

CP (2017-01)

Consultation Paper of the Cyprus Securities and Exchange Commission on the enhancement of the regulatory obligations of Cyprus Investment Firms when providing investment services in binary options

In the context of establishing effective communication with market participants regarding any proposed changes in the regulatory framework, the Cyprus Securities and Exchange Commission ('the CySEC') is circulating this Consultation Paper relating to obligations of Cyprus Investment Firms ('the CIFs') when providing investment services in binary options.

It outlines fundamental revisions and standardisations to the way investment services in binary options are provided to investors in terms of their nature, characteristics and trading methodology. In doing so, it enhances the standards required for CIFs to meet their obligations in acting in the best interest of their clients.

The proposed Circular under consultation is enclosed in Appendix 1. For better understanding, an overview of the main proposed changes in the regulatory obligations of CIFs when providing investment services in relation to financial instruments – binary options, is also attached in Appendix 2.

CySEC invites CIFs and market participants to submit their comments/suggestions, in word format, by March 3, 2017, at supervision@cysec.gov.cy.

February 13, 2017

TO : **Cyprus Investment Firms**

FROM : **Cyprus Securities and Exchange Commission**

DATE :

CIRCULAR NO :

SUBJECT : **Enhancing the regulatory obligations of CIFs when providing investment services in binary options**

The Cyprus Securities and Exchange Commission ('the CySEC') is revising the standards required for the provision of investment services in binary options by the Cyprus Investment Firms ('the CIFs'). This Circular establishes new standards relating to the nature, characteristics and trading methodology of these instruments to assist CIFs in meeting the obligations to act in the best interests of their clients. More specifically:

1. This Circular applies to CIFs which are currently providing investment services in relation to binary options.
2. According to Investment Services and Activities and Regulated Markets Law of 2007, as in force ('the Law'), CIFs must:
 - i. Act honestly, fairly and professionally in accordance with the best interests of their clients [article 36(1) of the Law] and provide adequate information to clients about the financial instruments offered [article 36(1)(b) of the Law].
 - ii. Execute orders on terms most favorable to clients (article 38 of the Law).
 - iii. Implement procedures and arrangements for the execution of orders which provide for the prompt, fair and expeditious execution of client orders (article 39 of the Law).
3. CySEC, after taking into consideration the above-mentioned regulatory obligations, is establishing the standards described in Annex 1 in order to assist the CIFs, defined in point 1 above, in meeting their obligations to act in the best interests of their clients.
4. If a CIF does not apply the standards of Annex 1 when providing investment services in binary options, it is highly unlikely that it could demonstrate to CySEC that meets the obligations of point 2 above.

5. Circular No C126 (issued on April 14, 2016) which revised accepted practices for the provision of binary options is repealed.
6. CIFs are requested to:
 - i. Without any delay, review their policies and arrangements and ensure that they fully comply with the provisions of this Circular.
 - ii. Without any delay, undertake, corrective measures/amending actions, where necessary, in order to comply with this Circular.
 - iii. Provide to CySEC confirmation signed by the Board of Directors as to CIFs' compliance with this Circular and, where applicable, describe the corrective measures adopted to ensure their compliance.

The above confirmation must be sent to supervision@cysec.gov.cy within three (3) months from the publication of this Circular.

Sincerely

Demetra Kalogerou
Chairman Cyprus Securities and Exchange Commission

A. Definitions

For the purpose of this Circular the following definitions apply:

2-Way Pricing Format: The continuous provision of both (i) a price to buy, and (ii) a price to sell, the same Digital Contract.

Digital Contract or Digital Option Contract: Any option with a discrete, rather than continuous, payout function, regardless of how the contract is named.

CIF: A Cyprus Investment Firm as defined in article 2 of the Law, offering Digital Contracts to any of its clients.

Call/Put: A Call, in the context of a Simple Digital Contract, is a contract where the most positive of the Digital Contract's potential Settlement Values occurs when the Expiration Value exceeds the Strike Price. A Put is a contract where the most positive of the Digital Contract's potential Settlement Values occurs when the Expiration Value is below the Strike Price.

Contract Name: The name used by a CIF to describe an individual/specific Digital Contract to its clients.

Contract Parameters: The collection of parameters defining a Digital Contract, namely Underlying Market, Tenor, Expiration Time, Strike Price(s), Style, whether it is a Call or Put and what its potential Settlement Values are.

Contract Series: A collection or "ladder" of Digital Contracts sharing the same Underlying Market, Style and Expiration Time. When a Contract Series is established all Digital Contracts within that series must share the same Tenor. A Contract Series may consist of a single Digital Contract only.

Expiration Time: The scheduled end of the Digital Contract's term.

Expiration Value: The level of the Underlying Market used to decide a Digital Contract's Settlement Value. In the case of European options, the Expiration Value is calculated at the Expiration Time of the Digital Contract. In the case of American options, an Expiration Value is calculated continuously throughout the life of the Digital Contract, and is continuously compared against the Digital Contract's Strike Price.

Information Provider: An independent publisher of market data, unaffiliated to the relevant CIF in each particular context, for instance Thomson Reuters, ACTIV Financial and Bloomberg.

Input Prices: The collection of prices for an Underlying Market considered by a CIF when calculating an Expiration Value. Input Prices may be valid (used in calculating the result) or invalid (deliberately removed from the calculation in order to better provide a representative Expiration Value).

Range Contract: A Digital Contract constructed from two Simple Contracts, whose discrete payout function is tied to whether its Underlying Market is between or outside a range determined by the Strike Prices of each of its constituent Simple Digital Contracts.

Recognised Exchange: A venue that is (a) a regulated market, MTF or systematic internaliser as defined in article 2 of the Law (b) a Designated Contract Market or Swap Execution Facility as defined by the Dodd–Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111–203) regulated by the Commodity Futures Trading Commission in the USA, (c) an exchange which is a full member of the World Federation of Exchanges as listed on that organisation’s website from time to time, where such exchange is incorporated or established in any of the G20 countries, Singapore or Switzerland, or (d) any such other venue as may be notified from time to time by CySEC.

Recognised FX Provider: A firm which is: (a) a Global Systemically Important Bank (G-SIB) as published by the Financial Stability Board from time to time, (b) a Domestic Systemically Important Bank (D-SIB) or Other Systemically Important Institution (O-SII) as determined by the relevant designated authority in each country worldwide, (c) an investment firm falling under Article 4(1)(2) of the Capital Requirements Regulation (575/2013), or (d) any such other firm as may be notified from time to time by CySEC.

Settlement Value: The value of a Digital Contract upon expiration. The Settlement Value is generated as a function of the Digital Contract’s Strike Price (or Strike Prices, in the case of Range Digital Contracts) and the Expiration Value of the Underlying Market.

Simple Contract: Any Digital Contract referencing only a single Strike Price.

Strike Price: The parameter of a Digital Contract that represents a level in the Digital Contract’s Underlying Market, and that is compared against the Expiration Value of the Underlying Market to calculate that Digital Contract’s Settlement Value.

Style: A Digital Contract may be in one of two Styles: (i) “**European Style**”, where Settlement Value is determined by reference to a single Expiration Value in the Underlying Market, calculated at Expiration Time, or (ii) “**American Style**”, also known as “**one-touch**”, where there is a continuous comparison of the Underlying Market with the relevant Strike Price, with expiration occurring only when the Underlying Market touches or passes through the level defined by the Strike Price, or when Expiration Time is reached, whichever occurs first.

Tenor: The amount of time between the start of a Digital Contract's Tradeable Period and that Digital Contract's Expiration Time.

Tradeable Period: The period during which a CIF allows client trading on a specified Digital Contract.

Underlying Market: The underlying security, derivatives contract, FX rate, equity index or other instrument that determines a Digital Contract's Settlement Value.

Valid FX Rate: A spot FX quote which fairly represents the current market price for the specified FX pair in the global OTC FX market, derived by the CIF from a streaming spot FX quote on that FX pair produced by a Recognised FX Provider, or from an aggregation of streaming spot FX quotes on the same FX pair produced by a number of Recognised FX Providers.

B. Pre-trade communication for each Digital Contract

1. CIFs must make clear the following Contract Parameters to clients, before any Digital Contract's Tradeable Period begins:
 - i. Underlying Market
 - ii. Expiration Time
 - iii. Strike Price (or Strike Prices, in the case of Range Digital Contracts)
 - iv. Whether it is a Call or Put, in the case of Simple Digital Contracts
 - v. Style of Digital Contract (American Style or European Style)
2. This information must be clearly and accessibly presented to the client on the CIF's electronic trading platform, as a series of fields on that platform and/or in the Contract Name of each Digital Contract. The information should be presented clearly for clients.
3. Options terminology should be avoided where a plain language alternative is possible. For example, a Contract Name like "Spot E/\$ to be above 10200 at 3pm" makes all five pieces of information clear and should be used in preference to the technically equivalent "3pm 10200 European Call on spot E/\$".

C. Communication of general trading methodology

CIFs must publish, on their website, the following information:

1. Specifications of all Contract Series routinely offered by the CIF (Contract Parameters and Tradeable Period for all Digital Contracts within each Contract Series).

2. The method of determining Expiration Values for each Underlying Market (please refer to **Section F** below).
3. A continuous flow of the rolling expiration values of the underlying asset of the Digital Contract throughout the lifetime of the Digital Contract. The rolling expiration value should be calculated as per **Section F** and must be displayed in a prominent way on the trading platform (i.e. displayed on the area where the clients place an order on the Digital Contract).
4. Where a CIF offers Digital Contracts which have an individual equity, an index of individual equities or a derivative contract as an Underlying Market, the identity of the Information Provider used to obtain prices used for the calculation of Expiration Values in each Underlying Market.
5. Where a CIF offers Digital Contracts which have a spot FX rate as an Underlying Market, the details of the algorithm used to calculate each Valid FX Rate from the relevant streaming quotes produced by the relevant Recognised FX Providers.
6. Where a CIF displays graphs in the trading platforms, these must be accurate, clear and understandable to the retail clients as to the describing illustrations.
7. Historical records of the Expiration Values for each Underlying Market which should be accessible to clients in a specific section of the trading platform or a relevant link referral to the website of the CIF.

D. Contract Parameters and construction of Contract Series

1. The Underlying Market must be:
 - a. a spot FX rate;
 - b. an individual equity traded on a Recognised Exchange;
 - c. an index derived from individual equities traded on a Recognised Exchange;
 - d. a derivative contract which is traded on a Recognised Exchange and which is settled with reference to a spot FX rate, a commodity, an individual equity or an index of individual equities; or
 - e. any such other instrument or event as may be notified from time to time by CySEC.
2. CySEC may expressly exclude certain venues or firms from being Recognised Exchanges or Recognised FX Providers from time to time.
3. The Tenor must be for a period of at least 5 minutes.
4. The Strike Prices must be fixed for all Digital Contracts within a Contract Series, and displayed electronically to clients, at least 10 seconds prior to those Digital Contracts entering their Tradeable Period. For the avoidance of doubt, the use of "floating" Strike Prices (where the Strike Price appears in the CIF's electronic

trading platform as a constantly updated variable until the moment a client trades) is not permissible.

5. The level of Settlement Value on a winning Digital Contract is left to the discretion of the CIF. However each Digital Contract must have two, and only two, potential Settlement Values, and the Settlement Value of a losing Contract must be 0.

For example, the contract *“Spot E/\$ to be above 10200 at 3pm UTC”* might have a Settlement Value of **\$1** should spot E/\$ be above 10200 at 3pm, and a Settlement Value of **\$0** should spot E/\$ be below 10200 (or exactly at 10200) at 3pm.

6. CIFs are free to set the Expiration Times of Contract Series at their discretion, subject to the restriction that no two Contract Series with differing Expiration Times can have their Expiration Times within 5 minutes of one another, and that Expiration Times may only be set on the hour, and at 5 minute intervals thereafter. For example, 1pm, 1.05pm and 1.10pm are acceptable Expiration Times; 1.01pm, 1.06pm and 1.11pm are not.

For the avoidance of doubt, CIFs may offer multiple Contract Series of Digital Contracts on the same underlying market simultaneously, provided the above rule is adhered to. As an example, at 2.55pm a CIF may simultaneously be offering clients a Contract Series of 40 contracts on E/\$ with an initial Tenor of 2 hours expiring at 3pm, a Contract Series of 10 contracts with an initial Tenor of twenty (20) minutes expiring at 3pm, and a Contract Series of 10 contracts with an initial Tenor of twenty (20) minutes expiring at 3.05pm. This is acceptable, so long as the Contract Parameters are clearly described to clients, because no Tenor is less than five (5) minutes and the Contract Series' Expiration Times are either simultaneous or, where not simultaneous, are at least five (5) minutes apart.

7. In order to ensure a CIF is able to offer continuously relevant contracts, even after a significant market move, CIFs may add additional Digital Contracts to a Contract Series after the Digital Contracts in the Contract Series have entered their Tradeable Period, provided:
 - a. the Strike Prices of all additional Contracts are fixed and displayed electronically to clients at least 10 seconds before those additional Digital Contracts enter their Tradeable Period;
 - b. the additional Digital Contracts have a Tenor of at least five (5) minutes; and,
 - c. except for Strike Price and Tenor, the additional Digital Contracts have the same Contract Parameters as the original Digital Contracts in the Contract Series.

E. Trading and settlement methodology

1. Algorithms for the calculation of Expiration Values are set out in **Section F** below. No other methodologies are permissible.
2. CIFs must store details of every calculated Expiration Value, including every Input Price (valid and invalid), for a period of five (5) years after calculation.
3. To ensure price transparency all Digital Contract prices must be presented in 2-Way Pricing Format, with a bid and an offer with identical “good-in” size, and must be continuously tradeable by clients throughout each Digital Contract’s Tradeable Period.
4. All client orders on Digital Contracts must be executed online and with no manual intervention.
5. All client orders on a given Digital Contract must be subject to the same execution arrangements, with all orders of a similar type being treated in the same manner with regards to speed, certainty of execution and whether the order is to buy or to sell, or to open or to close.
6. Clients must be able to sell to open, in addition to being able to buy to open, any offered Digital Contract.
7. For any given Digital Contract, at any given moment during that Digital Contract’s Tradeable Period, CIFs must provide a single, unique quote to all clients. Differential pricing, where one client, or group of clients, sees a different price from other clients on the same Digital Contract, is not permissible.
8. The Tradeable Period for a Digital Contract may end no sooner than one (1) minute before the Expiration Time applicable to that Digital Contract.
9. All client positions on Digital Contracts must be fully collateralised.

F. Permitted Expiration Value Algorithms

1. Settlement of European Style Digital Contracts where the Underlying Market is a spot FX rate
 - i. A CIF shall calculate the Expiration Value to be used in determining the Settlement Value of a Digital Contract by taking the simple arithmetic average of all valid Input Prices.
 - ii. The Expiration Value shall be rounded to one decimal place past the precision of the bid/ask prices forming the Valid FX Rate of the relevant FX pair.

- iii. Input Prices shall be taken only from the Valid FX Rate of the relevant FX pair, and shall consist of the mid-price of all quotes streamed over the 10 seconds leading up to the Expiration Time of the Digital Contract in question.
- iv. Valid Input Prices will be those Input Prices that:
 - a. do not fall in the lowest 30% of the relevant Input Prices; and,
 - b. do not fall in the highest 30% of the relevant Input Prices¹; and,
 - c. do not result from a quote with a bid/ask spread in excess of 0.1% of the Input Price in question.
- v. In the event that fewer than 4 valid Input Prices are recorded, CIFs shall calculate the Expiration Value by taking the last 10 quotes (prior to the Expiration Time of the Digital Contract in question) in the Valid FX Rate which have a bid/ask spread less than or equal to 0.1% of the relevant mid-price, then by taking the mid-price of each quote, then by discarding the highest 3 and the lowest 3 and then by averaging the remaining 4 mid-prices, rounding the answer to one decimal place past the precision of the bid/ask prices forming the Valid FX Rate of the relevant FX pair.

2. Settlement of American Style Digital Contracts where the Underlying Market is a spot FX rate

- i. A CIF shall calculate the Expiration Value continuously throughout the term of the Digital Contract by taking the mid-price of the most recent quote in the Valid FX Rate of the relevant FX pair, excluding any quotes with a bid/ask spread in excess of 0.1% of the mid-price of that quote.
- ii. The Expiration Value shall be rounded to one decimal place past the precision of the bid/ask prices forming the Valid FX Rate of the relevant FX pair.

3. Settlement of European Style Digital Contracts where the Underlying Market is an individual equity traded on a Recognised Exchange or a derivatives contract traded on a Recognised Exchange

- i. A CIF shall calculate the Expiration Value to be used in determining the Settlement Value of a Digital Contract by taking the simple arithmetic average of all valid Input Prices.

¹ Throughout this section the treatment of identical Input Prices shall be as follows: CIFs shall rank Input Prices from highest to lowest, with each identical Input Price receiving its own unique rank. Selection of valid Input Prices shall be performed by reference to this ranking. As an example, in a collection of 100 Input Prices resulting from quotes with an acceptably narrow spread, of which 40 have a value of 1010, 20 have a value of 1000 and 40 have a value of 980, valid Input Prices shall be the set {10x1010, 20x1000, 10x980}, leading to a calculated Expiration Value of 997.5.

- ii. The Expiration Value shall be rounded to one decimal place past the precision of the trade prices of the individual equity or derivatives contract, as reported by the Information Provider used by the CIF for the Underlying Market in question.
- iii. Input Prices shall consist of the trade prices, as reported by the Information Provider, over the 10 seconds leading up to the Expiration Time of the Digital Contract in question.
- iv. Valid Input Prices will be those Input Prices that (a) do not fall in the lowest 30% of Input Prices, and (b) do not fall in the highest 30% of Input Prices.
- v. In the event that fewer than 4 valid Input Prices are recorded, CIFs shall calculate the Expiration Value by taking the last 10 last trade prices (prior to the Expiration Time of the Digital Contract in question) reported by the Information Provider, then by discarding the highest 3 and the lowest 3 and then by averaging the remaining 4 trade prices, rounding the answer to one decimal place past the precision of the trade prices of the individual equity or derivatives contract, as reported by the Information Provider used by the Firm for the Underlying Market in question.

4. Settlement of American Style Digital Contracts where the Underlying Market is an individual equity traded on a Recognised Exchange or a derivatives contract traded on a Recognised Exchange

A CIF shall calculate the Expiration Value continuously throughout the term of a Digital Contract by taking the most recent trade price of the individual equity or derivatives contract, as reported by the Information Provider.

5. Settlement of European Style Digital Contracts where the Underlying Market is an index derived from individual equities traded on a Recognised Exchange

- i. A CIF shall calculate the Expiration Value to be used in determining the Settlement Value of a Digital Contract by taking the simple arithmetic average of all valid Input Prices.
- ii. The Expiration Value shall be rounded to one decimal place past the precision of the price ticks of the equity index, as reported by the Information Provider used by the CIF for the Underlying Market in question.
- iii. Input Prices shall consist of the price ticks, as reported by the Information Provider, over the 10 seconds leading up to the Expiration Time of the Digital Contract in question.
- iv. Valid Input Prices will be those Input Prices that (a) do not fall in the lowest 30% of Input Prices, and (b) do not fall in the highest 30% of Input Prices.

v. In the event that fewer than 4 valid Input Prices are recorded, CIFs shall calculate the Expiration Value by taking the last 10 last price ticks (prior to the Expiration Time of the Digital Contract in question) reported by the Information Provider, then by discarding the highest 3 and the lowest 3 and then by averaging the remaining 4 price ticks, rounding the answer to one decimal place past the precision of the price ticks of the equity index, as reported by the Information Provider used by the CIF for the Underlying Market in question.

6. Settlement of American Style Digital Contracts where the Underlying Market is an index derived from individual equities traded on a Recognised Exchange

A CIF shall calculate the Expiration Value continuously throughout the term of a Digital Contract by taking the most recent price tick of the equity index, as reported by the Information Provider used by the CIF for the Underlying Market in question.

Overview of the proposed changes in the regulatory obligations of CIFs when providing investment services in relation to financial instruments – binary options

	Existing framework (Binary Options)	Proposed framework (Digital Contracts/Options)
Types	<ul style="list-style-type: none"> • High/Low • One Touch • Ladder 	<ul style="list-style-type: none"> • Single binary option – one fixed strike price which is predetermined before execution • Ladder - multiple strike prices which are predetermined before execution • Range • One Touch
Price of the option	No price	Continuous provision of both (i) a price to buy, and (ii) a price to sell, the same Digital Contract
Method of determining Expiration Values for each Underlying Market	Predetermined methodology based on the discretion of each CIF	Based on a predetermined methodology set by CySEC
Duration of the option	On the discretion of each CIF - 60 seconds up to mostly one day	On the discretion of each CIF - Minimum 5 minutes
Strike Price	<ul style="list-style-type: none"> • Unknown to investors until executed • Floating – not fixed 	<ul style="list-style-type: none"> • Known to investors before execution • Fixed
Possibility for investors to exit before expiry	No - in most of the cases	Yes - always