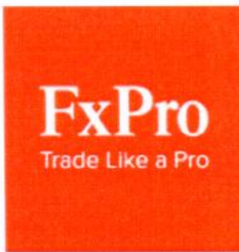

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By E-mail: cfdconsultation@centralbank.ie

May 29, 2017

Dear Sir/Madam,

Consultation on the Protection of Retail Investors in relation to the Distribution of CFDs

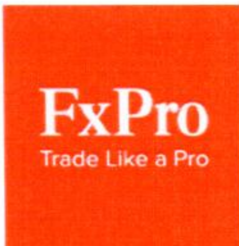
We hereby acknowledge the publication of Consultation Paper 107 "Consultation on the Protection of Retail Investors in relation to the Distribution of CFDs" on March 6, 2017. Please find below the responses to section 5.3 'Questions for Considerations' on behalf of two investment firms; FxPro UK Ltd. which is authorised and regulated by the Financial Conduct authority ('FCA') (reg. no. 509956) and FxPro Financial Services Ltd which is authorised and regulated by the Cyprus Securities and Exchange Commission ('CySEC') (license no. 078/07), collectively referred to as 'FxPro'.

1. **Which of the options outlined in this paper do you consider will most effectively and proportionately address the investor protection risks associated with the sale or distribution of CFDs to retail clients? Please give reasons for your answer.**

   FxPro is of the opinion 'Option 2: Enhanced Investor Protection Measures' (though not in its entirety, which we explain in Question 2) would be the most effective and proportionate response by the Central Bank of Ireland ('CBI') the reasons being:

   - CFDs allow retail clients access to trade a wide variety of asset classes through one brokerage account. The removal of CFDs would potentially remove access from such markets for the majority of retail clients who cannot afford to meet the minimum account balances required to open institutional accounts directly with a prime broker. Even for those who can afford to meet the higher requirements of institutional brokers, such retail clients would need to forego their retail classification and would need to be deemed as professional clients, thus losing the protections afforded to retail clients, and most specifically the protection of capping loses to the clients' deposits.

   - CFDs are a cost-efficient way of trading the financial markets. Leverage or margin when applied responsibly allows retail clients the ability to trade the underlying financial



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markets at a fraction of the cost required when trading the physical contracts. Removing access to CFDs would either remove all access to trading for some clients or would greatly increase the cost of trading for those who could afford to do so. Either way, retail clients will be disadvantaged.

- CFDs allow clients to hedge exposure against future currency receipts or expenses at a low cost. Removing access to CFDs would require such hedging of future exposure to be effected with larger financial institutions who are either unlikely to accommodate due to smaller trade size & clearing/settlement costs or will, most likely, require significant collateral from the client which puts the client at a significant disadvantage in terms of remaining competitive. Even if accommodated, such hedging of future exposure will certainly be more expensive for retail clients.

- Allowing access to trading CFDs provides retail clients with access to more than just trading platforms, CFD brokers offer a multitude of educational resources at no cost to clients, such educational materials help to enhance retail clients understanding of the financial markets and the impact macro-economic events can have on the global markets. Such educational resources would present a significant cost to retail clients if they were not readily available through CFD brokers and would certainly not be provided at no cost by institutional brokerages.

2. **In relation to Option 2:**

   a) **Do you agree with the proposal to restrict leverage to 25:1 for retail clients trading CFDs? Please give reasons for your answer.**

   Yes, we agree with setting a maximum leverage limit for retail clients. The suggested limits of 25:1 do not find us in agreement and we will explain the many reasons behind our belief below. While we understand and embrace that the goal of the CBI is to better protect retail clients, we do not believe that this goal will necessarily be achieved through such a severe reduction in leverage. On the contrary it will have an opposite effect as retail clients will move to less regulated brokers and to jurisdictions of lighter regime which provide far less protection for retail clients.

   We firmly believe that the introduction of such leverage will result in traders moving their accounts to brokers within the EEA or offshore who offer higher leverage, while we understand that ESMA may well introduce an industry wide leverage restriction, the likelihood is that this will not be implemented until at least 2018 by which point the damage to CBI regulated brokers who have lost their clients will have already been done.

   Retail traders find leverage an important factor when deciding on where to trade and this reduction will most likely force them to move elsewhere to maintain similar trade sizes using the funds they have available. There is a high risk that these restrictions will result in the CFD market in Ireland becoming uncompetitive when compared to other EEA and

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offshore countries who still offer higher levels of leverage. When considering other countries such as the USA who have introduced 1:50 leverage, we have to consider that only the leverage reduction is comparable and it does not consider other market conditions. In USA retail clients additionally cannot trade with brokers outside of the USA, thus there was not the risk to indigenous brokers. However, with regards to the CBI and MiFID passporting regulations, a leverage reduction may impact domestic brokers regulated by the CBI, as Irish residents reserve the right to select other brokers operating within the EEA who may be offering a higher leverage which satisfies their needs.

Most importantly also, the data of winning/losing US retail clients that are published quarterly reveal that despite the strict leverage restriction in the US, the ratio of winning/losing clients per quarter is very similar to European brokers. Using the latest publicly available data from US retail clients of Q3 2016, 35% of US retail clients had won on their trading using a maximum leverage of 50. Using our own internal data, where clients can utilize a maximum leverage of up to 500, 30% of clients had won in the same quarter. This is strong evidence which illustrates that a strict restriction in leverage does not support the notion that it will make clients more profitable. Please also note that the data was broadly comparable for all quarters of 2016 when compared to US retail clients winning/losing proportions.

To further support our belief that a strict leverage restriction will not be advantageous for retail clients, we have scrutinized in detail our own data and have verified that the leverage is not directly related with the loss of the clients. Our data show that clients who utilized a maximum leverage of 25:1 had lost twice as much per account than clients who utilized a maximum leverage of 500:1 and three times as much than clients who utilized a maximum leverage of 200:1 or 300:1, whilst also losing 50% more than clients who utilized a maximum leverage of 400:1. Hence, using a higher leverage does not imply that losses are magnified. While the sample size of the 25:1 is rather small, looking at the accounts with 50:1 leverage it is again evident that the accounts using lower leverage have similar or greater losses than the higher leverage accounts.

Please refer to table below for all of our clients' data:

Leverage	Number of accounts	Loss per account - US$
25	174	5,513
50	1,093	2,964
100	6,740	1,785
150	94	607
175	15	8,124
200	5,870	1,766
300	756	1,765
400	2,315	3,449
500	42,348	2,514

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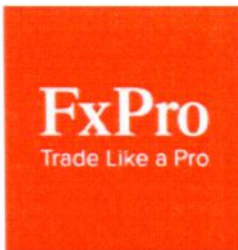
Whilst we do agree with limiting of leverage, we do not agree with the CBI assessment that limiting leverage to 1:25 will better prevent clients from loses, especially as the scenarios provided in the consultation paper did not consider the proven trading behaviour of retail traders and focused on one type of scenario with no external factors being considered. It is worth noting that though FxPro offers clients a maximum leverage of 1:500, this leverage is hardly ever utilized. As shown by the table above, around 70% of our clients' accounts are set up with a leverage of 500:1, however the actual utilized average leverage varies between 50:1 to 60:1, the most frequently used actual leverage (mode) is around 40:1 and the median leverage actually utilized is around 25:1.

Hence, we strongly believe that a strict leverage restriction will not alter the win/loss ratio of clients but will have negative effects on the retail clients for the reasons mentioned further above, resulting in a situation where clients are pushed abroad to brokers who do not provide retail clients with the same level of protections they are afforded under the CBI.

Though it is difficult to fully account for every scenario or outcome due to the large number of external factors which may influence a trader's decision making when entering, maintaining or exiting a position, we feel that when taking trading psychology and behaviour into account, there is a high likelihood that the reduction of leverage could potentially increase the losses some traders incur as they would be forced to increase the funds in their accounts in order to maintain higher margin requirements. The below table and the following paragraphs outline the impact of trading behaviour for a retail client and the potential outcome and likelihood for losses despite the leverage which is in place.

Leverage	Trade Size	Margin Required	Margin Call %	Pips to Margin Call	P/L
25:1	100,000	4,000	50%	200	-2,000
50:1	100,000	2,000	50%	100	-1,000
100:1	100,000	1,000	50%	50	-500
200:1	100,000	500	50%	25	-250

It has been widely documented in numerous published studies such as "The Behavior of Individual Investors" by Barber-Odean 2011 (paper attached) that when in a losing position, traders will often run losses in the hope of a market reversal as opposed to winning positions which are often exited at much lower returns, this is referred to as the "Disposition effect". Such behaviour is influenced heavily by the "Psychology of Decision Making" (paper attached) for each retail client, something which will be present regardless of the leverage requirements placed on a retail clients account, such behaviour



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will inevitably result in traders running into greater losses due to the increased margin which they will have to maintain to enter the position.

Our analysis for 2016 has shown that across asset classes, our clients have a greater number of winning/break even trades than they do losing trades, however the median loss is far greater than the median win for each asset class, supporting our analysis from the studies mentioned above. This further demonstrates the importance of trading psychology and the impact it has on a retail client's decision making, regardless of leverage. Putting stricter leverage limits in place will simply increase the amount of margin traders require, putting higher amounts at risk when entering into a position,, however it will do very little to change a trader's behaviour and as such will not greatly impact the winning/losing percentage.

Asset Class	No. of Winning Trades	No. of Losing trades	No. of Breakeven Trades	Median Winning Amount	Median Losing Amount	Ratio of Winning to Losing Amount
Commodities	1,399,741	895,465	20,490	1,265	-2,107	1:1.66
Forex	12,248,572	7,015,105	147,505	326	-877	1:2.69
Future	319,628	235,802	14,712	546	-1,918	1:3.5
Share/Index	371,843	214,998	11,531	171	-271	1:1.59
Grand Total	14,339,784	8,361,370	194,238	349	-952	1:2.7

We would also like to suggest a staged approach towards the introduction of reducing leverage requirements, staging the reduction of leverage over time will allow retail clients to realize that they do not require leverage at levels as high as 500:1 and that leverage does not really impact their trading, as we have documented above.

b) **Do you agree with the proposal that retail clients trading CFDs should not be at risk of potential limitless losses and that firms offering CFDs should be required to put in place negative balance protection on a per position basis? Please give reasons for your answer.**

FxPro has been offering negative balance protection to all retail clients since 2007 and firmly agrees that negative balance protection should be provided to all retail clients on a per account basis. However, in doing so, both retail clients and brokers must be protected.

For retail clients, the offering of negative balance protection should be enforced at no additional cost or burden to them. Other regulatory authorities within the European Union (i.e. the French AMF) have enforced the notion of limiting retail client losses, however, have allowed alternative solutions on a per position basis such as guaranteed stop-losses to formulate part of the answer. Brokers who offer guaranteed stop-losses impose a premium charge to retail clients for utilising this 'service', unlike those offering negative balance protection on an account level such as FxPro. As traders tend to be

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'directional', they trade multiple times. By charging on a per position basis, this 'premium' would be charged on every new position they open, increasing the trading costs in the long-term and essentially putting them at a disadvantage.

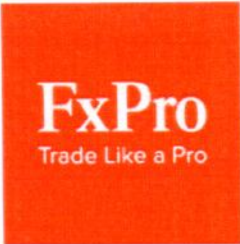
Protection for brokers offering negative balance protection though should also be considered, as retail clients from our experience have attempted to take advantage of this offering, by placing large trades in opposite directions ('buy' and 'sell') in the knowledge that FxPro would cover the loss-making trade. Under such circumstances, in the event a client has voluntarily abused this protection, brokers should be in a position to off-set the profitable trade against the negative balance incurred, whilst furthermore provide the abusive client with the option to continue trading without negative balance protection, higher margin levels or terminate the business relationship.

c) **Do you agree with the proposal to prohibit bonus promotions and trading incentives in relation to CFD client accounts? Please give reasons for your answer.**

We agree with the introduction of a ban on monetary bonuses which are directly linked to account opening or which are linked towards trading performance e.g. clients must execute a pre-determined number of trades or volume before the bonus amount is released, as these bonuses encourage irresponsible trading.

Having attended round-tables with regulatory bodies, we feel that the CBI will find it difficult to introduce a blanket rule surrounding the banning of incentives/bonuses as there is a very wide scope when defining an incentive. Additionally, many incentives which are simply rewards towards larger VIP clients could be banned under such a rule, despite their offering not being intended to incentivize an account opening or increased trading.

We feel the CBI should consider implementing guidelines towards what they consider an allowable incentive or bonus and what is not, taking into account monetary incentives or bonuses which may be redeemable versus those that may not. Take for example a broker offering to cover the bank charges a VIP client may face when depositing funds, which would fall under the latter but not materially impact the course of their trading. We have listed a sample set of guidelines below for your consideration.



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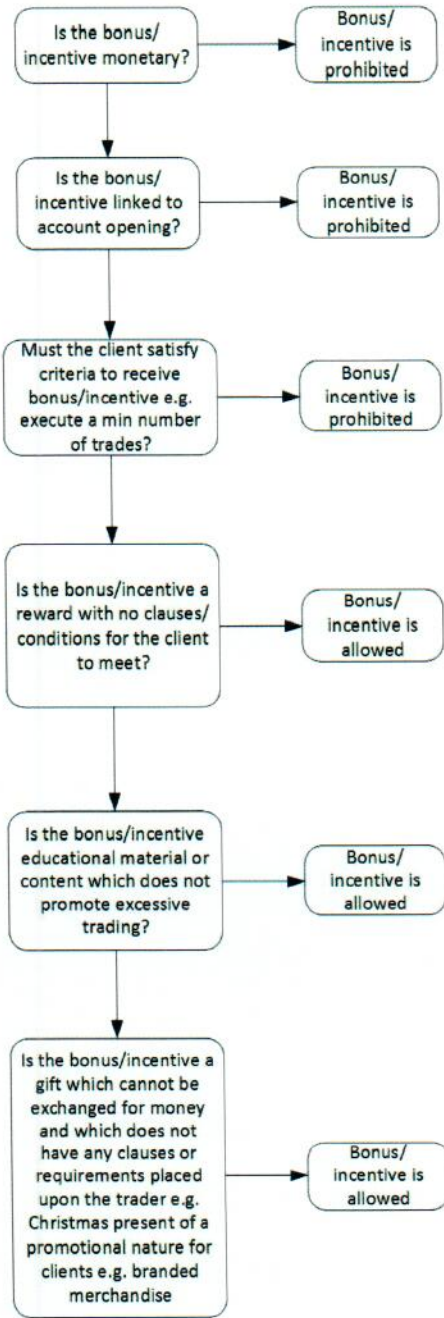

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d) **Do you agree with the proposal to require firms offering CFDs to retail consumers to provide a standardised risk warning to clients disclosing the percentage of active retail CFD clients who suffered a loss of equity during the previous quarter and over the previous 12-month period? Please give reasons for your answer.**

As in all industries where traders/investors trade or invest in order to make money, there are both traders/investors who may win and those who may lose. If we are going to apply this disclosure requirement in the CFD industry, then it should surely be added in all other relevant industries where people may win or lose money.

If the CBI does proceed with this disclosure, we strongly believe that the risk warning should include an industry wide profit/loss percentage as opposed to a broker specific profit/loss percentage. The purpose of including such a percentage is to better educate potential retail traders about the potential loss of their capital when trading CFDs, we feel that an industry wide percentage would better address this requirement, as opposed to the inclusion of a broker specific percentage, we have outlined our reasons for such a belief below:

- An industry wide percentage will more accurately reflect the risks associated with trading CFDs and will remove the risk of potential outliers being published which may greatly disadvantage or advantage individual brokers.

- Broker specific percentages will provide an unfair advantage to any broker who has a winning percentage higher than competitors as retail clients may incorrectly perceive such a broker as being more reliable or that they have a greater likelihood of achieving profits when trading with such a broker due to the advertised percentage and vice versa. There is very much a risk of clients being misled by such percentages and we feel that this would be prevented if there existed an industry wide percentage.

- The request to publish broker specific percentages implies that individual brokers have a direct impact on their individual profit/loss percentages and does not take into account differentiating factors between brokers, including but not limited to broker models, client mixes, product mix or market events which could greatly influence a profit/loss percentage.

- An analysis of our data, taken from our 2015 & 2016 client base from both our CYSEC licensed entity - FxPro Financial Services Ltd - and our FCA licensed entity - FxPro UK Ltd, has shown that there can be significant differences, in terms of winning/losing percentages, across client regions. Such differences, can play a large part in a broker's overall winning/losing percentages. If a broker has a client base predominantly from one or two of the regions which have shown to have a higher historical losing percentage then this may impact their overall numbers and will put the broker at a disadvantage, despite this being out of their control. Our analysis has shown that in some instances the difference between the winning and losing percentages between regions can be as high as 15%, our analysis found this to be the case in 2015 and 2016

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where the losing percentage for African clients was 15% higher than the losing percentage of clients from the CIS region for both years.

- The product offering and the popularity of specific products amongst brokers' clientele can also influence the impact on a brokers winning/losing percentage. This may lead to brokers publishing a profit/losing percentage which does not accurately reflect their overall product offering and as such clients will not have an accurate view as to the risk associated with trading their entire product range e.g. If a Broker's client base trades primarily CFDs on indices, however they also offer CFDs on FX, their winning/losing percentage will be based primarily on the data from the index based trading and will not correctly educate the client on the risk associated with trading CFDs on FX. Hence, an industry wide percentage will provide retail clients with a more comprehensive view of the risks.

While we agree with the need to publish a percentage to better inform clients about the risks of incurring a loss, there are several factors such as the above which have not been considered when requesting an individual broker percentage. Such factors play a key part in the makeup of different brokers risk percentages and may lead to significant percentage differences between brokers offering the exact same service or product offering. As previously mentioned, we strongly feel that such differences might wrongly disadvantage brokers and may result in clients basing their brokerage registration decision around the percentage which will be displayed on all marketing material.

Through the publication of an industry wide profit/loss percentage retail traders would have a clear indication of the risks associated with the CFD industry as a whole and the likelihood of incurring losses when trading. The industry in general and potential traders would be better served through an industry wide percentage as this would prevent any incorrect perceptions towards the likelihood of making a profit/loss when trading with an individual broker, and would also provide a level playing field amongst brokers.

Under the above-mentioned setup all brokers would be required to submit their profit/losing percentages to the FCA on a quarterly and yearly basis, with the FCA later releasing the quarterly/yearly percentage for all brokers to update their marketing material. All brokers would be required to maintain the original files in the event the FCA requested an audit of the data.

Further to the publication of the industry wide percentage, there is an array of data which brokers should publish to better educate their clients in relation to the operational models and the kind of execution which traders are likely to receive, such publications will improve transparency and remove any confusion surrounding a broker's operations. We would suggest the publication of (i) slippage statistics, (ii) manual vs automated trade execution percentage, (iii) re-quotes (where applicable), and (iv) all costs & fees associated with trading CFDs to be readily available on the brokers website.

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3. **Are there any further measures which the Central Bank should consider as part of its analysis? Please give reasons for your answers.**

Different leverage limits for inexperienced and experienced retail clients

Even though our historical analysis and published research papers have shown that experienced clients do not necessarily make greater returns, we believe the CBI should consider adopting different leverage limits dependent on the experience of retail clients, however that there should be clarity surrounding how an inexperienced trader and experienced trader are classified and how a broker is expected to determine this classification.

Currently all Brokers are required to carry out an appropriateness test which is in place to determine whether clients are appropriately suited for trading CFDs, the introduction of another benchmark to determine the suitability of a retail trader amounts to a level of overkill and adds further requirements for brokers to on-board clients. Incorporating the requirements for determining a client's experience into the appropriateness test would be a possible solution. A standardized appropriateness test which would require all brokers to follow the same criteria in terms of determining appropriateness would resolve the issue with individual broker tests and allow the easy implementation of determining a traders' experience. This suggestion removes the requirement for the implementation of another set of procedures for all brokers whilst furthermore, it will mean an easier implementation for brokers as it will only require development to an existing set of questions/criteria.

Enhanced disclosures/ risk warnings

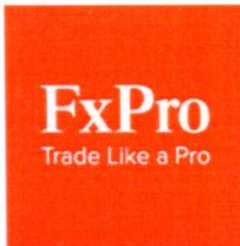
We believe that enhanced disclosures may contribute to better transparency and we welcome requirements which will better educate and inform traders of any potential risks associated with CFD trading.

We feel that the best way to address the issue of enhanced disclosures/risk warnings is for there to be a standardized risk warning for all CFD brokers, which must be implemented on all marketing material for any EEA brokers advertising to Irish residents through passporting.

In doing so however, it is our belief the CBI should disclose clear guidance how such risk warnings should be displayed on all forms of media content, as we have noticed that there are currently discrepancies between how Brokers display their risk warnings across advertising mediums such as Television across the industry. Our belief is that the risk warning should be displayed on all media content and throughout the entire duration of any video content.

Margin close out limit of 50%

We believe that a 50% margin close out level is very compatible with the market practices which we currently have in place as a 50% margin close out level will help to prevent retail clients incurring losses which would be exasperated at lower close out levels. Additionally, it



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will protect brokers offering negative balance protection from any retail clients who attempt to abuse the offering by limiting the possible losses a client can incur.

4. **In relation to the options outlined in this paper, are there any detrimental effects on investors or the markets or unintended consequences that you consider should be taken into account by the Central Bank? Please give reasons for your answer.**

   Removal of access to these products under the CBI would drive clients to overseas (off-shore) brokers. The industry has grown in popularity in recent years as evidenced from various external reports such as AITE and Investment Trends, as well as seen from data published from listed entities in both the UK and the US and the removal of access to CFDs would not dampen existing retail clients interest, it will simply force them to move to alternative brokers.

   Such action will result in clients losing the protections they are afforded under current European regulations. Take for example national investor compensation funds which guarantee a pre-determined financial amount of retail clients' investments, or even negative balance protection (for selective EU jurisdictions).

   Furthermore, the regulatory scrutiny of brokers established in lighter jurisdictions may not be up-to-par with that of regulatory authorities in the European Union, whilst certain brokers operate completely unlicensed further jeopardising retail clients who may fall prey to unscrupulous activities.

5. **What do you consider will be the likely effect of the options outlined in this paper on investors and market participants who may hold, use or benefit CFDs? Please give reasons for your answer.**

   Regarding 'Option 1: The Prohibition of the Sale or Distribution of CFDs to Retail Clients', please revert to the answer provided in question 4 above.

   As for Option 2, the effect is very much subjective to the path the CBI shall follow. The industry is mostly conducted online, thus a strict approach by the CBI will not curb existing demand but merely drive it towards more dangerous brokers established in lighter jurisdictions (if at all) who offer them what they seek (i.e. a higher leverage than 1:25).

   We believe the final leverage limits being put in place for experienced clients would be to limit leverage for major FX pairs and gold to 100:1, other FX pairs to 50:1, oil and major indices to 50:1, minor indices and single stock equities to 20:1. Our suggestion is derived using historical data of the daily volatility of each of the above financial instruments, which shows that the daily volatility of gold and major FX pairs to be broadly comparable and to be lower than that of minor FX pairs, major indices and oil trading.

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Should you require anything further, do not hesitate to contact us by email at compliance@fxpro.com.

Regards,

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Chief Executive Officer