

**PUBLIC NOTICE**

**on the issuance of a**

**MEASURE OF A GENERAL NATURE**

**regarding product intervention in relation to contracts for difference**

**of 25. 7. 2019**

The Czech National Bank (hereinafter the “CNB“), as the competent authority in the Czech Republic in accordance with Article 192a(1)(h) of Act No. 256/2004 Coll., on capital market undertakings, as amended (hereinafter the “ACMU”), in connection with Article 42 of Regulation (EU) No 600/2014 on markets in financial instruments (hereinafter “MiFIR”), issues, based on Article 136(1)(r) of the ACMU, in connection with Article 42(1) of MiFIR, this measure of a general nature in accordance with Article 171 et seq. of Act No. 500/2004 Coll., the Administrative Code, as amended:

- 1. Investment firms in accordance with Article 2(1)(1) of MiFIR and credit institutions in accordance with Article 2(1)(19) of MiFIR (hereinafter referred to jointly as “Investment Firms”) are prohibited from marketing, distributing and selling contracts for difference to Non-professional Clients in the Czech Republic and from the Czech Republic; this does not apply if the following conditions are met simultaneously:**
  - a) the initial margin for a Non-professional Client is set in an amount in accordance with Annex I;**
  - b) a contract for difference provider provides a Non-professional Client with initial margin protection;**
  - c) a contract for difference provider provides a Non-professional Client with margin close-out protection;**
  - d) a contract for difference provider provides a Non-professional Client with negative balance protection;**
  - e) a contract for difference provider does not provide a Non-professional Client, directly or indirectly, with any payment, monetary or non-monetary benefit in relation to the marketing, distribution or sale of a contract for difference, with the exception of**
    - profits realised from a contract for difference provided; and**

- **information and analytical tools, provided they relate to contracts for difference;**
  - f) **a contract for difference provider states in information to which a Non-professional Client has access and that concerns the marketing, distribution and sale of contracts for difference a warning in accordance with Annex II while complying with the rules in part A of Annex II.**
2. **For the purposes of this measure of a general nature the below terms are defined as follows**
- a) **“contract for difference” is a derivative that is a financial instrument in accordance with Directive 2014/65/EU of the European Parliament and of the Council on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, other than an option, future, swap or forward rate agreement, the purpose of which is to give the holder a long or short exposure to fluctuations in the price, level or value of an underlying asset and that must be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event;**
  - b) **“initial margin” means any payment for the purpose of entering into a contract for difference, excluding commission, transaction fees and any other related costs;**
  - c) **“initial margin protection” means the minimum initial margin determined by the share of the total notional value of the contract for difference (the determination of the maximum limit of leverage) in the amount set in Annex No. I;**
  - d) **“margin close-out protection” means the closure of one or more of a Non-professional Client's open contracts for difference positions on terms most favourable to the client in accordance with Article 15 et seq. of the ACMU when the sum of funds in the contract for difference trading account and the unrealised net profits of all open contracts for difference connected to that account falls to less than half of the total initial margin protection for all those open contracts for difference;**
  - e) **“negative balance protection” means a limit on a Non-professional Client's liability for all contracts for difference connected to the contract for difference trading account of such Non-professional Client to the funds in that contract for difference trading account;**
  - f) **“non-professional client” is a client other than a professional client in accordance with Article 2a or Article 2b of the ACMU;**
  - g) **“contract for difference provider” means an investment firm that agrees a contract for difference with a client on its own account.**

## Justification

### 1. LEGAL FRAMEWORK

1. In accordance with Article 42 of MiFIR, the competent authority of a Member State can, in the Member State or from the Member State, prohibit or restrict the marketing, distribution or selling of certain financial instruments,<sup>1</sup> financial instruments with certain set characteristics or a certain type of financial activities or practices, if it reasonably believes that a financial instrument, structured deposit or activity or practice gives rise to significant investor protection concerns. When doing this, it will take into consideration the criteria and conditions for the prohibition or restriction stated therein. A more detailed definition of some criteria is contained in Article 21(2) of Regulation (EU) 2017/567, supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council with regard to, inter alia, supervisory measures on product intervention and positions. Such **measure** can have a preventative nature (conclusion of Article 42(1) of MiFIR: “Where the conditions set out in the first subparagraph are fulfilled, the competent authority may impose the prohibition or restriction referred to in paragraph 1 on a precautionary basis before a financial instrument or structured deposit has been marketed, distributed or sold to clients.”).
2. In accordance with Article 1(2) of MiFIR, the regulation “applies to investment firms authorised under Directive 2014/65/EU and credit institutions authorised under Directive 2013/36/EU of the European Parliament and of the Council when providing investment services and/or performing investment activities and to market operators including any trading venues they operate,” (with the deviations specified below, which, however, do not concern the scope of Article 42 of MiFIR).<sup>2</sup>
3. The competent authority in the Czech Republic in accordance with Article 42 of MiFIR is the CNB, based on Article 192a(1)(h) of the ACMU.
4. For the purpose of complying with Article 42 of MiFIR, the CNB is entitled, in accordance with Article 136(1)(r) of the ACMU “to suspend the marketing or sale of investment instruments or structured deposits if the conditions stipulated in Article 40 to 42 of Regulation (EU) No 600/2014 of the European Parliament and of the Council are met”.
5. This measure concerns an uncertain group of persons, but it is, in accordance with MiFIR, a supervisory measure limited only to a certain type of financial instrument (contracts for difference). It is therefore not a legal regulation and in Czech law it is a measure of a general nature in accordance with Article 171 of the Administrative Code. The necessity of a material assessment of the characteristics of a measure of a general nature is confirmed, inter alia, by case law of the Constitutional Court (file ref. Pl. ÚS 19/11). This measure is different to a legal regulation, inter alia, through the CNB’s duty in accordance with Article 42(6) of MiFIR: “The competent authority shall revoke a prohibition or restriction if the conditions in paragraph 2 no longer apply.”
6. The duty in accordance with Article 42(6) of MiFIR also means that a “prohibition” or “restriction” in accordance with Article 42(1) of MiFIR is identical to “suspending” in accordance with Article 136(1)(r) of the ACMU, as in both cases it is a prohibition valid

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<sup>1</sup> In MiFIR a financial instrument is understood to mean the instruments defined in Czech law as investment instruments in accordance with Article 3 of the ACMU.

<sup>2</sup> The term “Investment Firm” corresponds, in Czech law, to the terms (1) securities dealer, (2) foreign person that has a license from the supervisory body of another European Union Member State for the provision of investment services, and (3) foreign person in accordance with Article 28(1) of the ACMU (i.e. a person from a country that is not a European Union Member State) that provides investment services in the Czech Republic through a branch. The term “Credit Institution” corresponds, in Czech law, to a bank and a foreign bank (and also a savings and loan co-operative).

“*until rescinded*”, or rather until a change to the conditions or until the execution of a remedy, but not a permanent prohibition.

7. In accordance with Article 199(6) of the ACMU, the CNB publishes a draft measure of a general nature in accordance with the ACMU and a measure of a general nature in accordance with the ACMU only in a manner enabling remote access.

## 2. CURRENT MEASURES AT THE EUROPEAN UNION LEVEL

8. In Decision (EU) 2018/796 of 22 May 2018 the European Securities and Markets Authority (ESMA) restricted the marketing, distribution or sale of contracts for difference to Non-professional Clients valid from 1 August 2018 for a period of three months.
9. In accordance with Article 40(6) of MiFIR, the ESMA has to review temporary product interventions (hereinafter “Product Interventions”) at reasonable intervals, at least every three months.
10. With regard to this duty and the ongoing nature of the reasons stated in Decision (EU) 2018/796, in ESMA Decisions No. (EU) 2018/1636 of 23 October 2018, No. (EU) 2019/155 of 23 January 2019 and No. (EU) 2019/679 of 17 April 2019 the restriction was renewed for a further three-month period in unchanged form, lastly on 30 July 2019.
11. The ESMA sees as the main reasons for the product interventions regarding contracts for difference, in particular, a significant threat to the protection of Non-professional Clients,<sup>3</sup> based on the non-transparency and complexity of contracts for difference<sup>4</sup> and their additional specific properties (in particular the negative influence of leverage, the size of potential harmful consequences<sup>5</sup>, the disproportion between the profit and the risk of loss<sup>6</sup>), and the increase in the number of Non-professional Clients that are trading in such products and suffering losses.
12. An ESMA decision in accordance with Article 40 of MiFIR has a temporary nature. They can be renewed, but renewal should not entail the introduction of a permanent prohibition.
13. In the course of 2019, using the procedure in accordance with Article 42(3) of MiFIR, some national authorities have notified of the intention to issue product intervention measures at the domestic level.<sup>7</sup> Others have declared an intention to do so in the course of 2019.
14. In the context of the product intervention regarding contracts for difference by the ESMA and co-ordinated preparations for product interventions regarding contracts for difference at the national level by most relevant national authorities, the CNB believes that the nature of contracts for difference without additional protective elements gives rise to significant fears about the protection of Non-professional Clients,<sup>8</sup> and it is of the opinion that this is a reasonable and supported belief.

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<sup>3</sup> Recital 13 of the preamble to Decision (EU) 2018/796. Here and below in the text of the measure of a general nature reference is made to ESMA Decision (EU) 2018/796, which is no longer valid, but the arguments contained in it continue to be relevant and the subsequent ESMA decisions on the renewal of the product measure for contracts for difference refer to it and no longer repeat the basic arguments.

<sup>4</sup> Part 2.1. of the preamble to Decision (EU) 2018/796.

<sup>5</sup> Recital 31 of the preamble to Decision (EU) 2018/796.

<sup>6</sup> Recital 37 of the preamble to Decision (EU) 2018/796.

<sup>7</sup> Autoriteit Financiële Markten in the Netherlands, the Financial Conduct Authority in Great Britain, Finanssivalvonta in Finland, Lietuvos Bankas in Lithuania, Finanzmarktaufsicht in Austria, CNVM in Spain, Finantsinspektsioon in Estonia, the Central Bank of Ireland in Ireland, CONSOB in Italy, Finanšu un kapitāla tirgus komisija in Latvia, CMVM in Portugal, NBS in Slovakia.

<sup>8</sup> In the context of MiFIR, where it is relevant, a client will be understood to be also a potential client.

### **3. COMPLIANCE WITH SUBSTANTIVE LAW CONDITIONS FOR ISSUE OF MEASURE IN CZECH REPUBLIC**

#### **3.1. “Financial Instrument”**

15. A measure in accordance with Article 42 of MiFIR can concern financial instruments or structured deposits or financial instruments or structured deposits with certain set characteristics or a certain type of financial activity or practice.
16. Derivative contracts settled in cash are called contracts for difference if their purpose is to provide the holder with exposure that could be long or short to fluctuations in the price, level or value of an underlying asset.<sup>9</sup> These contracts therefore offer the option of investing against the payment of a deposit, i.e. the initial margin (“collateral”). They enable investors to speculate on increases in the prices of underlying assets (through “long positions”) or their fall (through “short positions”). Such contracts for difference include, inter alia, products based on exchange rate differences or rolling spots.<sup>10</sup> This measure, however, does not affect options, futures, swaps and forward rate agreements.<sup>11</sup>
17. In accordance with Article 2(1)(9) of MiFIR, a financial instrument is understood to be a financial instrument as defined in Article 4(1)(15) of Directive (EU) 2014/65 of the European Parliament and of the Council on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (hereinafter “MIFID II”), which further refers to Annex I to MiFID II, which defines financial instruments in Part C, specifically in section 9 it states financial contracts for difference:
18. The term “financial instrument” in accordance with MiFID II was transposed into Czech law as the term “investment instrument”, which is defined in Article 3 of the ACMU. This definition does not differ from the definition in EU law and a contract for difference that is a financial instrument in accordance with EU law is currently an investment instrument in accordance with Czech law. In accordance with Article 3(1)(f) of the ACMU, contracts for difference are an investment instrument (the sale of such contract in accordance with Article 42 of MiFIR is understood to be its agreement).

#### **3.2. “Significant Investor Protection Concerns”**

19. In accordance with Article 42(2)(a)(i) of MiFIR it is possible to adopt a prohibition or restriction if the instrument (or the activity or practice) under assessment gives rise to significant investor protection concerns or poses a threat to the orderly functioning and integrity of financial markets or commodity markets or to the stability of the whole or part of the financial system. They can therefore be taken preventatively (conclusion of Article 42(1) of MiFIR).
20. Contracts for difference, with regard to the relatively small volumes of trading, are not a threat to the financial system or part thereof, they do not give rise to concerns about the orderly functioning of commodity markets. They can, however, give rise to significant investor protection concerns, specifically for Non-professional Clients, and therefore be a threat to the orderly functioning of financial markets. Further, the CNB dealt with the character of significant investor protection concerns.

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<sup>9</sup> Recital 8 of the preamble to Decision (EU) 2018/796.

<sup>10</sup> See ESMA Q&A, ESMA35-36-1262, pp. 14, section 5.12, accessible at [www.esma.europa.eu](http://www.esma.europa.eu).

<sup>11</sup> Recital 8 of the preamble to Decision (EU) 2018/796.

21. The significant investor protection concerns regarding contracts for difference were assessed by the CNB as concerns about investor protection in the Czech Republic. The CNB, nevertheless, in accordance with the purpose of the provisions in MiFIR, had to take into consideration the protection of investors in other Member States and in the event that there was a risk of the offering of contracts for difference from the Czech Republic by securities traders or foreign securities traders through a branch in the Czech Republic. Regarding the scope of this measure of a general nature see also part 4.
22. When determining whether there are such concerns, the CNB assessed the criteria and factors stated in Article 21(2) of Regulation (EU) 2017/567. In accordance with Article 21(1) of this regulation, the competent authorities can determine the existence of significant investor protection concerns based on one or more of the factors or criteria stated. After taking them into account, the CNB reached the conclusion that there was a significant threat to client protection, for the reasons specified below.

### **3.2.1. Degree of Complexity of Financial Instrument**

23. In the case of investments in contracts for difference invested capital is relatively very small due to the use of leverage. This applies also to the ratio of invested capital to potential profits or losses. When trading in contracts for difference, positive and negative price changes in the underlying assets are determinative. A client obtains part of the difference in the event that he correctly estimates the direction in which the price of the underlying asset moves, if the deviation is negative, he has to pay the difference. The difference that the client is to pay, however, can be multiples of the initial margin that he paid when opening the position.
24. The main risk of contracts for difference for Non-professional Clients results, in particular, from the use of leverage, which, depending on its size, increases the negative impacts of contracts for difference. Leverage can increase the profit for clients, but can also increase possible losses. Applying leverage to contracts for difference for the reasons specified below increases the probability of a loss or the probability of a profit<sup>12</sup> and influences the performance of an investment also by increasing the impact of transaction fees.
25. Another element of complexity related to trading in contracts for difference is linked to the simultaneous use of high leverage and the practice of automatic margin close-out. In accordance with contractual terms and conditions used ordinarily, investment firms are entitled to sell instruments on a client's behalf ("close a position") as soon as the account's balance reaches an agreed percentage of the initial margin.<sup>13</sup>
26. As a consequence of the interaction between the high leverage and the automatic margin close-out, there is an increase in the probability that either a client's position will be automatically closed in a short time period or the client will have to meet a margin call, to prevent the forced closing of his position. Leverage increases the probability that a client will not have sufficient funds (margin) for collateral for his open positions under contracts for difference and will cause a client's positions to be sensitive, to his detriment, to small fluctuations in the price of the underlying asset.<sup>14</sup>
27. In accordance with the ESMA findings, it is known to the CNB from supervisory activities that some investment firms use automatic margin close-out so that, in particular, they can more easily manage a client's exposure and his credit risk by closing a client's position before the client has sufficient funds to cover his current exposure.

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<sup>12</sup> Recital 21 of the preamble to Decision (EU) 2018/796.

<sup>13</sup> Recital 23 of the preamble to Decision (EU) 2018/796.

<sup>14</sup> Recital 24 of the preamble to Decision (EU) 2018/796.

28. Automatic margin close-out provides certain protection to clients and reduces the risk that the client (in particular in the case of high levels of leverage) will lose his whole initial margin or even more. Automatic margin close-out, however, does not exclude this risk (in a certain situation on the market a sale may not be accomplished or it may be accomplished for a much lower price), although a Non-professional Client relies on such protection with regard to the terminology used.
29. An example is the generally known situation where a number of Non-professional Clients lost marked amounts when the Swiss franc stopped following the Euro in January 2015.<sup>15</sup> A number of Non-professional Clients were not aware that, despite setting stop-loss limits, they could lose larger amounts than they invested,<sup>16</sup> although this happened to a large extent.

### **3.2.2. Degree of Transparency with Regard to Underlying Assets<sup>17</sup>**

30. The link between contracts for difference and underlying assets is apparently simple, but with regard to leverage in connection with usually rapid movements in the value of the underlying asset and the duration of an open position for contracts for difference successful investment often requires the correct estimation of even a minimal movement in the value of the underlying asset. A significant factor reducing the degree of transparency is also the fact that a contract for difference provider cannot derive its price offers retrospectively from the prices of concluded transactions that were published by a transfer point or information provider independent of the provider, but they must be determined based on an approximation of short-term future trends in the underlying asset, based on mathematical and statistical models. A client can therefore not verify that he got a fair price based on data from a source independent of the provider. With regard to the complexity of the approximation models, usually not even the supervisory body in a provider's Member State can uncover any intentional statistical deviations incorporated in the relevant algorithms for the purpose of systematically giving a provider an advantage over an investor. This makes contracts for difference much less transparent than standard investments.
31. The high levels of leverage that are usually offered to Non-professional Clients and the degree of volatility of the underlying assets, together with the transaction costs that have an impact on the performance of an investment, can lead to rapid changes in a client's investment position. The result is that a client has to take very rapid steps with the aim of managing exposure, where he tops up collateral, so that automatic close-out does not occur.<sup>18</sup>
32. The transparency of contracts for difference is also reduced by the impact of "gapping"<sup>19</sup> during a period of marked volatility on a market in connection with the underlying asset (for example a sudden collapse in the British pound<sup>20</sup> or the de-linking of the Swiss franc and the EUR<sup>21</sup>). "Gapping" is not exceptional for contracts for difference and the risks related to such events are increased by high leverage.<sup>22</sup> As a consequence of "gapping" there is also usually failure of providers' approximation models, which in some cases has as a consequence the

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<sup>15</sup> For example a Reuters report (<https://www.reuters.com/article/us-swiss-snb-brokers/swiss-franc-shock-shuts-some-fx-brokers-regulators-move-in-idUSKBN0KP1EH20150116>).

<sup>16</sup> Recital 27 of the preamble to Decision (EU) 2018/796.

<sup>17</sup> Article 21(2)(a) of Regulation (EU) 2017/567.

<sup>18</sup> Recital 29 of the preamble to Decision (EU) 2018/796.

<sup>19</sup> In the context of financial markets "gapping" means a situation where markets open markedly over or under the closing value the previous day without trading occurring in the meanwhile.

<sup>20</sup> For example, on 24 June 2016, after the announcement of the results of the referendum on the United Kingdom remaining in the EU, the EUR rose 6.5% against the GBP and the USD strengthened by almost 10% against the GBP.

<sup>21</sup> On 15 January 2015 the Swiss franc's exchange rate rose by almost a third in 7-10 minutes.

<sup>22</sup> Recital 28 of the preamble to Decision (EU) 2018/796.

fact that providers, in accordance with their terms and conditions of business, will subsequently close investors' profitable positions with the justification that they arose based on "incorrect listings".

### **3.2.3. Degree of Transparency of Costs and Fees<sup>23</sup>**

33. The structure of costs and fees that usually apply to trading in contracts for difference is hard to understand for Non-professional Clients and therefore lacks transparency. Non-professional Clients, in particular, find it hard to understand and assess the expected performance of contracts for difference, which is decisive for the assessment of the impact on transaction fees on such performance. Transaction fees for contracts for difference are usually related to the whole notional value of a transaction (i.e. the value including the influence of leverage) and, as a consequence of investing funds using higher leverage, investors pay higher transaction fees. Transaction fees are usually deducted from the initial margin deposited by the client and higher leverage can lead to a situation where the client, at the moment a position is opened, sees a marked loss on his account, caused by high transaction fees. Because transaction fees with higher leverage reduce a client's initial margin more, clients have to make more profit on the transaction itself. This means that clients are exposed to a higher risk of loss.<sup>24</sup>
34. In addition to transaction fees, (typically upon the opening and closing of a contract for difference account) additional costs and fees can be incurred. Such additional costs include, for example, a fee for opening a position or fees for account management. Fees designated for maintaining an open position, such as daily or overnight charges, are usually changed and can be increased by surcharges. The number and complexity of various costs and fees and their influence on a client's performance contribute to the insufficient transparency of contracts for difference.<sup>25</sup>
35. The CNB is of the opinion that for Non-professional Clients it is hard to make an informed assessment of the transparency of costs and fees in connection with the expected performance of contracts for difference.

### **3.2.4. Extent of Potential Harmful Effects<sup>26</sup>**

36. The ESMA states that, based on information from a number of national competent authorities, it can be deduced that the number of trading accounts of Non-professional Clients with providers of contracts for difference and binary options settled in the EEA rose from 1.5 million in 2015 to approximately 2.2 million in 2017.<sup>27</sup>
37. Studies performed by the relevant national bodies that focused on the results of Non-professional Clients investing in contracts for difference show that the large majority of Non-professional Clients in Member States investing in such products suffer losses:<sup>28</sup>
  - a) The Spanish Comisión Nacional del Mercado de Valores ("ES-CNMV") ascertained that approximately 82% of Non-professional Clients reported a loss in a period of 21 months between the start of 2015 and the end of 2016. The average loss per Non-professional Client was EUR 4,700;

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<sup>23</sup> Article 21(2)(a) of Regulation (EU) 2017/567.

<sup>24</sup> Recital 15 of the preamble to Decision (EU) 2018/796.

<sup>25</sup> Recital 15 of the preamble to Decision (EU) 2018/796.

<sup>26</sup> Article 21(2)(b) of Regulation (EU) 2017/567.

<sup>27</sup> Recital 32 of the preamble to ESMA Decision (EU) 2018/796.

<sup>28</sup> Recital 35 of the preamble to Decision (EU) 2018/796, which states examples of other analyses with similar results.

- b) The French Autorité des marchés financiers (“FR-AMF”) ascertained that in the period from 2009 to 2013 a total of more than 89% of Non-professional Clients’ accounts were loss-making and that the average loss per Non-professional Client was EUR 10,887. Based on data from the French ombudsman it was also found that the average total loss per year for complainants about contracts for difference in 2016 was EUR 15,207. In addition to this, the ombudsman stated that the practices of regulated providers started to be even more aggressive in 2016 and 2017. Complaints concerning cases of pressure and manipulation came in from complainants. Data for 2016 from mediation before the French ombudsman documents this fact, because the average compensation that complainants obtained based on mediation rose to EUR 11,938 and half of all cases concerned an amount higher than EUR 5,000. Losses suffered by some investors reached EUR 90,000 and aggregate losses in cases with the participation of investment firms with a corresponding authorisation exceeded EUR 1 million. The FR-AMF also found that the highest losses were made by the Non-professional Clients who traded the most (by number of transactions, average volume or cumulative volume), or continued trading for a longer period;
- c) An analysis by the Italian Commissione Nazionale per le Società e la Borsa (“IT-CONSOB”) drafted in 2016 showed that in 2014 – 2015 78% of Italian Non-professional Clients of a specific contract for difference provider suffered losses when investing in contracts for difference and 75% suffered losses when investing in products based on exchange rate differences, where the average loss was EUR 2,800. It was also found that there is a positive correlation between the number of transactions executed by Non-professional Clients and the amount of their losses. Subsequent research performed for IT-CONSOB in March 2017 and focused on five Italian branches of investment firms active in contracts for difference ascertained that Non-professional Clients investing in contracts for difference in 2016 suffered a loss in 83% of cases, where the average loss per client was approximately EUR 7,000;
- d) The Polish Komisja Nadzoru Finansowego (“PL-KNF”) performed a study in the first quarter of 2017 based on data provided by ten investment firms that offer contracts for difference and found that 79.28% of clients suffered a loss in 2016, with an average value of PLN 10,060. A similar study performed by PL-KNF based on data provided by seven investment firms offering contracts for difference in Poland in 2017 (177,883 client accounts, of which 40,209 were active) also showed that 79.69% of clients suffered losses in 2017, and the average loss was PLN 12,156. The percentage of active clients that suffered losses was, according to the findings of PL-KNF, 81% (2012), 81% (2013), 80% (2014), 82% (2015), 79% (2016) and 80% (2017).

38. The share of Non-professional Clients that suffered a loss was, according to the FR-AMF study,<sup>29</sup> consistent in every year in 2009 to 2013, despite variable annual yields on equity markets and commodity indexes in the same period.<sup>30</sup> The continuing losses of Non-professional Clients investing in contracts for difference indicate a structural property of the yield profile, which contrasts with the positive historical values for investments in other financial products, such as capital investment funds.

39. These findings are confirmed by data for the Czech Republic. Contracts for difference are offered by several providers who are subject to CNB supervision.<sup>31</sup>

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<sup>29</sup> Recital 35(iii) of the preamble to ESMA Decision (EU) 2018/796.

<sup>30</sup> Recital 37 of the preamble to ESMA Decision (EU) 2018/796.

<sup>31</sup> At the current time they are only branches of foreign securities traders. The CNB’s supervision is focused only on compliance with the rules for conduct by the supervised entities.

40. Reports submitted to the CNB by supervised entities indicate that until the introduction of the product intervention by the ESMA<sup>32</sup> in 2018 an average of 74% of all clients were making a loss.

### **3.2.5. Type of Client Affected<sup>33</sup>**

41. As is stated above in para. 36, the number of trading accounts of Non-professional Clients with providers of contracts for difference and binary options settled in the EEA rose from 1.5 million in 2015 to approximately 2.2 million in 2017. With regard to this number and the advertising practices used, there can be no doubt that the vast majority of clients were Non-professional Clients for which investing in contracts for difference is inappropriate.<sup>34</sup>
42. According to CNB data, in the Czech Republic in 2018 as of the end of each month an average of 1,743 clients held an open investment position in contracts for difference and an average of 1,161 of them were residents of the Czech Republic.
43. With regard to the evidence of losses on Non-professional Clients' accounts described in this measure (in particular part 3.2.4), it is clear that there is a significant threat to the protection of Non-professional Clients, both in the Czech Republic and in other EU Member States, as far as concerns the unrestricted marketing, distribution or sale of contracts for difference to this category of clients.

### **3.2.6. Sales Techniques Related to Contracts for Difference<sup>35</sup>**

44. The relevant national authorities in this area have registered aggressive marketing practices and misleading promotional statements. They include, for example, using sponsoring agreements or linking up with leading sports teams, which gives the mistaken impression that complex and speculative products like contracts for difference are suitable for the retail market through support for general brand awareness.<sup>36</sup>
45. Some relevant national authorities have stated that contract for difference providers ordinarily do not publish the risks of such products, in particular they conceal the possibility of rapid losses that could exceed the funds invested by clients.<sup>37</sup>
46. A common characteristic of the marketing and sales techniques regarding contracts for difference is the offering of trading (monetary or non-monetary) benefits, such as bonuses, with the aim of attracting Non-professional Clients and getting them to invest in contracts for difference. This concerns, for example, the offering of various gifts and bonuses, misleading information at seminars offered for free, the provision of apparently simple and advantageous strategies for trading, or the option of trading at reduced costs (for example margins or fees) with the aim of motivating the client to trade more actively.<sup>38</sup>
47. Bonuses (including the timing of their offer) and other trading benefits can draw attention away from the product's highly risky nature. They are usually targeted so that they attract Non-professional Clients and get them to trade. Non-professional Clients, as a consequence of

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<sup>32</sup> See section 10 of the justification.

<sup>33</sup> Article 21(2)(c) of Regulation (EU) 2017/567.

<sup>34</sup> See the CNB's *Opinion Notification of Risks Linked to Investing in Contracts for Difference*. Accessible at [www.cnb.cz](http://www.cnb.cz).

<sup>35</sup> Article 21(2)(j) of Regulation (EU) 2017/567.

<sup>36</sup> Recital 44 of the preamble to ESMA Decision (EU) 2018/796.

<sup>37</sup> Recital 45 of the preamble to ESMA Decision (EU) 2018/796.

<sup>38</sup> Recital 47 of the preamble to ESMA Decision (EU) 2018/796.

the offering of a bonus or other benefit, do not sufficiently assess how the large risk related to contracts for difference is.<sup>39</sup>

48. Further, trading benefits are often related to other conditions, e.g. clients have to put a certain minimum volume of funds on a client account and make a certain minimum number of transactions.<sup>40</sup>

### **3.2.7. To What Extent Do Contracts for Difference Endanger Trust in the Financial System<sup>41</sup>**

49. A combination of the complexity and insufficient transparency of contracts for difference, including the negative consequences of the use of leverage described,<sup>42</sup> the extraordinary high share of loss-making client accounts of Non-professional Clients, the often frequently misleading and aggressive marketing and distribution, providers' conflicts of interests and other aspects of trading in contracts for difference stated above (in particular the influence of leverage), all contribute to Non-professional Clients being in a position to lose (and often losing) significant funds, and, as a consequence, losing trust in the financial system.
50. With regard to the high probability that they will suffer a loss, Non-professional Clients that are not experienced in investing on the capital market or have only insufficient experience of this and that were attracted by aggressive marketing by contract for difference providers could reach the conclusion that such products were a representative sample of financial (investment) instruments.
51. This fear is confirmed by the high number of Non-professional Clients in some countries and the number of complaints concerning these products, as can be seen from the IOSCO report.<sup>43</sup>
52. In the period from 2014 to 2018 the CNB received a total of 135 complaints concerning trading in contracts for difference (an average of 23 complaints a year). This represented a 44% share of complaints made about securities traders. The complaints made clear the systemic fears of Non-professional Clients in this area and the fact that clients did not understand the principles governing the operation of contracts for difference.

### **3.3. “In at least one Member State”**

53. In accordance with Article 42(2)(a)(i) of MiFIR, a measure can be implemented if the instrument (or activity or practice) under assessment gives rise to significant investor protection concerns in at least one Member State.
54. The aforementioned fears concern both the Czech Republic and other EU Member States. Part 3 of this justification shows that the condition “in at least one Member State” is met.

### **3.4. Insufficiency of Current Requirements regarding Risks for Non-professional Clients**

55. In accordance with the requirement of Article 42(2)(b) of MiFIR, the CNB considered whether the threat of a loss for Non-professional Clients under contracts for difference is sufficiently dealt with by current regulatory requirements in accordance with European Union legal regulations applicable to binary options.

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<sup>39</sup> Recital 48 of the preamble to ESMA Decision (EU) 2018/796.

<sup>40</sup> Recital 49 of the preamble to ESMA Decision (EU) 2018/796.

<sup>41</sup> Article 21(2)(v) of Regulation (EU) 2017/567.

<sup>42</sup> See section 37 of this justification.

<sup>43</sup> Report on the IOSCO Survey on Retail OTC Leveraged Products, (FR14/2016, December 2016), pp. 46. Available at [www.iosco.org](http://www.iosco.org).

56. The applicable requirements are applied at the level of European Union law by MiFID II, MiFIR and Regulation (EU) No 1286/2014 of the European Parliament and of the Council.<sup>44</sup> This primarily concerns:
- a) The requirement to provide clients with the relevant information in accordance with Article 24(3) and (4) of MiFID II (transposed into Article 15a(1), Article 15(6) and Article 15d(1) to (5) of the ACMU);
  - b) The requirement to assess the suitability and appropriateness of investments for the client in accordance with Article 25(2) and (3) of MiFID II (transposed into Article 15h and Article 15i of the ACMU);
  - c) The requirement for the best method of executing orders in accordance with Article 27 of MiFID II (transposed into Article 15l(1) to (6), Article 15m, Article 15n(1) to (5), Article 15r(1) to (5), Article 731 of the ACMU);
  - d) The product management requirements in accordance with Article 16(3) and Article 24(2) of MiFID II [transposed into Article 7(5), Article 8(5), Article 12, Article 12a(1)(b) to (e), (h), (i), (l), Article 12a(2) to (3), Article 12d, Article 12ba(1) to (3) and (5) to (6), Article 12bb, Article 13, Article 12e(1) to (2), Article 15a(3) to (5), Article 15b, Article 17(1) to (5), Article 24(5)(a), (c) and (e) of the ACMU];
  - e) The requirements for ascertaining and managing a conflict of interests in accordance with Article 12(b) of the ACMU and Article 33 to 43 of Regulation (EU) 2017/565;
  - f) The requirements concerning the publication of information in accordance with Articles 5 to 14 of Regulation (EU) No 1286/2014.
57. With regard to the fact that Article 42(2)(b) of MiFIR refers to EU legal regulations, the CNB, in the remainder of the text, states references to the relevant EU legislation, including directives, not to binding Czech regulations. The rules stated in directives (specifically in MiFID II) were fully transposed and apply in the Czech Republic, as is illustrated by the summary stated in paragraph 56.

#### *Requirement to Provide Clients with Relevant Information*

58. Upon the passing and implementing of MiFID II (the transposition was performed by an amendment to the ACMU, No. 204/2017 Coll., with effect from 3 January 2018), there was a marked expansion of the duty of investment firms, i.e. in accordance with the ACMU securities traders, in the area of publication of information about costs and fees. Nevertheless, rules based on the provision of information, including better information about costs, of themselves, are not sufficient to deal with the complicated risk linked to marketing, distribution and sale of contracts for difference to Non-professional Clients.
59. Specifically, Article 24(3) of MiFID II, inter alia, requires that contract for difference providers ensure that all information, including promotional communications for clients or potential clients, are fair, clear and not misleading. Article 24(4) of MiFID II also requires that a contract for difference provider provides clients or potential clients, a sufficient time in advance, with the relevant information about itself and its services, about financial instruments and proposed investment strategies, about places of execution, about all costs and related fees, warnings concerning risks related to investments in such instruments and information about whether an investment instrument is for non-professional or professional clients.

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<sup>44</sup> Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs).

60. Based on a description of the investor protection concerns in connection with investing in contracts for difference (in particular regarding their complexity, riskiness and leverage effect), it is clear that damage to investors cannot be fully and properly prevented only by applying these rules. This type of publication of information does not sufficiently draw clients' attention to the specific negative consequences (the almost certain negative yield for inexperienced Non-professional Clients) of investing in the aforementioned instruments and does not deal with the concerns related to the properties of contracts for difference.
61. The CNB also considered the importance of rules concerning the publication of information in Regulation (EU) No 1286/2014. This regulation sets out uniform rules concerning the format and content of the statement of key information that has to be provided by providers of structured retail investment products and insurance products with an investment element (hereinafter "Products with an Investment Element") to Non-professional Clients with the aim of enabling them to understand the main characteristics of a Product with an Investment Element and the related risks and compare it to other products. In particular Article 8(3)(d) of Regulation (EU) No 1286/2014 stipulates, inter alia, the methodology for presenting an aggregate risk indicator and accompanying explanations, including whether a Non-professional Client can lose all capital invested or whether he could be obligated to settle other financial obligations.
62. This type of aggregate publication of information, however, does not sufficiently inform Non-professional Clients of all the consequences of investing in contracts for difference. The creator of a product, for example, is not obligated, as a part of the performance indicator, to state information about the total percentage of accounts of Non-professional Clients that have suffered a loss or the probability of occurrence of individual performance scenarios.
63. The mere publication of information in accordance with Regulation (EU) No 1286/2014 is then wholly insufficient in the case of instruments that are themselves too complex, risky and unsuitable for Non-professional Clients.

#### *Requirement of Assessing Suitability and Appropriateness of Investment for Client*

64. The requirements concerning an assessment of suitability were also strengthened in Article 27 of MiFID II, in particular as far as concerns the provision of information about suitability for a client and a specification of the assessment of suitability. Specifically, Article 25(2) of MiFID II requires that providers of some investment services for contracts for difference obtain the necessary information regarding a client's or potential client's knowledge and experience, inter alia, in the investment field relevant to the specific type of product, that person's financial situation including his ability to bear losses, and his investment objectives, including his risk tolerance, so as to enable the contract for difference provider to recommend to the client or potential client the investment instruments that are suitable for him and are in accordance with his risk tolerance and ability to bear losses. If a provider is of the opinion that a product is not appropriate for a client or potential client, it cannot provide him with the relevant service. The requirements concerning an assessment of suitability, however, apply only during the provision of the investment service of investment advice or the management of a client's assets, so these requirements are usually not important in connection with the marketing, distribution and sale of contracts for difference, as these processes take place mostly using electronic platforms without the provision of investment advice or the management of a client's assets.
65. The aims of an assessment of suitability (assessment of products with regard to clients' knowledge and experience, their financial situation and investment aims) remained basically unchanged in MiFID II compared to the previous regime and, as is shown by the information

in the justification for this measure and in the ESMA Decision,<sup>45</sup> they are not sufficient to prevent damage to non-professional investors.

66. The requirements concerning an assessment of the suitability of an investment for a client were strengthened in MiFID II in a similar manner, in particular by narrowing the list of simple instruments and therefore by limiting the extent of instruments for which it is possible to provide the investment service of execution or handover of an order without performing a suitability or appropriateness test. Contracts for difference are complex financial instruments, and therefore they should always be the subject of a full assessment of appropriateness in accordance with Article 25(3) of MiFID II. Article 25(3) of MiFID II requires that contract for difference providers ask their clients or potential clients to provide information regarding that person's knowledge and experience in the investment field, inter alia, in connection with the specific instrument offered or demanded so as to assess whether the instrument envisaged is appropriate for the client or potential client. If, however, a contract for difference provider thinks that a product is not appropriate for a client or potential client, it only provides a simple warning.
67. The above parts of the justification indicate that the requirements for an assessment of suitability and an assessment of appropriateness in connection with valid legal regulations were not sufficient to ensure the protection of Non-professional Clients that suffered marked losses when investing in contracts for difference, i.e. significant investor protection fears were and still are appropriate.

#### *Requirement for Best Execution of Orders*

68. As far as concerns the best execution of orders, Article 27 of MiFID II stipulates that a contract for difference provider must take "all sufficient steps" to obtain, when executing orders, the best possible result for their clients. Market participants, in addition, must publish supplementary information and, in particular, contract for difference providers are obligated to publish the five best places for executing orders where they executed clients' orders and the results they achieved when executing the aforementioned orders.
69. The CNB considered whether new rules concerning the best execution of orders could resolve, at least, the some concerns related to the marketing, distribution or sale of contracts for difference to Non-professional Clients. Requirements concerning the best execution of orders, inter alia, strengthen the standard of execution of orders, as they require that contract for difference providers check the appropriateness of a price proposed to a client when executing orders or deciding on trading, including instruments created at the client's request. The requirements of MiFID II imply the gathering of market data used for an estimate of the price of an instrument and, if possible, a comparison with similar or comparable instruments.
70. These requirements therefore have the potential to reduce the costs of trading in contracts for difference (and thereby increase the accessibility of contracts for difference), but they do not deal with the consequences of their complexity, or the low probability of a client making a profit. They therefore do not deal with the risks related to characteristics of an instrument other than the execution of orders.

#### *Product Management Requirements*

71. The CNB considered the impact of the new rules concerning product management that were stipulated in Article 16(3) and Article 24(2) of MiFID II. The aforementioned rules require that providers creating financial or investment instruments (including contracts for difference)

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<sup>45</sup> Recital 61 of the preamble to Decision (EU) 2018/796.

for sale to clients ensure that such investment instruments are designed in such a manner to meet the needs of the designated target market of end clients in the relevant client category, that the strategy for the distribution of such products is in accordance with the designated target market and that contract for difference providers take appropriate steps with the aim of ensuring that the financial instruments will be distributed on the designated target market. It is also required that they regularly examine the identification of the target market and product performance. Contract for difference providers must understand the investment instruments that they are offering or recommending, assess the compatibility of such instruments with the needs of clients to whom they provide investment services, also with regard to the designated target market of end clients, and ensure that the investment instruments are offered or recommended only if it is in the client's interest.

72. In addition to this, contract for difference providers that distribute an investment instrument that they did not create must have suitable systems implemented to obtain and understand the relevant information concerning the product approval procedure, including the designated target market and product properties. Contract for difference providers distributing investment instruments created by other persons to which the product management requirements stipulated in MiFID II do not apply must also have suitable systems to obtain additional information about such financial instruments.<sup>46</sup>
73. The purpose of the MiFID II product management requirements is to narrow the type of clients (define the target market) for which financial instruments are suitable and to which they could be distributed. Without the restriction of contracts for difference in accordance with this measure of a general nature, however, with regard to the properties of contracts for difference (high degree of losses, expected negative yield, often non-transparent structure of prices, fees and commissions, made worse by the negative influence of leverage), in the opinion of the CNB, in agreement with the ESMA, it is not possible to determine any retail target market for such contracts for difference, or rather all Non-professional Clients should belong to the “negative market”, i.e. the group of persons to whom such instrument should not be offered at all, unless it is accompanied by additional protective elements.
74. In addition to this, Article 21(2)(c), fifth bullet point, of Regulation (EU) 2017/567 states as among the facts that should be taken into consideration when considering product interventions, “the fact of whether the product or service is being sold to clients outside the intended target market or where the target market has not been adequately identified”, i.e. it expressly assumes that the existence of product management rules or non-compliance with such rules does not prevent the application of Article 42 of MiFIR and, on the contrary, could be one of the reasons for its application.
75. This measure of a general nature does not completely prohibit investments in contracts for difference, but it protects Non-professional Clients through a number of measures. Regardless of this measure of a general nature, it is necessary to regard contracts for difference as unsuitable for inexperienced Non-professional Clients. Contract for difference providers should, as a part of the rules for the creation of products, carefully define the target market and clients themselves should approach such risky instruments very cautiously. Even when applying the exception in accordance with this measure of a general nature, contracts for difference will be suitable for Non-professional Clients only exceptionally, in the case of very

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<sup>46</sup> Recital 68 of the preamble to Decision (EU) 2018/796.

experienced Non-professional Clients who fully understand the related risks, have sufficient financial reserves and also sufficient time to monitor exposure from contracts for difference.<sup>47</sup>

*Summary of Reasons Current Regulatory Requirements Do Not Sufficiently Deal with Risks Resulting for Non-professional Clients from Some Contracts for Difference*

76. Despite the aforementioned requirements of legal regulations, when trading in contracts for difference, which are often unsuitable for them, Non-professional Clients lost their funds invested, until the introduction of the product measures by the ESMA<sup>48</sup>. The CNB therefore has a material and justified fear that without the adoption of a product measure at the national level that prohibits the offering of some highly-risky contracts for difference to Non-professional Clients such Non-professional Clients will continue to be exposed to unreasonable risks. The current requirements of MiFID II and other regulations do not deal with the protection of such Non-professional Clients, with regard to the above.
77. With regard to the aforementioned negative properties of contracts for difference<sup>49</sup>, it is a product that is generally unsuitable for Non-professional Clients. It is also necessary to emphasise that a contract for difference provider is also the counterparty in such transaction, which inevitably leads to a conflict of interests. With regard to the fact that contracts for difference are traded outside organised markets (OTC transactions), the rights and duties are usually determined by the provider's terms and conditions of business. In this way the provider determines the basic parameters of trading (underlying asset, method of determining price, spread, fees, trading hours, lot size).
78. With regard to the fact that the requirements of EU (and Czech) legal regulations do not sufficiently deal with the risks described for Non-professional Clients, they cannot be dealt with by perfected supervision in accordance with Article 42(2)(b) of MiFIR ("and the issue would not be better addressed by improved supervision or enforcement of existing requirements"). This is because effective punishment, in the event of a breach of the rules, occurs *ex post* and does not lead to compensation for a loss suffered by a client. The threat of high monetary fines or the removal of a license from a contract for difference provider does not represent a deterrent that could prevent the offering of contracts for difference to Non-professional Clients, as it is a form of certain profit for contract for difference providers and the corresponding expected losses for Non-professional Clients. The only effective way to set out the duties of investment firms regarding clients is to adopt the rules and restrictions specified below.

**4. RULES AND RESTRICTIONS RELATED TO CONTRACTS FOR DIFFERENCE IN ACCORDANCE WITH THIS MEASURE OF A GENERAL NATURE**

79. The CNB regards it as reasonable and justified to follow on from previous ESMA product interventions<sup>50</sup> and, in the same manner, limit the marketing, distribution and sale of contracts for difference to Non-professional Clients by prohibiting the marketing, distribution or sale of contracts for difference to Non-professional Clients, unless the conditions in accordance with this measure of a general nature are met. The rules and restrictions specified below must be complied with by investment firms, if they want to market, distribute and sell contracts for difference to Non-professional Clients in the Czech Republic and from the Czech Republic.

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<sup>47</sup> See the CNB's Opinion *Notification of Risks Linked to Investing in Contracts for Difference*. Accessible at [www.cnb.cz](http://www.cnb.cz).

<sup>48</sup> See section 10 of the justification.

<sup>49</sup> Cf. section 24 et seq. of the justification.

<sup>50</sup> See section 6 et seq. of the justification.

#### 4.1. Initial Margin Protection

80. The introduction of limits on leverage protects Non-professional Clients, because it will require, before the termination of a contract for difference, that they pay a minimum initial margin. This requirement is known as “initial margin protection”. This limits a client’s nominal exposure in relation to the amount of funds invested in the opening of a position. Because the costs a client has to take into account increase with the nominal value of the investment exposure, initial margin protection reduces the probability of client losses in comparison with those that could be expected if higher leverage were used.<sup>51</sup>
81. Empirical academic research confirms this analysis and, according to it, limits on financial leverage will improve the average results for investors.<sup>52</sup>
82. The CNB, when setting the limits for initial margin protection, accepts limits for initial margin protection introduced by ESMA Decision (EU) 2018/796. These limits for initial margin protection will be, in accordance with available information, used in other jurisdictions when introducing national product measures (with the exception of marginal exceptions).<sup>53</sup>
83. The CNB regards it as reasonable to accept limits on initial margin protection in particular in order to rule out the possibility of arbitration and also because it identifies with the ESMA’s justification (analysis) regarding specific limits for initial margin protection, as stated below.
84. Initial margin protection for each underlying asset was set in accordance with the volatility of the relevant underlying assets with the help of a simulation model, in order to assess the probability a client will lose 50% of his initial investment during the relevant period of holding. The ESMA performed a quantitative simulation of the distribution of revenues that a client could expect from one contract for difference given various levels of leverage. The starting point for the simulation was data about the daily market price for 10 years (in most cases) for various types of underlying assets ordinarily used for contracts for difference that are sold to Non-professional Clients. The analysis used a contract for difference where the position was closed if the current margin reached 50% of the initial margin. The simulated probability with which the position is closed depends on the leverage (and increases with it). With the help of the aforementioned simulation, the dependence of the probability of the automatic closing of a position under a contract for difference (automatic closing will occur if the margin reaches 50% of the original margin) was ascertained in relation to leverage for individual underlying assets. The results of the simulation model enable the setting of limits for financial leverage (in accordance with the type of the underlying asset) that should lead to a reduction in the probability of the premature closing of an investment position and therefore a reduction in the probability there will be high damage to clients across the various types of underlying assets.<sup>54</sup>
85. The ESMA analysis<sup>55</sup> is based on the fact that, with regard to the retail nature of Non-professional Clients and statistics showing the time of holding of contracts for difference

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<sup>51</sup> The higher the leverage, the more probable are a client’s losses, because the spread and the fees comprise a large part of the initial margin. Higher leverage also increases the probability that a client will lose a set percentage of the margin, which increases the risk of serious damage to the investor.

<sup>52</sup> *Should Retail Investors’ Leverage Be Limited?* Rawley Z. Heimer and Alp Simsek. NBER Working Document No. 24176, issued in December 2017 and available at: [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2150980](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2150980).

<sup>53</sup> UK-FCA informed the ESMA about a change to limits for government bonds, now 30:1 instead of the original 5:1, see *Opinion of the European Securities And Markets Authority on the product intervention measure relating to binary options proposed by the Financial Conduct Authority of the United Kingdom* (ESMA35-43-1723), pp. 3.

<sup>54</sup> Recital 102 of the preamble to Decision (EU) 2018/796.

<sup>55</sup> ESMA, *Product Intervention Analysis, Measures on Contracts for Differences*, ESMA50-162-215.

(using data obtained by the competent national authorities) it is reasonable to set the initial margin protection in such a manner that it is assumed that Non-professional Clients hold assets for at least one day. With the aim of obtaining a consistent reference point, the analysis simulated what leverage would lead, with a 5% probability, to the closing of positions,<sup>56</sup> for various underlying assets. The extent of results in every asset class was then applied when selecting a limit for leverage. In most cases the limits were set conservatively with regard to the lower limit of the spread. How liquid various assets are was taken into consideration.

86. The alternative was, for example, to set a uniform limit for leverage for all contracts for difference without regard to the underlying asset. This, however, does not correspond to the differences in historical price volatility between various classes of underlying assets or differences in the structure of typical fees as a part of an investment firm offering contracts for difference and in typical client behaviour.<sup>57</sup>
87. For example, oil and gold are often traded under contracts for difference for commodities, but simulations show that leverage leading to a 5% probability of closing of positions for gold is about double that for a contract for difference for oil. Limits on leverage for contracts for difference for gold are therefore different to limits for contracts for difference for oil and other commodities. Determining initial margin protection in this manner, in particular through simulated positions open for at least one day, provides a consistent and necessary level of protection for Non-professional Clients, who do not actively have to monitor their position during a trading day or cannot assess the need for rapid responses with regard to the volatility of the market in the underlying assets. In the case of contracts for difference for shares, the data in the aforementioned statistics indicate that they are usually held longer than other assets. Holding for up to 5 days was taken into consideration.<sup>58</sup>

#### **4.2. Margin Close-out Protection**

88. Another measure to protect Non-professional Clients is margin close-out protection (MCO). This measure supplements initial margin protection and alleviates the risk that Non-professional Clients will lose significant funds exceeding the funds they invested in contracts for difference under ordinary market circumstances.
89. The CNB regards it as reasonable and justified to adopt margin close-out protection, as was first introduced by ESMA Decision (EU) 2018/796. This MCO variant will be used also in other Member States during the introduction of national product measures. The CNB intends to maintain a uniform method of MCO in the EU and take into consideration the reasons stated below.
90. Providing margin close-out protection and standardising the ratio at which it is required, so that contract for difference providers close a client's position under a contract for difference (at the level of 50% of the value of the initial margin) is also aimed at dealing with the inconsistent application of procedures for MCO by contract for difference providers. Some competent national authorities have found that contract for difference providers enable clients' funds to fall to 0–30% of the initial margin required for the opening of a position under a contract for difference.<sup>59</sup> By doing so providers expose clients to a risk of loss higher than the initial funds, in particular in the case of gapping (cf. para. 32). A level of margin close-out that is too high would, on the contrary, expose clients to the frequent closing of

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<sup>56</sup> ESMA, *Product Intervention Analysis, Measures on Contracts for Differences*, ESMA50-162-215, pp. 31–38.

<sup>57</sup> Recital 104 of the preamble to Decision (EU) 2018/796.

<sup>58</sup> Recital 103 of the preamble to Decision (EU) 2018/796.

<sup>59</sup> Recital 107 of the preamble to Decision (EU) 2018/796.

positions, which may not be in their interest. A fifty per cent threshold value mitigates the risk of marked losses by Non-professional Clients. It is therefore reasonable and was set in the ESMA Decision.

91. Consideration was also given to the use of MCO protection for individual positions (a contract for difference is closed out if its value falls below 50% of the value of the initial margin), which would ensure the efficient application of initial margin protection for every class of underlying asset and a fixed upper limit for leverage for a certain class of underlying asset. This would also reduce the complexity of a product and improve understanding of it by Non-professional Clients.
92. A comparison of alternative MCO approaches led to the conclusion that for investors it would be better to apply protection to a whole account, rather than the principal of a position, as
  - a) it supports a varied portfolio of investments, which not only creates greater investment opportunities for clients, but, in particular, reduces risk;
  - b) it limits the room in which investors bear the costs resulting from new opening of positions, with regard to the fact that when applying it to an account as a whole positions are closed less often; and
  - c) it is a less limiting, and therefore a generally preferred solution from the viewpoint of constitutional principles.
93. With regard to the aforementioned analysis, the CNB is of the opinion, the same as the ESMA, that MCO applied to an account (in connection with other rules in accordance with this measure of a general nature) is more appropriate than MCO for individual positions. MCO applied to an account, in particular, enables the close-out of a position under one or more contracts for difference that are most favourable for a Non-professional Client, to ensure that the account's value does not fall under 50% of the initial margin. For these purposes, the value of an account is understood to mean the value of funds on the relevant account together with unrealised net profits from open exposures under contracts for difference related to the relevant account.
94. MCO protection in accordance with this measure does not prevent a provider from applying an MCO rule to individual positions with a requirement of 50% of the initial margin for a specific position.

### **4.3. Negative Balance Protection**

95. The purpose of negative balance protection is to provide a mechanism of protection in the event of extreme conditions on the market, as was the case, for example, when the Swiss franc's link to the Euro was ended in January 2015. In the event of such extreme situations, when there is a change to the price of the underlying asset that is sufficiently large and sudden, a contract for difference provider may not be able to arrange the closing of a position, as required by margin close-out protection, and a client could have a negative balance on his account.<sup>60</sup>
96. The purpose of negative balance protection is to ensure that the maximum losses of a Non-professional Client from trading in contracts for difference (including costs and fees) will be limited to total funds related to trading in contracts for difference that are on the account of a Non-professional Client for such trading. Such funds include funds that have to be paid in the future into the relevant account with regard to net profits achieved from the close-out of

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<sup>60</sup> A number of competent national authorities have stated that after such events customers owe markedly more than they invested, so they wind up with a negative balance on their account for trading based on contracts for difference.

positions under contracts for difference linked to the relevant account. It is important to ensure that a Non-professional Client does not incur additional liabilities related to his trading in contracts for difference. This measure sets out the rules only in relation to contracts for difference. If the account of a Non-professional Client also includes other investment instruments (for example unit trusts or shares), this will not be taken into consideration for a calculation in accordance with this measure of a general nature.

97. With the aim of considering the impact of negative balance protection on investors, the following scenarios were considered:
  - a) investment negative balance protection on an account for trading in contracts for difference held for Non-professional Clients;
  - b) negative balance protection for every contract for difference position held by a Non-professional Client.
98. The impact on Non-professional Clients resulting from various options in the event of extreme events on the market has to be compared with the costs of providing such protection. In particular, this concerns the costs of contract for difference providers, which would have to include, in particular, ongoing costs that result from the need to increase capital or collateral as a part of a risk assessment. These costs could be transferred to the Non-professional Clients themselves.
99. The risk of marked losses suffered by a Non-professional Client arising in the event of the absence of negative balance protection could, on the other hand, mean that a Non-professional Client will, as a consequence of extreme conditions on the market, owe the investment firm money. Such situation is especially difficult for Non-professional Clients without sufficiently liquid assets. The CNB therefore, the same as the ESMA, chose the option of negative balance protection for a whole account for trading in contracts for difference as the method for dealing with this source of potential losses and also minimising related costs for providers and Non-professional Clients. If negative balance protection were imposed on each contract for difference, there would be a risk of unreasonable costs for Non-professional Clients and providers.
100. If negative balance protection were introduced on the principal of a position, providers would have to bear all losses exceeding funds reserved for a position, including the initial margin and any other collateral. If negative balance protection did not enable the setting off a significant loss against other positions in a Non-professional Client's portfolio, the rule for a position would increase the market risk of contract for difference providers. This would probably lead to an increase in capital requirements for contract for difference providers and the costs of it would probably be transferred to clients.

#### **4.4. Warning of Risks**

101. Another measure with the aim of limiting risk for Non-professional Clients in relation to contracts for difference is to require the statement of standardised and specific warnings regarding the ratio between losses on Non-professional Clients' accounts. The CNB's findings<sup>61</sup> and information of other competent authorities<sup>62</sup> indicate that contract for difference providers often do not clearly state information about the highly risky and complex nature of such products. A warning of risks, in particular, often does not clearly state the

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<sup>61</sup> See the CNB's Opinion *Notification of Risks Linked to Investing in Contracts for Difference*, section 8. Accessible at [www.cnb.cz](http://www.cnb.cz)

<sup>62</sup> For example, UK-FCA <https://www.fca.org.uk/publications/multi-firm-reviews/cfd-firms-fail-expectations-appropriateness-assessments> or NL-AFM <https://www.afm.nl/en/nieuws/2015/feb/rapport-cfd>.

possibility and probability of rapid losses that could exceed the funds invested by clients, or such statements are weakened through the manner of their presentation or claims about potential profits.

102. Even if such warnings are provided, they are not standardised and it is hard to compare them.
103. The warning of risks for a specific provider introduced in this measure will give Non-professional Clients basic information about specific products, in particular about the percentage of accounts of Non-professional Clients that suffer a loss when trading in contracts for difference. The ESMA states that in accordance with available studies a standardised risk warning markedly improved the understanding of products on the part of Non-professional Clients. Customers better understood the possibility of a loss of funds that they invested and the probability they would make a profit.<sup>63</sup>
104. The requirement that contract for difference providers state the percentage of Non-professional Clients' accounts that are loss-making is aimed at compensating for the tendency of contract for difference providers to emphasise the potential profits over losses.
105. The CNB also expects that a warning will support Non-professional Clients in the making of an informed decision on whether they want to continue to trade in this highly-risky product where making a loss is more probable than making a profit.
106. So that Non-professional Clients are warned of the risk of losses in connection with investing in contracts for difference, the CNB, the same as the ESMA, is of the opinion that every contract for difference provider must inform its clients of the ratio of accounts for trading in contracts for difference belonging to Non-professional Clients that suffered a loss in the last 12 months. In order to ensure this information is current and comparable, it is necessary to update this calculation quarterly. The stated ratio must be presented in a simple and clear manner as a part of a warning of risks in every statement of the provider related to the offering of contracts for difference.
107. In order to determine whether an account is loss-making, realised and unrealised gains and losses have to be taken into account. Realised gains and losses relate to the positions of contracts for difference that were concluded during the calculation period. Unrealised gains and losses apply to the value of open positions at the end of the calculation period. So that it is possible to provide a comprehensive picture of the ratio of accounts where there was a profit or loss, during calculations it is necessary to take into consideration all costs in relation to trading in contracts for difference.

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<sup>63</sup> Recital 126 of the preamble to Decision (EU) 2018/796.

#### 4.5. Prohibition against Monetary and Non-monetary Benefits

108. Supervision investigations have indicated that at promotional events contract for difference providers ordinarily offer bonuses or other incentives for trading in contracts for difference (for example “bonuses for trading”), which often deflect the attention of Non-professional Clients from the highly-risky nature of contracts for difference. Through this procedure providers attract Non-professional Clients that would otherwise evidently not decide to invest in such products. These benefits are often conditional on Non-professional Clients depositing funds on an account or making a certain volume of transactions.<sup>64</sup> Although in accordance with Article 15(3), second sentence, of the ACMU a monetary or non-monetary benefit provided to a client is not regarded as an incentive, it is appropriate to have an express prohibition against performance provided to Non-professional Clients in connection with transactions in contracts for difference that would be against the rules of due diligence. In practice the current rules have not prevented illegal performance. It is also necessary to ensure a uniform approach within the European Union.
109. The prohibition against monetary and non-monetary benefits, however, does not affect the provision of information and analytical tools if they concern contracts for difference, because they help clients make decisions.
110. With regard to the risks that these benefits (which turn out to be more or less illusory) represent to Non-professional Clients, the CNB, in harmony with the ESMA,<sup>65</sup> regards their restriction as necessary and reasonable.

#### 5. PROPORTIONALITY OF MEASURE<sup>66</sup>

111. In accordance with Article 42(2)(c) of MiFIR, a product intervention can be adopted if it “is proportionate taking into account the nature of the risks identified, the level of sophistication of investors or market participants concerned and the likely effect of the action on investors and market participants who may hold, use or benefit from the financial instrument ....”
112. The CNB, in accordance with the ESMA, believes that the options have been exhausted in this area. In November 2013, European supervisory authorities for the financial market (ESMA, EBA and EIOPA) issued a joint opinion on product proceedings, which limits the basic principles valid for the processes of creation of financial instruments.<sup>67</sup> In February 2014, the ESMA issued an opinion on procedures for investment firms selling complex instruments<sup>68</sup> and in March 2014 it issued an opinion concerning structured retail products.<sup>69</sup> Other warnings were issued by the competent authorities of Member States, including the CNB.<sup>70</sup>

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<sup>64</sup> Recital 137 of the preamble to Decision (EU) 2018/796.

<sup>65</sup> Recital 139 of the preamble to Decision (EU) 2018/796.

<sup>66</sup> Article 42(2)(c) of MiFIR.

<sup>67</sup> Joint Opinion of European Supervisory Authority *Manufacturers' Product Oversight and Governance Processes* (JC-2013-77) Accessible at [www.eiopa.europa.eu](http://www.eiopa.europa.eu).

<sup>68</sup> ESMA Opinion *MiFID practices for firms selling complex financial products* of 7 February 2014 (ESMA/2014/146). Accessible at [www.eiopa.europa.eu](http://www.eiopa.europa.eu).

<sup>69</sup> ESMA Opinion *Structured Retail Products - Good practices for product governance arrangements* of 27 March 2014 (ESMA/2014/332). Accessible at [www.eiopa.europa.eu](http://www.eiopa.europa.eu).

<sup>70</sup> *Report on Performance of Supervision of Financial Market for 2015*, pp. 28. Similar in other years. Supervision Benchmark No. 1/2018 *Requirements for Performance of Activities of Securities Trader when Providing Investment Services in Area of Financial Contracts for Difference* accessible at [www.cnb.cz](http://www.cnb.cz).

113. With regard to the nature of the ascertained significant threat to investor protection, the CNB, in harmony with the ESMA, is of the opinion that it is necessary and reasonable to temporarily restrict the marketing, distribution or sale of contracts for difference to Non-professional Clients.
114. The set of rules and restrictions issued in connection with ESMA Decision (EU) 2018/796 and other ESMA decisions on this area is necessary and reasonable to deal with the threat to investor protection. This reduces excessive and significant losses that affect Non-professional Clients under contracts for difference and improves the standard of information Non-professional Clients have about related risks. Benefits obtained from solutions to an identified threat to investor protection in the proposed way predominate over the potential consequences for contract for difference providers.<sup>71</sup> The prohibition does not have a damaging effect on the efficiency of financial markets or on investors that would be unreasonable given the benefit of the measure.
115. The prohibition also does not affect professional clients, who have a greater ability to assess the risky nature of an investment and are better able to assess the properties of financial products. The aforementioned group of professional clients includes natural persons that have sufficient knowledge and experience so that they can be classified as a professional client at their own request.
116. Non-professional Clients will be able to obtain contracts for difference, under the conditions of this measure of a general nature, where the CNB, in harmony with the ESMA, emphasizes the main benefits of the measure:<sup>72</sup>
- a) reduction in the risk of the unsuitable sale of contracts for difference and related financial consequences that is a big benefit for Non-professional Clients and for financial markets as a whole;
  - b) reduction in risks related to regulatory arbitrage across various entities and jurisdictions;<sup>73</sup>
  - c) renewal of trust of clients in financial markets, including trust in providers active in this sector that could suffer detriment to reputation resulting from the problems that investors face.
117. With regard to the fact that the limits of initial margin protection have applied in accordance with ESMA Decisions from 1 August 2018, the CNB does not expect that the introduction of initial margin protection would entail additional costs for contract for difference providers.

### **5.1. Prohibition against Discrimination against Providers from Other European Union Member States**

118. In accordance with Article 42(2)(e) of MiFIR, a measure adopted cannot have “a discriminatory effect on services or activities provided from another Member State.” The prohibition against discrimination results also from other regulations and is included in the principles supporting the rule of law.
119. The rules for this measure of a general nature apply, as appropriate, to everybody who offers contracts for difference in the Czech Republic or from the Czech Republic and cannot

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<sup>71</sup> A potential reduction in the income of contract for difference providers due to lower volumes of trading, lower total transaction fees paid by clients and lower client losses.

<sup>72</sup> Recital 86 of the preamble to Decision (EU) 2018/796.

<sup>73</sup> In particular in the overall context, i.e. the introduction of product intervention measures at the national level by the competent authorities of Member States for supervision of capital markets, see Section 11 of the justification.

therefore have a discriminatory effect for services or activities provided from another Member State.

## **6. COMPLIANCE WITH PROCEDURAL CONDITIONS FOR ISSUE OF MEASURE IN CZECH REPUBLIC**

120. In accordance with Article 42(2)(d) of MiFIR, a measure implemented should be properly discussed with the competent authorities in other Member States that such measure could affect.
121. The CNB called on 10. 6. 2019, in the form of an electronic communication through the ESMA, on the competent authorities in other Member States to make a statement on such notified intention till 20<sup>th</sup> of June 2019. The CNB regards this procedure as proper consultation and in this manner the CNB contacts the other competent authorities in other Member States in this matter. CNB did not receive any reaction from concerned national competent authorities.
122. In accordance with Article 42(2)(f) of MiFIR, a measure adopted should be discussed with “*public bodies competent for the oversight, administration and regulation of physical agricultural markets under Regulation (EC) No 1234/2007.*”
123. The CNB identified the Ministry of Agriculture of the Czech Republic as the public entity competent for the oversight, administration and regulation of physical agricultural markets. CNB and the Ministry of Agriculture of the Czech Republic accomplished a consultation on the prohibition of marketing, distribution and sale of contracts for difference to other than professional clients from and in the Czech Republic in accordance with Article 42(2)(f) of MiFIR on 21. 6. 2019. As the result, the Ministry of Agriculture of the Czech Republic confirmed that a measure implemented does not pose a threat to the orderly functioning and integrity of commodity market.
124. The CNB also made a notification in accordance with Article 42(3) of MiFIR on 24. 6. 2019. CNB did not receive any reaction from concerned authorities.
125. A draft of this measure of a general nature was published from 25. 6. 2019 to 11. 7. 2019 in a manner enabling remote access in accordance with Art. 172(1) of the Administrative Code in connection with Art. 199(6) of ACMU. CNB invited the persons concerned to file their written comments in respect of the proposed measure in the public notice on the issuance of a measure of a general nature. CNB did not receive any comment from concerned person in the period of 15 days.
126. It is not possible to submit a remedy against a measure of a general nature in accordance with Article 173(1) of the Administrative Code.

### **Effect**

This measure of a general nature will become effective on 9<sup>th</sup> of August 2019.

*signatures and stamp of ČNB*

Marek Mora  
Deputy Governor

Vojtěch Belling  
Executive Director, Regulation and  
International Cooperation Department

This measure of a general nature was published on 25. 7.2019

## ANNEX I

### AMOUNT OF INITIAL MARGIN IN ACCORDANCE WITH TYPE OF UNDERLYING ASSET

- a) 3.33% of the notional value of a contract for difference, if the underlying currency pair is comprised of two of the following currencies: US dollar, Euro, Japanese yen, British pound, Canadian dollar or Swiss franc.
- b) 5% of the notional value of a contract for difference, if the underlying index, currency pair or commodity is:
  - i. one of the following share indexes:
    - Financial Times Stock Exchange 100 (FTSE 100 index),
    - Cotation Assistée en Continu 40 (CAC 40 index),
    - Deutsche Bourse AG German Stock Index 30 (DAX30 index),
    - Dow Jones Industrial Average (DJIA index),
    - Standard & Poors 500 (S&P 500 index),
    - NASDAQ (NASDAQ composite index),
    - NASDAQ 100 (NASDAQ 100 index),
    - Nikkei (Nikkei 225 index),
    - Standard & Poors/Australian Securities Exchange 200 (ASX 200 index),
    - EURO STOXX 50 (EURO STOXX 50 index),
  - ii. a currency pair comprising at least one currency that is not stated in section a), above, or
  - iii. gold.
- c) 10% of the notional value of a contract for difference, if the underlying commodity or share index is a commodity or share index other than those stated in section b), above.
- d) 50% of the notional value of a contract for difference, if the underlying asset is a cryptocurrency.
- e) 20% of the notional value of a contract for difference, if the underlying asset is a:
  - i. share; or
  - ii. is not otherwise specified in this annex.

**ANNEX II**  
**WARNING OF RISKS**  
**PART A**

**Requisites of Warning of Risks**

1. A font size that is at least the same as the predominating font size has to be used for a warning of risks. A warning must be in the same language that is used in a statement or published information.
2. If a statement or published information is on a permanent medium or at a website, the warning of risks must be in the format stated in part B.
3. If a statement or published information is on a medium other than a permanent medium or at a website, the warning of risks must be in the format stated in part C.
4. If the number of characters contained in a warning of risks in the format stated in part B or C exceeds the limit on the number of characters that is permitted by the standard conditions of the provider of the advertising space in which contracts for difference are offered to potential clients, they can be warned of the risks stated at variance with paragraphs 2 and 3 in the format stated in part D.
5. If a warning of risks is used in the format in part D, a statement or published information will contain a direct reference to the website of the contract for difference provider that contains the relevant warning of risks in the format stated in part B.
6. A warning of risks must contain the current ratio of losses of Non-professional Clients of a specific investment firm based on the ratio of loss-making accounts for trading in contracts for difference provided to Non-professional Clients by this investment firm. The calculation is performed every three months, always for a period of the 12 months before the day on which the calculation is performed (the "Calculation Period"). For the purpose of the calculation:
  - a) a loss is regarded as having been made on an account of a Non-professional Client for trading in contracts for difference, if the sum of all realised and unrealised net profits for contracts for difference related to an account for trading in contracts for difference during the Calculation Period is negative;
  - b) the calculation includes all costs concerning contracts for difference related to an account for trading in contracts for difference, including all fees and commissions;
  - c) the following items are excluded from the calculation:
    - i. an account for trading in contracts for difference on which there was no open position under a contract for difference in the Calculation Period;
    - ii. all profits and losses from products other than contracts for difference related to an account for trading in contracts for difference;
    - iii. all deposits or withdrawals of funds from an account for trading in contracts for difference.
7. A procedure different to paragraphs 2 to 6 is used if, in the last Calculation Period, an investment firm did not have an open contract for difference linked to the account of a Non-professional Client. In such case a standard warning of risks in the format stated in parts E to G is used.

**PART B**

**Warning of Risks Arising for Specific Provider, Provided on Permanent Medium and at Website**

Contracts for difference are complex instruments and, as a consequence of the use of leverage, they are linked to a high risk of rapid loss.

***[insert percentage for the provider]*% of retail investors' accounts suffered a loss when trading in contracts for difference with this provider.**

You should consider whether you understand how contracts for difference operate and whether you can afford a high risk of the loss of your funds.

#### **PART C**

##### **Abbreviated Warning of Risks Arising for Specific Provider**

***[insert percentage for the provider]*% of retail investors' accounts suffered a loss when trading in contracts for difference with this provider.**

You should consider whether you can afford the high risk of loss of your funds.

#### **PART D**

##### **Warning of Specific Providers about Risks with Limited Number of Characters**

***[insert percentage for the provider]*% of retail investors' accounts suffered a loss.**

#### **PART E**

##### **Standard Warning of Risks on Permanent Medium and at Website**

Contracts for difference are complex instruments and, as a consequence of the use of leverage, they are linked to a high risk of rapid loss.

**When trading in contracts for difference 74–89% of retail investors' accounts suffer a loss.**

You should consider whether you understand how contracts for difference operate and whether you can afford a high risk of the loss of your funds.

#### **PART F**

##### **Abbreviated Standard Warning of Risks**

**When trading in contracts for difference 74–89% of retail investors' accounts suffer a loss.**

You should consider whether you can afford the high risk of loss of your funds.

#### **PART G**

##### **Standard Warning of Risks with Limited Number of Characters**

**74–89% of retail investors' accounts suffered a loss.**