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Wholesale Conduct Policy
Financial Conduct Authority
12 Endeavour Square
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By email: cp18-38@fca.org.uk

8 February 2019

Dear Sir or Madam

FCA CP 18/38 - Restricting contract for difference products sold to retail clients

The City of London Law Society ("**CLLS**") represents approximately 17,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees.

This letter has been prepared by the CLLS Regulatory Law Committee (the "**Committee**"). The Committee not only responds to consultations but also proactively raises concerns where it becomes aware of issues which it considers to be of importance in a regulatory context.

We welcome the opportunity to respond to CP18/38.

Given the significant impact of the product intervention proposals in respect of CFD-like options, it is important that the proposed definition of "*restricted options*" is as certain as possible. The CP states at 3.11 that the new definition is intended to capture "*options that include additional product features, which ensure the value of the option changes in a linear manner with the value of the underlying asset, excluding costs, charges, and spreads…The proposed scope is not intended to capture traditional or "vanilla" options*."

We refer to the proposed definition of "*restricted option*" in the draft Glossary amendments in Appendix 1 to the CP.

Condition 1: "that is in the money at the point of sale"

We note that in the money is already a defined term in the Glossary. It is defined as "*the strike price…being less than the current market value of the underlying instrument, in the case of a call option…or vice versa, for a put option*". The Glossary definition of "*option*" refers to various potential underlying instruments. Some of these underlying instruments are priced in multiple venues, making it difficult for firms to be certain that they know what "*current market value*" is at any given time.

Further, the definition of "*restricted option*" requires firms to interpret "*at the point of sale*", and in particular to work out at which point in time they need to be satisfied that the option is in the money. We assume that the intention is that firms conduct reasonable checks of readily available pricing sources immediately prior to pricing, and then enter into the option. Guidance confirming this could be helpful. We note the potential difficulties that firms may have in being certain of current market value in times of extreme price volatility.

Condition 2: "where the value is determined by one-to-one fluctuations in the value or price of the underlying asset"

An option would not meet this condition if in particular defined circumstances (e.g. the value or price of the underlying asset rises above X or below Y) the value of the option is subject to a limitation and therefore does not change in a linear manner in relation to the underlying asset, even if it does have a linear relationship where such limitations do not apply. We assume that a firm could include a limitation on value that applies in specific circumstances (e.g. a cap or floor) and thereby take the option outside of the definition of restricted option, on the basis that it would not meet this second condition. This would be the case even if the specific circumstances in which non-linear valuation applies are unusual, and there is linear correlation most of the time.

Condition 3: for which the value is not significantly affected by the time to expiry

Our understanding is that in respect of most options, the value would be affected in the run up to expiry by the reduced time available for the strike price to be reached. As time to expiry reduces, there is less time for the option to reach the strike price. For example, the value of the option should decrease when the market for that option becomes increasingly certain that the strike price will not be met in the remaining time available. Accordingly, this condition should only be met by an option where the payouts are not linked to a strike price or other static pricing point being met. We note your reference at 3.14 to delta one options, with strike prices very unlikely to be met at all times during the term of the option, but question whether all of the options intended to be caught by the definition of restricted options share that same feature.

Secondly, we query how firms can accurately determine the meaning of "*significantly*" when seeking to assess this third condition. For example, when considering future enforcement action against a firm, what would the FCA use as its benchmark in terms of "*significantly*" if part of its enforcement case was that the financial instrument in question is a restricted option?

Conclusion

As noted above, some of the concerns we have raised could be addressed through guidance (e.g. in PERG) but our overall conclusion is that the proposed definition of restricted option contains some significant elements of uncertainty and thereby risks capturing unintended targets and missing some intended targets. Our view is that the definition needs to be reconsidered. We would be happy to discuss this further.

If you would find it helpful to discuss any of these comments then we would be happy to do so. Please contact Karen Anderson by telephone on +44 (0) 20 7466 2404 or by email at Karen.Anderson@hsf.com in the first instance.

Yours faithfully

Karen Anderson
Chair, CLLS Regulatory Law Committee

THE CITY OF LONDON LAW SOCIETY
REGULATORY LAW COMMITTEE

Individuals and firms represented on this Committee are as follows:

Karen Anderson (Chair, Herbert Smith Freehills LLP)
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