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Dear CEO

Providers and distributors of contracts for difference (CFD) products: resolving failings which may cause significant consumer harm

We recently carried out a review of the CFD[1] market. It looked at where firms offer these complex, high-risk instruments to retail customers on either an advisory or discretionary (including limited power of attorney) portfolio management basis. The review assessed both the conduct of firms which provide the CFD service (the 'providers') and the organisations that distribute the product and deal with the end consumer (the 'distributors'). We want to ensure that firms:

- deliver CFD products to the intended target market and
- pay due regard to the interests of customers and treat them fairly

Our review included:

- firms' identification of a target market and ability to explain how the CFD product is aligned to this group's needs
- providers' processes for taking on new distributors
- how effectively providers communicate, monitor and provide the relevant degree of challenge over how distributors sell the product
- use of management information (MI) and key performance indicators (KPIs)
- whether distributors identify, manage and mitigate potential conflicts of interest
- distributors' client categorisation processes

[1] The FCA Handbook designates contracts for difference, spread bets and certain 'rolling spot' FX contracts as types of 'CFD', which in turn are a type of derivative.

- end consumer gain/loss data from July 2015 to June 2016 and

- distributors' remuneration arrangements and controls

The review uncovered areas of serious concern that we want to highlight to firms across the industry. This letter sets out our observations and asks you to consider whether your firm complies with the FCA's requirements for providing and distributing CFD products and has taken into consideration our relevant guidance.

Focus of our review

The review assessed 19 firms that provide CFDs to intermediaries which in turn distribute this product to retail consumers on either an advisory or discretionary basis. It also evaluated 15 firms that distribute CFDs on these bases to retail investors.

We reviewed processes, policies, controls and oversight arrangements at sample firms. We then compared them against relevant requirements in the FCA Handbook, particularly the Conduct of Business Sourcebook (COBS), Senior management arrangements, systems and controls (SYSC) and our Principles for Businesses. We expect firms to ensure that their arrangements meet these requirements. To evaluate firms against good market practice, we also used our regulatory guide 'The Responsibilities of Providers and Distributors for the Fair Treatment of Customers' (RPPD).

We reviewed large, medium and small firms in terms of their number of CFD customers to ensure a representative sample of the sector.

Next steps

You should consider the issues we raise in this letter against the conduct of your firm as a CFD provider or distributor. If, when reviewing your arrangements, you identify any areas of concern, we expect you to have regard to the applicable rules and guidance in this letter and take action to ensure compliance.

Summary observations

- Most providers and distributors in our review were unable to offer a satisfactory definition of their target market or to explain how they align the needs of this group to the CFD product they offered.

- Given the level of risk of these products, it is important firms comply with our rules. We note that the majority (76%) of retail customers who bought CFD products on either an advisory or discretionary basis lost money over the 12 month period under review (July 2015 to June 2016).

- We saw a wide range of communication, monitoring and challenge practices by providers over their distributors, many of which were ineffective and did not meet our expectations.

- Most sample providers had flawed due diligence processes for taking on new distributors.
- We identified weaknesses in the conflict of interest management arrangements at all the distributors we assessed.
- Most firms had MI and monitoring structures in place. However, flaws in these tools meant firms did not have the effective oversight they needed to robustly challenge poor conduct or control failings. Some firms were unable to offer any evidence of MI or KPIs.
- The quality of remuneration arrangements at CFD distributors was mixed. While some demonstrated good practice, many firms had significant room for improvement.
- Several distributor firms had problems with their processes and the criteria they consider acceptable when categorising clients as elective professionals.

These findings suggest that CFD providers and distributors may be failing to conduct their activities in accordance with our Principles for Businesses, the Client's best interests rule (COBS 2.1.1R) and SYSC. All firms must ensure that they comply with the FCA's requirements when providing or distributing CFDs and should take into consideration our guidance on these areas.

Areas of concern

Target market identification and aligning this group to the characteristics of the product

As stated in our 2016 Dear CEO letter, CFDs are high-risk, complex financial products. They are typically used for speculative trading purposes and are often highly leveraged. This puts individuals at risk of losing significantly more than their original investment. Because of this, firms should define their target market precisely. This will enable them to understand and evaluate how suitable and appropriate the product is and also assess whether it is meeting their clients' needs on an ongoing basis. RPPD 1.17(1) outlines that providers should identify their target market, which means they should determine which types of customer the product or service is likely to be suitable for. Providers should therefore be able to explain how their target market is aligned with the product they are offering. This is particularly relevant to Principles 2 (Skill, care and diligence) and 5 (Market conduct).

Across the sample, we found the majority of CFD providers and distributors had a poor target market definition. Many relied on broad investor descriptions such as '*experienced*', '*sophisticated*' and '*financially literate'*, without setting out what these terms actually mean in practice. Most firms were also unable to adequately explain how the nature and risks of the CFD product was aligned to their target market.

In our view, excessively broad definitions of target markets may lead firms to conclude that CFDs are suitable and/or appropriate for the majority of potential customers, even when this is unlikely to be the case. Additionally, if providers share a poorly defined target market definition with their distributors to help their decision-making, then these intermediaries may also reach the same incorrect conclusions about an end-consumer's suitability for this high-risk, complex financial product.

Communication, oversight and challenge

We looked at how providers communicate, monitor and, where appropriate, challenge how their CFD product is being distributed. In line with RPPD 1.18(2), providers should ensure that the information that they pass on to distributors is '*sufficient, appropriate and comprehensible in substance and form, including considering whether it will enable distributors to understand it enough to give suitable advice (where advice is given) and to extract any relevant information and communicate it to the end customer*.'

In line with this guidance, examples of the type of information providers could share with their distributors are: the product's characteristics, including associated risks (or be able to evidence why this was not considered necessary), the product's intended target market and whether the information they provide is or is not intended for the end-customer's use. We expect firms to comply with Principle 2 (Skill, care and diligence) in this respect.

In our view, none of the 19 providers in our review were acting in line with our guidance (RPPD). Additionally, these firms could not demonstrate that they were acting with due skill, care and diligence. As a result, they risk non-compliance with Principle 2 (Skill, care and diligence). We were particularly concerned with providers' lack of effective communication and challenge, given that the majority of retail investors (76%) lost money over the period we reviewed.

Process for taking on new distributors

The review looked at providers' due diligence when taking on new distributors. This should include assessing how the CFD product will be distributed and the distributor's knowledge and understanding of the product. RPPD 1.18 and 1.20 provide detail about how firms should meet the fundamental obligation in Principle 2 (Skill, care and diligence) when selecting distributors.

Only one of 19 providers in our review was able to demonstrate robust due diligence during this process. The remaining 18 firms were unable to do so. In our view, a robust process enables providers to understand whether an intermediary has the necessary knowledge and experience to distribute the product and if the distributor's target market matches that of the product provider. These failings increase the risk of poor outcomes for consumers and raise concerns about possible non-compliance with Principles 2 (Skill, care and diligence) and 6 (Customers' interests).

Managing conflicts of interest

We also reviewed how distributors identify, manage and mitigate potential conflicts of interest. SYSC 10.1.3R states that '*a firm must take all reasonable steps to identify conflicts of interest… between the firm… and a client of the firm or one client of the firm and another client*'. Managing conflicts of interest is also covered by Principles 3 (Management and control) and 8 (Conflicts of interest).

All distributors in our review had conflict of interest management arrangements that were either ineffective or needed improvement. Several firms failed to record a single instance of a conflict of interest affecting their business and a number of others claimed there were no potential conflicts of interest.

Firms that fail to adequately identify, manage and mitigate the potential conflicts of interest inherent to their business, which could affect the delivery of good consumer outcomes, risk non-compliance with these rules and principles.

Use of MI and KPIs

The review looked at the use of MI and KPIs by providers and distributors. While some firms had implemented effective monitoring structures, the majority had weak MI and KPIs, with several failing to provide any evidence of them. We are therefore concerned that some firms may be failing to comply with Principle 3 (Management and control) and not taking heed of our guidance (RPPD 1.20(2)).

RPPD 1.20(2) specifies that **providers** should review and analyse relevant information so that they can detect patterns in distribution, such as if it is in line with what they planned, how the target market compares to the actual recipient and assess the performance of their distribution channels. This guidance helps firms comply with Principle 2 (Skill, care and diligence) when they choose and review their distribution channels. Where firms are not following RPPD guidance and have not implemented other tools to ensure they are acting in this manner, they risk non-compliance with Principle 2. In such cases, it would be difficult for them to demonstrate that they had effective oversight of the distribution of their CFD product and that they could robustly challenge distributors where needed.

Additionally, **distributors** should have adequate metrics in place to enable them to accurately oversee their distribution of CFDs and challenge poor practices. Without effective monitoring systems, we are concerned that firms may not recognise process or control failures, risking non-compliance with Principle 3 (Management and control). Because of the weaknesses we identified, distributors may fail to identify and therefore confront instances where CFDs are not being distributed honestly, fairly or professionally in the best interests of the client, or having due regard to the interests of customers and treating them fairly. This risks distributors failing to comply with COBS 2.1.1R and Principle 6 (Customers' interests), respectively.

While monitoring tools enable effective oversight, it is critical that providers and distributors challenge inappropriate conduct and poor customer outcomes. Our review found a distinct lack of effective challenge throughout the 12 month review period.

Client categorisation

The review considered client categorisation, in particular how distributors categorise clients as 'elective professional'. Under COBS 3.5.3R, firms are expected to undertake an adequate assessment of a client's expertise, experience and knowledge to ensure they have reasonable assurance that the client is capable of making their own investment decisions and properly understands the risks involved.

We identified a number of firms that accepted weak answers or asked inadequate questions to assess whether a client could opt up to elective professional status under the requirements set out in COBS 3.5.3R. In particular, firms asked clients poor 'qualitative' questions to assess, with a reasonable level of assurance, whether they had sufficient knowledge and experience. This raises concerns of potential non-compliance with this rule. We expect firms to go beyond asking clients for their own opinion of their knowledge and experience, as this is inevitably subjective and is unlikely to be reliable, at least on its own. Firms should request facts and information to support their assessment of a prospective client's expertise, knowledge and experience in ways that gives them reasonable assurance, given the nature of the planned transactions or services, that the client is capable of making their own investment decisions and understands the risks involved.

Remuneration arrangements

Some distributors had taken steps to identify and mitigate potential conflicts between portfolio managers/advisers and their clients caused by incentive structures. However, many failed to provide satisfactory evidence that they complied with the remuneration code where relevant or had considered FCA sales incentives guidance (FG13/01).

Some firms paid their employees on a 100% variable basis. This arrangement significantly increases the risk of mis-selling since staff may feel pressured to achieve minimum sales targets, regardless of whether this delivers good outcomes for customers. We found a lack of formal processes and documentation for some firms' remuneration policies and processes – the link between an employee's conduct and associated level of pay was sometimes unclear. One distributor admitted it had not implemented a system where poor employee conduct could result in reduced levels of compensation. It said this was because putting a price on compliance could encourage poor staff conduct if the reward for poor behaviour was greater than the cost of the penalty. In line with our guidance (FG13/01), non-financial measures and penalties imposed on members of staff due to poor conduct should be capable of completely overriding financial compensation.

At some firms, senior staff held several roles; for example, at one firm the CEO was also Head of Compliance. This amounts to a conflict and so should require the firm to put in place relevant controls. These were habitually missing. Others remunerated staff based entirely on the revenue they generated, without regard to the firms' overall profitability. SYSC 19C.3.26G explains that profits are a better measure on which to base remuneration, since they commonly reflect risks not adequately captured by accounting revenue.

Overall, we consider that distributors need to significantly improve their remuneration structures and how they identify and manage associated conflicts.

Next steps

Given the significant weaknesses we found across our sample, we believe there is a high risk that firms across the sector are not meeting our rules and expectations when providing and distributing CFDs. As a result, consumers may be at serious risk of harm from poor practices in this sector.

In particular, firms need to improve a number of oversight and control arrangements to reach standards we would consider adequate, given the relevant rules and guidance mentioned throughout this letter. We are concerned that if firms do not address these poor practices, there is a greater risk that consumers will experience poor outcomes through the provision and distribution of CFDs.

You should consider whether your firm complies with the FCA's requirements when providing or distributing CFDs to retail customers on an advisory or discretionary basis.

Following our feedback to them, several firms have said they intend to stop providing CFDs to firms that distribute this product on an advisory or discretionary basis. Others are no longer distributing this complex, high-risk product on these bases to retail consumers. This review also identified a CFD provider whose arrangements were so poor that we intend to take further action.

The provision and distribution of CFD products and delivering good customer outcomes in this sector will remain areas of focus for us. We will undertake further work on these topics and may ask you to take part in a follow-up review to assess how firms have responded to this feedback. Where we identify breaches of our rules, we will take appropriate action, including appointing investigators to examine specific firms, individuals or practices.

The European Securities and Markets Authority (ESMA) announced on 15 December 2017 that it is considering the use of product intervention powers to address risks to investor protection surrounding the provision of CFDs. In particular, ESMA is considering measures to prohibit or restrict the marketing, distribution or sale of CFDs to retail clients. It is conducting a public consultation in January 2018 on this matter.

MiFID II came into effect on 3 January 2018. Firms should pay particular attention to our new Product Intervention and Product Governance Sourcebook (PROD). This implements MiFID II's product governance requirements into the FCA Handbook as rules for firms who manufacture (ie provide) and/or distribute financial instruments. When we follow-up on this topic in the future, we will assess firms' arrangements against these new provisions.

Yours faithfully

Megan Butler
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