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Our Ref:

Dear CEO,

Client take-on review in firms offering contract for difference (CFD) products

We have recently reviewed the procedures for taking on new clients in a sample of ten firms that offer CFD products. We reviewed:

- the firms' approaches to assessing the appropriateness of CFD trading for prospective clients
- initial disclosures to clients
- anti-money laundering (AML) controls
- client categorisation

We have identified several areas of concern which we wish to highlight to firms across the industry. In this letter we explain the issues we have identified and ask you to consider whether your firm complies with FCA requirements for sales of CFD products.

NB - *Contracts for difference, Spread bets and 'Rolling Spot' FX are all designated as a type of 'CFD' under our Handbook's Glossary of definitions, which in turn are a type of derivative.*

Focus of our review

The review sampled ten firms that offer CFD products to clients on a non-advised basis. We included a range of firms from the sector to cover smaller and larger firms.

The key focus of the review was to assess the client take-on procedures against the requirements of the COBS and SYSC rules (set out in the annex to this letter). We expect all firms to ensure that their client take-on process meets these requirements.

Next steps

You should consider the points we raise in this letter regarding the process that your firm follows when taking on new clients. If, when reviewing your processes, you identify any areas of concern, we expect you to have regard to Principle 6 (Customers' interests) as well as

Principle 11 (Relations with regulators) and act accordingly.

Results from our review

- we saw a range of approaches to completing the appropriateness assessment, most of which were not in line with COBS 10
- most risk warnings issued to clients who failed the appropriateness assessments were not adequate
- anti-money laundering controls in place to manage the increased risks posed by higher risk clients were insufficient

These findings also suggest that firms may not be acting in the best interests of their clients and treating them fairly, bringing into question firms' compliance with COBS 2.1.1R and the Principles.

All firms operating in this sector should ensure that they comply with the FCA's requirements when making non-advised sales of CFDs.

Areas of concern

Appropriateness assessments

CFDs are complex, leveraged products that can put clients at risk of losing more than their original investment. Our review identified several key areas of concern, in particular, the inability of some firms to assess appropriateness and to warn clients for whom CFDs are not appropriate.

We saw that many firms in our sample:

- gathered insufficient detail regarding the types of service, transaction and designated investments with which the client is familiar (COBS 10.2.2R(1))
- did not take into account the nature, volume and/or frequency of the client's previous transactional experience or the time period over which such transactions had been carried out (COBS 10.2.2R(2))
- used a scoring system that gave too much weight to a number of other less relevant factors (e.g. age, length of time at address), so that the client's relevant knowledge and experience no longer determined the outcome of the appropriateness assessment (COBS 10.2.1R(2))
- did not assess whether CFDs were appropriate for the client and instead asked the client to self-certify that they understood the risks of the investment e.g. by ticking a box to confirm this (COBS 10.2.1R(1))
- did not assess the client's level of experience and knowledge, for example they did not assess the client's education or identify their profession, or relevant former profession (COBS 10.2.2R(3))

We also saw evidence of poorly worded risk warnings that did not set out the nature and risks of CFD products in a manner that was clear, fair and not misleading (COBS 4.2.1R and 10.3.1R).

We saw that many firms had not established a process to assess whether clients who fail the appropriateness assessment (and who have received a risk warning letter), but who

nonetheless wish to trade in CFDs, should be allowed to proceed with CFD transactions (COBS 10.3.3G).

Anti-money laundering

We are also concerned that some firms in our sample did not have AML systems and controls in place which were proportionate to the nature, scale and complexity of their activities. In particular, we found that:

- although firms were conducting adequate customer due diligence (CDD) on standard risk clients, predominantly through the use of electronic identification systems, many were not conducting enhanced due diligence on clients identified as high risk
- client AML risk assessments did not often consider a range of factors and instead focused on jurisdictional risk, limiting their effectiveness

Client categorisation

The review assessed firms' approaches to categorising clients. We had been concerned that firms offering CFD products might be incorrectly categorising clients as 'professional'. However, we were encouraged to see that eight of the ten firms that we assessed had classified all of their clients as 'retail', giving them the highest level of protection.

Wider implications

Given the poor results that we observed across our sample, we are concerned that there is a high risk that CFD providers industry-wide are not meeting the requirements of the rules when taking on new clients and/or are failing to do enough to prevent financial crime.

In particular, it appears that firms may not have processes that allow them to assess the appropriateness of CFD trading for prospective clients, which could result in firms failing to identify clients for whom CFDs are not appropriate. We were also concerned to find that firms' communications did not meet our expectations. As an example, risk warnings given to clients did not convey in a clear and fair way that the product was not appropriate for the customer.

Please see the annex for further details of the relevant rules and money laundering regulations.

We ask you to consider whether your firm complies with FCA requirements for sales of CFD products and the points we raise in this letter regarding the process that your firm follows when taking on new clients.

Yours faithfully,

Megan Butler
Executive Director of Supervision
Investment, Wholesale & Specialists Division

Annex

Our rules

Principle 1 of our Principles for Businesses requires firms to conduct their business with integrity. Principle 2 requires firms to conduct their business with due skill, care and diligence. Principle 3 requires firms to take reasonable care to organise and control their affairs responsibly and effectively, with adequate risk management systems. Principle 6 requires firms to pay due regard to the interests of their customers and treat them fairly. Principle 7 requires firms to pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.

COBS 10 sets out firms' obligations in relation to assessing appropriateness. In particular:

COBS 10.2.1R:

(1) When providing a service to which this chapter applies, a firm must ask the client to provide information regarding his knowledge and experience in the investment field relevant to the specific type of product or service offered or demanded so as to enable the firm to assess whether the service or product envisaged is appropriate for the client.

(2) When assessing appropriateness, a firm:

(a) must determine whether the client has the necessary experience and knowledge in order to understand the risks involved in relation to the product or service offered or demanded;

(b) may assume that a professional client has the necessary experience and knowledge in order to understand the risks involved in relation to those particular investment services or transactions, or types of transaction or product, for which the client is classified as a professional client.

[Note: article 19(5) of MiFID and article 36 of the MiFID implementing Directive]

COBS 10.2.2R:

The information regarding a client's knowledge and experience in the investment field includes, to the extent appropriate to the nature of the client, the nature and extent of the service to be provided and the type of product or transaction envisaged, including their complexity and the risks involved, information on:

(1) the types of service, transaction and designated investment with which the client is familiar;

(2) the nature, volume, frequency of the client's transactions in designated investments and the period over which they have been carried out;

(3) the level of education, profession or relevant former profession of the client.

[Note: article 37(1) of the MiFID implementing Directive]

COBS 10.3.1R:

(1) If a firm considers, on the basis of the information received to enable it to assess appropriateness, that the product or service is not appropriate to the client, the firm must warn the client.

(2) This warning may be provided in a standardised format.

[Note: article 19(5) of MiFID]

COBS 10.3.3G:

If a client asks a firm to go ahead with a transaction, despite being given a warning by the firm, it is for the firm to consider whether to do so having regard to the circumstances.

COBS 2.1.1R sets out the client's best interests rule:

COBS 2.1.1R:

(1) A firm must act honestly, fairly and professionally in accordance with the best interests of its client (the client's best interests rule).

(2) This rule applies in relation to designated investment business carried on:

(a) for a retail client; and

(b) in relation to MiFID or equivalent third country business, for any other client.

(3) For a management company, this rule applies in relation to any UCITS scheme or EEA UCITS scheme the firm manages.

[Note: article 19(1) of MiFID] and article 14(1)(a) and (b) of the UCITS Directive]

COBS 4.2.1R sets out the fair, clear and not misleading rule:

COBS 4.2.1R:

(1) A firm must ensure that a communication or a financial promotion is fair, clear and not misleading.

(2) This rule applies in relation to:

(a) a communication by the firm to a client in relation to designated investment business other than a third party prospectus;

(b) a financial promotion communicated by the firm that is not:

(i) an excluded communication;

(ii) a non-retail communication;

(iii) a third party prospectus; and

(c) a financial promotion approved by the firm.

[Note: article 19(2) of MiFID, recital 52 to the MiFID implementing Directive and article 77 of the UCITS Directive]

SYSC 6.3 sets out firms' obligations in relation to AML controls. In particular:

SYSC 6.3.1R:

A firm must ensure the policies and procedures established under SYSC 6.1.1R include systems and controls that:

- (1) enable it to identify, assess, monitor and manage money laundering risk; and
- (2) are comprehensive and proportionate to the nature, scale and complexity of its activities.

SYSC 6.3.3R:

A firm must carry out a regular assessment of the adequacy of these systems and controls to ensure that they continue to comply with SYSC 6.3.1R.

SYSC 6.3.6G:

In identifying its money laundering risk and in establishing the nature of these systems and controls, a firm should consider a range of factors, including:

- (1) its customer, product and activity profiles;
- (2) its distribution channels;
- (3) the complexity and volume of its transactions;
- (4) its processes and systems; and
- (5) its operating environment.

SYSC 6.3.7G:

A firm should ensure that the systems and controls include:

- (1) appropriate training for its employees in relation to money laundering;
- (2) appropriate provision of information to its governing body and senior management, including a report at least annually by that firm's money laundering reporting officer (MLRO) on the operation and effectiveness of those systems and controls;
- (3) appropriate documentation of its risk management policies and risk profile in relation to money laundering, including documentation of its application of those policies (see SYSC 9);

(4) appropriate measures to ensure that money laundering risk is taken into account in its day-to-day operation, including in relation to:

- (a) the development of new products;
- (b) the taking-on of new customers; and
- (c) changes in its business profile; and

(5) appropriate measures to ensure that procedures for identification of new customers do not unreasonably deny access to its services to potential customers who cannot reasonably be expected to produce detailed evidence of identity.

Money Laundering Regulations 2007

Regulation 14: Enhance customer due diligence and ongoing monitoring (only sections applicable to our findings have been detailed below):

(1) A relevant person must apply on a risk-sensitive basis enhanced customer due diligence measures and enhanced ongoing monitoring:

- (a) in accordance with paragraphs (2) to (4);
- (b) in any other situation which by its nature can present a higher risk of money laundering or terrorist financing.

(2) Where the customer has not been physically present for identification purposes, a relevant person must take specific and adequate measures to compensate for the higher risk, for example, by applying one or more of the following measures:

- (a) ensuring that the customer's identity is established by additional documents, data or information;
- (b) supplementary measures to verify or certify the documents supplied, or requiring confirmatory certification by a credit or financial institution which is subject to the money laundering directive;
- (c) ensuring that the first payment is carried out through an account opened in the customer's name with a credit institution.

(4) A relevant person who proposes to have a business relationship or carry out an occasional transaction with a politically exposed person must:

- (a) have approval from senior management for establishing the business relationship with that person;
- (b) take adequate measures to establish the source of wealth and source of funds which are involved in the proposed business relationship or occasional transaction; and
- (c) where the business relationship is entered into, conduct enhanced ongoing monitoring of the relationship.

(5) In paragraph (4), "a politically exposed person" means a person who is?

(a) an individual who is or has, at any time in the preceding year, been entrusted with a prominent public function by:

- (i) a state other than the United Kingdom;
- (ii) a Community institution; or
- (iii) an international body, including a person who falls in any of the categories listed in paragraph 4(1)(a) of Schedule 2;

(b) an immediate family member of a person referred to in sub-paragraph (a), including a person who falls in any of the categories listed in paragraph 4(1)(c) of Schedule 2; or

(c) a known close associate of a person referred to in sub-paragraph (a), including a person who falls in either of the categories listed in paragraph 4(1)(d) of Schedule 2. 5

(6) For the purpose of deciding whether a person is a known close associate of a person referred to in paragraph (5)(a), a relevant person need only have regard to information which is in his possession or is publicly known.

Financial Crime: A Guide for Firms

<https://www.handbook.fca.org.uk/handbook/FC/>

Other reference material:

FSA implementation factsheet on appropriateness:

http://www.fsa.gov.uk/pubs/other/implement_factsheet.pdf

ESMA investor warning on CFDs:

<https://www.esma.europa.eu/sites/default/files/library/2015/11/2013-267.pdf>