RegCORE Client Alert

Financial Services: BaFin proposes rules banning the marketing, distribution and sales of futures with additional payment obligations to retail investors

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Overview

The German Federal Financial Supervisory Authority (**BaFin**) on 17 February 2022 published its consultation on its proposals for a general ruling regarding futures with "additional payment obligations".[1] The powers of BaFin to propose such new rules are set out in EU rulemaking and notably the product intervention powers set out in Art. 42 of MiFIR.[2] The consultation on the new rules[3] runs to 17 March 2022.

Interestingly, the draft rules only apply to an investment firm – and not to credit institutions i.e., banks, who may also offer such products. The BaFin's rules and thus the ban applies inbound business, notably to those investment firms that have their registered office in Germany and who distribute (or intend to) futures with additional payment obligations to retail clients domiciled in Germany and equally to those investment firms located in another Member State of the European Economic Area (**EEA**) that conduct (or intend to) trading in futures with additional payment obligations with retail clients domiciled in Germany. The BaFin's rules and ban does not apply to those investment firms that are domiciled in Germany that engage in (or intend to) trading in futures on an outbound basis i.e., from Germany to retail clients domiciled outside of Germany in the EEA or outside of the EEA.

The final rules and thus the restrictions set out in them would take effect three months after the enactment of the new rules.

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1 For further details of the BaFin's consultation see here.
2 Regulation (EU) No. 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No. 648/2012.
3 See non-binding English convenience translation of the rules in current draft form available here.

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Why the BaFin is pressing for a ban

Following BaFin's investor protection concerns on the marketing, distribution and sales of futures with margin calls to retail investors, this consultation aims to set out the rules and supervisory expectations of how firms should comply. The BaFin's proposal on futures, builds upon similar moves by BaFin (following EU-wide action) in 2017 in the banning of the offering of Contracts for difference (**CFD**s) (including rolling spot forex products and financial spread bets) with additional payment obligations to retail clients. The 2017 rules and thus the ban on CFDs were updated in 2019 with certain clarifications and allowed for certain products to be offered to retail clients albeit under certain conditions being met.[4] Primarily this meant investment firms have to ensure that the CFD does not have any additional payment obligations and that any loss is limited to the amount invested (i.e., a "negative balance protection".

While futures and CFDs are certainly important financial products for retail clients, BaFin's view (for CFDs and now for futures) is that retail clients transacting in financial products involving an obligation to (our emphasis in italics and explanations in square brackets) "…make additional payments [i.e. margin calls but not all types – see below] are *exposed to substantial risk. In highly volatile market situations, these products can result in unlimited losses*. If the capital invested is not enough to offset losses, investors must use their other assets. Retail clients can lose significantly more than their invested capital; in the past, some investors have been required to make six-figure additional payments."

Given the experience gained in respect of the BaFin's ban on CFDs, it is conceivable that many firms may look to adapt some of their future products to comply with the BaFin's new rules and introduce products with a negative balance protection instead of ceasing the offer of futures products with additional payment obligations altogether.

Details of the ban – some discrepancy in the details in the current draft rules

The BaFin's new proposed ban comes as a result of financial services firms moving from non-permitted CFD products to offering and marketing futures with additional payment obligations but also an increasing number of mini and micro futures products. These have been held by BaFin to be subject to a higher degree of risk that is both adverse to retail investors in particular when such risks are not clearly described and disclosed.

The rules themselves, a General Administrative Act of the BaFin, which enjoys the force of law, applies to "Investment firms are prohibited from marketing, distributing and selling futures with additional payment obligations to retail clients within the meaning of Article 4 (1) (11) of MiFID II in Germany."

However, the draft rules do not:

- define futures (this is done at the EU-level in MiFIR/MiFID II) but rather set out, at length, in the draft's Section 1.1. a general description of how futures work – this is problematic for a number of reasons given that the description, while correct in certain parts, cross-refers only to German legal commentary and not to EU-level commentary nor definitions in MiFIR/MiFID II but also fails to account for direct market access-based trading (even though this may only be available for certain retail clients' tradres);
- define how the ban applies (or does not) in the case of reverse solicitation (which could apply for EEA and non-EEA firms); and
- provide sufficient detail on what constitutes "voluntary" in the context of provision of additional obligations. At the very start of the draft rules, the BaFin states that (our emphasis in italics): "In the case of additional payment obligations within the meaning of number 1, this is a requirement to compensate a loss after the forced liquidation of other trading positions by providing additional funds from other assets. *A voluntary increase in the margin by the retail client in order to avoid a forced liquidation does not constitute an additional payment obligation in the sense of this order*. Additional payment obligations exist if retail clients can incur losses that go beyond the capital they have invested." As a result of this drafting – additional payment obligations are much wider than just typical variation/maintenance margin calls.

The BaFin's draft rules provide further rationale on why this ban (notably given the last bullet point above) is, in its view, necessary from an investor protection perspective (our emphasis in italics):

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[4] See non-binding English convenience translation of the CFD ban rules, as updated in 2019, available here.

"Although many intermediaries have implemented such a margin call procedure and actively tell investors about potential insufficient coverage or impending negative balances on the margin account, this is not the case with all intermediaries. In their general terms and conditions, intermediaries also do not normally undertake to make a margin call, but see this as an (optional) service offering for investors. In addition, *in particular in the event of strong price movements, it may not be possible to make a margin call in good time and the position may have to be forcibly closed out before the retail client is informed*.

In some cases, the margin obligations are determined by the intermediaries at the portfolio level. In such cases, all additional payment obligations in futures or options trading are offset against each other. In the event of insufficient coverage in a futures contract, for example, the intermediary could then not only forcibly close out futures positions, but also other positions, until the (additional payment) obligation is fulfilled by closing out other transactions.

In the past, especially in the case of special market events and associated unexpected, significant price fluctuations that ran counter to investor expectations, it was evident that considerable additional payment obligations could arise. Prominent examples of such "black swan" events include the slump in oil prices in spring 2020 or the "Swiss franc crash" in January 2015.

In these situations, the *collateral provided by investors was often insufficient to cover the losses incurred. Because of strong price fluctuations, investors mostly did not have time to voluntarily increase their collateral, so brokers forcibly closed out positions*. Since the liquidation of other positions – to the extent they existed – could not cover all of the losses, investors were forced to settle the outstanding amounts from their private assets. In such cases, the losses resulting from the transactions in question often exceeded the amount invested by a multiple. The amount of any possible additional payment obligation and the amount that then has to be reimbursed is not limited to the original amount, but can be far more. This results in the risk that retail clients in particular are not aware of the extent of the actual risk of loss or significantly underestimate it.

Due to the way futures are designed, there is also the risk of additional payment obligation when the overall market develops normally, for example if individual underlying instruments such as shares or commodities move strongly in a different direction than investors expect*. Additional payment obligations therefore arise not only in the case of the special market events described above, but also, for instance, in the case of volatility or market developments affecting specific underlying instruments.*

In this case, the multiplier (the loss may exceed the capital paid in by a multiple) results from the leverage effect, as only a fraction of the contract value of the future is required to be held by the investor in the form of the margining requirements. In the example of a EUREX contract, it is not necessary to invest the entire contract total of EUR 400,000 for a DAX future with an assumed index level for the underlying instrument of 16,000 points, but only EUR 31,200 must be deposited. This corresponds to a margin of 7.8 % of the contract value (see also example in Table 1). The ratio of the contract value to the required (initial) margin also indicates the level of the leverage. Investors do not have to invest the entire amount, but essentially speculate on credit. In some cases, leverage in excess of 1,000 is possible.

Retail clients buy futures for hedging and speculation. Investors can offset price losses in underlying instruments (on the spot market) using futures. Moreover, due to the low capital required (the margin) and the resulting leverage effect, investors can exploit market changes in the underlying instrument for only a small stake."

BaFin had considered whether, as an alternative to a ban, more stringent enforcement of provisions of the German Securities Trading Act (*Wertpapierhandelsgesetz* – WpHG) (such as greater transparency, disclosure and monitoring of risks of products and their suitability and appropriateness would serve the aims of minimising risks to retail clients. In light of the above the BaFin is treading a fine line in these draft rules. On the one hand it is balancing investor protection concerns, a cornerstone of its mandate, with product intervention powers. These rules effectively seek to prevent retail investors exposure to market risk even though the rationale (see part 2 of the draft rules) justify the ban due to "extraordinary events" and "risk of unlimited losses" driving what are "significant investor protection concerns".

The BaFin's ban also creates a jurisdiction-specific divergence from the EU's Single Rulebook on financial services notably in the context to the EU's MiFIR/MiFID II regime which harmonises the EU Single Market for financial services and which the EU-level authorities, notably the European Securities and Markets Authority (**ESMA**) continues to press for financial services firms but equally national competent authorities (**NCA**s), such as BaFin to do more on supervisory convergence and reduction of fragmentation to ensure the Single Rulebook is truly single in nature. It remains to be seen whether NCAs and/or ESMA will consider following a similar approach (some similar but not identical bans do exist in other EU Member States) or otherwise

press BaFin to allow for some futures products to be tradable for German domiciled retail clients (i.e., in the same way that the BaFin CFD ban was amended slightly).

What affected financial services firms might wish to do now

Aside from responding to the consultation, affected financial services firms will need to take preparatory action – both in terms of updating documentation and client-facing communications, but also in respect of (as the BaFin notes in section 2.6.1.3.1 of the draft rules) on IT (equally reporting) costs, marketing costs, legal costs as well as changes to how firms hedge the market risk they assume in the amount of additional payment obligations if they have to rule out the additional payment obligation in their contractual relationship with the retail clients, which could cause additional costs for the affected financial services firm.

Affected financial services firms will also want to ensure they have a comprehensive plan to dealing with both existing customers affected by the ban but also in relation to new customers both in terms of existing futures products but also those, as certain firms may wish to amend, that will comply with what BaFin is proposing in its final rules. Affected financial services firms should therefore also be cognisant of recent changes to German law (notably with respect to consent requirements in changes to general terms and conditions) that require active consent as opposed to deemed consent and forward-plan timelines for communications with retail clients accordingly and what this means for those arrangements concluded with wholesale market counterparties to generate exposures as well as hedging to be able to offer futures with additional payment obligations to retail clients generally but also specifically in respect of the BaFin's proposed ban.

It is conceivable that the BaFin will look to ensure that the affected financial services firms are diligent in ensuing that any request for clients to opt-up from retail client status to elective professional client status (as the draft rules would not apply to such client categorisation) are conducted in a sufficiently robust manner. Firms should also recall, that given the conclusion of ESMA's recent Common Supervisory Action (see our dedicated coverage on this) on both suitability and appropriateness rules, that client categorisation as well as suitability and appropriateness tests continue in 2022 and likely for a considerable period beyond to be in focus of both the BaFin but also NCAs and equally on a thematic level also ESMA.

Equally, it should be expected that the BaFin, other NCAs and ESMA will look to explore any increases in bad conduct in portfolio-wide close-outs, even if in light of increased geostrategic tensions causing exacerbated market volatility, conducted with retail clients.

Outlook

Financial services firms operating into or from Germany may want to consider stepping up their preparatory measures including their horizon risk management. This might help firms in forward-planning the impact but also differences between the BaFin's rules as well as those supervisory expectations set by the EU-level authorities across the EEA, in particular on MiFIR/MiFID II suitability and appropriateness[5].

While some of these rules and expectations may be overlapping, and some may stem from common EU principles or rulemaking, there are still a number of jurisdiction-specific requirements but also unintended conceptual divergences that firms are nevertheless expected to comply with, irrespective of EU-level aims of improving supervisory convergence of both the body of rulemaking, including in its Single Rulebook for financial services across the EU's Single Market but also the supervisory culture across relevant authorities.

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5 For further details of PwC Legal's dedicated client-centric online services to help with horizon scanning, risk mapping (including with data lakes) and compliance framework documentation please contact PwC Legal's EU RegCORE.

About us

PwC Legal is assisting a number of financial services firms and market participants in forward planning for changes stemming from these proposals.

If you would like to discuss any of the developments mentioned above, or how they may affect your business more generally, please contact any of our key contacts or PwC Legal's RegCORE Team via de_regcore@pwc.com or our website.

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