FINANCIAL MARKETS AUTHORITY
TE MANA TĀTAI HOKOHOKO

JUNE 2024

Consultation: Standard conditions for derivatives issuer licences

About this consultation

The Financial Markets Authority - Te Mana Tātai Hokohoko (FMA) is considering imposing a new standard condition and varying an existing standard condition for all derivatives issuer (DI) licences. All licensed DIs operating in New Zealand must comply with standard conditions the FMA imposes on their licences.

Retail investors who trade derivative products are exposed to unique risks. The FMA's view is that a new condition setting leverage limits and a revised suitability condition will help retail investors manage these risks.

- **Leverage**

  FMA-licensed DIs are currently not subject to leverage conditions. Some offer leverage up to 500:1. This level of leverage exposes investors to the risk of significant loss. The proposed new standard condition 14 will align DIs with leverage limits in other jurisdictions.

- **Suitability**

  Standard condition 12 requires licensed DIs to assess the suitability of a derivative for a retail investor before the investor enters into the derivative. The requirements are not complex, but our monitoring has identified instances of non-compliance and ineffective procedures since the condition was introduced in 2015. The revised condition is designed to help DIs consistently assess suitability.

We welcome your feedback on the proposed standard conditions discussed in this paper. Please use the feedback form at the end of this document to submit your feedback. If you have queries about this consultation, please email questions@fma.govt.nz or call us on 0800 434 566 (+64 3 962 2695).

Submissions close at 5pm on 7 August 2024. After this date, we will consider all submissions and finalise the standard conditions we may impose or vary. We will publish the final standard conditions on our website.

This consultation is for FMA-licensed derivatives issuers and other interested parties.	It seeks feedback on proposed standard conditions on a market services licence for derivatives issuers.

Contents

Background

FMA's ability to impose licence conditions

The FMA may, by written notice, impose conditions on a licence when the licence is issued or add conditions at any time after issuance.[1]

Derivatives issuer licences granted under section 396 of the Financial Markets Conduct Act 2013 (FMC Act) are subject to conditions imposed by the FMA. The Standard Conditions for derivatives issuer licences are published together with explanatory notes on how derivatives issuers should satisfy each condition.

In respect to imposing a condition on a market services licence for DIs,

- Regulation 201(1)(g) of the Financial Markets Conduct Regulations 2014 (FMC Regulations) permits the FMA to impose a condition requiring DIs to conduct suitability assessments for retail investors, and
- Regulation 201(1)(h) permits the FMA to impose a condition requiring DIs to maintain and enforce leverage limits for retail investors.

The FMA must give licensees at least 10 working days' notice before exercising a power to impose a new condition or vary an existing condition. The notice must explain that the FMA may exercise the power, and the reasons for exercising the power. The notice must provide an opportunity for licensees to make written submissions within the notice period.[2]

The FMA is conducting a public consultation because we are interested in hearing views from the wider public and not just current licence holders. We will take submissions into consideration before deciding whether to impose the conditions. Once any changes to the conditions have been finalised, we will undertake the process set out in section 405.

FMA's 2020 DI Sector Risk Assessment

In 2020, the FMA published a Derivatives Issuer Sector Risk Assessment (SRA), which summarised key risks posed by DIs to the FMA's objective of promoting fair, efficient, and transparent financial markets. We used a combination of our own observations and DI self-assessments to evaluate the governance, culture, systems and controls used by 25 licensed DIs to meet their compliance obligations.

The SRA identified multiple risks relating to product suitability, counterparty risk, derivative investor money, margining, advertising and outsourcing, and rated them from high to low.

The risk presented by highly leveraged derivatives was rated medium-high and discussed in the SRA under the heading "Retail customers may be getting poor outcomes from margin trading". For those DIs offering margin trading, the SRA asked about leverage levels and retail investors with negative balances in their trading accounts. One response indicated that 25-50% of their retail investors' accounts contained negative

[1] FMC Act section 403(1)
[2] FMC Act section 405

balances – evidence that margin requirements may have exceeded investors' deposits. High levels of leverage can magnify losses, causing investors to not only lose their initial deposit, but in some cases resulting in a negative balance in their trading account (a debt payable from the investor to the DI).

The SRA rated suitability risk as high. It found that up to 25% of firms may not be taking reasonable steps to assess whether derivatives are suitable for their retail investors, e.g. considering prior trading experience, understanding of leverage, or understanding of risk.

Proposed standard conditions for derivatives issuers

The new leverage condition (standard condition 14) and revised suitability condition (standard condition 12) proposed in this consultation would likely be imposed on all licensed derivatives issuers.

The following sections outline further details of the proposed standard conditions. Unless the wording explicitly indicates otherwise, 'you' and 'your' mean the entity that holds the licence. In all instances, 'us' and 'we' means the FMA.

Leverage

Overview

Derivatives (such as futures or forward contracts, options, swap agreements, contracts for difference (CFD), margin contracts, or rolling spot contracts) can be used to speculate, hedge or gain exposure to a variety of underlying asset classes.

Licensed DIs offer retail investors over the counter (OTC) derivatives such as contracts for difference (CFD), futures and option contracts. Some retail investors use derivatives for speculative purposes. DIs allow investors to leverage their exposure to financial products by depositing capital (margin), which acts as a deposit towards a larger financial exposure. The amount of leverage is inverse to the margin deposited and is expressed as a percentage (for example a 20:1 leverage ratio would mean that margin of 5% was required as an initial deposit).

Currently, there is no limit to the amount of leverage a licensed DI can offer to retail investors in New Zealand. While some licensed DIs limit CFD leverage to 30:1, others offer up to 500:1. We have observed that the number of margin calls[3] per investor is significantly higher for DIs offering high leverage levels.

Rationale for new standard condition on leverage

Leverage can enable efficient asset allocation, but highly leveraged derivatives mean retail investors may experience losses in excess of what they expected. The higher the level of leverage, the greater the financial impact felt from price volatility, which can be positive or negative, depending on the investor’s position (ownership of the derivative at any given time).

There are ways to manage the risks created by leveraged derivatives. Investors can use stop loss orders (an instruction to trade when prices reach certain levels) or they can deposit funds to retain their positions. Alternatively, the DI may close an investor’s positions once the initial margin is eroded. However, DIs are not obligated to protect investors from entering a negative account balance (effectively a debt payable by the investor to the DI).

The financial impacts of trading derivatives are intensified by low liquidity in the market. Liquidity in this context refers to how easily an asset can be converted into cash (sold) without affecting the asset’s market price. Without adequate liquidity, derivative prices are more volatile and if an investor holds a highly leveraged contract, they may find that they cannot close the position without taking a substantial loss.

[3] Where the percentage of an investor’s capital falls below the DI’s required amount, meaning the investor must deposit more funds.

International approach to derivatives regulation

The approach to regulating derivatives varies, but regulators in Australia, the United Kingdom, the US, and Europe have used leverage restrictions and product intervention powers to help control risks. Some have banned CFDs while other have applied limits to how much a derivative may be leveraged in particular asset classes. For example:

- In the United Kingdom, the Financial Conduct Authority (FCA) Handbook establishes margin requirements for 'restricted speculative investments'[4] (CFDs, spread betting, rolling spot forex contracts and restricted options).
- The Australian Securities and Investments Commission (ASIC) sets leverage limits of 30:1 for CFDs.
- The European Securities and Markets Authority (ESMA) requires leverage limits, a margin close-out rule and negative balance protection on a per account basis for CFDs.[5]
- In the US, CFDs are banned, and the Commodity Futures and Trading Commission (CTFC)[6] and the National Futures Association (NFA)[7] both limit Forex Dealer Members' leverage.

Leverage limits

Many regulators use the same leverage limits for underlying asset classes for derivatives. The risk profile of each asset class depends on its volatility, regulation, and speculative nature. Assets that are more volatile, less regulated, and more speculative carry higher degrees of risk.

The leverage limits set out in the table below are used by ASIC, the FCA and ESMA.

Asset class	Leverage
FX (major pairs)	30:1
FX (minor pairs)	20:1
Indices (major)	20:1
Indices (minor)	10:1
Gold	20:1
Commodities (excl. gold)	10:1
Shares	5:1
Cryptoassets	2:1

[4] Restricted speculative investments | FCA Handbook
[5] ESMA product intervention measures in relation to CFDs and binary options offered to retail investors FAQ
[6] Position Limits for Derivatives | CFTC website
[7] Forex Transactions: Regulatory Guide | NFA website

Proposed new standard condition for leverage

We are proposing a new standard condition as set out below. It could be imposed on derivatives issuers licences. The condition would set leverage limits by asset class for current and future OTC derivatives available to retail investors. While some jurisdictions only set leverage limits for select OTC products such as CFDs[8] or foreign currency derivatives, we are proposing limits that apply to **all** OTC derivatives offered to retail investors. Our monitoring of DIs has shown that most retail investors use OTC derivatives to speculate, and when speculation is enabled by high leverage there is a greater chance of losing money.

We acknowledge that retail investors who use OTC derivatives to hedge their exposure to the underlying securities will also be impacted by the introduction of this leverage condition. However, we consider that they represent a small percentage of total derivatives investors.

We are seeking feedback on the current use of derivatives, the proposed condition itself, and potential costs and impacts to DIs and investors of implementing the condition.

Implementation timeframe

We are also seeking feedback on whether the new standard condition 14 (if we decide to impose it) should come into effect 6 months after the date we publish a decision, or sooner. Most DIs will be aware of the proposed condition and should have – at a minimum – considered how they will implement processes and procedures to meet the requirements set out in the standard condition. However, we want to be sure DIs have sufficient time to prepare.

Proposed standard condition wording

14. Leverage limit

Standard Condition: *(This standard condition will be effective from xx Date 2024)*

1. You must not offer or issue an over-the-counter derivative to a retail investor unless the terms of the derivative require the retail investor to provide an initial margin of at least:

    (a) 3.33% of the value of the total exposure derived from the transaction if the underlying for the derivative is an exchange rate for a major currency pair; and

    (b) 5% of the value of the total exposure derived from the transaction if the underlying for the derivative is an exchange rate for a minor currency pair, a major stock market index or gold; and

    (c) 10% of the value of the total exposure derived from the transaction if the underlying for the derivative is a minor stock market index or a commodity other than gold; and

[8] REP 724 Response to submissions on CP 348 Extension of the CFD product intervention order | ASIC

(d) 50% of the value of the total exposure derived from the transaction if the underlying for the derivative is a cryptoasset (including cryptocurrency); and

(e) 20% of the value of the total exposure derived from the transaction if the underlying for the derivative is an equity security or an asset not otherwise listed in 1(a) to (d).

2. You must not offer or issue an over-the-counter derivative to a retail investor unless the terms of the derivative provide for the following:

(a) At all times the net equity of a retail investor’s derivative account must not be less than the aggregate margin requirement required to maintain the investor’s open derivative position(s) that are connected to that account;

(b) If at any time the net equity of a retail investor’s derivative account is less than the aggregate margin requirement required to maintain the investor’s open derivative position(s) at that time that are connected to that account, you must, as soon as market conditions allow and on terms most favourable to the retail investor, terminate or close out one or more of the retail investor’s open derivative position(s) that are connected to that account until the time at which the first of the following occurs:

(i) the net equity of the retail investor’s derivative account is equal to or greater than the aggregate margin requirement for the retail investor’s remaining open derivative position(s) that are connected to that account; or

(ii) all open derivative position(s) that are connected to the retail investor’s derivative account are terminated or closed out.

3. In this condition, --

aggregate margin requirement in relation to a retail investor’s open derivative position(s) at a time, means an amount that is the greater of:

(a) 50% of the aggregate of the maintenance/variation margin required by you to be provided by the retail investor in relation to each open position for those derivatives at that time; or

(b) 50% of the aggregate initial margin that would have been required under paragraph 1(a) to (e) if each position for those derivatives had been opened at that time.

derivative account means an account that a retail investor has with you through which the retail investor can place orders to acquire and dispose of derivatives.

exchange rate for a major currency pair means an exchange rate for a pair of currencies that consists of any two of the following:

(a) US Dollar;

(b) Euro;

(c) Japanese Yen;

(d) Pound Sterling;

(e) Canadian Dollar; and

(f) Swiss Franc.

exchange rate for a minor currency pair means an exchange rate for a pair of currencies that is not an exchange rate for a major currency pair.

major stock market index means any of the following stock market indices:

(a) Cotation Assistée en Continu (CAC 40);

(b) Deutsche Bourse AG German Stock Index (DAX);

(c) Dow Jones Industrial Average (DJIA);

(d) EURO STOXX 50 Index (EURO STOXX 50);

(e) Financial Times Stock Exchange 100 (FTSE 100);

(f) NASDAQ-100 Index (NASDAQ 100);

(g) NASDAQ Composite Index (NASDAQ);

(h) Nikkei Index (NIKKEI 225);

(i) Standard & Poor's 500 (S&P 500);

(j) Standard & Poor's/Australian Securities Exchange 200 (S&P/ASX 200).

minor stock market index means an index that is not a major stock market index.

net equity in relation to a retail investor's derivative account, means the sum of the following:

(a) the amount of derivative investor money held in respect of the investor in the account; and

(b) the net realisable value of derivative investor property held in respect of the investor and in relation to the account; and

(c) to the extent not referred to in (a) or (b), the net realisable value to the investor of derivatives issued by you to the investor that are connected to the account.

net realisable value has the meaning given to it in regulation 244A of the Financial Markets Conduct Regulations 2014.

retail investor has the meaning set out in regulation 5(1) of the Financial Markets Conduct Regulations 2014.

Explanatory note: Paragraph 1 requires the terms of any derivative that you offer to retail investors to include minimum initial margin requirements based on the value of the total exposure derived from the transaction, so that the leverage ratio offered to investors does not exceed the following limits at the time of issue:

- 30:1 for an exchange rate for a major currency pair
- 20:1 for an exchange rate for a minor currency pair, gold or a major stock market index
- 10:1 for commodities (excluding gold) or a minor stock market index
- 2:1 for cryptoassets (including cryptocurrency)
- 5:1 for equity securities or other underlying assets.

For the purposes of this condition, the “total exposure derived from the transaction” is the total contractual exposure derived from the transaction. An example is set out below:

Person A has $10,000 of derivative investor money held in trust by you:

a) Based on the $10,000 margin provided, Person A can purchase gold derivative contracts with a total exposure derived from the transaction up to a maximum of $200,000, i.e. $10,000 ÷ 0.05.

b) Based on the $10,000 margin provided, Person A can purchase share derivative contracts with a total exposure derived from the transaction up to a maximum of $50,000 i.e. $10,000 ÷ 0.2.

Paragraph 2 standardises the operation of margin close out requirements for retail investors by requiring you to maintain and enforce the applicable margin requirements for as long as the retail investor’s derivative position(s) that are connected to that account remain open.

Where, in acting under the requirements of paragraph 2, you are required to terminate or close out one or more of a retail investor’s open positions, you must do so as soon as market conditions allow and on terms most favourable to the retail investor. This means that when you are executing these orders, we would expect you to consider the principles of best execution and place the retail investor’s interests above your own. As part of this consideration, we would expect you to consider factors such as price, costs, speed, likelihood of execution, size of positions, prevailing market conditions and possible market impacts, as well as any other consideration relevant to the execution of an order.

Suitability

Current suitability standard condition

Standard condition 12 requires DIs to take all reasonable steps to determine whether retail investors have the ability to understand the particular type of derivative and the risks involved.

Standard condition 12 requires DIs to do the following:

- Before entering into a derivative with a retail investor, DIs must request sufficient information of the investor's knowledge, experience and understanding of the specific derivative, so they can assess whether the derivative is suitable for that investor.
- The DI must take all reasonable steps in determining suitability.
- If the investor is deemed not to have the ability to understand the derivative and the risks involved, the DI must not enter into the derivative with the investor.
- If the investor elects not to provide the information, the DI must tell the investor that they are required to request this information and warn them (in writing) that without it there is a strong chance they will not understand the derivative and the risks involved.

Rationale for revising suitability standard condition

Findings from our SRA and subsequent monitoring indicate licensed DIs may not be taking reasonable steps to determine suitability and may be entering into derivatives despite them not being suitable for the investor. Our monitoring also found that where suitability is being assessed, the suitability assessments are poorly designed and sometimes ineffective.

For example, some licensed DIs have:

- Entered into derivatives despite having information that showed the derivative was not suitable for the investor.
- Not taken reasonable steps to obtain enough information to assess suitability and then issued a warning to the investor and entered into the derivative.
- Not considered an investor's prior trading experience, understanding of leverage, or understanding of risk when assessing suitability.
- Failed to keep written records of suitability assessments, or stated that record keeping was not necessary as their product offering was not complex.

Licensed DIs offer a wide range of derivatives with varying degrees of risk. While some are straightforward, others, like binary options or cryptocurrency CFDs, can be opaque or volatile and are therefore riskier.

The SRA stated that "[o]verall, we consider that cryptocurrency CFDs, high leverage and binary options are not suitable for most retail investors."[9] This highlights the need for consistent and robust suitability assessments for each derivative.

Proposed revised suitability standard condition

We consider it both appropriate and necessary to revise the suitability standard condition to help ensure that DIs ask retail investors for relevant information needed to assess whether the derivative is suitable, and to prevent DIs from entering into a derivative despite assessing a product to not be suitable or not receiving adequate information to conduct a suitability assessment.

We revised the condition to require that DIs must determine whether the retail investor understands the derivative before entering into it. The DI may not issue a warning and/or enter into the derivative when the product is not suitable or when the DI is unable to assess suitability.

Implementation timeframe

We are also seeking feedback on whether the revised standard condition 12 (if we decide to revise it) should come into effect 6 months after the date that we publish a decision, or sooner. Most DIs will be aware of the proposed revision and should have – at a minimum – considered how they will implement processes and procedures to meet the requirements set out in standard condition 12.

Further, we should note that if we decide to impose a revised condition, the original standard condition 12 will remain in place until the date the revised condition is imposed.

[9] DI SRA page 3.

Proposed revisions shown in track changes

12. Suitability of products for clients

Standard condition: (*This standard condition will be effective from xx Date 2024)*

Before entering into a particular type of derivative with a retail investor for the first time, you must ask the retail investor to provide information about the individual's knowledge, experience and level of understanding of the relevant type of derivative ~~(unless you already have such information)~~ so as to enable you to assess whether the derivative is suitable for the individual.

When assessing suitability, you must take all reasonable steps to determine whether the retail investor ~~has the ability to~~ understands the particular type of derivative and the risks involved, based on the information you have concerning the investor.

If, based on the information you have concerning the retail investor, you consider that the investor does not ~~have the ability to~~ understand the particular type of derivative and the risks involved, or if the retail investor provides insufficient information to enable you to assess suitability or elects not to provide this information, you must not enter into that derivative with the investor.

~~If the retail investor elects not to provide the information to enable you to assess suitability, or if the investor provides insufficient information, you must warn them that you are required to request information from the investor in order to assess whether the derivative is suitable for the individual. The warning must note that without such information there is a strong risk you will not be able to assess whether they have the necessary ability to understand the derivative and the risks involved. This warning must also be in writing and prominently displayed.~~

~~Consequently, you must strongly advise the investor to provide you with any requested information that you believe is necessary to enable you to assess suitability.~~

~~If a retail investor asks you to go ahead with entering into a derivative in circumstances where you do not have sufficient information to assess whether the derivative is suitable for the individual, despite you having given the above warning, you may choose whether or not to go ahead with the transaction having regard to all the circumstances.~~

Proposed standard condition wording

12. Suitability of products for clients

Standard condition: (*This standard condition will be effective from xx Date 2024)*

Before entering into a particular type of derivative with a retail investor for the first time, you must ask the retail investor to provide information about the individual's knowledge, experience, and level of understanding of the relevant type of derivative so as to enable you to assess whether the derivative is suitable for the individual.

When assessing suitability, you must take all reasonable steps to determine whether the retail investor understands the particular type of derivative and the risks involved, based on the information you have concerning the investor.

If, based on the information you have concerning the retail investor, you consider that the investor does not understand the particular type of derivative and the risks involved, or if the retail investor provides insufficient information to enable you to assess suitability or elects not to provide this information, you must not enter into that derivative with the investor.

Explanatory note: This standard condition does not require, or authorise, the licensee to provide financial advice in relation to the derivative. It is independent of, and not related to, any obligations regarding the suitability of financial advice required under the FMC Act or the Code of Professional Conduct for Financial Advice Services.

The purpose of the condition is to reduce the possibility of derivatives being sold to people who do not understand the derivative, or the risks involved. The condition places a positive onus on you to seek information regarding the retail investor's knowledge, experience, and level of understanding of the relevant type of derivative, to enable you to assess the investor's understanding of that derivative and the risks involved, and therefore determine the suitability of the product.

The approach to the suitability assessment may be proportionate to the complexity of the derivative. Where a derivative is more straightforward, less information may be needed from certain retail investors to enable you to determine that those investors understand the particular type of derivative and the risks involved.

For example, where a retail investor buys a simple deliverable forward FX contract, there would be no need to do more than check that the investor understands that the value of the foreign currency they are buying may be different (in terms of NZ Dollars) by the time it is delivered.

When assessing whether a retail investor understands the particular type of derivative and the risks involved, it may be appropriate to consider information such as:

- whether the investor is familiar with the particular type of derivative or other similar derivatives
- the nature, volume, and frequency of other relevant transactions entered into by the investor and the period over which they have been carried out
- the level of education and profession, or relevant former profession, of the investor
- whether the investor has received financial advice in relation to the derivative and whether the relevant adviser has confirmed that the investor understands the particular derivative and risks involved

- the nature of the proposed transaction as a whole

The standard condition does not require you to consider all the above bullet points in every case, and other factors may be appropriate. You must decide what information should be collected, relative to the derivative being offered, to enable you to determine whether the retail investor understands the particular type of derivative offered and the risks involved.

Where the retail investor is not an individual, you must assess the relevant director(s), employee(s) or agent(s) (as appropriate) acting on behalf of the investor to determine whether they, either collectively or individually, understand the particular type of derivative and the risks involved.

Note that you are required to retain records of suitability assessments conducted with retail investors to ensure compliance with standard condition 3.

This standard condition only applies to transactions entered into on or after [*date TBD*]. No review and assessment of transactions entered into before [*date TBD*] is required under this standard condition.

The current standard suitability condition remains in place until the revised condition is put into place.

Consultation questions

New standard condition 14 (leverage)

1. Do you think leverage limits should apply to all types of derivatives? Please explain your answer and outline any exceptions.
2. Do you agree with the proposed initial margin percentages set out in paragraph 1 of the condition? Please explain.
3. Do you agree with the requirement in paragraph 2 of the proposed condition that requires DIs to close out or terminate an investor's position(s) should the net equity be less than the aggregate margin requirement? Please explain.
4. Do you think the FMA should consider a different approach to limit leverage? If so, please explain.
5. If you are a DI, what implementation costs would there be for your firm for the proposed leverage limits? Please outline any required actions and related costs in as much detail as possible.
6. What do you think would be the impact (cost/benefit) of the proposed leverage limits:
   a) on investors?
   b) on you as issuer/provider?
7. How long will it take for you to implement systems, policies and procedures to administer the proposed leverage limits? Please provide as much detail as possible.

Revised standard condition 12 (suitability)

1. Do you agree with the FMA's proposed suitability standard condition? Please explain your answer.
2. Do you think the FMA should consider a different approach to revising the suitability standard condition? If so, please explain.
3. Standard condition 12 has been revised to require DIs to "…take all reasonable steps to determine whether the retail investor understands the particular type of derivative and the risks involved…" instead of the previous requirement to determine whether the retail investor "has the ability to understand" the particular type of derivative and the risks involved (emphasis added). Do you agree with the requirement that DIs must determine whether the retail investor understands the type of derivative and the risks involved? Please explain.
4. What costs would there be to your firm to revise your current suitability assessment process to meet the proposed suitability standard condition? Please outline any required actions and related costs in as much detail as possible.
5. What would be the impact (cost/benefit) of the proposed suitability standard condition on you and on your investors?

Feedback form

Consultation: Standard conditions for derivatives issuer licences

Please submit this feedback form electronically in both PDF and MS Word formats and email it to us at consultation@fma.govt.nz with 'Standard conditions for derivatives issuer licences': [your organisation's name]' in the subject line. Thank you. **Submissions close on 7 August 2024.**

Date: Number of pages:

Name of submitter:

Company or entity:

Organisation type:

Contact name (if different):

Contact email and phone:

Question number	Response

Feedback summary – *if you wish to highlight anything in particular*

Please note: Feedback received is subject to the Official Information Act 1982. We may make submissions available on our website, compile a summary of submissions, or draw attention to individual submissions in internal or external reports. If you want us to withhold any commercially sensitive or proprietary information in your submission, please clearly state this and note the specific section. We will consider your request in line with our obligations under the Official Information Act.

Thank you for your feedback – we appreciate your time and input.