

## The provision of services relating to binary options

Regulation

- Act No. 256/2004 Coll., on capital market undertakings, as amended (**Act**)
- Decree No. 303/2010 Coll., on the details of certain rules in the provision of investment services (**Decree**)

Provisions

- Articles 3, 4, 15d(1)(c), 15h, 15i, 15k, 15l and 15n of the Act
- Articles 19(1)(a) and 19(2) of the Decree

Question

**Are binary options a financial instrument?**

Answer

Binary options are instruments that allow speculating on an increase or decrease in the value of an underlying asset, typically the exchange rate of a currency or combination of currencies.<sup>1</sup> The binary option has only two possible outcomes, as the investor, having paid the initial deposit (option premium) for his investment in the binary option, usually

- either – if he is successful in his investment, i.e. if he correctly predicts the movements in the value of the underlying asset – receives a predefined fixed amount of money<sup>2</sup> when the option expires, which, net of the option premium, represents his profit,<sup>3</sup>
- or – if he is unsuccessful – loses the option premium, which represents his loss.<sup>4</sup>

Despite having the obvious characteristic of a bet (which is more or less the case for all derivatives), binary options are instruments that satisfy the usual features of a derivative,<sup>5</sup> i.e.

- (a) settlement is postponed compared to a usual prompt (spot) transaction (associated with waiting for price movements in the future);
- (b) the yield is derived from the movement in the price of the underlying asset;
- (c) leverage is present, resulting in a larger response to movements in the price of the underlying asset than in the case of a direct holding of the underlying asset (it is sufficient that this is a usual feature).

Options derived from exchange rates, which are most common in practice, are always financial instruments, whether settled in cash or by delivery of the underlying asset (Article 3(1)(d) of the Act).

The European Commission also considers binary options to be financial instruments pursuant to Annex 1 Section C of the MiFID.<sup>6</sup>

**Binary options are thus typically financial instruments pursuant to Article 3(1) of the Act.**

An important aspect of investing in binary options is that, unlike, for example,

<sup>1</sup> Identically e.g. the European Commission: “[...] private contracts between the client and the Investment Firm [...] [t]hrough these [...] clients can speculate on which direction the price of an underlying product will move within a specified time frame.”. See: <http://ec.europa.eu/yqol/index.cfm?fuseaction=question.show&questionId=1095>

<sup>2</sup> For the most common binary options, referred to as call/put or high/low options, this amount is almost double the option premium.

<sup>3</sup> The potential profit on these transactions is often expressed as a percentage based on the ratio of the potential profit to the option premium. For example, if the option premium is €10 and a successful investor is paid €18.5, i.e. his profit is €8.5, then the percentage profit will be “85%”.

<sup>4</sup> We disregard the third possible outcome where the value of the underlying asset is equal to the reference price upon expiry (the option is “at the money”) and the investor makes neither a loss nor a profit, except for fee expenses.

<sup>5</sup> However, it may not satisfy the usual characteristics of an option, as the option of exercising the right of sale/purchase of the underlying asset is absent from these instruments, i.e. the underlying asset is not transferred.

<sup>6</sup> See the answers of the European Commission to questions regarding the single market in respect of the MiFID (ID 995 and ID 1095) available here:

<http://ec.europa.eu/yqol/index.cfm?fuseaction=question.show&questionId=955>  
<http://ec.europa.eu/yqol/index.cfm?fuseaction=question.show&questionId=1095>

shares or bonds, for which the probability of success can be increased by suitable analysis of the available data, binary options are usually based on very short expiration times. It is thus usually impossible to analyse relevant data. Generally, the success of investing in binary options requires the use of advanced statistical and mathematical methods, which are not usually available to retail investors. The success of individual investors depends on their knowledge and experience and also on their access to technical and analytical facilities. However, based on the probability in a long series, an investor's probability of success or failure will be close to 50%. For options with a 50% probability, it thus holds that any fee or any unfavourable ratio of the premium to the potential profit will result in the investor incurring losses in the long run.

We also deem it necessary to mention that **the provision of core investment services relating to derivative financial instruments, and thus also to binary options, is reserved for investment firms** (Articles 4a and 5(1) of the Act) as investment intermediaries and their tied agents are not authorised to provide or broker these investment services (Articles 29(1) and 32a(1) of the Act).

Question

**May investment firms offer binary options to non-professional (retail) clients, and if so, under what conditions?**

Answer

Generally, the Act does not prevent investment firms from offering binary options to (retail) clients. However, in the case of complex instruments, including binary options, an investment service provider is obliged to assess the appropriateness or suitability of the investment for the specific non-professional client (*a contrario* Article 15k(1) of the Act), as the provision of a service related to binary option without these tests ("execution only") is ruled out due to derivative nature of these options. **For most non-professional clients, investment in binary options will not be in line with their knowledge and experience.**

If an investment firm wishes to offer a specific client investment in binary options, he must, among other things, assess that the provision of the investment service relating to binary options corresponds to the client's knowledge and experience ("appropriateness test", Article 15i(2) of the Act). **The necessary knowledge includes knowledge of probability theory and the ability to apply it to specific transactions in binary options.** Each provision of the service of transmission or execution of an order to purchase a binary option, or to execute a transaction for the investment firm's own account, must pass the appropriateness test. In addition, investment advice may be provided in respect of binary options, subject to a suitability test (Article 15h of the Act) where the client's investment objectives and financial situation are taken into account in addition to his knowledge and experience.

Besides the above requirement to assess the necessary knowledge and experience in an appropriateness test, the client must also be informed about the reference price formation mechanism and about the source of data used to determine the reference price. This arises from the duty to provide information about "the nature and features of the financial instrument" (Article 15d(1)(c) of the Act and Article 19(1)(a) of the Decree) as **information about the source and formation of the reference price and the source of data constitutes essential information about the features of the relevant binary option.** Knowledge of the determination of the reference price may be critical to the success or failure of the client's transaction. We therefore consider the requirement to provide detailed information about the inputs used to calculate the price to be consistent with the nature and features of this financial instrument and necessary for making an informed investment decision (Article 19(2) of the Decree).

Significance of the answer for

This answer expresses the opinion of Czech National Bank staff members. The courts and the Bank Board of the Czech National Bank may be of a different

those to which it is addressed opinion. When performing financial market supervision, however, the Czech National Bank will consider action that is in accordance with the answer – within the bounds of the answer and its assumptions – to be action that is in accordance with the law, unless it is apparent from the circumstances that the answer is not applicable to the case in question.

Contact person: Pavel Maránek, [pavel.maranek@cnb.cz](mailto:pavel.maranek@cnb.cz)  
Date: 14 October 2015