MFSA MALTA FINANCIAL SERVICES AUTHORITY

Consultation Document

Consultation on the Implementation of National Product Intervention Measures in relation to Binary Options

This document seeks feedback from the industry on the proposed product intervention measures with respect to binary options which the MFSA proposes to take in the terms of its powers under Article 42 of MIFIR.

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NOTE. The documents circulated by the MFSA for the purpose of consultation are in draft form and consist of proposals. Accordingly, these proposals are not binding and are subject to changes and revisions following representations received from Licence Holders and other involved parties. It is important that persons involved in the consultation bear these considerations in mind.

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Chapter 1: Binary Options

This Consultation Document relates to measures the MFSA is proposing to introduce in relation to Binary Options.

1.1 What are Binary Options?

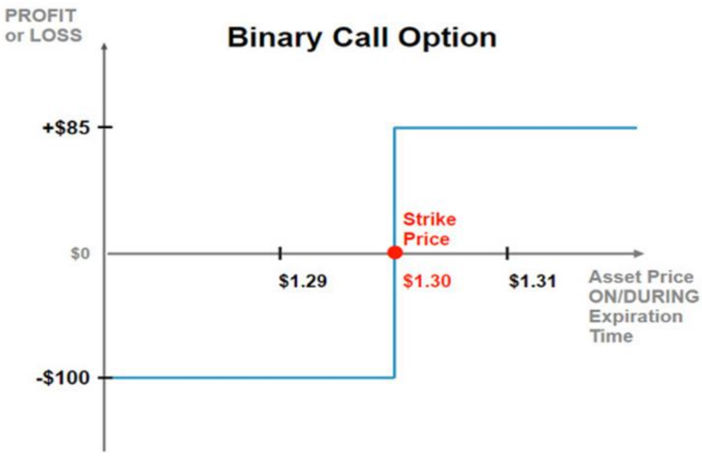
Binary Options are cash settled derivatives in which the payment of a fixed monetary amount depends on whether one or more specified events in relation to the price, level or value of the underlying occurs at, or prior to, the derivative's expiry (for example the underlying has reached a specified price ('the strike price') at expiry). In addition, Binary Options also include contracts in which payment is contingent on multiple events occurring.

1.2 How do Binary Options Work?

The following is an example of how a Binary Option works:

- A binary options brokerage is offering 85% payout for the binary call option on EUR/USD which is currently trading at $1.30.
- Investor A believes that the price will rise over the next 5 minutes and decides to invest $100 to purchase a binary call option on EUR/USD expiring in the next 5 minutes.
- If EUR/USD goes up to say $1.31 five minutes later, the investment pays off and the traders earns a profit of 85% of his initial investment, which is $85.
- However, if the price of EUR/USD drops down to say $1.29 instead, the trader will have lost his initial investment of $100.

The above can be illustrated by the following diagram:



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1.3. Are Binary Options Complex Instruments?

Binary options are considered as complex products, with a price structure that makes it difficult for the retail client to accurately evaluate the value of the option in the light of the probability of the reference event happening. Although retail clients can use research engines, available to the public in general, or tools that can help them to determine the price of a binary option, they face significate asymmetries when compared with the information that the binary option distributor has. Moreover it is also noted that European retail clients usually acquire these instruments through the over-the-counter market, which means that the price, the performance and liquidation of the instruments bought are not standardised, which hinders the ability of the retail client to understand the characteristics of these financial instruments.

The binary nature of these financial instruments means that they are mainly used for speculative purposes. The payment of a fixed monetary value or zero, limits the value of binary options as a hedging instrument, in contrast to the traditional options, which allow those who acquire them to manage risk by setting a maximum or minimum level for a given asset, to which they may be directly exposed.

The complexities of the pricing structure pose a risk of significant information asymmetries between providers and retail clients and hence raise significant investor protection concerns. Furthermore, there are a number of inherent features of binary options that make them complex and difficult for retail clients to understand. Besides representing a high risk, binary options present negative structural returns, which means that the more positions the investor acquires, the more likely she/he is to lose money. The combined effect of the pricing structure and the application of transaction fees to each trade is that a large majority of retail client accounts lose money in aggregate (even though they may make short-term profits) and providers, which are typically direct counterparties to the trade, make a profit from clients in the long term through their losses from trading and through transaction fees.

Lastly, although binary options are complex financial instruments, they are offered to retail clients via electronic platforms, without the provision of investment advice or portfolio management. Accordingly, the pricing, performance and settlement of binary options is not standardised. This impairs retail clients' ability to understand the terms of the product.

Further to the above, the differences in the type of ‘yes/no propositions’ that form the basis of a binary option, the complex pricing structure (sometimes including two-way pricing) and the existence of even more complex offerings (such as options that package together a set of binary options), add to the complexity of these products and further undermine retail clients' ability to understand that the specific features of one type of binary option do not necessarily feature in another.

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Furthermore, binary option providers are typically the counterparty to their retail clients' trades, with the provider determining the price at execution and the payment at expiry. In this regard, providers often require clients to acknowledge that the prices used to determine the value of the binary option may differ from the price available in the respective underlying market. This means that it may not always be possible for retail clients to check the accuracy of the prices received from the provider. These factors make it extremely complex for retail clients to value binary options objectively. The high level of complexity and poor degree of transparency associated with binary options therefore confirms that a significant investor protection concern exists.

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Chapter 2: Product Intervention Measures relating to Binary Options

2.1 ESMA Product Intervention Measures

In accordance with Article 40 of MiFIR, ESMA can introduce temporary intervention measures which are valid for a period of three months. Before the end of this period, ESMA will consider the need to extend the intervention measures for a further three months. If ESMA does not renew the measures they will expire.

In 2018, ESMA formally adopted Product Intervention (PI) measures on Binary Options (BOs) which is essentially a **prohibition** (ban) on the marketing, distribution or sale of binary options to retail investors. For this purpose, binary options have been defined as being:

"a derivative that meets the following conditions, irrespective of whether it is traded on a trading venue:

- *a) it 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) it only provides for payment at its close-out or expiry;*
- *c) its payment is limited to:*
  - *i. a predetermined fixed amount or zero if the underlying of the derivative meets one or more predetermined conditions; and*
  - *ii. a predetermined fixed amount or zero if the underlying of the derivative does not meet one or more predetermined conditions."*

The prohibition contained in the ESMA measure mentioned above does not apply to:

- a) a binary option for which the lower of the two predetermined fixed amounts is at least equal to the total payment made by a retail client for the binary option, including any commission, transaction fees and other related costs;
- b) a binary option that meets the following conditions:
  - i. the term from issuance to maturity is at least 90 calendar days;
  - ii. a prospectus drawn up and approved in accordance with Directive 2003/71/EC (the Prospectus Directive) is available to the public; and
  - iii. the binary option does not expose the provider to market risk throughout the term of the binary option and the provider or any of its group entities do not make a profit or loss from the binary option, other than previously disclosed commission, transaction fees or other related charges.

This measure was initially applied by all National Competent Authorities, falling under ESMA, as from 2 July 2018. Since then, ESMA has extended this measure for three consecutive times with the latest extension being Decision EU 2019/509 of the 22 March 2019. Accordingly, these will remain in force until the 1 July 2019.

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2.2 Proposed National Product Intervention Measures

Under Article 42 of MiFIR, National Competent Authorities have the power to permanently prohibit or restrict the marketing, distribution or sale of financial instruments or a type of financial activity or practice.

The MFSA has carefully considered ESMA's position as well as that of other European National Competent Authorities and is proposing to adopt product intervention measures in terms of Article 42(2) of MIFIR with respect to Binary Options. The proposed measure would essentially mirror the temporary measures from ESMA referred to above and which are currently active throughout the EU. In this regard, the measures proposed to be taken by the MFSA in this regard, would be applicable to investment firms based in Malta and which market distribute or sell, binary options as defined above to retail clients, as well as to investment firms from other EU Member States marketing, distributing or selling such instruments in Malta either through the establishment of a branch in Malta (freedom of establishment) or through the provision of services on a cross border basis (freedom of service).

The adoption of this national product intervention measure is based on significant investor protection concerns, especially on a cross-border basis resulting from the very nature of binary options which gives rise to inherent high risk of consumer detriment.

It is envisaged that this national measure would come into effect at the expiration of the ESMA measures currently in force.

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Chapter 3: The Proposed Regulatory Requirements

The MFSA is proposing to implement the national product intervention measure outlined in Chapter 2 of this Document by including the relevant provisions in the Conduct of Business Rulebook

Prior to the adoption of the ESMA PI measure, MFSA already had in place the Notice to applicants for a Category 3 Investment Services Licence that would like to carry out binary options trading ,in terms of the Investment Services Act, Cap. 370, dated 14th July 2015.

The Authority will also be including, the requirements of the abovementioned Notice, relating to,:

i. The requirement to have a Category 3 Investment Services Licence
ii. Shareholding Structure;
iii. Capital requirements;
iv. Competence requirements;
v. Local Presence/Corporate Governance set-up;
vi. Record Keeping;
vii. Systems;
viii. Liquidity providers/Counterparties;
ix. Restriction of Activities; and
x. Passporting of Services.

in the relevant parts of the Investment Services Rulebook and the Conduct of Business Rulebook. In this regard, it is important to note that the requirements contained in the abovementioned Notice, relating to:

i. Instruments; and
ii. Consumer protection measures

have been superseded the ESMA product intervention measures and the proposed national product intervention measures and therefore will not be reflected in the abovementioned Rulebooks.

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Chapter 4: Action Required and Way Forward

The Authority is issuing this Consultation Document to the public to allow all stakeholders to comment, make suggestions and other contributions to the proposals. For this purpose, the following questions may be considered:

A. Do you agree with the permanent product intervention measures being proposed by the MFSA which would apply to persons offering services to retail investors, in relation to Binary Options, in or from Malta?

B. If the answer to question A above is “no”, please provide reasons.

C. What other measures, in addition to, or in substitution of, the proposed national measures would you suggest to be implemented by the MFSA to mitigate consumer detriment in this area?

Any feedback is to be sent by email to csu@mfsa.com.mt by not later than the 27 May 2019.

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