ESMA35-43-3109

**OPINION OF THE EUROPEAN SECURITIES AND MARKETS AUTHORITY**

**of 20 October 2022**

**on the product intervention measure relating to futures with additional payment obligations proposed by the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)**

Having regard to Article 43(2) of 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 ([1]),

Having regard to Article 44(1) of Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC ([2]),

THE EUROPEAN SECURITIES AND MARKETS AUTHORITY BOARD OF SUPERVISORS HAS ADOPTED THIS OPINION:

## 1. Introduction and legal basis

1. National competent authorities (NCAs) may take product intervention measures in accordance with Article 42 of Regulation (EU) No 600/2014 (MiFIR). At least one month before a measure is intended to take effect, an NCA must notify all other NCAs and the European Securities and Markets Authority (ESMA) of the details of its proposed measure and the related evidence, unless there is an exceptional case where it is necessary to take urgent action.

2. In accordance with Article 43 of MiFIR, ESMA performs a facilitation and coordination role in relation to such product intervention measures taken by NCAs. After receiving notification from an NCA of its proposed measure, ESMA must adopt an opinion on whether it is justified and proportionate. If ESMA considers that the taking of a measure by other NCAs is necessary, it must state this in its opinion.

[1] 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 (OJ L 173, 12.6.2014, p. 84).
[2] Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC (OJ L 331, 15.12.2010, p. 84).

3. The Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) notified ESMA on 31 August 2022 of its intention to take a product intervention measure under Article 42 of that Regulation (national measure).

4. Prior to the notification, BaFin published a consultation paper ([3]) setting forth the rationale for the national measure.

5. The national measure set out in more detail below consists of a permanent prohibition of the marketing, distribution or sale of futures with additional payment obligations to retail clients, unless:

   (a) the additional payment obligations for retail clients are contractually excluded by the product provider;

   (b) before entering into the transaction, the retail client confirms to the product provider that it is purchasing the future with additional payment obligations solely for hedging purposes (the hedging carve-out); or,

   (c) the future with additional payment obligations is purchased by the retail client for the purpose of settling or closing out existing (open) future positions that were entered into by that investor before the national measure took effect.

   In the cases referred to in points (a) to (c) above, the prohibition would not apply and futures with additional payment obligations could hence be marketed, distributed or sold to retail clients.

6. Futures with additional payment obligations addressed by the national measure are futures within the meaning of Article 4(1)(15) of Directive 2014/65/EU (MiFID II) ([4]) in conjunction with points (4) to (7) and (10) of Section C of Annex I of that Directive. Additional payment obligations are contractual obligations whereby the retail client can be required to use additional funds from its other assets to compensate the product provider for losses resulting from the forced liquidation by the provider of any open future contract. Retail clients are clients within the meaning of Article 4(1)(11) of MiFID II.

7. The national measure is intended to apply both to futures providers authorised in Germany and to futures providers authorised in another Member State that provide investment services and/or perform investment activities in Germany by way of a branch or the freedom to provide services.

[3] BaFin - Press release - Product intervention: BaFin seeks to better protect retail clients ….

[4] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directives 2002/92/EC and 2011/61/EU (OJ L 173 12.6.2014, p. 349).

8. Future providers are (i) investment firms within the meaning of Article 4(1)(1) of MiFID II, and (ii) credit institutions within the meaning of Article 4(1)(27) of that Directive when providing investment services and/or performing investment activities.

9. Neither ESMA nor any other NCA has taken product intervention measures relating to futures with additional payment obligations. However, ESMA and all other NCAs have implemented negative balance protections in the context of their CFDs product intervention measures ([5]).

10. BaFin informed ESMA that the national measure is intended to take effect from 1 January 2023.

## 2. BaFin's justification of the product intervention measure

11. BaFin notified ESMA that it has complied with the conditions set out in Article 42 of MiFIR, including that it has assessed the relevance of all factors and criteria listed in Article 21 of Commission Delegated Regulation (EU) 2017/567 ([6]) and that is has taken into consideration all those that are relevant.

*Significant Investor Protection Concerns*

12. BaFin reported the following significant investor protection concerns observed in Germany:

<u>The degree of complexity of the financial instrument in relation to the type of clients and the particular features or components of the financial instrument</u>

13. Futures are standardised forward contracts. As derivatives, they reference an underlying such as the price of a financial instrument or commodity or other asset, an exchange rate, or an index. This reference price or value is determined when the contract is initiated. Futures may require delivery of a physical reference asset or be cash-settled. In the former case, there is a contractual obligation to deliver (short position) or receive (long position) a certain quantity of an underlying instrument at the set price. Futures often operate on leverage.

14. Leveraged products are inherently very complex. Retail clients normally find it difficult to assess the performance of these products, in particular due to their increased volatility. The additional payment obligations further increase and intensify the complexity of calculating performance. The maximum loss or the maximum amount of any loss and

[5] European Securities and Markets Authority Decision (EU) 2018/796 of 22 May 2018 to temporarily restrict contracts for differences in the Union in accordance with Article 40 of Regulation (EU) No 600/2014 of the European Parliament and of the Council (OJ L 136, 1.6.2018, p. 50). ESMA's opinions on NCAs' product intervention measures on CFDs are published on ESMA's website (Product Intervention (europa.eu)).

[6] Commission Delegated Regulation (EU) 2017/567 of 18 May 2016 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council with regards to definitions, transparency, portfolio compression and supervisory measures on product intervention and positions (OJ L 87, 31.3.2017, p. 90).

thus the risk of such an investment cannot be determined by retail clients because, due to the additional payment obligation feature, losses are not limited exclusively to the amount invested. In the case of short positions, losses are potentially unlimited.

15. Although the risk of additional payment obligations is particularly high in cases of atypical, special market events ("black swan" events) involving very large price movements, this risk can also arise in less extreme circumstances - for example where individual underlying instruments, such as shares or commodities, move strongly in a different direction in a shorter term than the investor had expected. The greater the leverage, the greater the risk of the investor owing more than the amount invested. For leveraged positions, only a fraction of the contract value of a future is required to be held by the retail client in the form of margin requirement.

16. In addition, BaFin reported that there is no obligation for product providers to make a margin call. This means that retail clients cannot rely on providers informing them in the event of imminent insufficient coverage. It may also happen that, even where there is a margin call, the client only has a few minutes to voluntarily increase the collateral.

<u>The size of potential detrimental consequences and the type of clients involved</u>

17. According to BaFin's observations made in the course of its supervisory activities, the number of retail clients trading in futures is considerably higher than the number of professional clients. In addition, a market survey conducted by BaFin covering the period from July 2019 to June 2020 showed that over that period both the volume of trading and the number of retail clients trading in futures increased by around 15%. During the same period, the total volume of futures traded by retail clients in Germany was around EUR 78 billion. It also emerged that retail clients invested primarily in "mini" or "micro" contracts with smaller nominal amounts making such futures more accessible to retail clients.

18. This market trend in Germany is confirmed by an analysis made by BaFin based on the data on transactions in financial instruments reported to it pursuant to Article 26 of MiFIR concerning futures contracts traded on the European Exchange – EUREX Frankfurt AG (EUREX). The analysis revealed that the number of clients (both retail and professional) trading futures on EUREX almost tripled from 2018 to 2021, reaching approximately 70,000 clients in 2021. This data leads BaFin to expect a further growth of this market segment, including of the sub-segment of retail clients trading futures and, in particular, mini and micro future contracts. This assessment is also based on increasing advertising activities by providers and the increased offering of mini and micro future contracts observed by BaFin in Germany.

<u>The existence and degree of disparity between the expected return or profit for investors and the risk of loss</u>

19. The scale of potential detrimental consequences and the degree of disparity between the expected return and the risk of loss is particularly significant for futures with additional payment obligations. As indicated above, the loss from investing in such a financial instrument may exceed the amount invested by a multiple. Therefore, the risk-return ratio is highly detrimental to retail clients.

The selling practices associated with the financial instrument

20. Especially since the CFD product intervention measures started to apply in Germany, futures are regularly promoted to German retail clients as an alternative to CFDs. Providers encourage retail clients in Germany to trade futures for speculative purposes, referring to the sometimes higher and theoretically unlimited leverage available. This difference from CFDs is highlighted positively by providers, often without mentioning the risk of unlimited losses.

21. Bonus or discount promotions are regularly used by providers in Germany to win new clients. Often, providers target retail clients who do not have the necessary level of knowledge and experience with futures transactions. In many cases, the risks are inadequately presented to clients. For example, attention is rarely drawn to the risk of additional payment obligations. In most cases, advertising – particularly through affiliates – is not identified as such, instead giving the appearance of an informative article or a comparison portal.

22. In particular, mini and micro futures contracts are actively advertised in Germany. They are often described as being very suitable for retail clients. Retail clients may therefore get the impression that these products are generally suitable for them, without fully understanding the risks of the additional payment obligations, which are often not mentioned. The advertisers' target group is usually retail clients who pursue a speculative trading strategy, and less those who purchase futures for hedging purposes.

23. Overall, the selling and advertising strategies of providers in Germany aim to highlight the advantages of futures trading for retail clients and are intended to make those products attractive as an alternative investment, especially for retail clients, as reflected by the market and product development of mini and micro future contracts. At the same time, however, there is a growing danger that the unlimited risk of loss inherent to the product – something which is completely atypical compared to other investment products – is often overlooked or underestimated, especially by the less experienced client group of retail clients.

24. For the above reasons, BaFin reached the conclusion that futures with additional payment obligations, except if purchased for hedging purposes or to close out existing open future positions entered into before the date of taking effect of the national measure, pose significant investor protection concerns in Germany. BaFin considers that, without the national measure, those products would continue to cause retail clients harm, particularly due to the risk of (potentially unlimited) losses.

25. As already indicated, the national measure would not apply to the offer of futures with additional payment obligations to retail clients where the client confirms that the product is purchased solely for hedging purposes (hedging carve-out). BaFin reported that, based on the feedback received in its public consultation on the national measure, some retail clients in Germany trade and know how to trade futures to hedge their business risks, other trading positions or their portfolios of financial instruments. Furthermore, according to BaFin, there is a need for hedging, for instance, in the agricultural sector where most farmers and agricultural companies do not qualify as professional clients. BaFin reported that these individuals and entities hedge their businesses against bad harvests, weather impacts, or prices of correlating commodities or other goods necessary for their production. BaFin also reported that, based on its knowledge, the same applies in respect of many small German businesses and SMEs operating in other sectors, such as in particular the processing, handicraft and construction sectors.

26. In addition, BaFin believes that confirmation by retail clients that a future with additional payment obligations is acquired for hedging purposes sufficiently ensures that those retail client are protected (because they hold one or more positions which they reasonably expect to be negatively correlated with that of the relevant future).

27. Furthermore, BaFin is of the view that providers may rely on the confirmation from retail clients that the product is purchased for hedging purposes. Further verifications by product providers are not required.

28. Retail clients may provide the confirmation referred to in paragraph 27 above, for example, through the following statement integrated into the provider's order screen, on which the retail client would have to click: "I hereby certify that this futures transaction is being entered into exclusively for hedging purposes and that I bear the risk of any additional payment obligations." In case of orders placed over the phone, the retail client could confirm the hedging purpose of the transaction orally. This confirmation would enable retail clients to continue entering into futures transactions without any protection against the risk of additional payment obligations. If such confirmation is not made, futures may not be offered to retail clients in Germany unless the provider has contractually excluded any additional payment obligation.

29. Regarding the exception concerning existing open future transactions, BaFin notes that this exception aims to ensure that retail clients will be able to close out open futures positions by way of a corresponding offsetting transaction. This exception has a limited scope of application as it only concerns futures positions that were opened by the retail client before the effective date of the national measure.

*Existing Union law regulatory requirements do not sufficiently address the risks*

30. BaFin believes that existing regulatory requirements applicable to the marketing, distribution or sale of futures with additional payment obligations do not sufficiently address the threat posed to retail clients by those products for the following reasons:

Adequate provision of information

31. BaFin has examined the requirements of fair client information under Article 24 of MiFID II and considers that those requirements are not suitable to address the risk of unlimited losses posed by futures with additional payment obligations. Improving information to retail clients does not prevent those clients from being exposed to the risk of losing more money than they have invested.

Suitability and appropriateness requirements

32. The suitability requirements set out in Article 25(2) of MiFID II are only applicable to the provision of investment advice and portfolio management. However, the marketing, distribution or sale of futures with additional payment obligations is normally performed through electronic platforms without the provision of investment advice and portfolio management. Therefore, those requirements are insufficient to address the risks identified.

33. Futures with additional payment obligations are subject to the appropriateness assessment referred to in Article 25(3) of MiFID II. However, this assessment, even where properly performed, does not address the risks for retail clients posed by futures with additional payment obligations and in particular the risk of potentially unlimited losses. Even retail clients who have the appropriate experience and knowledge regarding this type of products must bear the risk of being obliged to make unlimited additional payments, for which they may have to tap their other assets. Furthermore, even if non-appropriateness has been demonstrated, the requirements set forth in Article 25(3) of MiFID II cannot prevent a retail client from entering into the transaction if a warning has been made. Therefore, the risks identified cannot be adequately addressed through improved supervision and enforcement of the appropriateness assessment requirements.

Product governance

34. BaFin has also examined whether the risks identified would be better addressed by improved supervision or enforcement of the requirements on product governance set out in Articles 16(3) and 24(2) of MiFID II and Articles 9 and 10 of Commission Delegated Directive (EU) 2017/593 ([7]).

35. BaFin considers that improved supervision or enforcement of those requirements does not represent a viable option as it would require several intermediate steps which would have to be monitored in each individual case and, if necessary, enforced. Instead, the significant investor protection concerns identified pertain not only to an individual

[7] Commission Delegated Directive (EU) 2017/593 of 7 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to safeguarding of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or reception of fees, commissions or any monetary or non-monetary benefits (OJ L 87, 31.3.2017, p. 500).

provider of futures with additional payment obligations but constitute a market-wide issue involving numerous German providers as well as providers authorised in other Member States offering their services in Germany. Hence, it is most effectively addressed through the national measure which would create standardised requirements and a consistent level of protection of retail clients in Germany against the risk of being required to make additional payments when trading futures (unless the transaction is entered into for hedging purposes or to close out existing future positions).

Key information documents

36. BaFin has also taken into consideration the relevance of the disclosure requirements set out in Articles 5 to 14 of Regulation (EU) No 1286/2014 (PRIIPS) ([8]). However, this type of disclosure does not address the risk related to additional payment obligations for retail clients. An improved supervision or enforcement of those disclosure requirements is therefore not a suitable means. BaFin considers that the PRIIPS Regulation does not contain any requirement that would eliminate or sufficiently address the issue.

*Improved supervision or enforcement would not better address the issue*

37. As mentioned in paragraphs 30 to 36 above, BaFin does not believe that improved supervision or enforcement of existing requirements can adequately address the concerns identified.

*Proportionality*

38. BaFin states that the national measure is justified and proportionate. BaFin considered possible alternative options, such as increasing the margin requirements, requiring providers to have reliable margin call procedures, or introducing marketing restrictions. However, none of these options was deemed sufficient to adequately address the significant investor protection concerns identified.

39. In addition, BaFin notes that the national measure does not impose a full ban. Futures with additional payment obligations may continue to be marketed, distributed or sold to retail clients that purchase the product for hedging purposes or to close out existing future positions that were opened before the national measure took effect.

40. According to BaFin, the national measure addresses the significant investor protection concerns by establishing an appropriate and consistent level of protection that limits the losses which retail clients who trade futures in Germany for speculative purposes can incur.

[8] Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs) (OJ L 352, 9.12.2014, p. 1).

41. BaFin expects that providers will face certain costs when implementing the national measure, such as IT costs, consulting costs and costs related to the need to update their terms and conditions as well as to establish a procedure documenting confirmation of the ‘for hedging purposes’ exemption. BaFin also expects that providers may incur costs related to hedging the additional market risk they will assume when excluding the additional payment obligations. However, BaFin considers that the overall costs of the national measure for providers will be of a limited extent and will be outweighed by the benefits of the measure in terms of addressing the significant investor protection concerns identified.

42. Similarly, BaFin considers that any potential negative impact of the national measure on retail clients – particularly in terms of reduced investment opportunities – is proportionate and will be outweighed by the investor protection benefits of the measure.

43. Regarding the hedging carve-out, BaFin believes that this exception is proportionate because it ensures an appropriate balance between the affected interests of providers and the individual interests of retail clients on the one hand, and the public objective of protecting the collective interests of investors on the other.

44. Regarding the exception concerning existing future positions, BaFin is of the view that this exception is proportionate, because it takes into account the interests of retail clients in the settlement of futures positions already opened and hence avoids the negative consequences that could arise from the fact that retail clients may no longer be able to close out these open positions with a corresponding offsetting transaction.

*Consultation of competent authorities in other relevant Member States*

45. BaFin informed ESMA that it has consulted NCAs in three other Member States that might be significantly affected by its measure, namely the Central Bank of Ireland (CBI), the Cyprus Securities and Exchange Commission (CySEC) and the Commission de Surveillance du Secteur Financier of Luxembourg (CSSF).

46. One NCA noted that certain terms of the national measure were not sufficiently defined and that the scope of application of the measure should be limited to cases where the retail client does not receive investment advice.

47. BaFin appreciates the feedback and has revised and clarified certain terms of the national measure as well as the exceptions to the prohibition. Regarding the suggestion to limit the scope of the measure to the non-advised distribution of futures with additional payment obligations, BaFin notes that, as already stated above, those products are usually offered via electronic trading platforms without the provision of investment advice or portfolio management.

*Discriminatory effect on services or activities provided from another Member States*

48. BaFin does not believe that the national measure has a discriminatory effect (including an indirect one) on services or activities provided from another Member States because the national measure provides for equal treatment of the marketing, distribution or sale of the products regardless of the Member State from which those services or activities are carried out.

*Consultation with public bodies competent for the oversight, administration and regulation of physical agricultural markets*

49. BaFin has no indication that futures with additional payment obligations pose a serious threat to the orderly functioning and integrity of the national physical agricultural market. Nonetheless, BaFin has informed the German Federal Ministry of Food and Agriculture (BMEL) about the planned national measure and has given the Ministry the opportunity to comment.

*Timely Notification*

50. BaFin notified ESMA and the NCAs of the national measure not less than one month before the measure is intended to take effect.

## 3. ESMA's assessment of the national measure's justification and proportionality

51. In its assessment of the justification and proportionality of the national measure, ESMA has taken into account (i) the reasons provided by BaFin in its notification of the national measure, as reflected in this opinion; (ii) BaFin's consultation paper and subsequent draft of the proposed national measure; (iii) the complexity of futures with additional payment obligations, including the risk of losses for retail clients; and (iv) BaFin's assessment of the futures market in Germany and its evolution.

52. In its product intervention measures on CFDs ([9]), ESMA considered the risk that, after the entry into effect of the measures, providers of CFDs could try to offer products with similar features, such as futures, and indicated that ESMA and NCAs would closely monitor whether such new distribution trends would develop raising similar detrimental consequences for retail clients as those observed in relation to CFDs. For the purposes of this national measure, ESMA has assessed the relevance of BaFin's supervisory experience which indicates a growing trend of futures with additional payment obligations being offered to retail clients in Germany and the high risks for retail clients stemming from those products. In particular, ESMA has considered the risk of significant losses for retail clients deriving from the additional payment obligations and notes that this risk – which was also observed in the context of CFDs – has been addressed in ESMA's product intervention measures and the subsequent NCAs' product intervention measures through the introduction of a negative balance protection ([10]). ESMA believes

[9] Decision (EU) 2018/796, paragraph 145.
[10] ESMA Decision (EU) 2018/796, paragraphs 118-124.

that the risk for retail clients to lose more money than they have invested presents an important risk of major consumer detriment.

53. ESMA also notes that BaFin has considered less restrictive measures. However, given the specificities of the national market, its evolution as well as the selling and advertising practices of providers observed by BaFin in Germany, such measures would not adequately address the significant investor protection concerns identified by BaFin.

54. For the above reasons, ESMA believes that the proposed prohibition of the marketing, distribution or sale of futures with additional payment obligations to retail clients in Germany is justified and proportionate. At the same time, ESMA notes that the hedging carve-out included in the national measure has a broad scope. The planned carve-out would concern all retail clients (who are not commonly expected to invest in financial instruments for hedging purposes) and would apply across all sectors (and not only to certain sectors, such as the agricultural one, where retail clients who are usually business owners commonly invest in futures to hedge certain business risks). Furthermore, the carve-out is designed so as to enable retail clients to proceed with a futures transaction simply by confirming (either through a click on the relevant icon in the provider's order screen or orally) the 'hedging purposes' of the transaction, without any obligation of the provider to verify that the product has in fact been purchased for hedging purposes. In ESMA's view, this may lead to the risk of circumvention. Retail clients may be steered by product providers towards clicking the 'for hedging purposes' icon and hence into making a decision that, if they were fully informed of and understood the risks of the product, they would not make.

55. In the light of the above, while ESMA has duly taken into account the need for the hedging carve-out expressed by BaFin given the specificities of the German futures market and the use of those products for hedging purposes by German retail clients, ESMA trusts that BaFin will closely monitor the aforesaid risks of circumvention and possible improper steering behaviour which, if not duly controlled, may ultimately render the national measure unable to effectively tackle the significant investor protection concerns identified by BaFin in respect of futures with additional payment obligations.

56. Finally, ESMA notes that the national measure does not apply to the marketing, distribution or sale of futures with additional payment obligations to retail clients outside Germany by product providers authorised in Germany. While ESMA is generally of the view that retail clients should be effectively protected regardless of their location, ESMA has considered that the national measure aims to address the specific concerns identified by BaFin in respect of the retail market of futures with additional payment obligations in Germany. Furthermore, ESMA has taken into account the capacity of BaFin to continue to closely monitor the national market and the activity of future providers, including when investment firms authorised in Germany provide services across the EU.

## 4. Conclusion

57. For the above-mentioned reasons, ESMA is of the opinion that the proposed national measure is justified and proportionate.

58. As to whether the taking of the measures should be considered by other national competent authorities, ESMA is of the opinion that insufficient evidence has been gathered to make such determination at this stage. Therefore, ESMA encourages national competent authorities to monitor futures with additional payment obligations at national level to assess whether similar risks for retail clients as those identified by BaFin could arise.

59. This opinion will be published on ESMA's website in accordance with Article 43(2) of MiFIR.

Done at Paris, 20 October 2022

For the Board of Supervisors
Verena Ross
Chair

*[Signed]*