

IG GROUP RESPONSE TO ESMA CALL FOR EVIDENCE ON POTENTIAL PRODUCT INTERVENTION MEASURES ON CFD AND BINARY OPTIONS TO RETAIL CLIENTS

5th February 2018

Overview

IG has provided CFDs to retail clients for 44 years. We are the world's largest CFD provider and we have a clean regulatory record in every jurisdiction in which we operate.

We use targeted marketing, minimum wealth restrictions and appropriateness testing to ensure we only take on clients for whom CFDs are appropriate. Our clients understand the risks of CFDs, have a realistic view of the difficulty of trading CFDs profitably and report a high level of satisfaction with the service we provide for them. IG acted as CFD counterparty to 110,000 EU retail clients last year, yet EU NCAs have received almost no complaints related to our firm.

We share ESMA's desire to improve standards of behaviour in the CFD industry and protect European consumers. We therefore support aspects of ESMA's proposals, namely standardised risk warnings, a ban on financial incentivisation, the introduction of proportionate, evidence-based leverage limits, and measures to place an absolute limit on client losses that are consistent with existing industry and regulatory practice.

We do not, however, agree that the temporary intervention powers under Article 40 MiFIR are an appropriate or lawful mechanism for introducing such measures, nor do we agree with the specific values of the proposed leverage restrictions.

In the document that follows we answer the specific questions raised by ESMA. However, in advance of this we feel it is particularly important to make five distinct points.

1. The proposed leverage restrictions are disproportionate.

We support the introduction of leverage restrictions. However, the proposed leverage restrictions have been selected with the primary objective of indiscriminately inhibiting the use of CFDs, rather than to exercise any specific protective function connected with the impact of CFD transaction fees or of realistic expectations of market volatility in underlying assets. We understand ESMA's motivation in proposing such restrictions. However, ESMA's approach has not appropriately accounted for (i) the potential unintended and counterproductive side effects on the retail market for CFDs of severe restrictions and (ii) the impact of such restrictions on well-informed retail clients (i.e. our typical clients) for whom CFDs are a perfectly appropriate trading and hedging tool.

2. The proposed measures on per-position margining and per-account negative balance protection are overcomplicated.

In their current form these measures would be difficult and expensive for firms to implement and difficult for clients to monitor, or understand. Simple, efficient and easy to implement solutions to the client protection concerns that ESMA identifies as the motivation for these particular measures have already been designed and implemented by both the AMF and the BaFin and could easily and rapidly be introduced by firms across the EU.

ESMA's contemplated use of temporary emergency product intervention powers suggests that it believes there is an immediate and urgent need for action. If this is the case we do not understand why ESMA is proposing margining and no-negative protection measures that will require an implementation period several months longer than the adoption of either of the simple, effective, pre-existing solutions developed and already implemented by EU NCAs.

3. The proposed intervention is opposed by large numbers of retail clients who currently trade CFDs with responsible firms.

Several UK CFD firms contacted their retail clients with an email that objectively described the impact of ESMA's proposed measures and informed them of ESMA's consultation process. ESMA's site repeatedly crashed under the IT load of those clients' responses. An independent site, www.replytoesma.trading, was established by IG, on which we uploaded all client comments that were forwarded to us, positive or negative, excluding only those responses containing excessive use of profanity. 98% of the more than 14,000 responses we received from retail clients across the EU opposed the measures, often in vehement terms.

These are not the responses of naïve or misinformed individuals. The minimal number of complaints related to our firm, and independent survey evidence on the knowledge and beliefs of our clients (included in this document), jointly demonstrate what we at IG have long known: that our retail client base has a high awareness of the risks of CFDs and of the likelihood of trading CFDs profitably. Our retail clients are highly engaged with financial markets and gain a positive utility from the challenge of trading. They believe that they should have the right to risk their own money in a way that they themselves see fit. They certainly do not agree that they will benefit from ESMA's contemplated actions.

We remind ESMA that there exists a large and longstanding market of well-informed retail clients who trade CFDs with responsible providers like IG. We urge ESMA to reflect on the wisdom of using sweeping pan-European product intervention powers in order to address malpractice by firms based in certain EU Member States, rather than by taking the more proportionate approach of coordinating the use, by relevant NCAs, of those NCAs' newly introduced product intervention powers.

4. The proposed intervention would have counterproductive consequences.

Data collected by IG suggests that significantly more than 50,000 retail clients across Europe use CFDs to hedge the risk of their other investments. ESMA's

unnecessarily restrictive proposals on leverage and per-position margining will prevent these clients from doing so in future.

In addition to this, the proposed intervention would create a significant opportunity for regulatory arbitrage that is likely to result in a widespread negative impact on retail clients across the EU. The responses from retail clients that ESMA has received will, we assume, have left ESMA in no doubt as to the unpopularity and perceived disproportionality of its proposed measures. In a survey conducted by an independent third party, 80% of our EU retail clients said they were likely or very likely to consider a non-EU CFD provider in order to access their preferred level of leverage in the event that the proposed leverage restrictions were to come into force. Survey evidence from Japan (where leverage restrictions of an equal severity to those suggested by ESMA have already been implemented) suggests that at least one third of Japanese retail CFD clients currently trade with high-leverage offshore providers. Survey evidence from Singapore (where less severe, but significant, restrictions have been imposed) suggests that 20% of Singaporeans are trading with high-leverage offshore providers.

ESMA's proposals represent a huge commercial opportunity for irresponsible CFD firms based outside the EU, or for firms that would be willing to base themselves outside the EU in future. These firms would not, of course, impose the contemplated measures and could be expected to invest significantly in marketing in order to alert European retail clients to this fact. There is no practical mechanism for EU NCAs to monitor and prevent non-EU firms from directing their online marketing messages at EU consumers, though many NCAs might feel forced to divert significant time and resources in an attempt to do so.

The net result of ESMA's contemplated actions, in particular the imposition of leverage restrictions at the currently proposed levels, would be that many tens of thousands of EU retail clients would be exposed to the irresponsible marketing, sales and trade execution practices of firms based beyond the reach of any EU NCA.

Furthermore, driving a significant proportion of EU consumers toward unregulated non-EU firms would undermine the reach and effectiveness of the regulatory measures that ESMA advocates and with which IG agrees, namely standardised risk warnings, a ban on financial incentivisation, leverage limits that are proportionate and evidence-based, and measures to place an absolute limit on client losses that are consistent with existing industry and regulatory practice.

ESMA has rightly identified increased minimum margins as a key tool for reducing the risk of CFDs to a certain subset of retail clients. However, ESMA has overestimated the positive impact, and underestimated the potential counterproductive impact, of an excessively restrictive approach, as well as the impact of such an approach on well informed retail clients who do not want or need this level of protection. ESMA is right in general principle; we feel strongly that it needs to act in a more proportionate manner if it intends to be proven right in practice.

5. The proposed intervention could trigger legal challenge that will damage ESMA's reputation

ESMA's contemplated course of action represents its first use of its new powers under MIFID II. As such the action is in the nature of a test case and will set a precedent for similar action in future. It is therefore vital this process should run smoothly, be based on well-founded argument and meaningful consultation, and should drive a result that will clearly demonstrate that ESMA has achieved its declared aim of consumer protection. As well as enhancing ESMA's reputation and standing this would also be beneficial to responsible CFD firms, all of which have an interest in seeing the problems in our industry being firmly and effectively addressed.

Unfortunately the disproportionate and counterproductive nature of ESMA's measures, and the process it has followed so far and seeks to follow in future, has left ESMA vulnerable to legal challenge. ESMA's proposed use of product intervention powers in this case does not conform with the EU principle of proportionality and the principle of subsidiarity set out in Article 5 of the Treaty on European Union. Nor does the proposed use conform with the process for the use of such powers set out in Articles 40, 42 and 43 of MiFIR.

The exercise of ESMA's product intervention powers under Article 40 MiFIR is subject to a condition, amongst others, that "a competent authority or competent authorities have not taken action to address the threat or the actions that have been taken do not adequately address the threat". In this regard, IG is strongly of the view that this condition is not satisfied in the present circumstances.

It is clear from the postponed initiatives of certain national regulators conducted during 2017, including the UK's FCA, that NCAs have sought to defer, willingly or otherwise, to ESMA's proposed pan-European measures, despite Article 42 MiFIR providing a codified framework for the exercise of national measures to address issues of malpractice.

In any event, no NCA has taken any measures or action under the formal product intervention powers afforded to them under Article 42 MiFIR.

Any argument by ESMA that the condition under Article 40(2)(c) MiFIR is satisfied due to measures taken by NCAs before 3 January 2018 would be ill founded, primarily because such an approach would involve justifying measures to be taken under one regulatory framework based on actions taken in a markedly different regulatory environment, in which NCAs did not have a harmonised and codified framework for interventionary action. As Recital 29 MiFIR makes clear, the use of ESMA's temporary product intervention powers under Article 40 MiFIR is intended to be "*exceptional*" and a last resort, to be used in the event that the powers of NCAs under Article 42 MiFIR have proved inadequate.

Until such time as Article 40(2)(c) MiFIR is satisfied, IG remains of the view that any measures exercised by ESMA under Article 40 MiFIR would be unlawful.

ESMA's failure to follow an appropriate process in respect of its powers under MiFIR, combined with the disproportionality of the proposed intervention, lead us to believe that ESMA will encounter legal challenge should it proceed on its currently contemplated course of action. Such an outcome will be damaging for the credibility and reputation of ESMA and will do nothing to help protect European consumers.

This outcome could be avoided were ESMA to suggest a more proportionate set of measures. While ESMA's adherence to Article 40 MiFIR would remain in dispute, the motivation of other parties to mount a challenge in this regard would be diminished. All responsible stakeholders share ESMA's consumer protection objectives.

We urge ESMA to carefully consider these points before deciding on its future course of action.

A: Do you think ESMA has adequately identified the instruments in the scope of its possible measures?

ESMA's definition of a CFD in paragraph 3 of the call for evidence is unclear, and appears to rely on various elements of each of those financial instruments defined under paragraphs 4, 5 and 9 of Section C, Annex I of MiFID II. We note that, given the amalgamated nature of the proposed CFD definition, the measures currently proposed by ESMA would potentially apply to a broad array of cash-settled products, whether traded over-the-counter or via a trading venue, and it is concerning that ESMA is seeking to utilise sweeping product intervention powers without clarity as to which products these powers will apply to.

Further, we note that a number of NCAs have sought to define CFDs in national legislation, with the clarity of such definitions a sharp contrast to the uncertainty created by paragraph 3. By way of example, under English law, a contract for difference is clearly defined as a specified instrument under Article 85 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 as amended, with additional guidance from the FCA and a history of judgments from the English courts helping to define the key features of these financial instruments. We are surprised, therefore, that ESMA is not seeking to utilise the knowledge and expertise concentrated in NCAs in this regard.

ESMA's definition of a Binary Option is simultaneously (i) too narrow, as it limits itself to instruments in which only two discrete pay outs are possible (it would be easy to circumvent ESMA's measures by designing binary-type instruments with multiple discrete pay outs, or with a small interest yield), and (ii) too broad, in the sense that it is not limited to instruments where the underlying is a financial instrument, potentially bringing a variety of gambling products into the scope of the proposed measures despite the regulation of gambling products being subject to a wholly separate framework.

Given that a clear regulatory framework now exists for binary options in certain Member States, it is concerning that ESMA's efforts to define binary options add ambiguity and uncertainty to the market's, and to other NCAs', understanding of these products and their regulatory treatment.

B: What impact do you consider that the introduction of leverage limits on the basis described (applying to retail clients only) would have on your business? Please describe and explain any one-off or ongoing costs or benefits.

These limits are grossly disproportionate and will result in a significant one-off migration of IG's retail clients to unregulated or poorly-regulated CFD providers based outside the EU.

Around 60,000 of IG's EU retail clients trade in such a way that they will be negatively impacted by these leverage limits. 80% of our EU retail clients claim they would be likely or very likely to consider using a non-EU CFD provider in order to access their preferred level of leverage¹. Survey evidence from our clients in Japan², where leverage restrictions of 25:1 were imposed some years ago, suggests that

¹ See appendix 1

² See appendix 2

28% of them currently trade with an overseas provider in order to access higher leverage. Given that the Japanese survey suffers from selection bias, in that the pool of Japanese IG clients exclude those who trade offshore completely, we believe at least 33% of Japanese clients across the industry are currently trading offshore. Given the similarity of ESMA's proposals to the measures implemented in Japan we cannot see why at least 33% of all EU retail clients would not similarly choose to open an account and trade with high leverage non-EU providers, were ESMA to proceed with its contemplated course of action. In IG's case, this would equate to at least 36,300 individual consumers.

On an ongoing basis these limits will mean our ability to compete with the online marketing of non-compliant operators based outside the EU will be compromised. We estimate that up to 33% of retail clients who would otherwise have started trading CFDs with our firm will be diverted into opening an account with a non-compliant competitor based outside the EU. This equates to the diversion of around 8,600 retail clients per year from IG to poorly regulated non-EU firms.

C: What impact do you consider that the introduction of a margin close-out rule on a per-position basis (applying to retail clients only) would have on your business? Please describe and explain any one-off or ongoing costs or benefits.

We do not fully understand the proposal and so are unable to provide an accurate estimate of its impact on our business. The wording of paragraph 16 (ii) appears to entertain the concept of an allocated variation margin for each position but does not make clear the mechanism by which clients will be permitted to allocate excess cash to a position (e.g. whether the concept of negative variation margin is permitted in cases of profitable trades, or from which distinct pools of cash variation margin should be drawn from or released to, and in which order (see D, below)).

Under one possible interpretation of the proposals it seems that ESMA's intention is that firms must maintain and administer separate and distinct pools of cash – initial margin cash and variation margin cash – and that a fixed amount of initial margin cash must be held against an individual client position regardless of that position's profitability, an arrangement that, as well as adding to the complexity of implementation for firms, would further compound the disproportionality of ESMA's proposed leverage restrictions from the point of view of clients.

We are unsure how the rule is intended to operate in cases where a retail client holds a position with an inherent limited risk feature, such as a long CFD position on an option, or a CFD on any underlying that has an attached guaranteed stop. In either of these cases a client would have a completely known maximum risk which would be fully collateralised. We do not understand what purpose the close out rule would serve in these cases, and suggest ESMA clarifies that it should not apply under such circumstances³.

³ An approach followed by MAS in Singapore, where CFDs with a guaranteed stop fall outside standard leverage restrictions and instead attract a margin of 110% of the amount risked (the 10% over-round being intended to cover the erosion of margin by funding costs on positions held over many days).

Related to this, IG is not clear as to the basis for ESMA's assertion in paragraph 16(ii) that the mechanism of closing out an open derivative contract as a means of managing both a firm's credit, market and counterparty risk and the client's risk of loss is subject to the best execution provisions under Article 27 MiFID II. Further, where a firm receives a specific instruction from a client, it is required to adhere to that specific instruction with the effect that any best execution obligation is set aside to the extent that the firm is adhering to the specific instruction. Under the proposed measures, IG would be unable to follow instructions received by clients at the commencement of an order relating to guaranteed stop loss levels where those instructions are not compatible with the 50% initial margin close out level.

ESMA states it has an intention to ensure the rule is as clear and straightforward to understand as possible by investors. The rule, as currently described, is certainly not clear and straightforward to understand. This is supported by the fact that ESMA, via NCAs, felt the need to provide additional examples as to how it envisages the margin close out rule operating, due to widespread uncertainty following the publication of the call for evidence. The rule is a departure from current market practice, both in the CFD industry and in other margin trading industries, and will appear clumsy, confusing and disproportionate to retail traders in all but the simplest of cases.

The rule will increase the difficulty for clients of establishing and maintaining control of their desired exposure in cases where the client holds multiple positions simultaneously. 70% of IG's active client base (i.e. 77,000 European retail clients) hold multiple positions and will be negatively impacted because of this issue. We expect this to act as a push factor encouraging the migration of some of these clients away from our firm and toward non-EU providers.

Regardless of the correct detailed interpretation of the proposal, its imposition would require our firm to make a significant IT investment – we believe at least 10,000 man days – translating to an elapsed time for implementation of several months, even with all development teams working at full capacity, and a financial cost of around £3.5m. Part of this IT effort would be focused on adjusting our back office, and our margin close-out system, to cater appropriately for the dramatic change in the way we will be expected to margin our clients. However, we believe most effort would be focused on making a significant investment in the appearance and functionality of our trading platforms, both online and on mobile apps, and on client statements, in order that investors would be able to (i) efficiently allocate variation margin by position, frequently over many positions and in fast moving markets, and (ii) understand how and why their trading positions were at risk of automated close-out against their wishes despite, in many cases, holding apparently ample margin on their account.

In addition to this, we anticipate that the measures would require us to make amendments to the underlying customer agreements currently in place with the 110,000 EU retail clients that currently trade CFDs with us. This would be a time-consuming process that would give rise to additional costs for our business.

D: What impact do you consider that the introduction of negative balance protection on a per-account basis (applying to retail clients only) would have on your business? Please describe and explain any one-off or ongoing costs or benefits.

If it is ESMA's intention to replicate the per-account no negative protection developed by the BaFin in Germany, we can implement this measure swiftly and with little cost.

However, as written the proposal appears to envisage a significantly more complicated solution. The description in paragraph 16 (iii) implies that firms should support four distinct classes of cash held on an investor's account:

- (i) initial margin
- (ii) variation margin (as in paragraph 16 (ii), it is not clear how ESMA expects variation margin to work, specifically how this distinct class of cash is expected to vary as position valuations move into profitability, and how and in what proportion any increase in variation margin should be funded from other distinct classes of cash on account),
- (iii) "any realised profits in respect of closed CFDs remaining in the CFD trading account" (no explanation is given of whether this special pool of cash is a net or a gross figure), and
- (iv) by implication, some class of free or unencumbered cash that may have been deposited in the account by an investor but has not been counted as initial margin, nor drawn (via some unspecified mechanism) into the class of variation margin, and which cannot be traced to the prior closing of a CFD trade.

Implementing this system in our back office, and re-engineering our client statement and trading platforms across web and mobile devices in order to communicate this system clearly and effectively to our clients, will take us several months, and cost several hundred thousand pounds.

If, in fact, it is ESMA's intention that the simple BaFin no negative account solution be implemented, we suggest the wording of the rule be amended as follows:

ESMA ... would require a CFD provider to limit the retail client's aggregate liability for all CFDs connected to that client's CFD trading account with that provider to the sum of the funds in the CFD trading account, together with any collateral in related accounts specifically reserved as margin relating to the operation of the CFD trading account.

E: What impact do you consider that a restriction on incentivisation of trading (applying to retail clients only) would have on your business? Please describe and explain any one-off or ongoing costs or benefits.

This restriction will have no impact on our business.

F: What impact do you consider that a standardised risk warning (applying to retail clients only) would have on your business? Please describe and explain any one-off or ongoing costs or benefits.

Provided that the guidelines on the size and wording of the warning are fair and proportionate, and are genuinely aimed at informing clients rather than disrupting the legitimate business of firms, we welcome this measure and do not think its implementation will impose any material costs on our business, or on the business of other responsible providers. The measure can be implemented quickly and with minimal cost.

We do not believe a fair and proportionate warning would have any impact on our client recruitment, as the consumers that form our target market are very well informed about the risks and difficulty of trading on financial markets and do not hold unrealistic expectations about their ability to trade profitably⁴.

G: Please provide evidence on the proportion of retail clients that use these products for hedging purposes and how the suggested measures will affect them.

In surveys 13% of our clients cite hedging as a key reason for their use of CFDs, and 49% of currently active retail clients confirm they have used CFDs to hedge on at least one occasion over the past year⁵. This translates to an affected population of between 14,300 and 53,900 of IG's EU retail clients, and between 49,100 and 185,200 EU retail clients across all CFD firms⁶. The disproportionate leverage restrictions proposed by ESMA, and ESMA's suggested per-position margin rule, would dramatically reduce the ability of such clients to use CFDs to hedge in future.

H: What impact do you consider that a prohibition on providing binary options to retail clients would have on your business? Please describe and explain any one-off or ongoing costs or benefits.

We do not think this prohibition will have a significant impact on our business.

I: What impact do you consider that the envisaged measures would have on retail investors?

1. Proposed leverage restrictions

IG supports leverage limits on CFDs. However, the limits proposed by ESMA are disproportionate and we do not believe they are sufficiently underpinned by evidence from client outcomes, or by rational mathematical analysis.

The restrictions, together with the proposed per-position margin close out rule, will effectively prevent EU retail clients from using CFDs to hedge their investments in

⁴ See appendix 3

⁵ See appendix 4

⁶ Assuming an EU-wide market of 378,000 retail clients. See appendix 6 for our derivation of this estimate

other instruments. As we explain in our answer to question G, above, the evidence suggests that between 49,000 and 185,000 retail clients will be negatively affected in this way.

The restrictions are extraordinarily unpopular with retail clients⁷ and are likely to generate the counterproductive result of driving many thousands of European consumers to trade CFDs with firms based outside the EU, often in jurisdictions chosen to allow the firms to operate with little or no meaningful regulatory supervision. These retail clients will lose the consumer and investor protections they currently benefit from, and will be likely to suffer poor outcomes as a result of poor sales, marketing and trade execution practices.

ESMA has underestimated:

- (i) The importance of leverage to consumers who trade CFDs, or who are interested in trading CFDs⁸.
- (ii) The degree to which retail clients understand and gain satisfaction from trading CFDs, often using multi-position, multi-asset strategies, and their consequent hostility to ESMA's proposed measures⁹.
- (iii) The willingness of retail clients to contract with firms which are unregulated, or which are regulated in locations other than the consumer's home state¹⁰.
- (iv) The commercial attractiveness of the CFD market in the EU to parties who are based outside the EU, or who would be willing to base themselves outside the EU in the aftermath of the imposition of these measures¹¹.
- (v) The practical difficulties faced by all NCAs in attempting to restrict the EU-targeted online marketing activity of parties based outside the EU, or of effectively warning European consumers against dealing with such parties¹².

We present data supporting each of these points in the appendices to this document. We urge ESMA to consider this evidence carefully, as it leads to the conclusion that the contemplated restrictions will result in a widespread, and very obvious, negative impact on retail clients across the EU. The proposed

⁷ Over 14,000 retail clients commented on ESMA's proposals on the website www.replytoesma.trading. 98% of these clients registered opposition to ESMA's contemplated course of action.

In terms of geographical split, 57% of these clients were based in the UK, 16% were based in Germany, 12% were based in Italy, 9% were based in France, 5% were based in Spain and the remainder were spread across the rest of the EU. Strong disagreement with ESMA's proposals was consistent across all geographies.

⁸ See appendix 1, section (i)

⁹ See appendices 3, 4 and 5

¹⁰ See appendix 1, sections (ii) and (iii)

¹¹ See appendix 6

¹² See appendix 7

restrictions, as currently envisaged, are not in the best interests of consumers, or of responsible firms, or of EU NCAs, or of ESMA itself.

The best outcome for EU consumers would be for the demand for CFDs in the EU to be met by EU-based firms, operating under the supervision of EU NCAs, offering a CFD product whose risk is limited by proportionate and evidence-based leverage restrictions, using marketing that complies with appropriate legal and regulatory frameworks.

However, the disproportionality of ESMA's suggested restrictions, and the commercial attractiveness of the EU CFD market to outside parties, make such an outcome unlikely. The restrictions will hand an overwhelming online marketing advantage to aggressive non-compliant firms based outside the control of EU NCAs. This will result in poor client outcomes for tens of thousands of European consumers.

In the light of this we urge ESMA to reconsider the level of the suggested leverage restrictions. ESMA's call for evidence suggests (para 20) that ESMA has undertaken quantitative analysis on this issue. We cannot give our view on the strength of this analysis as ESMA has chosen not to include details of the work in the call for evidence, or to share details of it directly with us. However, IG is happy to share our own quantitative analysis with ESMA in this document¹³, together with evidence on the link between leverage and client outcomes from our own client base¹⁴.

Our work suggests that leverage restrictions of 100:1 on FX and equity indices, 20:1 on commodities and between 10:1 and 5:1 on individual equities would be sufficient to protect consumers, particularly when combined with an appropriate risk warning and a no-negative guarantee operating at either a per-account or per-position level. In our commercial judgement, such limits would also leave EU-based firms able to compete effectively against online offers of much higher leverage made by non-compliant firms based outside the EU.

Under our analytical framework, we find it impossible to generate results supporting ESMA's proposals without assuming transaction costs per trade which are very much higher than those observed in practice¹⁵.

2. Per-position margin close out rule

The proposed per-position margin close-out rule is likely to prove problematic for many retail clients. It is different from current industry practice, and different from the practice followed by firms offering other margin trading products (futures, options) that CFD clients might already have encountered, and will therefore result in clients being closed out regardless of the amount of equity held on their account in a way that many will find surprising and confusing. It will take firms months to implement in a way that allows investors to be properly informed about their positions. The lack of the ability to offset variation margin between positions will effectively prevent clients from using multiple CFDs to hedge a diverse investment portfolio, or from pursuing many popular trading strategies where a portfolio of

¹³ See appendix 8

¹⁴ See appendix 9

¹⁵ See appendix 10

positions is held simultaneously, where the offset of variation margin between positions is a practical necessity.

70% of IG's clients use trading strategies where they hold multiple positions at a time, and 13% cite hedging as a key reason for their use of CFDs. If our clients are taken as representative this implies that between 265,000 and 314,000 retail investors across Europe stand to be negatively impacted by this proposals.

If the aim of this measure is, as stated by ESMA, to ensure that clients are routinely protected from losing more than their investment, and that the rule is as clear and straightforward to understand as possible, then an easier and less disproportionate way of achieving this is to enforce a conventional per-account margin close out rule (of the kind already accepted and understood by CFD clients, and traders of other margined products, across Europe) in conjunction with a per-account no negative protection of the form already put into practice by the BaFin in Germany. This would be easy for the industry to implement quickly and would preserve the ability of investors to use CFDs to efficiently hedge their investment portfolios and to use multi-position trading strategies.

If ESMA is determined to move forward with a per-position close out policy, then a far clearer option from the point of view of retail clients, and a far easier solution for firms to implement quickly, is to adopt the solution developed by the AMF in France and insist that clients leave explicit guaranteed stop orders against all positions, allowing those clients to define the amount they wish to risk on each position in a clear, transparent and simple to understand manner while fully protecting them from the possibility of excessive loss. Should ESMA opt for this solution we suggest it issues guidance to NCAs as to the extra regulatory capital that CFD firms must hold to ensure they are appropriately equipped to bear the risk of a per-position guarantee.

3. Negative balance protection

IG has been a longstanding supporter of "no negative" protection for retail clients, either on a per-position or per-account basis. However, as currently drafted, ESMA's proposed solution appears to envisage a departure from current market practice. It contains concepts unheard of on accounts used to trade other, analogous, margin trading products, is unnecessarily complicated, is likely to cause confusion to retail clients and will require a lengthy period of implementation by firms.

Two individual NCAs, the AMF and the BaFin, have already introduced measures that place an absolute limit on client losses. In each case the measures fully achieve the desired policy goal, are simple for retail clients to understand and have been rapidly implemented by firms. We feel strongly that ESMA's aims would be best served by mandating the implementation of one of these two solutions, rather than by introducing a third, more complicated and less easy to implement, mechanism across the EU.

4. Standardised risk warning and restriction on the incentivisation of trading

IG believes that many thousands of retail investors across Europe will benefit significantly from ESMA's proposed measures concerning the provision of a standardised risk warning and on the restriction on the incentivisation of trading. These measures inform and protect investors, are quick and simple to implement, will materially disrupt the client acquisition efforts of irresponsible firms and are very unlikely to drive any counterproductive outcomes.

On the specific subject of the risk warning, we believe clients will be better informed if firms display their own win/loss proportions rather than an industry average collated by each NCA. This will lower the administrative load on individual NCAs as well as better informing clients about the specific firm they may be considering trading with. NCAs should issue clear guidance to firms as to the methodology they should use when compiling these statistics, in order that different firms may be fairly compared.

The risk warning should also be deployed proportionately. We welcome ESMA's consideration of an abbreviated warning in cases other than a durable medium or webpage. We also believe the scope of the proposal should be better defined. If, for instance, ESMA intends that firms should display a lengthy warning on every page of a firm's website, then the result would be counterproductive, as it would hamper the usability of websites for existing retail clients (who, our evidence suggests, have an already good understanding of the chances of trading profitably) and for existing professional clients (for whom the message is neither intended nor needed), whilst deadening the impact of the message, through constant repetition, for new retail clients. The imposition of the measure in such a way would be a clearly disproportionate attempt to disrupt the legitimate business of CFD firms rather than to genuinely inform and protect retail clients.

We think the net effect of a ban on incentivisation, and of a proportionately applied risk warning, would be to significantly shrink the number of unsophisticated European consumers who trade CFDs and to ensure all consumers are unambiguously aware of the difficulty of trading CFDs profitably. These are outcomes that IG wholeheartedly supports.

However, as emphasised above, the benefits of these measures will be diminished if ESMA simultaneously introduces measures that are likely to have the effect of driving a significant proportion of consumers toward non-EU unregulated firms (i.e. disproportionately severe leverage limits and rules on per-position margining and per-account negative balance protection that are inconvenient for consumers and disrupt their legitimate trading strategies), thus increasing the market share and online presence of firms that will not provide risk warnings or refrain from incentivisation.

J. Do you believe that specific restrictions concerning CFDs in cryptocurrencies should be introduced? In particular, what impact do you consider that assigning a leverage limit of 5:1 to such CFDs would have on firms' business and / or any expected additional benefits for retail clients? How would such an impact compare to that from the possible alternatives of lower leverage limits such as 2:1 or 1:1, or a prohibition on the sale, marketing

and distribution of such CFDs? Please describe and explain any one-off or ongoing costs or benefits.

We believe an outright prohibition on the sale, marketing and distribution of cryptocurrency CFDs would prove counterproductive, in that it would drive consumers wishing to trade cryptocurrencies toward unregulated cryptocurrency exchanges, where they would be exposed to exceptionally high counterparty risk and where they would lose the consumer and investor protection measures they currently benefit from when contracting with a regulated EU-based CFD firm.

We offer extremely restricted leverage on cryptocurrency CFDs and do not believe a conservative leverage cap would have a significant impact on our business. We think that such a cap would be entirely appropriate, given the high transaction costs and high price volatility of cryptocurrencies. In the future, as the asset class matures and both transaction costs and price volatility decrease, we believe NCAs should be open to reviewing the level of the restriction.

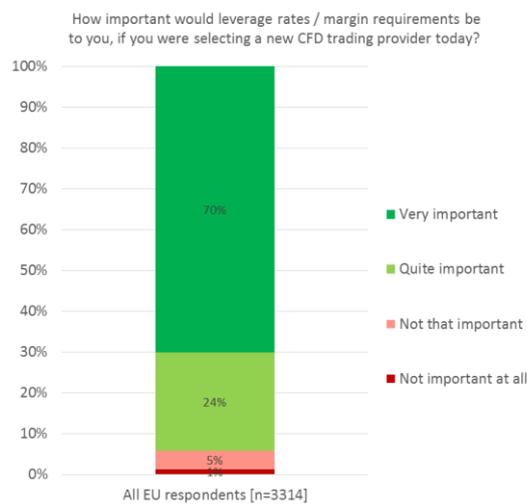
Appendix 1: IG client willingness to use a non-EU CFD provider

We asked an independent third party, Investment Trends Ltd, to survey our EU retail clients on various issues connected to ESMA’s proposals.

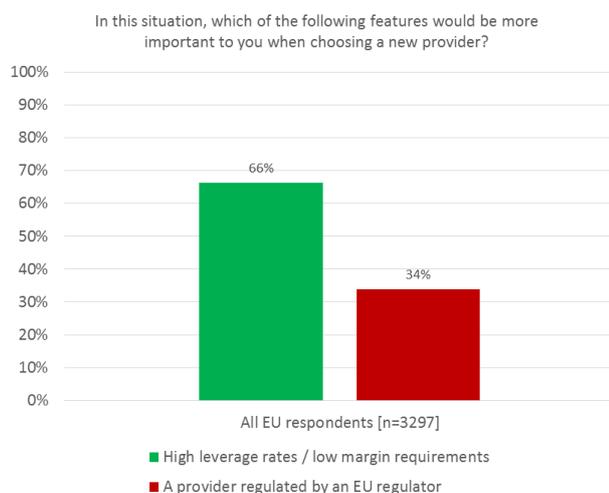
The survey included a number of questions on leverage, on the relative importance placed by clients on leverage vs. regulatory status of firms, and the consequent likelihood of EU retail clients considering high-leverage non-EU firms as a CFD provider.

The results demonstrate that:

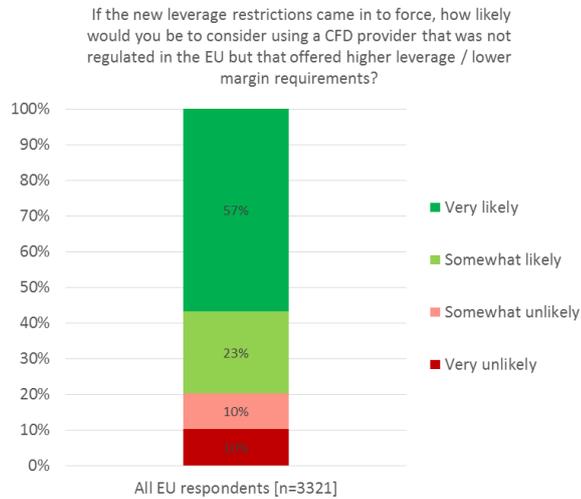
- (i) Leverage is an extremely important factor for retail clients, with 94% rating leverage as either a “quite important” or a “very important” factor in their choice of CFD provider:



- (ii) The regulatory status of a firm is much less important to clients than the leverage a firm is able to offer. Two thirds of retail clients rated available leverage as more important than regulatory status:



- (iii) Many retail clients appear willing to act on these motivations and consider trading with non-EU firms in return for higher leverage. 23% would be “somewhat likely” to do so, and 57% would be “very likely” to do so:

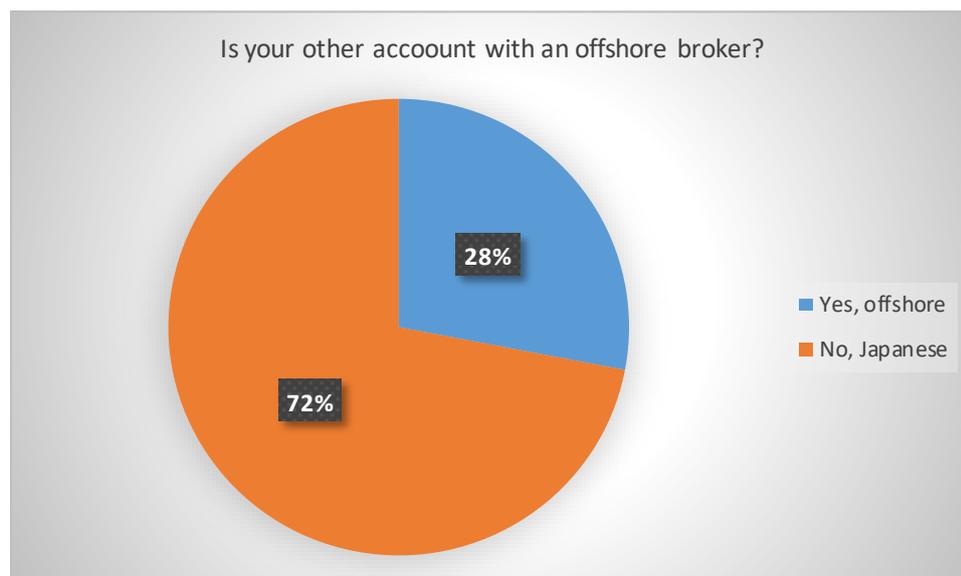


In the light of this evidence we do not think it unreasonable to assume at least 33% of retail clients in the EU are likely to trade with non-EU CFD providers as a result of the aggressive leverage restrictions proposed by ESMA. This estimate is firmly supported by evidence gathered in the Japanese and Singaporean markets (see appendix 2).

Appendix 2: Impact of Japanese and Singaporean leverage restrictions on Japanese and Singaporean retail markets

IG has an office in Japan, where we are regulated by the JFSA as a CFD provider. In September 2017 we surveyed our Japanese clients about their trading habits. The Japanese FCA imposes leverage restrictions of an almost identically disproportionate nature to those suggested by ESMA (25:1 in FX).

For clients who traded with other firms in addition to IG (85% of the total), 33% used firms which have no office in Japan, and which offer higher leverage – i.e. 28% of all IG’s Japanese clients are trading offshore in order to access higher leverage:

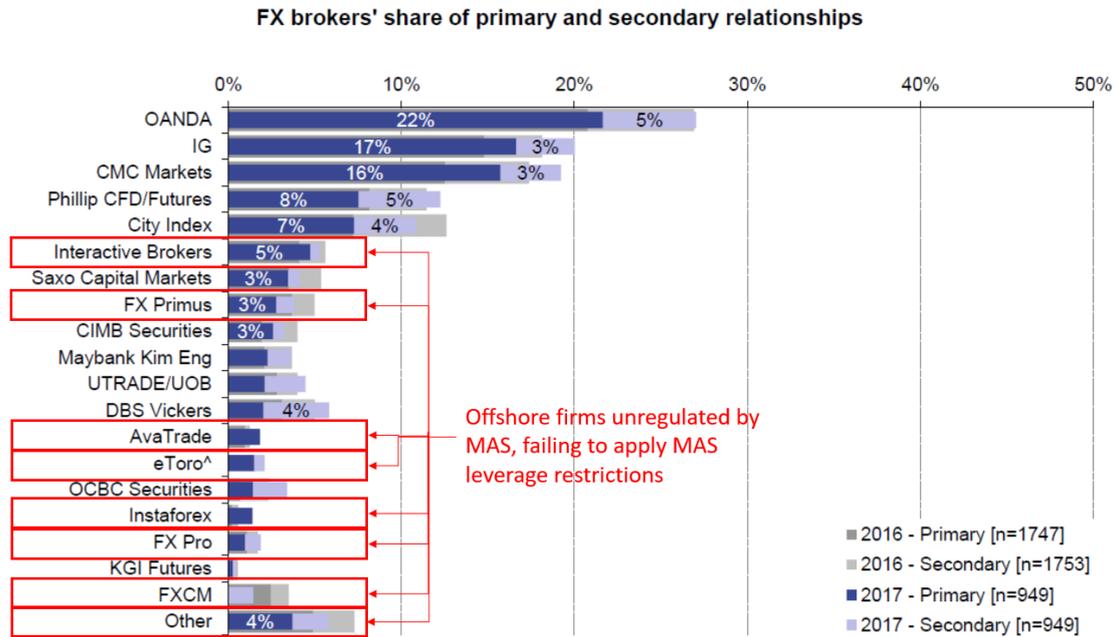


We think there are strong reasons to believe this figure of 28% represents a lower bound on the share of the retail Japanese market transacting offshore, owing to the sampling bias of surveying only IG clients (i.e. a pool of traders who by definition does not include those who have migrated the entirety of their business to unregulated offshore providers, and which also includes a population of traders (3.5% of the total) who went through a burdensome administrative process to declare themselves as Corporates, specifically in order to escape restrictions).

This willingness to trade offshore is particularly striking given that offshore providers typically charge three or four times the transaction fees of onshore providers. We think this huge differential in fees eloquently demonstrates the degree to which Japanese retail clients value access to leverage:

Provider	Location	USD/JPY Spread	Leverage
XM	Offshore	1 ~	888:1
FXDD		2	500:1
Titan FX		1.33	500:1
Axiory		0.4~	400:1
Land FX		0.8 ~	500:1
GEM Forex		1.2 ~	1000:1
SBI	Onshore	0.29	25:1
DMM		0.3	25:1
GMO		0.3	25:1
YJFX		0.3	25:1
FXTF		0.3	25:1
IG		0.3	25:1

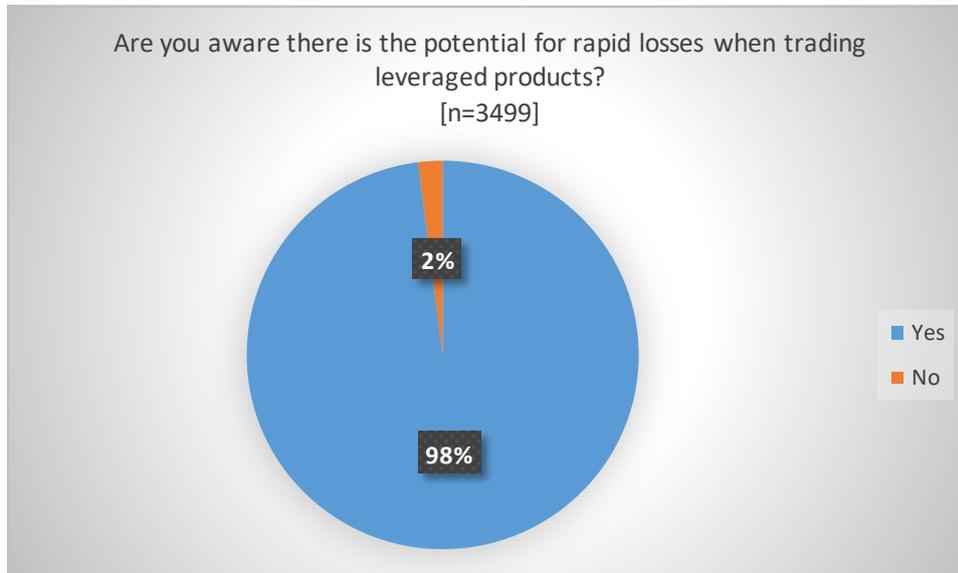
IG also has a regulated office in Singapore. The local regulator, MAS, applies leverage restrictions that are less aggressive than those applied in Japan (50:1 on FX, rather than the 25:1 imposed in Japan). Unlike the Japanese market, Singapore is actively surveyed by Investment Trends, Ltd. This survey evidence indicates that offshore firms control around 20% of the Singaporean FX market (by client number):



Appendix 3: IG client understanding of risk and reward

In early 2017 we asked Investment Trends Ltd to survey our clients on their awareness of the risk of CFD trading, and on their perception of how likely it was that they would be able to trade profitably.

98% of those who responded confirmed they were aware of the potential rapid losses when trading leveraged products:



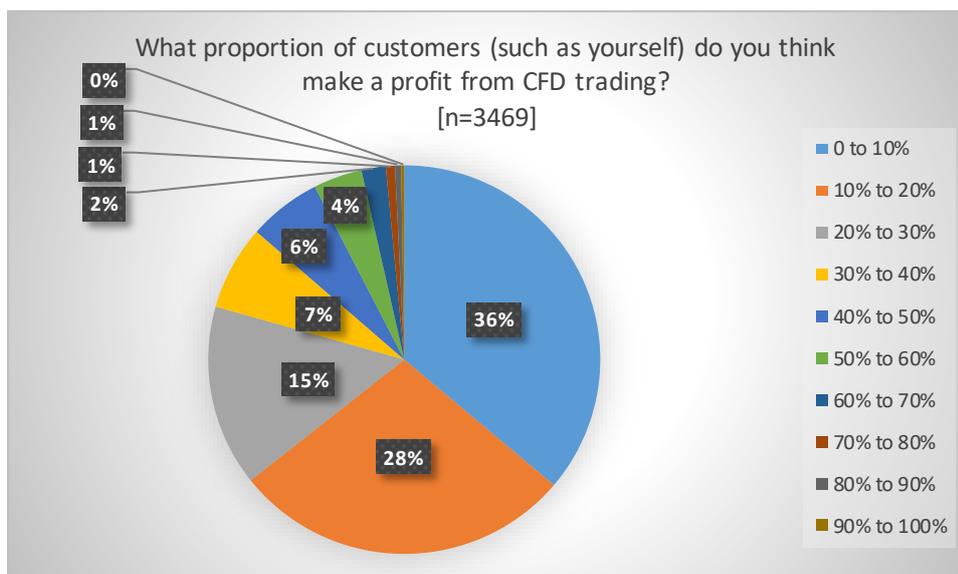
When we asked them what proportion of CFD traders *such as themselves* trade profitably:

36% believed that less than 10% of CFD traders are profitable.

64% believed that less than 20% of CFD traders are profitable.

92% believed that less than 50% of CFD traders are profitable.

The average estimate of probability of profitability, across all clients, was **20%**:



The actual proportion of profitable accounts across IG's European clients for the calendar year 2017 was **24%**. We believe this is likely to be very similar to the result for on-exchange futures traders, or for active traders of any other leveraged speculative financial product, such as warrants or turbos. Speculative trading is a zero sum activity and transaction costs act as a drag on performance, regardless of the instrument being traded. Though individual clients may register significant profits or losses, the average client P&L for IG clients in a typical year is a loss equal to the average transaction charges our clients choose to pay us over that year in order to gain exposure to financial markets.

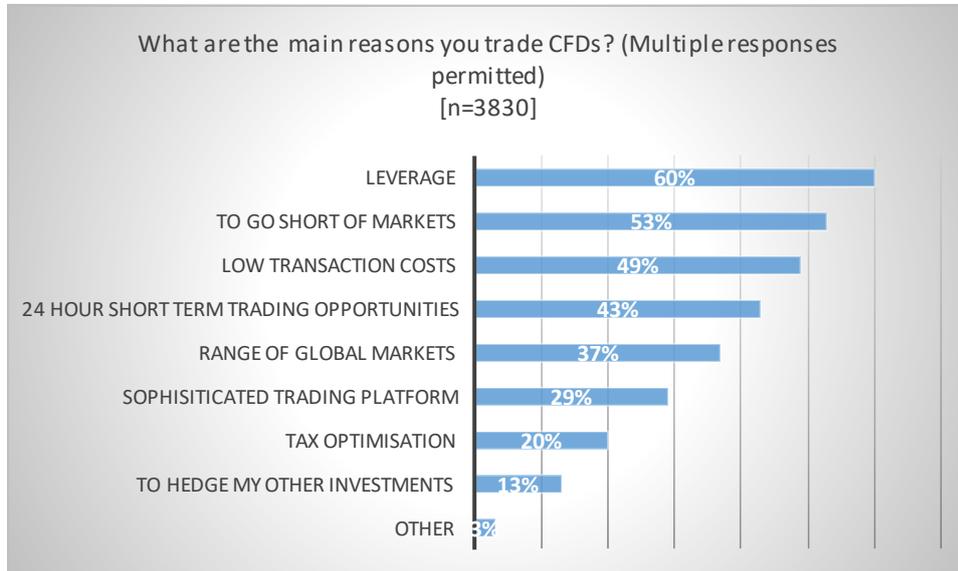
Our clients have no unrealistic expectations about the ease of trading. They trade, in part, precisely because to be a successful trader is a challenge, and they gain a positive utility and an intellectual satisfaction from their trading activity that is not directly correlated with overall profit or loss.

We believe this realistic view is common across clients recruited by all responsible CFD firms that operate under the regulatory oversight of an effective NCA. In its most recently published statistics, the UK's Financial Ombudsman Service ("FOS") reveals that it accepted 121 new cases related to CFDs from April 2017 to December 2017 and upheld only 27. This is in the context of, by the FCA's estimate, ~500,000 CFD traders worldwide who transact with UK firms each year and who are therefore eligible to lodge complaints, of whom 70%-80% would have been likely to have lost money. If the CFD clients of UK firms have a generally held expectation that they should make money from their CFD trading then this low level of complaints is inexplicable.

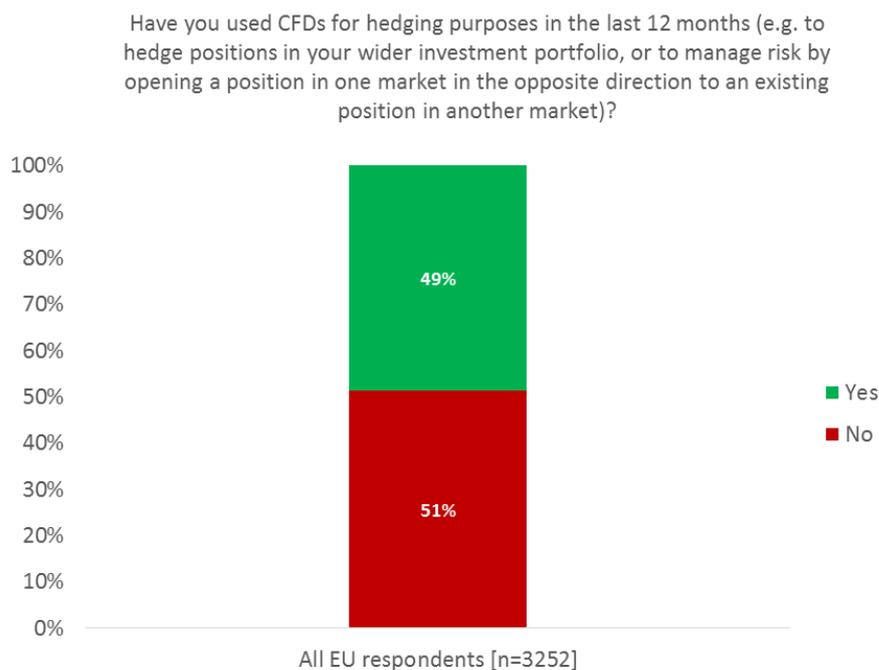
The FOS uphold rate (which is considerably lower than in most other sectors, and for much more vanilla products) would seem to suggest that the Ombudsman does not often conclude that customers have been misled by UK CFD firms into unrealistic expectations as to trading outcomes, or have failed to understand the risks associated with leverage.

Appendix 4: Use of CFDs to hedge

As part of the survey work carried out by Investment Trends in early 2017, clients were asked for their motivations for trading CFDs. 13% cited hedging as a main reason for their trading:



However, many clients use CFDs for hedging purposes from time to time, even if they would not nominate this activity as the main driver of the use of the product. The survey work carried out by Investment Trends in 2018 in the aftermath of ESMA's call for evidence demonstrates that a further 36% of clients fall into this category, leading to a total of 49% clients using CFDs to hedge over the course of a calendar year:



Appendix 5: Sophistication of retail CFD trading strategies

Our clients' engagement with the CFD product, and the degree to which they are likely to be driven to non-compliant providers by the proposed per-position margin rule, can be gauged from the sophistication of their trading strategies. Analysis of hourly snapshots taken over the period 13/01/18 to 19/01/18, over all EU retail clients (4.65 million snapshots in total), reveals that at any given time:

1. 70% of IG's EU retail accounts which are holding an open CFD position, hold multiple open CFD positions.
2. 52% of IG's EU retail accounts which are holding an open CFD position, hold multiple open CFD positions in different underlying assets.
3. 23% of IG's EU retail accounts which are holding an open CFD position, hold multiple open CFD positions in assets in entirely different asset classes.

Our client base also contains a population of 7,400 EU retail clients who traded CFDs on options during 2017, including several hundred retail clients habitually using CFDs on options to create complex multi-option strategies. We do not believe ESMA has devoted due consideration to how its proposed margin rules should operate with respect to this kind of business and are pessimistic, should ESMA proceed as contemplated, that such clients will be able to pursue their trading with EU-regulated firms in future.

Appendix 6: Size and commercial attractiveness of the EU retail CFD market

Investment Trends, Ltd analyses CFD market share for a number of CFD firms. From their estimates of IG's market share in key EU member states we are able to estimate a total number of retail CFD clients in the EU.

Results for the UK, France, Germany and Spain (below) suggest a total retail market across these countries of 304,000 individuals. For historic reasons IG has a high share (36%) of the UK market. We have a 22% share of the combined German, French and Spanish markets. If we assume IG's market share across the rest of the EU is also 22% this implies a market size of **378,000** retail clients.

Country	IG market share	IG retail clients	Total retail clients
UK	36%	69163	192119
Germany	20%	9876	49380
France	42%	8036	19133
Spain	15%	6530	43533
Total (Germany France & Spain)	22%	24442	112047
Rest of EU	<i>assume 22%</i>	16128	73934
Grand total	29%	109733	378100

If we assume that 33% of EU retail clients will seek their preferred leverage elsewhere, we can expect that 125,000 retail clients from the EU will begin trading with non-EU CFD firms within a short period of ESMA's action. These clients will be dealing with firms over which EU NCAs have no influence and which in many cases may be entirely unregulated.

IG on boards around 26,000 new retail clients across the EU each year and we conservatively estimate 33% of these, or 8,600 clients, will be diverted to non-EU providers if ESMA introduces the proposed measures. If we assume IG's share of new client flow is the same as its overall market share (29%), then 29,600 clients per year will be diverted out of the EU.

In actual fact IG's share of new client flow is certainly far lower than 29% (a figure which is driven by our firm's long history and strong position in the UK, rather than current marketing performance). Independent survey evidence from Investment Trends Ltd suggests IG's share of new clients in Europe is no higher than 22%, implying a diversion of at least 39,000 new retail clients per year to CFD firms based outside the EU.

The commercial opportunity for unregulated non-EU firms does not lie solely in the large number of clients that will be attracted to them. It is also the case that offshore providers offering high leverage will be able to charge much higher transaction fees

in exchange for that leverage. This is clearly demonstrated by the leverage offered, and fees charged, by providers who target the Japanese market (see appendix 2, above). This combination of high transaction fees and plainly excessive leverage is likely to drive extremely poor outcomes for the retail clients concerned, even in the absence of the poor execution practices and high pressure sales techniques that unregulated firms may resort to using.

Appendix 7: Ineffectiveness of marketing restrictions on non-compliant firms

The commercial impact of ESMA’s proposed measures will be to reduce the attractiveness to retail clients of EU-based CFD providers, at the expense of firms based outside the EU who would not be forced to implement ESMA’s disproportionate measures. EU firms’ client acquisition costs within the EU will rise as a result, whereas the client acquisition costs of unregulated non-EU firms would drop. This will change global marketing spend patterns, leading to a dramatic increase in the online share of voice in the EU of irresponsible, non-EU firms.

There is no practical way for NCAs to prevent the marketing of non-EU firms directed at EU retail clients. These firms can use a multitude of channels (including, but not limited to, paid search, social media, offline sports sponsorship, non-finprom “comparison tables” and optimised natural search) to ensure their marketing message reaches its intended audience. No NCA has the resources to monitor these channels effectively. Even if an NCA were to be allocated sufficient resources to monitor the problem, they would lack any effective tools to sanction non-EU firms, or to inhibit their activity to any significant extent.

This is well illustrated by the current situation in Belgium, where an outright ban on the marketing and distribution of CFDs has been imposed. A Belgian resident who googles the term “CFD brokers” will be confronted with a mixture of paid marketing, organic search results and comparison tables offering dozens of firms willing to accept Belgian clients:

Google – The current situation (Belgium – CFD Brokers) as seen on mobile device at Jan 2018



The best that NCAs can do is to issue warnings to consumers, and to maintain publicly available lists of known poorly behaving firms. Despite the best efforts of NCAs it is highly unrealistic to assume that typical retail consumers have any significant awareness of the existence of such warnings and blacklists.

Severe leverage restrictions will have much the same unintended consequences as a conventional marketing ban. Japan is a clear example of an online CFD market

that has been distorted by a set of disproportionate restrictions (the restrictions applied in Japan are almost identical to those contemplated by ESMA).

The screenshot below shows the results presented to a Japanese client who googles the terms “FX high leverage”. Almost every result is a comparison table that features a series of irresponsible firms that will have paid to be included in each comparison site. The comparison sites themselves are not paying to appear on google – rather, they have been optimised to appear as a natural search result. Even if the Japanese FCA were granted sweeping, and extraterritorial, powers to block conventional paid online marketing by offshore firms, we cannot see how they could inhibit this kind of natural search/comparison table approach.

Google – The Current Situation (Japan) as at Jan 2018

Key

- Financial promotion by FX comparison website promoting JFSA regulated firms
- SEO result from FX comparison websites promoting non-regulated FX firms
- SEO result from FX comparison websites promoting non-regulated FX firms
- SEO result from FX comparison websites promoting non-regulated FX firms
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Appendix 8: Full leverage analysis, capturing the impact of transaction fees

Evidence from our own clients (see appendix 9) suggests that leverage restrictions do not have the powerful effect on client behaviour that one might expect (we think ESMA assumes that the net result will be a reduction in trading activity, a reduction in mean loss per client and an increase in % profitable accounts. Our evidence does not support these assumptions).

Nevertheless, we strongly support the introduction of proportionate leverage restrictions. This is because proportionate leverage restrictions will protect clients from being “churned” by badly behaving firms. Churning occurs when a client is offered so much leverage that they are highly likely to be stopped out at a loss, for margin reasons, shortly after entering a position¹⁶. This practice allows irresponsible firms to avoid hedging client exposure (as the client exposure rarely survives for long). This boosts firms’ profits (because they are no longer paying fees to hedge), allows firms to operate with less capital (because they need pay no broker margin) and leads to a serious conflict of interest, where firms’ profits correspond directly to client losses (rather than reflecting transaction costs paid, as is the case at IG).

A key issue, therefore, is to determine at what level of leverage this “churning” effect becomes significant. This is the purpose of the analysis that follows.

Section A: Expected P&L, expected probability of profit in a market without transaction fees

In the absence of transaction fees, trading on even the highest leverage has no effect on (i) a trader’s average P&L or (ii) their probability of winning on any given trade, or series of trades.

Without transaction fees, a trader’s *average* P&L is always zero. A trader’s probability of winning a trade is driven entirely by their appetite for a large profit, relative to their tolerance for loss. The higher this appetite, the lower their probability of winning but the more they will win if the trade works out. In general our clients have a low appetite, leading to the result that most of their trades make money (but average profit size is smaller than average loss size). This would be true even if we never charged spread, commission or funding.

A trader who is willing to suffer a loss of £100 (or willing to deposit only £100) but will only take profits when they have a position that is winning £1000 will lose 10 times for each time they win. Net P&L = £1000 – (£100*10) = 0.

A trader who is willing to suffer a loss of £100 (or willing to deposit only £100) but will take profits whenever they have a position that is winning £10 will win 10 times for each time they lose. Net P&L = (£10*10) - £100 = 0.

It does not matter how high or low the leverage involved is, or how volatile the underlying market. This line of reasoning always applies in an efficient market.

¹⁶ Note that less than 2% of client positions held at IG are automatically stopped out because of a lack of margin

Without it a trader could derive infinite profits simply by selecting the “correct” target-win-size-to-loss-size ratio and placing an infinite series of trades with appropriately-distanced stop and limit orders against each one.

Section B: Impact of transaction fees on client outcomes

Transaction fees change this picture and are the true factor driving poor client outcomes.

Average client losses on any given trade or series of trades will, on average, be the sum of transaction fees paid (spread, commission and funding) over that trade or series of trades.

The probability of a client winning any given trade, or series of trades, remains primarily a function of their preferred take-profit size, relative to their tolerance for losses. However, trading fees reduce this probability of winning. At most levels of leverage, this reduction in probability is very small.

In cases of extremely high leverage, the transaction fees faced by the client begins to approach the value of the deposit charged. In these extreme cases, the probability of a client winning on a trade is materially distorted.

The average client loss on a highly leveraged trade will still be equal to transaction fees, on average. This is invariant to leverage, for a given characteristic trade size, and represents the price paid by a client to buy a desired market exposure.

However, under extreme leverage they will not be getting value for money for these fees. They will lose much more often (and win much more rarely) than they should expect, given their profit-to-loss size preferences. This is how extreme leverage results in a poor client outcome.

We can accurately model the size of this distortion of winning probabilities.

Define:

Round-trip transaction fees on trade = expected client loss on trade = s

Probability of losing trade = l

Deposit supporting trade = p

Targeted winning amount, as a multiple of deposit = r

Assume a trader will hold a position until either they lose their entire deposit or they are winning an amount equal to $r \times p$.

These variables are related as follows:

$s = [\text{probability of losing deposit} \times \text{size of deposit}] - [\text{probability of profit} \times \text{size of profit if it occurs}]$

$$s = lp - (1-l)rp$$

Or

$$I = (s+rp)/(p+rp)$$

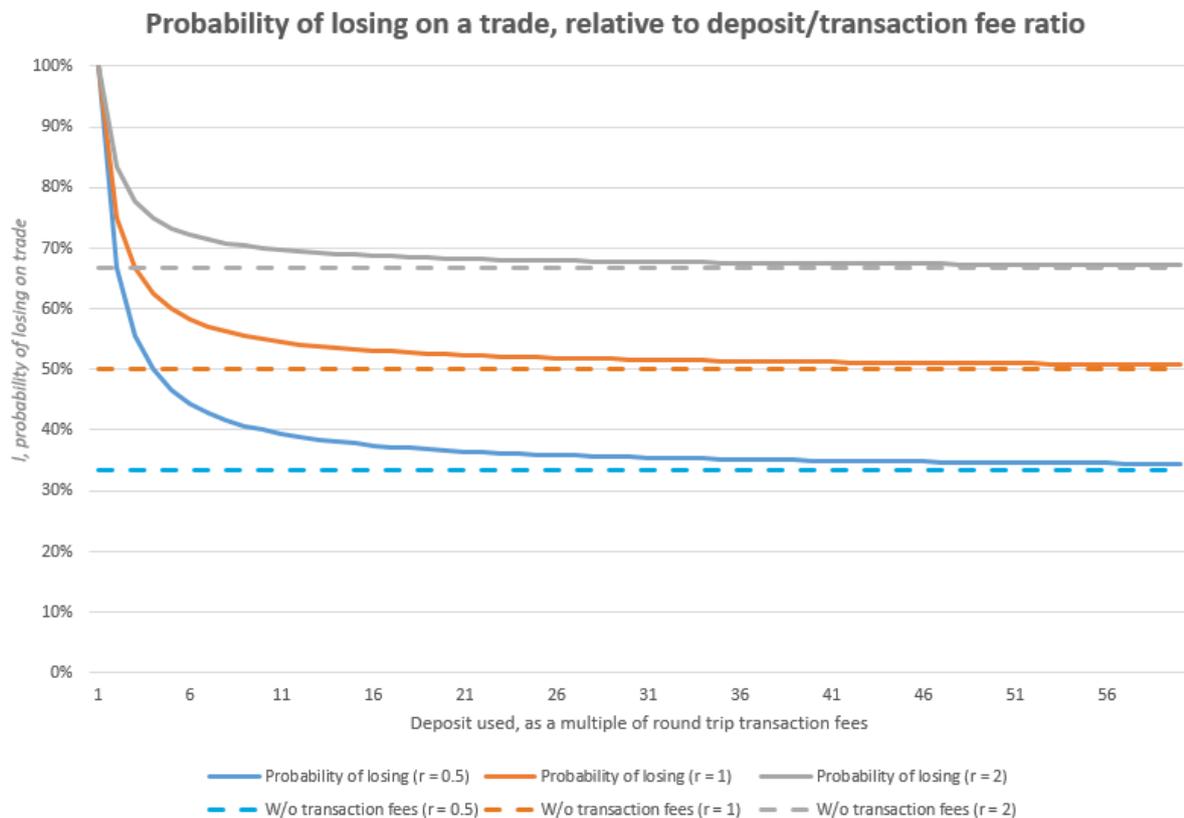
Or

$$I = (1+rx)/(x+rx)$$

(If we define the deposit used by the client in terms of multiples of transaction costs faced by the client ($x = p/s$)).

We can plot a chart of I for a range of different values of x and r .

When we plot I , the problem becomes clear:



Each horizontal *dotted* line shows the correct probability of loss for a client with a certain strategy, in an efficient market and in the absence of transaction fees:

Grey: Client aims to take profit of twice their deposit ($r=2$). Client therefore loses on 67% of occasions.

Orange: Client aims to take profit of equal size to their deposit ($r=1$). Client therefore loses on 50% of occasions.

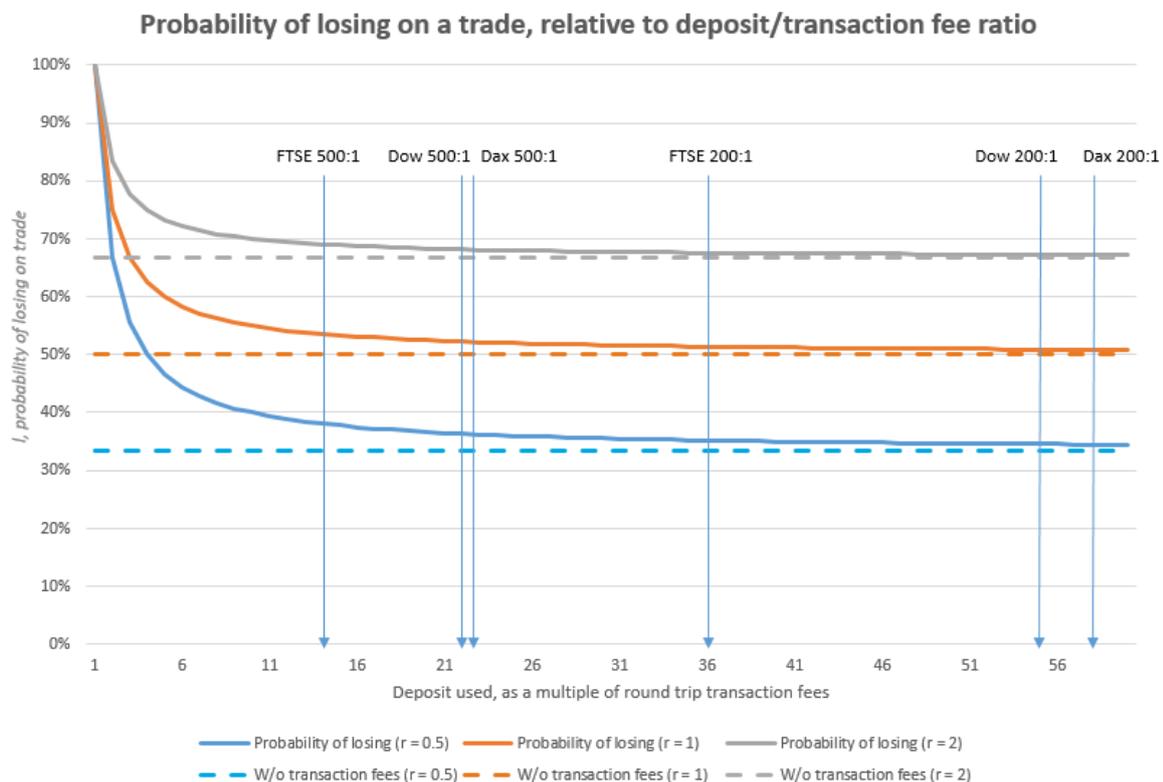
Blue: Client aims to take profit half as large as their deposit ($r=0.5$). Client therefore loses on 33% of occasions.

The equivalently coloured *solid* lines show what happens when transaction fees are brought into the reckoning. It is clear that, when the deposit used is of the same order of magnitude as the transaction fees charged, the probability of losing on a position diverges from the costless trade probability, dramatically so as the {deposit size}:{transaction fees} ratio shrinks below 10:1. In extremis, when the ratio is 1:1 (i.e. deposit used is equal to transaction fees) the client is instantly stopped out as soon as they trade, 100% of the time and has no possibility of profiting, regardless of trading strategy.

This effect is independent of market volatility. The analysis is constructed around client outcomes, not around assumptions of counterparty credit risk. The distortion of win/loss probabilities is driven wholly by transaction fees in each market and the client's deposit size and take-profit strategy.

Section C: Assessment of leverage currently offered, in context of transaction fees charged

We have marked on the chart below vertical arrows representing the deposit/transaction fee ratio for a client trading 3 different markets (FTSE, Dow and Dax), using a deposit size that is equivalent to each indicated leverage ratio and paying IG's typical transaction fees. A market with a relatively high transaction fee, traded on very high leverage, puts clients into a position where their chance of losing is significantly higher than it ought to be, and significantly higher than they might expect:

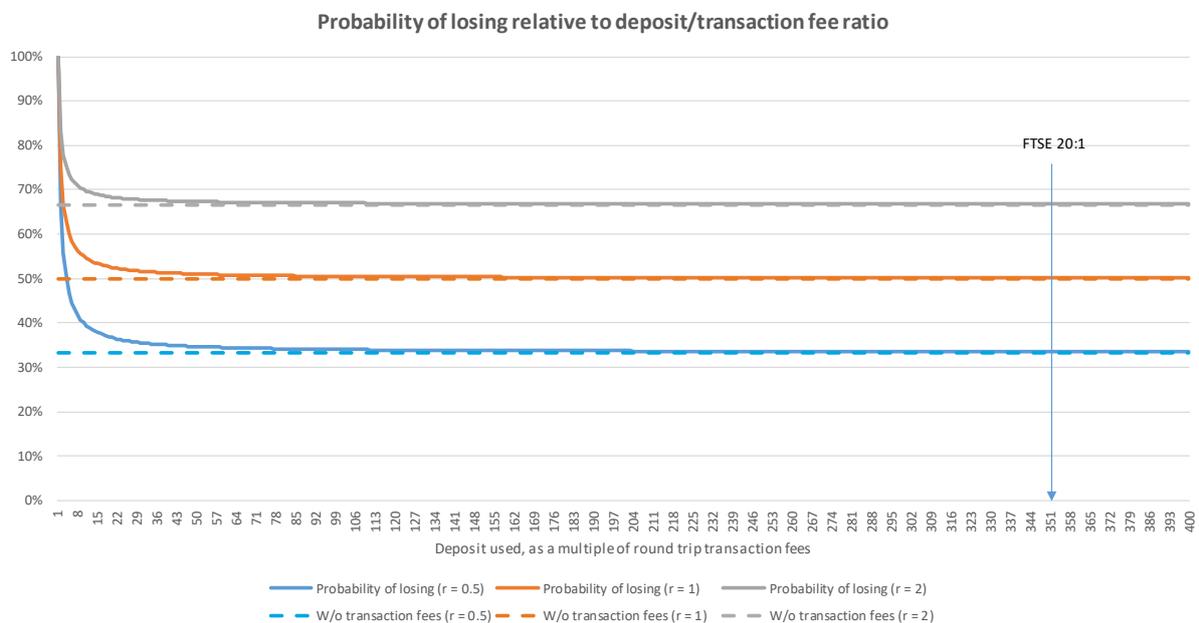


We believe our current leverage limit of 200:1 on major indices protects clients from a distorted win/loss probability even for a market with a relatively large transaction fee (FTSE).

Any firm that allows ultra-high leverage, and/or significantly increases apparently low transaction fees by charging very high overnight funding or “admin” charges is effectively forcing clients toward the danger zone at the left hand edge of the chart. This is an example of poor practice that is intuitively easy to understand, even without this theoretical framework, as a “churn and burn” business model.

Zooming out, as we do in the table and chart below, it can be seen that the further mitigation provided by the extreme leverage restrictions proposed by ESMA is minimal:

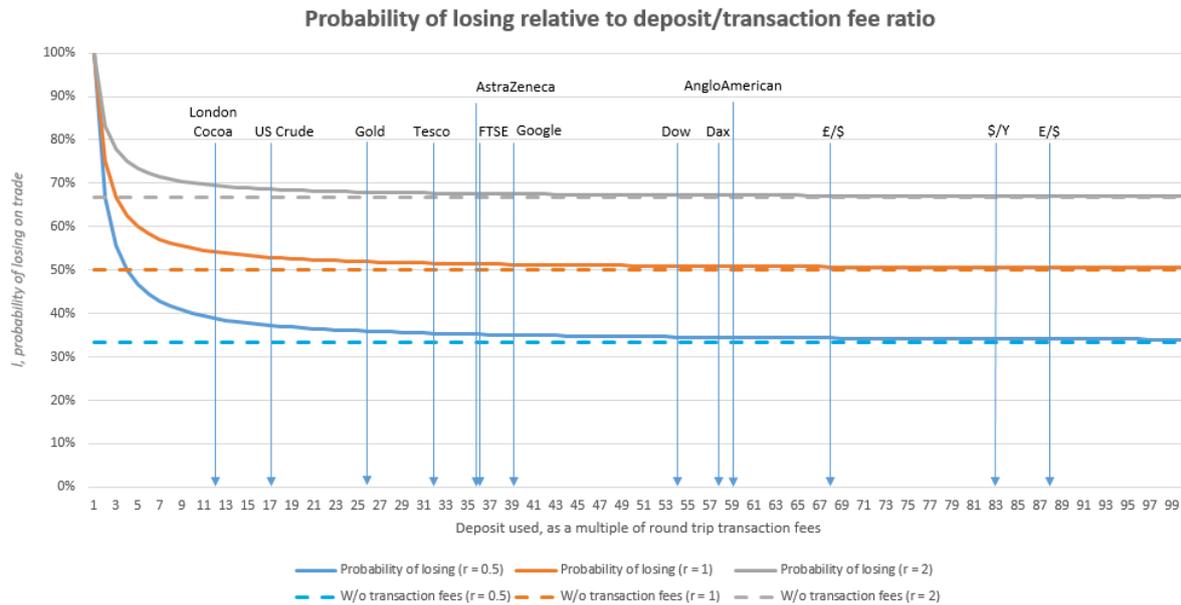
FTSE, r=0.5	Probability of losing trade
Costless Trade	33%
500:1, with fees	38%
200:1, with fees	35%
100:1, with fees	34%
50:1, with fees	34%
20:1, with fees	34%



There is no meaningful impact on client outcome, defined as a distorted loss probability, from tightening leverage restrictions beyond 100:1. There is, however, a steadily increasing opportunity for regulatory arbitrage created by such tightening,

and a consequent steadily increasing probability of unintended negative outcomes for the EU retail market.

We can carry out this analysis across IG's product range, to examine the interaction between costs and leverage for products other than equity indices:



It can be seen from this that, barring some commodities with high transaction costs, IG's current maximum leverage regime (200:1 in major indices and FX, 20:1 for major equities, 10:1 down to 4:1 for smaller equities) protects our clients effectively, given the current level of our transaction fees.

A maximum leverage of 40:1 on commodities would unambiguously place all of IG's major commodity markets outside the corrosive zone where probability of winning a trade departs significantly from the theoretical probability in the absence of fees.

This analysis does not assume an aggressive 50% per-position automated close out approach. The impact of such an approach would be to reduce these safe leverage levels by half, as a client is effectively forced to trade out of a position earlier than might otherwise be the case, potentially leading to distorted win/loss probabilities. Even at a 50% reduction, though, this analysis suggests that clients are protected from distorted outcomes by restrictions of 100:1 for FX and equity indices, 20:1 for commodities, 10:1 for major individual equities and 5:1 for smaller individual equities.

Appendix 9: Impact of leverage restrictions on IG client outcomes

Although we have no visibility on the evidence that ESMA may be using to support its proposed level of leverage restrictions, we are aware that a number of NCAs, including the FCA in the UK, have previously put forward proposals influenced by comparisons between typical client outcomes in Japan (where leverage is heavily restricted) and those experienced by EU clients.

The table below gives results for IG retail clients in Japan vs. the EU, for calendar year 2017. We have controlled for differences in asset class preferences by isolating the results of FX traders (most Japanese clients fall into this category). The table shows an entirely typical difference in performance between the two populations:

Territory	Number of FX clients	Mean transaction fees paid	Mean client P&L (including transaction fees)	% winning accounts
Japan	4,984	£129	-£97	49%
EU	62,049	£1,196	-£488	30%

Japanese retail clients, trading under leverage restrictions that are almost identical to those proposed by ESMA, apparently trade far less than EU clients (paying, on average, £129 in spread and funding over the course of 2017, compared to the £1,196 paid by the average EU FX trader).

The average loss of Japanese clients is also far less than for EU clients (£97 over the course of the year, rather than £488).

49% of Japanese FX clients made money in 2017, vs. only 30% of EU FX clients.

This appears to be the strongest possible confirmation that ESMA's proposed restrictions will have a very significant impact on client behaviour, leading to a very significant positive impact on client outcomes for EU clients.

However, this conclusion is incorrect. Care must be taken to ensure the comparison is not distorted by the significant structural differences of the Japanese retail market. Specifically, account must be taken of the widespread tendency of Japanese clients to engage in the "FX carry trade", where clients establish an FX position where they are short Yen (and thus pay a very low level of interest) and long of a high yielding currency (such as Brazilian Real). This tendency to carry trade is a longstanding feature of the Japanese market, driven by the history of low returns for Yen-denominated investments. It long predates the imposition of leverage restrictions.

Carry-trading clients are of a different nature to the typical retail clients who choose to trade FX with IG. They (carry traders) very rarely trade, but instead hold static positions where they collect the interest differential on those positions. Because they pay few transaction costs, and receive net interest, they tend to be quite profitable over extended periods of time (though can lose enormous amounts once every few years, for example if/when the Brazilian Real collapses against the Yen).

A very significant number of Japanese clients engage in FX carry trades, while almost no EU clients do so. This has the effect of boosting the average performance of Japanese clients with respect to EU clients. But this difference in outcome is not the result of the leverage restrictions that are in effect in Japan.

The table below applies a clean analysis of clients trading with IG over the course of 2017. We have removed carry traders from the population in each territory by separating out clients who “paid” negative fees over the year (fees in this context are the sum of bid/ask spread paid, plus funding paid, less funding received on positions with a negative interest rate differential. The only way to achieve a net negative result on fees paid is to be a carry trader). This treatment is not perfect, as many speculative Japanese clients may also place some carry trades, boosting their apparent performance:

Client type	Territory	Number of FX clients	Mean transaction fees paid	Mean client P&L (including transaction fees)	% winning accounts
Speculative Traders	Japan	3,384	£1,345	-£667	41%
	EU	60,720	£1,237	-£437	30%
Carry Traders	Japan	1,600	-£2,442	£1,107	66%
	EU	1,329	-£673	-£2,803	39%

Please note the following points:

1. At least 32% of Japanese FX clients are carry traders, against 2% of EU FX clients.
2. Once carry traders are (mostly) removed from the sample for each jurisdiction, leaving a population of speculative FX traders, it can be seen that Japanese speculative FX traders traded as actively as EU FX traders during 2017 (i.e. they paid almost equal amounts of transaction fees) and experienced a significantly higher mean loss than EU FX traders.

The first point, taken with the fact that FX is overwhelmingly the most popular asset class in Japan, means that overall Japanese CFD client outcomes cannot be directly compared against overall EU CFD client outcomes.

The second point reveals that the leverage restrictions imposed by the JFSA, which are almost identical to those contemplated by ESMA, have had no significant positive impact on mean client outcomes. This data suggests that proposed leverage restrictions will not have the impact on clients that ESMA envisages (though, as other evidence in this response demonstrates, the restrictions can reasonably be expected to drive significant counterproductive negative outcomes in the form of market migration).

Note that, in paying an equivalent amount of transaction fees, the leverage-restricted Japanese clients have traded far *more* notional than EU clients – the competitive nature of the Japanese market is such that transaction fees per \$m are much lower than elsewhere in the world.

Despite this, it could be possible to point to the higher probability of profitability of Japanese clients, even after correcting for carry traders, and take that statistic as supportive of the positive impact of leverage restrictions. The problem with this line of argument is that (i) intense local competition means that Japanese traders pay lower transaction fees per trade, boosting their profitability probability regardless of leverage used (see analysis in appendix 8), and (ii) not all carry trading has been removed from the sample – the “speculative traders” line will still be boosted by the impact of long term carry trades carried out by traders who nevertheless paid positive net transaction fees overall.

We can derive a cleaner view of the impact of leverage restrictions on % likelihood of account profitability by comparing the results for IG’s FX retail clients, in various jurisdictions, with the publically declared statistics of the specialist FX brokers that dominate the US market. The table below gives this comparison:

	Maximum permitted leverage	2016 Q1	2016 Q2	2016 Q3	2016 Q4	2017 Q1	2017 Q2	2017 Q3	2017 Q4	Mean
FXCM*	50:1	28%	29%	33%	-	-	-	-	-	30%
GAIN CAPITAL GROUP LLC	50:1	29%	29%	32%	28%	36%	31%	32%	33%	32%
OANDA CORPORATION	50:1	35%	34%	38%	34%	38%	33%	34%	33%	35%
IG EU (FX clients only)	200:1	30%	33%	35%	31%	37%	32%	33%	38%	33%
IG Singapore (FX clients only)	50:1	28%	34%	43%	32%	43%	33%	32%	37%	35%
IG Japan (FX clients only)	25:1	27%	26%	46%	36%	43%	54%	55%	51%	42%

*FXCM exited US market Q3 2016

There is no difference in the % of profitable accounts between US FX clients (trading on 50:1 leverage), EU IG FX clients (trading on 200:1 leverage) and Singaporean IG FX clients (trading on 50:1 leverage). With respect to IG’s Japanese FX clients, the overall impact of the carry trading tradition and particularly low transaction fees is to raise % profitable accounts by around 8% relative to other FX clients at IG. Note, however, how this percentage of profitable traders drops very significantly in periods of Yen strength (such as the first half of 2016).

Appendix 10: Assumptions necessary to derive ESMA's current proposals

Under the analytical framework developed in appendix 8, above, we would argue that a deposit/transaction fee ratio of less than 30 leaves a client open to “churning”, i.e. to an unacceptably high distortion in the win/loss probability implied by their preferred trading strategy. If we further conservatively assume a strict per-position margining policy where positions are closed out at 50% margin this moves the critical deposit/transaction fee ratio to 60.

The table below gives the per trade transaction fee that must be assumed to push clients into the “danger zone” where they are trading on a deposit/transaction fee ratio of less than 60, given ESMA's proposed margin requirements in some of our key products:

Market	ESMA proposed minimum margin requirement	Transaction fee required to push client into danger zone, given ESMA minimum margin	Typical round trip transaction fee, in reality	Ratio of disproportionality
Dax	5%	0.08%	0.009%	9.6x margin necessary
E/\$	3.33%	0.06%	0.006%	9.7x margin necessary
Gold	5%	0.08%	0.027%	3.1x margin necessary
WTI Crude	10%	0.17%	0.058%	2.9x margin necessary
Google	20%	0.33%	0.130%	2.6x margin necessary
AstraZeneca	20%	0.33%	0.138%	2.4x margin necessary

Under this framework, ESMA has overstated the necessary margin requirements by a factor of 2 or 3 for equities and commodities, and by a factor of 10 for major indices and FX pairs. ESMA has gone far further than could be justified with reference to any reasonable client protection concern based around distorted win/loss probabilities, particularly in the case of low volatility, low transaction fee asset classes such as equity indices and FX.

We do not know the details of ESMA's analysis, but we conclude from the above table and from the wording in the call for evidence that it has been carried out using a completely different conceptual framework.

We do not believe that ESMA's contemplated restrictions are based around traditional volatility-based credit risk models (which of course are designed to protect firms rather than clients), or around protecting clients from very large losses (which is clearly the motivation of its no-negative proposals).

Instead, we imagine ESMA is motivated by a central assumption: that, by insisting that firms charge their clients a very large amount of margin, retail clients with limited

financial resources, for whom CFDs are inappropriate, will respond by reducing their trade size or, possibly, by not trading CFDs at all. ESMA has picked large minimum requirements in key asset classes, and then has applied an approximate rule of thumb, varying the amount charged in other asset classes by reference to each asset class's historic market volatility.

We are sympathetic to ESMA's central assumption, and to its motivation in putting forward proposals in this area. We support all proportionate measures aimed at keeping CFDs out of the hands of retail clients for whom CFDs are inappropriate. It is certainly the case that an increase in required margin will inhibit CFD trading to some extent, and that this inhibitive effect will be strongest on those who may not have sufficient resources to be using CFDs. Taken in isolation, this inhibition of trading for retail clients with few resources is clearly a good policy outcome. However, we observe the following:

- (i) We cannot see how this approach can lead to an objective, evidence based recommendation for proportionate leverage limits. If ESMA is to come to an objective conclusion on appropriate leverage measures it must consider evidence on the likely client behavioural response to variations in available leverage. These behavioural responses will be positive (retail clients for whom the product is inappropriate trading less) and negative (inhibition of hedging activity, and market flight to non-EU providers). Without this evidence, the precise level of leverage limits can only ever be an arbitrary decision. This arbitrary decision may result in much larger negative impacts than positive impacts, to the overall detriment of EU retail clients.
- (ii) Our evidence on the client response to ESMA's proposals suggest that, for this particular proposal, ESMA may have got the balance wrong. Leverage restrictions spark client migration wherever they are imposed. Evidence from the trading behaviour of our client base suggests it is not clear that leverage restrictions powerfully impact client outcomes such as likelihood of profitability, or mean P&L. Restrictions, in our view, are certainly necessary in order to protect clients from being churned by irresponsible firms. Our analytical framework provides a robust way of identifying the proportionate level of restriction needed to address this particular issue.
- (iii) This is not the best tool for achieving ESMA's client protection aim. It represents an example of addressing a provider problem (firms marketing to, and on boarding, clients for whom CFDs are inappropriate) by attacking a product (CFDs themselves). It is by attacking the product rather than the providers that ESMA is creating the risk of unintended negative consequences. ESMA's proposed risk warnings, coupled with robust enforcement by NCAs of ESMA's Q&A on the provision of CFDs and the target market provisions of the newly introduced product governance rules, are a better way of addressing the provider problem, are free from unintended client migration consequences and would not impact on the legitimate trading activity of retail clients for whom CFDs are an appropriate trading and hedging tool.