss cannot be limited by the process known as margin call.

Price fluctuations of the underlying may be so significant within the shortest intervals that the CFD provider will no longer have time for a margin call to the retail investor and the CFD position will have to be forcibly closed on an ad hoc basis. During unforeseen turbulence on the market, it is not possible to (fully) liquidate the CFD position opened by the client in the event of unfavourable price performance, because the market maker which is the client's counterparty is not obliged to continually provide price quotations. Unlike the operators of multilateral trading facilities or systematic internalisers, the CFD providers which act as market makers are not subject to the obligation to publish binding quotes during regular trading hours for the underlyings of the products they offer. The closing of an existing CFD position in order to limit losses can therefore be suspended or significantly delayed to the client's disadvantage – which is exactly what happened on 15 January 2015 during the CHF/EUR crash.

If the retail client avails themselves of the investment services of a CFD provider which provides principal broking services and executes client orders with other CFD providers (market makers or liquidity providers of a liquidity pool), there may be a risk for the retail investor (even if price quotations are continually provided) that the aforementioned liquidity providers will not make available the trading volume required by the client. In such instances, an open CFD position could be only partially closed. In the event of extreme price fluctuations, this can lead to a situation where the client's losses can amount to multiples of the capital invested despite a forced closing of the CFD position by the CFD provider.

2.1.5. No limitation of the risk of loss by stop-loss orders

Furthermore, the level of the retail investor's risk of loss cannot be limited by stop-loss orders.

If the retail investor places a stop-loss order with the CFD provider to limit their losses, the CFD provider is only obliged to execute this order at the "next available" price of the underlying. Significant losses may also be incurred by the retail client upon execution of the stop-loss order. This is because execution at the "next available" price means that the price used to calculate the difference owed by the retail client may

differ significantly from the price set by the retail investor as the threshold which triggers the closing of the position. Here, too, the price of the underlying may fluctuate so much within the shortest periods of time that the "next available" price can catapult the difference to be paid by the retail investor to multiples of the capital they originally invested.

Finally, it must be pointed out that both ESMA and the EBA warned retail clients in their investor warning of 28 February 2013 that, in the case of leveraged trades, retail investors' losses may significantly exceed their original investment.

2.1.6. Relevance of investor protection concerns based on the number of retail investors affected

The large number of CFD clients also speaks for the relevance of investor protection concerns. According to the market study conducted on behalf of the CFD association *CFD Verband e.V.* by the Research Center for Financial Services, there were around 127,137 CFD client accounts in 2015.¹⁹ The number of retail clients affected is roughly the same.

3. Proportionality assessment

3.1. Suitability within the meaning of section 4b (2) no. 2 of the WpHG

The intended restriction is suitable for taking account of the aforementioned significant investor protection concerns that exist:

The elimination from CFDs of the additional payments obligation is a suitable way of countering retail investors' incalculable risk of loss. As a result, the complexity of calculating potential losses is significantly reduced. Although losses on the part of the retail client are not completely eliminated as a result, they are limited to the capital originally paid in by the client. This will enable the retail client to better manage their risks of loss.

In this respect, speculation (more or less) on credit is then no longer possible in any event, as the amount speculated would exceed the capital paid into the trading account. Losses are thus limited to the capital provided by the client for speculative purposes and do not encroach on the client's other assets.

Neither the price gaps themselves described earlier nor the right to exercise discretion granted to providers in relation to setting prices in this

¹⁹ http://www.cfdverband.org/wp-content/uploads/2014/03/CFD_Jahresstatistik_2015.pdf

context nor any failure of the stop-loss mechanisms can then still lead to incalculable losses on the part of the retail clients.

In this respect, the intended measure counters all significant investor protection concerns brought forward.

The legislators themselves also believe that protection against additional payments obligations is basically a suitable investor protection measure. Therefore, with the aim of protecting investors from margin calls²⁰, in section 5b of the German Capital Investment Act (*Vermögensanlagengesetz – VermAnlG*), they have provided that capital investments with an obligation to make additional payments shall not be permissible for public offer or distribution in Germany.

3.2. Proportionality of the measure within the meaning of section 4b (2) no. 3 of the WpHG

The measure is also proportionate considering the risks identified, the level of expertise of the investors or market participants concerned and the likely consequences of the measure for said investors and market participants. In this case, interests are to be weighed up by way of an overall assessment of all relevant concerns. It must be borne in mind here that the legislators afford particular importance to the protection of collective consumer interests. In this case, the public interest in protecting the collective interests of consumers outweighs the economic interest of the CFD providers concerned in achieving unlimited turnover from marketing, distributing and selling CFDs.

3.2.1. Effects of the restriction on retail investors

The effects of the restriction on retail investors are proportionate.

The restriction pertains to the marketing, distribution and sale of CFDs to retail investors where the CFDs establish an obligation on the part of the retail investor to make additional payments. CFDs without an additional payments obligation, on the other hand, may continue to be marketed, distributed and sold to retail investors. Access to CFDs for retail clients within the meaning of section 31a (3) of the WpHG is therefore not blocked completely.

The interest of retail investors in using CFDs with an additional payments obligation comes behind the public interest in limiting the risks associated with this particular financial instrument.

²⁰ Bundestag printed paper 18/3994, p. 43.

Furthermore, this General Administrative Act does not pertain to the marketing, distribution and sale of CFDs to professional clients. In the case of these clients, it can be assumed that they have the necessary knowledge and experience to be able to adequately judge the risks associated with those CFDs which are the subject of the restriction discussed above. In addition, these clients are better able to bear the financial risks associated with the purchase of CFDs with an additional payments obligation. This category includes, in particular, those retail clients who may be categorised as professional clients upon request pursuant to section 31a (7) of the WpHG.

3.2.2. Effects of the restriction on market participants

The anticipated effects of the restriction on market participants are also proportionate.

The General Administrative Act pertains to an isolated market segment. It can be ruled out with high probability that the General Administrative Act will have any effect on the financial sector as a whole. There is little interdependence between the CFD market and other capital markets, and the effects on stock exchange trading are minimal.

The General Administrative Act provides for a restriction of the marketing and sale of CFDs to retail clients where these financial instruments establish an obligation on the part of the retail client to make additional payments. In this sense, the General Administrative act does not constitute a complete product ban.

Furthermore, by granting a reasonable implementation period the General Administrative Act takes account of any processes of adaptation in the CFD sector. These processes of adaptation affect in particular those CFD providers which provide principal broking services by executing client orders (CFD opening and closing orders) via market makers or liquidity providers. In such cases, client orders are executed through the conclusion of a further CFD with the CFD provider acting as market maker or liquidity provider. This new CFD mirrors exactly the CFD concluded with the client. The role of the CFD providers offering principal broking services is limited in this respect to that of an intermediary between the retail client and the market maker or liquidity provider which enjoys the financial gains and suffers the financial losses resulting from the contracts for difference. In relation to market makers or liquidity providers, CFD providers which execute client orders within the context of principal broking services constitute a special category of professional clients (so-called eligible counterparties within the meaning of section

31a (4) of the WpHG). CFD transactions with eligible counterparties remain unaffected by this General Administrative Act, which means that a market maker may continue to sell CFDs to professional clients without any restrictions. In the case of CFD providers acting as intermediaries, the restriction on the marketing, distribution and sale of CFDs with an additional payments obligation can, in this respect, lead to the following situation: on the one hand, they will no longer be allowed to call for additional payments from their clients while, on the other hand, when concluding transactions for the account of the client they may themselves be obliged to make additional unlimited payments to market makers or liquidity providers. This will force the CFD providers concerned to seek market makers and liquidity providers which will be prepared to forgo the intermediaries' additional payments obligation.

The adaptations to the CFD providers' business models and the resulting consequences for these providers are proportionate. In this case, the process of adaptation is taken account of by the period allowed for implementation of the General Administrative Act, which can be found in said Act. During this period, the CFD providers will be able to adapt their business models to the fact that, in future, CFDs may only be marketed to retail investors where the CFDS do not establish an obligation on the part of the investor to make additional payments. In particular, it will be possible during this time for the CFD providers to adapt their IT systems. Precisely those CFD providers which offer principal broking services will be enabled, where necessary, to adapt the cooperation agreements they have already concluded with undertakings acting as market makers or liquidity providers to ensure compliance with the provisions of the General Administrative Act.

II. Exercising of discretion

Section 4b (1) of the WpHG grants me discretion when deciding on a restriction of the marketing, distribution and sale of particular financial instruments. In this case, I am exercising this discretionary power as follows:

Within the context of the selection of measures relating to CFD providers, ultimately only the measure mentioned above comes into consideration. The measure I intend taking is proportionate in the wider sense, as it is suitable, necessary and appropriate.

1. Suitability of the restriction

The restriction on the marketing, distribution and sale of CFDs with an additional payments obligation is suitable in order to achieve the aim pursued with this measure. The restriction will counter financial activities and practices that give rise to significant investor protection concerns. It is thus suitable for the purpose of achieving its objective.

2. Necessity of the restriction

The restriction is also necessary. There is no other more moderate measure which would be equally suitable in dispelling the significant investor protection concerns that exist in relation to CFDs with an additional payments obligation.

Even though an intensification of efforts on the part of CFD providers to advise retail clients in relation to the risks associated with CFDs could, in principle, be considered as a more moderate measure, this would not change anything in terms of the risk arising from the obligation on the part of the retail client to make additional payments. Over the past three years, BaFin has consistently worked on an intensification of efforts to advise retail investors in relation to the risks associated with such products. In particular, it enforced a requirement that CFD providers have clearly visible risk warnings on their websites. BaFin pays particular attention towards ensuring that, if the CFD providers highlight any advantages associated with CFDs, they also point out to their clients or potential clients the incalculable nature of the risks of loss associated with CFDs. However, because of their lack of requisite trading experience, retail clients view these risk warnings as purely theoretical scenarios. In this respect, the intensification of efforts to advise retail investors in relation to the risks associated with CFDs did not protect the retail investors from huge losses. A typical retail investor lacks the necessary experience to realistically assess the likelihood of a loss scenario materialising.

A warning issued by BaFin would not be a more moderate yet equally effective measure for dispelling the significant investor protection concerns that exist. Instead, supervisory authorities have observed that the investor warning from ESMA and the EBA dated 28 February 2013 did not have any significant effect on the trading behaviour of retail investors in CFDs, nor on the loss ratio of such investors.

Raising potential CFD clients' product-specific level of knowledge, through the use of educational tools, for example, does not constitute a more moderate measure in this case. Such tools (webinars, for instance)

have been used intensively heretofore by CFD providers in order to attract primarily clients with little knowledge or experience of capital markets to CFD trading. However, tools like these cannot replace the trading experience which is absolutely necessary for CFD trading. The same applies to the use of demo accounts, where the client trades using a virtual account balance. Such virtual trading experience cannot turn a retail investor into an experienced investor, as the losses suffered in this context are of a completely different quality to actual losses suffered. However, even if one were to presume that such virtual trading experience would be enough to substitute practical trading experience, the investor would have to gain enough experience to meet the requirements set out in section 31a (7) of the WpHG in order to realistically assess the risks of unlimited CFDs and to effectively manage these risks. In such a case, they would have to be categorised as professional clients, which would mean that the marketing of relevant CFDs to those affected would no longer fall under the scope of this General Administrative Act.

2.1. Proportionality of the General Administrative Act in the narrower sense (appropriateness)

The restriction is also proportionate in the narrower sense of the word. The different legally protected rights are to be weighed up by way of an overall assessment of all relevant concerns.

The legislators afford great importance to the protection of the collective interests of consumers. Within its legal mandate, BaFin is obliged pursuant to section 4 (1a) of the German Act Establishing the Federal Financial Supervisory Authority (*Gesetz über die Bundesanstalt für Finanzdienstleistungsaufsicht – FinDAG*) to protect the collective interests of consumers. This legal mandate is to be viewed in light of the economic significance of collective consumer protection. By participating in the capital market, the typical retail investor is primarily pursuing the aim of capital accumulation. This is fundamentally a process of saving or investment. The capital required for this typically comes from the retail investor's other income.

The CFD providers, too, see themselves as part of the capital market and market their investment services and products as speculative investment opportunities and not as an opportunity to participate in a chance-based lottery, for example. Even though the retail investor is reminded by way of multiple warnings from the CFD providers that their investment should be understood as risk capital, at the same time, based on their connection to stock exchange prices and reference markets, the CFDs are marketed as an opportunity to participate in developments on the capital market over the long term. For the average retail

investor, CFDs are a speculative investment and not a wager whose likelihood of success depends on chance and whose potential for loss is incalculable.

At the same time, it must be borne in mind that each retail investor must decide for themselves, with due consideration of their personal life circumstances and financial situation, whether or not CFDs are a suitable investment for them. In this respect, the purchase of a CFD constitutes an exercise in private autonomy. The General Administrative Act limits this autonomy, as it restricts the retail investor's options, at least indirectly. However, this restriction is proportionate, since the effects of the General Administrative Act on the retail investor remain limited.

Furthermore, it must be considered that retail investors are not completely barred from trading in CFDs with an additional payments obligation. If they gain the trading experience referred to in section 31 (7) of the WpHG or if they have the requisite professional experience within the meaning of section 31a (7) sentence 3 no. 3 of the WpHG, they can, pursuant to section 31a (7) sentence 1 of the WpHG, request to be categorised as a professional client and, following the granting of this status, receive access to unlimited CFDs, provided they have cash deposits and financial instruments worth in excess of EUR 500,000. This is appropriate, since it can be assumed that such an investor, based on their experience, knowledge and expertise, is able to adequately assess the incalculable risks that are attached to a CFD and bear the associated financial risks.

The interest in protecting the collective interests of consumers ultimately outweighs the interest of CFD providers in continuing to pursue their commercial interests without any restrictions. Product providers whose business models are based on the sale of products which may at any time drive the retail investor to financial ruin cannot expect that a weighing up of their economic interests and those of the investors will result in an outcome favourable to them.

III. Appropriateness of the implementation period

The implementation period envisaged in item 1 of the General Administrative Act is appropriate. With due consideration of a potentially necessary adaptation of the business models of CFD providers to the restriction which is the subject of this General Administrative Act, it is reasonable to expect that the CFD providers fulfil the obligation within three months of the General Administrative Act being disclosed. The establishment of a transitional period is necessary in this case for reasons of proportionality (cf. the explanations provided under I.3.2.). Neither does

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the aforementioned implementation period run contrary to the purpose of the measure. Instead, the aim of the measure is to give CFD providers the opportunity to adapt their business models to the intended restriction.

Notices:

Pursuant to section 17 (2) sentence 1 of the FinDAG, the General Administrative Act shall be publicly announced.

Pursuant to section 4b (6) of the WpHG, objections to and appeals against the measures under subsection (1) shall have no postponing effect.

I would also like to point out that, pursuant to section 39 (2) no. 2b of the WpHG, an administrative offence is deemed to be committed by any party who, wilfully or negligently, fails to comply with an enforceable order under section 4b (1) of the WpHG."

Yours faithfully,

(Roegele)