REGULATION IMPACT STATEMENT

Product intervention: OTC binary options

April 2021

About this Regulation Impact Statement

This Regulation Impact Statement (RIS) sets out policy advice and recommendations from ASIC's Market Supervision team to ASIC's delegate under s1023D(3) of the Corporations Act on product intervention proposals relating to over-the-counter (OTC) binary options.

What this Regulation Impact Statement is about

This Regulation Impact Statement (RIS) sets out policy advice and recommendations from ASIC's Market Supervision team to ASIC's delegate under s1023D(3) of the *Corporations Act 2001* (Corporations Act) on product intervention proposals relating to over-the-counter (OTC) binary options.

This RIS is prepared under the Regulatory Impact Analysis (RIA) framework administered by the Office of Best Practice Regulation, a branch of the Department of Prime Minister and Cabinet. The RIA framework provides high-level principles for policy makers and outlines the requirements and process for developing a RIS.

Under the RIA framework, the Regulatory Burden Measurement (RBM) framework must be used by policy makers to estimate the regulatory compliance burden of policy proposals (a subset of the broader costs in an assessment). The RBM framework is a standardised method for calculating the compliance costs (administrative and substantive) and delay costs of regulation. Costs excluded from the RBM framework, but analysed in the RIS, include opportunity costs, indirect benefits and costs (including competition effects) and ASIC's enforcement costs. Generally, the RIA framework does not consider regulatory impact on foreign investors or consumers.

This RIS considers the regulatory and financial impact of ASIC's proposal to make a market-wide product intervention order to prohibit the issue and distribution of OTC binary options to retail clients and alternative policy options. Our policy advice and recommendations aim to strike an appropriate balance between:

(a) addressing the nature, likelihood and extent of consumer detriment resulting from binary options issued in or from Australia;

(b) the financial and other impact of the proposed orders on consumers, binary option providers and government; and

(c) any likely effects on competition in the Australian financial system.

This RIS is not an assessment of the product intervention power itself, which commenced on 6 April 2019, nor is it legal advice on the legislative requirements for use of the product intervention power by ASIC, which differ from the RIA framework.

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A Executive summary

1 This RIS addresses ASIC's proposal in Consultation Paper 322 *Product intervention: OTC binary options and CFDs* (CP 322) to exercise its product intervention power in Pt 7.9A of the Corporations Act to make a market-wide product intervention order (Proposed Order) to prohibit the issue and distribution of OTC binary options to retail clients.

2 The RIS also addresses a policy option based on consultation feedback which would require client assessment, disclosure of risk warnings and a pricing methodology and restriction of inducements. Consideration is also given to making no policy change.

3 The RIS is prepared under the RIA framework administered by the Office of Best Practice Regulation, a branch of the Department of Prime Minister and Cabinet. The RIA framework provides high-level principles for policy makers and outlines the requirements and process for developing a RIS. Under the RIA framework, the RBM framework must be used by policy makers to estimate the regulatory compliance burden of policy proposals (a subset of the broader costs in an assessment). The RBM framework is a standardised method for calculating the compliance costs (administrative and substantive) and delay costs of regulation. Costs excluded from the RBM framework, but analysed in the RIS, include opportunity costs, indirect benefits and costs and ASIC's enforcement costs. Generally, the RIA framework does not consider regulatory impact on foreign investors or consumers.

4 The RIS sets out the ASIC Market Supervision team's analysis under the RIA framework of the expected regulatory impact of these three policy options in relation to binary options and our policy advice and recommendations to ASIC's delegate under s1023D(3) of the Corporations Act.

5 The RIS is not an assessment of the product intervention power itself, which commenced on 6 April 2019, nor is it legal advice on the legislative requirements for use of the product intervention power by ASIC, which differ from the RIA framework.

6 Important consumer protections in Ch 7 of the Corporations Act are afforded to retail clients and do not apply to professional investors, sophisticated clients or other wholesale clients. For example:

(a) a product provider does not have to give a Product Disclosure Statement (PDS) to a wholesale client;

(b) a wholesale client cannot access the dispute resolution scheme administered by the Australian Financial Complaints Authority (AFCA);

(c) the best interests duty, conflicted remuneration protections and fee disclosure requirements in Pt 7.7A do not apply to wholesale clients;

(d) the product intervention powers in Pt 7.9A do not apply to conduct in relation to a wholesale client; and

(e) protections in the design and distribution obligations in Pt 7.8A (commencement deferred until 5 October 2021) will not apply in relation to a wholesale client.

7 Under Pt 7.9A of the Corporations Act, ASIC may make a product intervention order if it is satisfied that a financial product that is available for issue or regulated sale to retail clients has resulted in, or will or is likely to result in, significant detriment to retail clients.

8 The product intervention power is intended to enable ASIC to take a more proactive approach to regulating financial products and reducing the risk of significant detriment to retail clients, even if a product provider has complied with all applicable disclosure requirements.

9 Binary options are OTC derivatives that allow clients to enter 'all-or-nothing' contracts determined by the occurrence or non-occurrence of a specified event in a defined timeframe (e.g. the price of gold increasing in 30 seconds). Under 12,000 retail clients trade binary options with four licensed binary option providers.

10 We are concerned that binary options have resulted in, will and are likely to result in, significant detriment to retail clients because:

(a) the inherent structural design of binary options (i.e. all or nothing payoff, short contract duration and negative expected return) makes them unsuitable as an investment or risk management product for retail clients;

(b) there is a high likelihood of cumulative losses from trading binary options over time, likely resulting in significant individual and market-wide financial losses to retail clients;

(c) approximately 80% of retail clients lose money trading binary options which are marketed as 'straightforward', 'limited risk' investment products that offer 'turbo results' despite their complexity and risks;

(d) we estimate that retail clients of licensed binary option providers incurred net losses of approximately $490 million from trading binary options in 2018, based on licensed binary option providers' reported gross trading revenue;

(e) losses incurred by Australian retail clients from trading binary options between 1 December 2018 and 30 November 2019 exceeded $7.1 million and we estimate that net financial losses exceeded $6.7 million. This data does not capture all licensed binary option providers and so likely underestimates aggregate and net losses to Australian retail clients from trading binary options in that period.

11 For many years ASIC has taken strong and frequent regulatory action, using a range of regulatory tools, to address concerns about binary options. Appendix 1 to CP 322 outlines several such actions. However, concerns remain despite these interventions.

12 An increasing number of foreign regulators have implemented measures to prohibit or restrict the offer of binary options in their jurisdictions.

13 ASIC has consulted with key stakeholders, including binary option providers, industry bodies, consumer groups, consumers of OTC binary options and members of the public. ASIC received over 400 submissions to CP 322. Of those, more than 60 submissions responded to the proposed market-wide product intervention order for binary options. Consumer groups, most consumers, industry bodies and AFCA strongly supported ASIC's proposal to prohibit the issue and distribution of binary options to retail clients. Notably, four of the five licensed binary option providers also supported the proposed prohibition, including one that has since ceased dealing in binary options.

14 We considered the following three options in light of this consultation:

(a) **Option 1:** Prohibiting the issue and distribution of binary options to retail clients (Proposed Order).

(b) **Option 2:** Imposing conditions on the issue and distribution of binary options to retail clients that require client assessment, disclosure of risk warnings and a pricing methodology and restriction of inducements (respondent-suggested option).

(c) **Option 3:** No change (status quo option).

15 We recommend Option 1 to ASIC's delegate under s1023D(3) of the Corporations Act for the following reasons:

(a) Option 1 would best achieve the objective of reducing the risk of significant detriment to retail clients resulting from binary options, compared with Options 2 and 3, because:

(i) Option 1 would reduce the risk of significant detriment to retail clients comprehensively and systemically by prohibiting the issue and distribution of binary options to retail clients;

(ii) the suggested alternative measures in Option 2 would leave the inherent risks associated with trading binary options largely unchanged and would likely be ineffective in reducing the risk of significant detriment to retail clients and so are unlikely to be of net benefit to the Australian community and economy;

(iii) maintaining the status quo under Option 3 would not achieve the objective of reducing the risk of significant detriment to retail clients resulting from binary options.

(b) Clients properly classified under the Corporations Act as 'sophisticated investors' (s761GA), 'professional investors' (s761G(7)(d)) or otherwise as wholesale clients (s761G(7)) are not affected by Options 1 and 2 (and are generally afforded fewer consumer protections than retail clients under the corporations legislation).

(c) Option 1 is consistent with regulatory measures in force in peer jurisdictions, which would promote trust and confidence in the Australian financial system more broadly.

(d) We expect that Option 1 would result in an overall net benefit to the Australian community because the benefits would outweigh the costs. The benefits include improved trust and confidence in the Australian financial system and the economy over time through greater foreign investor confidence and financial savings for consumers (Australian residents now account for more than 95% of the retail clients of licensed binary option providers). The costs include increased costs to the four binary option providers (compliance costs and opportunity costs) and reduction in consumer choice of high-risk, speculative financial products.

(e) Compliance costs to binary option providers from the suggested alternative measures in Option 2 are likely to be substantially higher than the modest compliance costs of Option 1.

(f) Option 1 would likely have little to no effect on competition in the financial system because:

(i) binary options do not support meaningful competition for the benefit of consumers;

(ii) of the relative size of the binary options market and considering there are four binary option providers and around 12,000 retail clients;

(iii) various substitute financial products may be used by retail clients desiring high-risk, short-term speculation or risk management.

(g) A prohibition on binary options under Option 1 would not have any material effect on underlying financial markets.

16 We recommend use of the product intervention power in Pt 7.9A of the Corporations Act to make the Proposed Order in Option 1.

17 If the Proposed Order is made, we recommend that the prohibition takes effect at least 20 business days after the day on which the order is made and remains in force for 18 months. Ministerial approval is necessary to extend a product intervention order beyond that period. We would monitor the effectiveness of any product intervention order (if made) to help ASIC decide whether the order should be extended and to provide a report to the Minister for approval of any extension.

B Introduction

OTC binary options

18 Binary options are OTC derivatives that allow clients to speculate on the occurrence or non-occurrence of a specified event in a defined timeframe. This can include an event related to movements in the price of a financial product, a market index or an economic event (such as central bank interest rate decisions).

19 'Over-the-counter' or 'OTC' means that the derivatives are transacted between two counterparties (being the provider of the derivative and the client), not on an exchange. In Australia, binary options are currently only traded OTC.

20 The term 'binary' illustrates the typical 'all-or-nothing' payout structure of binary options. If the event specified in the binary option occurs (e.g. the S&P/ASX 200 index is below 6,000 at market close), the client 'wins' (i.e. the client receives a predetermined cash payout, less any fees and costs). If the event specified in the binary option does not occur, the client 'loses' (i.e. the client loses their investment amount, plus any fees and costs).

21 For example, an 'up-down' binary option (also known as a 'fifty-fifty' binary option) is determined by whether the price of an underlying asset goes up or down over a specified period. 'Volatility' binary options refer to binary options that are quoted at a range of strike prices with different probabilities.

22 The predetermined cash payout for a 'winning' binary options contract is sometimes expressed as a dollar figure (e.g. $180) or a profit as a percentage of the investment amount (e.g. 80% return on the investment amount).

23 Binary options typically have a short-term contract duration. For example, some issuers offer binary options to retail clients with a contract duration of only 30 seconds. We note that binary options with longer contract durations of 30 days or more are currently not offered in Australia to retail clients.

24 The minimum investment amount to enter into a binary options contract can be minimal—as small as $10. Binary option providers may also charge additional fees and costs, such as commission costs.

25 Binary options are often marketed by providers under different names or descriptions. Examples include 'all-or-nothing options', 'fixed return options', 'digital options' and 'countdowns'. Our reference to 'binary options' is intended to capture all derivatives that fall within our proposed definition of binary options, however named or described.

Binary options issued in Australia

26 ASIC is responsible for the regulation and supervision of Australian financial services (AFS) licensees who carry on a business in Australia of issuing and making a market in binary options to retail and wholesale clients.

27 Currently, there are four licensed providers of binary options to retail clients in Australia, down from five in 2018–19 and nine in 2016–17.

28 In the period 1 January 2018 to 31 December 2018, the five licensed binary option providers reported to ASIC that they had:

(a) entered into approximately 140 million binary options transactions with retail clients located in Australia and offshore (up from an estimated 35 million transactions in 2016–17); and

(b) gross trading revenue totalling $490 million attributed to dealing in binary options in Australia.

29 Since April 2019, the licensed binary option providers have advised us of a material decline in the number of their retail clients—from over 280,000 to under 12,000. More than 95% of the remaining retail clients are Australian residents. This decline followed an ASIC warning to OTC derivative issuers against providing unlicensed or unauthorised services to clients located in jurisdictions where regulators had imposed restrictions (including in Europe, Japan, North America and China). Some binary option providers' subsequent actions to cease trading binary options with retail clients in such jurisdictions will have a commensurate impact on future transaction volumes, revenues and profits of binary option providers.

30 While acknowledging the recent decline in the number of retail clients, without product intervention there is nothing to preclude an increase in retail clients trading in binary options over time. Notably, the incidence of loss-making by retail clients has remained consistent in recent years with data from one provider recording that 78% of its Australian retail clients were unprofitable for the 12-month period from 1 December 2018 to 30 November 2019, compared with approximately 80% of nine providers' retail clients in 2016–17: see paragraphs 82–83.

Concerns remain despite regulatory action

31 For many years ASIC has taken strong and frequent regulatory action, using a range of regulatory tools, to address concerns about binary options.

32 Appendix 1 to CP 322 outlines several such actions, including:

(a) enforcement action against identified misconduct (e.g. permanently banning Jana Jaros and Jackson Lawrence Malcom Capper from providing financial services or from engaging in credit activities after they were convicted of operating a binary options trading ‘boiler room’ (see Media Release (18-034MR) *Operators of ‘binary options trading boiler room’ banned following convictions* (8 February 2018));

(b) public warning notices and other statements—for example, a warning that some AFS licensees may be breaking overseas laws (see Media Release (19-088MR) *Some AFS licensees may be breaking overseas laws* (11 April 2019)) and a public warning notice in relation to Titantrade.com which is a website offering binary options (see Media Release (16-246MR) *ASIC warns investors about Titantrade.com* (4 August 2016) and PWN 2016-4 (PDF 65 KB) and related Federal Court proceedings outlined in Media Release (17-391MR) *ASIC takes further action in Allianz Metro binary option trading investigation* (17 November 2017));

(c) surveillance projects and thematic reviews (e.g. we conducted a review of mobile app stores focusing on apps with binary options trading that were offered to Australian consumers by unlicensed entities (see Media Release (17-257MR) *ASIC targets unlicensed binary option mobile apps* (1 August 2017));

(d) stronger regulations (e.g. making the ASIC Client Money Reporting Rules 2017, which commenced on 4 April 2018); and

(e) retail client education campaigns about the risks of trading binary options (e.g. a Moneysmart video *Binary options trading—watch this before you trade* and social media campaign from 3–8 June 2018).

33 However, concerns remain despite these interventions.

Product intervention power

34 As part of its response to the Financial System Inquiry, the Australian Government introduced a product intervention power that enables ASIC to make a product intervention order when a financial product has resulted, will result or is likely to result in significant detriment to retail clients: Pt 7.9A of the Corporations Act.

35 The object of Pt 7.9A of the Corporations Act is to provide ASIC with powers that it can use proactively to reduce the risk of significant detriment to retail clients resulting from financial products: s1023A of the Corporations Act.

36 The Explanatory Memorandum to the Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2018 further explains that:

(a) the power is intended to enable ASIC to take action before harm, or further harm, is done to consumers (at [2.7]); and

(b) significant detriment to consumers may result from a product even if the provider has complied with all applicable disclosure requirements in relation to the product (at [2.34]).

37 In considering significant detriment to retail clients resulting from a financial product, ASIC must take into account:

(a) the nature and extent of the detriment;

(b) without limiting the above, the actual or potential financial loss to retail clients resulting from the product;

(c) the impact that the detriment has had, or will or is likely to have, on retail clients.

38 ASIC may also take other matters into account.

39 In Regulatory Guide 272 *Product intervention power* (RG 272), ASIC explains that the product intervention power enables it to take a more proactive approach to regulating financial products and reducing the risk of significant consumer detriment. The power:

(a) enables ASIC to respond to problems in a flexible, targeted, effective and timely way;

(b) enables ASIC to take action on a market-wide basis; and

(c) is available without a demonstrated or suspected breach of the law, which enables ASIC to take action before significant detriment, or further detriment, is done to consumers so that ASIC can better uphold community expectations on the conduct of firms that issue or distribute products.

40 A product intervention order remains in force for 18 months or any shorter period specified in the order: s1023G(2) of the Corporations Act. Ministerial approval is necessary to extend a product intervention order beyond that period. We would monitor the effectiveness of any product intervention order (if made) to help ASIC decide whether the order should be extended and to provide a report to the Minister for approval of any extension.

International measures

41 An increasing number of foreign regulators in developed economies have implemented measures to prohibit or restrict the offer of binary options to retail clients to address investor protection concerns caused by the characteristics of the product. We are aware of regulatory interventions in place in 32 countries.

42 The European Securities and Markets Authority (ESMA) first exercised its temporary intervention powers to prohibit the issue of binary options to retail

clients on 2 July 2018. The prohibition was primarily intended to address the significant investor protection concerns about the product characteristics, including the complexity of the pricing structure, which typically result in a negative expected return for the retail client. ESMA noted concerns raised by many European national competent authorities (NCAs) that this investment product shared several characteristics with gambling products.

Note: See ESMA, European Securities and Markets Authority Decision of 22 May 2018 to temporarily prohibit the marketing, distribution or sale of binary options to retail clients in the European Union in accordance with Article 40 of Regulation (EU) No. 600/2014 of the European Parliament and of the Council, June 2018.

43 On 1 July 2019, ESMA announced that the temporary prohibition had ceased because most regulators in Europe had implemented permanent measures in their own jurisdictions that were at least as stringent as its temporary prohibition.

Note: See ESMA media release *ESMA ceases renewal of product intervention measure relating to binary options*, issued 1 July 2019.

44 As of April 2020, the jurisdictions in the European Union that have implemented national product intervention measures to permanently prohibit binary options are Hungary, Norway, Slovenia, Croatia, Sweden, Malta, France, Cyprus, Germany, Bulgaria, Denmark, Latvia, Greece, Italy, Portugal, Ireland, Luxembourg, Czech Republic, Estonia, Slovakia, Spain, Lithuania, Finland, Austria, Netherlands, Poland, Belgium and Romania.

45 In February 2020, ESMA reported that the product intervention measures had been effective. There were no new authorisations of providers offering binary options to retail clients and there was no longer an authorised binary options market for retail clients in the European Union. ESMA also noted that NCAs reported limited non-compliance with the prohibitions.

Note: See ESMA, *Final report: ESMA's technical advice to the Commission on the effects of product intervention measures* (PDF 425 KB), February 2020.

46 The UK Financial Conduct Authority (FCA) has implemented a permanent prohibition on the sale, marketing and distribution of binary options (including securitised binary options) to retail clients. The FCA was concerned that binary options posed a risk of harm to retail clients due to the inherent features of the product and the widespread scams by unauthorised entities. The FCA also noted that binary options can induce addictive behaviours akin to gambling.

Note: See FCA consultation paper CP18/37 *Product intervention measures for retail binary options* (PDF 487 KB), 7 December 2018, p. 21.

47 Table 1 summarises examples of measures implemented by foreign regulators in relation to OTC binary options. For the jurisdictions in the

European Union that have implemented permanent national product intervention measures, we have included the Netherlands as an example.

Table 1: Existing measures implemented by foreign regulators for OTC binary options

Regulator	Existing measures
Authority for the Financial Markets of the Netherlands (AFM) (Netherlands)	AFM has permanently prohibited the marketing, distribution or sale to retail clients of binary options by firms that carry out activity in, or from, the Netherlands. The prohibition took effect on 19 April 2019. The prohibition is the same as ESMA's temporary measure before its expiration. This means that a limited subset of binary options are excluded from the scope of the prohibition. See AFM media release *AFM takes national measures to prohibit binary options and to restrict the marketing or sales of CFDs*, issued 17 April 2019.
Financial Conduct Authority (FCA) (United Kingdom)	FCA has permanently prohibited the sale, marketing and distribution of binary options to retail clients by firms that carry out activity in, or from, the United Kingdom. The prohibition took effect on 2 April 2019. See FCA policy statement PS19/11 *Product intervention measures for retail binary options*, issued March 2019.
Canadian Securities Administrators (CSA) (Canada)	CSA has prohibited binary options trading where the contract duration is less than 30 days. See CSA Multilateral Instrument 91-102 *Prohibition of binary options and related companion policy*, 28 September 2017.
Commodity Futures Trading Commission and Securities and Exchange Commission (USA)	Binary options are covered by legislation on swaps or securities-based swaps and may typically only be offered to retail clients on an exchange market (i.e. OTC is not permitted).

48 The International Organization of Securities Commissions (IOSCO) has developed a toolkit to give guidance on measures that could be used by regulators to reduce harm to retail investors. Regulators can use these measures if they consider other measures are insufficient in mitigating the investor protection risks arising from a product in its jurisdiction. IOSCO gives the example that:

> … because of their inherent complexity and the lack of transparency in their pricing, IOSCO members may consider that there are inherent flaws in binary options as products that render them unsuitable for sale to retail clients by intermediaries. In addition, the product features of binary options may mean that some of the measures present in toolkit have little impact on addressing the risks arising from binary options. Therefore, IOSCO members may choose to adopt the measure restricting intermediaries from selling these products as a proportionate measure to help ensure a sufficient level of protection for retail clients.
>
> Note: See IOSCO, *Report on retail OTC leveraged products*, final report, September 2018, p. 21.

C Assessing the problem

No meaningful investment or risk management utility

49 We are concerned that binary options do not provide meaningful investment or risk management utility for retail clients because the characteristics of binary options are incompatible with those uses and result in a high likelihood of cumulative financial losses over time.

High likelihood of cumulative financial losses over time due to product characteristics

50 Binary options are likely to result in cumulative individual and market-wide financial losses to retail clients over time due to the following product characteristics:

(a) 'all or nothing' payoff structure, where one of the two possible outcomes for a binary options contract is that the retail client will lose their entire investment amount;

(b) short contract duration (e.g. the average contract duration of binary options traded with one provider was less than six minutes); and

(c) negative expected returns.

51 Generally, the 'expected return' of an investment is the amount of profit or loss a retail client can anticipate receiving on that investment. When trading binary options, the retail client faces a negative expected return because the present value of the expected payoff for a binary options contract is lower than the initial investment: see example below.

Example

Example of negative expected return for fifty-fifty or up-down binary options

A 'fifty-fifty' or 'up-down' binary option, based on the level of large stock Index ABC, is issued with a contract duration of 10 minutes. The investment amount is $100, and the predetermined payout is $180 (i.e. the initial $100 + $80).

If after 10 minutes the price of Index ABC is higher, the client receives a payout of $180 (less any fees or costs), which includes a net profit of $80.

If the price of Index ABC is lower, the client loses their $100 initial investment plus any fees and costs.

The probability of any return is around 50%, assuming that the market is efficient and random given the very short time horizons. With a 50% probability of Index ABC being higher after 10 minutes, the expected value of the binary option is half of $180 (i.e. $90) which is 10% less than the initial investment. The expected return of this binary option is therefore negative.

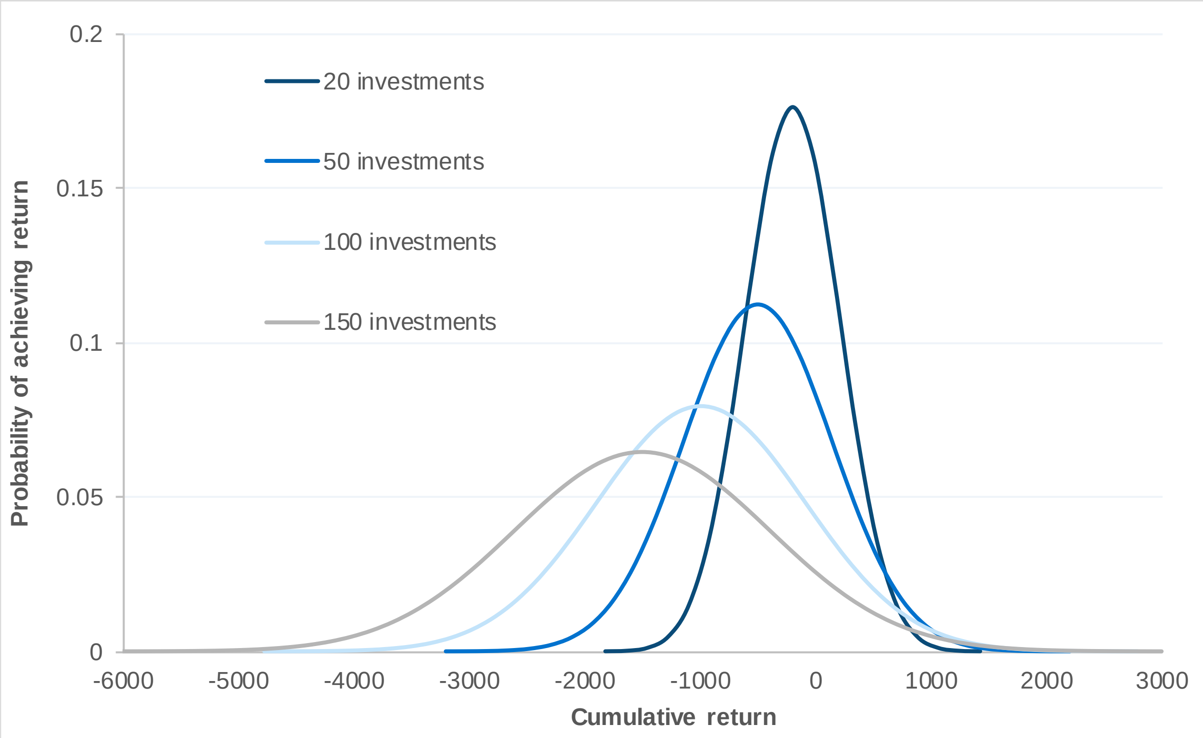
52 Binary option pricing, probabilities and expected returns are highly complex concepts. Disclosure of these concepts and risks to retail clients is mandatory under Australian legislation, but disclosure does not resolve their complexity and is insufficient to drive good consumer outcomes.

53 IOSCO described these characteristics and risk in its *Report on retail OTC leveraged products*:

> For binary options, the following risks can be seen to arise:
>
> - Although the products appear simple and therefore attractive to retail clients, firms use complex probability methodologies to calculate pay-offs that ensure that on aggregate, the firm always profits from the trades. This also makes it difficult for clients to fairly value the product and make an informed investment decision;
> - The lack of transparency in the price of the underlying asset makes it often difficult for a retail client to assess the fairness of the price at the start of the contract and at expiry;
> - The very short duration of many binary option contracts exacerbates the above risks.
>
> …
>
> Although they are sold as straightforward products and perceived as simple by retail clients, binary options present significant information asymmetries, which are often exploited by firms to the detriment of the client, as set out above.
>
> Note: See IOSCO, *Report on retail OTC leveraged products*, final report, September 2018, p. 5.

54 Figure 1 illustrates that, as a retail client trades more binary options contracts over time, there is a greater probability of suffering a loss on a cumulative basis.

Figure 1: Distribution of aggregate returns from selected numbers of repeated 'fifty-fifty' binary options trades



Source: Based on analysis by ESMA, *Product intervention analysis: Measure on binary options*, 1 June 2018, ESMA50-162-214.

Note: Figure 1 is explained in paragraphs 55–59 (accessible version).

55 Figure 1 replicates a simulation run by ESMA as part of its quantitative analysis of the return distribution for retail clients in Europe in 'fifty-fifty' binary options.

56 It illustrates the distribution of aggregate returns from different scenarios of repeated $100 trades in a binary options contract with a fixed 180% payout —that is, the retail client receives $180 if they win and loses $100 if they lose—and an equal 50% chance of winning or losing.

57 The likelihood of specific outcomes from the different scenarios can be inferred from the chart. The proportional area under the curve which lies to the left of zero indicates the likelihood of losing money overall, while peaks represent the most likely outcomes.

58 The shift of the return distributions to the left as the number of trades increases indicates that the more binary options trades made, the greater the likelihood that the retail client will lose money overall, and the larger the expected loss.

59 For example, when 20 trades are made, the probability of a cumulative loss is approximately 75%, with the most likely outcome being a loss of $200. When 150 trades are made, the probability of loss is roughly 92% and the most likely outcome is a loss of $1,500.

60 Fifty-fifty binary options offered in Australia share the characteristics modelled in the simulation with fifty-fifty binary options offered in Europe. As such, we consider ESMA's analysis of aggregate returns from binary options trading to be highly relevant to the Australian market.

61 Our analysis of binary options trades with licensed providers in Australia supports this simulation and shows that the percentage of clients that lose trading fifty-fifty binary options increases the more they trade over time: see paragraph 83.

62 Although the simulation in Figure 1 does not directly apply to volatility binary options, because they are quoted at a range of strike prices with different probabilities of exercise, our concerns about product characteristics and client losses also apply to volatility binary options: see further discussion at paragraph 105.

Product characteristics incompatible with investment or risk management uses

63 Binary options' product characteristics—'all or nothing' payoff structure, short contract durations and negative expected returns—make them incompatible with use for investment or risk management.

64 In addition to carrying a high likelihood of cumulative trading losses, binary options do not offer participation in the growth in value of the underlying asset, unlike other types of OTC derivatives or exchange-traded products. This is because the payoffs for binary options are fixed and predetermined.

65 The 'all or nothing' payoff structure of binary options, typically small investment amounts and very short contract durations, generally makes this product unsuitable for risk management arrangements such as hedging (compared with exchange-traded options).

66 In submissions to CP 322, consumer groups, most consumers, industry bodies and AFCA shared our concern that binary options have no meaningful investment or risk management utility. AFCA considers that the sale of binary options, their structure and the terms on which they are offered are the product of the provider taking unfair advantage of the consumer. ACI Australia Limited (ACI) said it has always maintained that binary options serve no use to any end user. The Australian Financial Markets Authority submitted that '[o]n the analysis presented binary options do not compensate investors for the risk they take on by offering commensurate expected rewards. For this reason, the high level of risk arguably represents retail investor detriment outweighing investor choice'.

67 Various alternative financial products are available for use by retail clients desiring high-risk, short-term speculation—such as contracts for difference (CFDs) (which from 29 March 2021 must be offered in accordance with

product intervention order (PDF 181 KB) conditions including CFD leverage ratio limits among other consumer protections), exchange-traded options or even shares. However, these substitute financial products have productive uses and benefits that binary options do not have. For example, shares, which are issued by companies to raise equity capital, can produce positive cumulative returns over long time periods that on average are superior to other product classes, while exchange-traded options are effective hedging instruments.

68 A redistribution of investable funds from binary options to alternative financial products may lead to improved investment outcomes for retail clients, subject to each retail client's overall investment strategy.

Unexpected losses from 'straightforward', 'limited risk' products with 'turbo results'

69 Despite the complex and risky characteristics of binary options, the products are promoted by licensed providers as 'straightforward', 'limited risk' investment products that allow retail clients to get 'turbo results' from short-term market movements.

70 Further, binary option providers commonly offer trading inducements to clients, such as bonus trades, cash-back offers and fee rebates. For instance, in 2019 one binary option provider paid trading inducements to clients equivalent in value to 14% of its trading revenue.

71 Marketing and promotional tools of this kind may distract retail clients and prospective retail clients from the risks of trading binary options and result in unexpected losses.

72 In 2014, Investment Trends surveyed over 10,000 forex and share traders for its *November 2014 Australian Foreign Exchange Report* and asked them (among other things) why they used binary options instead of, or in addition to, trading margin FX. Only 34 consumers responded (in their own words) to this question, saying:

(a) binary options were easy, simple or straightforward (nine consumers);

(b) they were starting out, learning about binary options or did not know about forex contracts (eight consumers);

(c) binary options have shorter timeframes or are fast (seven consumers);

(d) binary options had high returns, more profits or were less likely to fall (four consumers);

(e) they used binary options in addition to forex contracts (three consumers);

(f) trading binary options was good fun (one consumer).

73 IOSCO also noted in 2018 that binary options 'are sold as straightforward products and perceived as simple by retail clients' although they 'present significant information asymmetries, which are often exploited by firms to the detriment of the client': see paragraph 53.

Note: See IOSCO, *Report on retail OTC leveraged products*, final report, September 2018, p. 6.

74 Consumer submissions to CP 322 also indicated belief among retail clients that binary options are straightforward, easy to understand products that they will be able to use effectively to generate investment returns or manage investment risks. Of the 44 consumer submissions that gave feedback specific to binary options, six of the 11 consumers who opposed the Proposed Order indicated that they trade binary options on an informed basis in pursuit of profits. Two consumer submissions said binary options could be used for hedging. There was no support among the consumer submissions for the proposition that recreation or entertainment was a motivation for trading binary options.

75 AFCA said in its submission that 'in [their] experience, these products [binary options] are marketed to consumers with little to no experience who are told they can "learn to trade" with the provider. In spite of this, [their] experience suggests that issuers rarely educate, teach or equip consumers with the necessary skills and knowledge'.

76 AFCA, consumer groups, industry bodies, four binary option providers and a 3:1 majority of consumer submissions supported the Proposed Order (see paragraph 100).

Disclosure is often ineffective

77 Generally, retail clients do not seek or receive financial product advice before deciding to trade binary options through online platforms and mobile applications. Some binary option providers ask retail clients questions about trading and risk during the account opening process and give additional risk warnings to retail clients where the product suite may be unsuitable. One large binary option provider does not gather any information from retail clients about their risk tolerance, relying instead on risk disclosures in its PDS.

78 In Report 632 *Disclosure: Why it shouldn't be the default* (REP 632), ASIC and AFM considered the effectiveness of disclosure for financial products on consumer outcomes. The report covers evidence and research (including 33 case studies) over a 10-year period for a broad range of financial products and services in Australia, the Netherlands, the United Kingdom and the United States. In the report, ASIC and AFM found that disclosure and warnings were often ineffective, and at times backfired, contributing to consumer harm.

79 Two key reasons why financial product disclosure and warnings can fail, which are identified and evidenced in REP 632, are that they do not solve product complexity and can be crowded out or manipulated by product providers—for example, through their advertising and marketing efforts. In our view, both of these limitations are highly relevant to the sale of binary options.

80 REP 632 also includes Australian research that found that many investors did not access disclosure documents for investment products at all, and those who did skipped large parts of these documents. The research also identified case studies where financial product warnings had backfired.

Significant detriment resulting from binary options

81 In these circumstances, we are concerned that OTC binary options have resulted in, will and are likely to result in, significant detriment to retail clients—primarily in the form of financial losses.

Around 80% of retail clients who trade binary options lose money

82 Nine binary option providers reported to us in 2017 that approximately 80% of their retail clients lost money trading binary options over a 12-month period. The proportion of unprofitable retail clients was similar for trading in up-down and volatility binary options.

83 Analysis provided by one binary option provider of the profitability of its Australian retail clients, using data for the 12-month period from 1 December 2018 to 30 November 2019, showed that, on average:

(a) 67% of its Australian retail clients were unprofitable in any given week during this period;

(b) 74% of its Australian retail clients were unprofitable in any given three-month period; and

(c) 78% of its Australian retail clients were unprofitable across the year and only 2.7% of its Australian retail clients made a net profit of $500 or more across the year.

84 For one binary option provider, the median tenure of its retail clients was 125 days before leaving its platform.

Financial losses to retail clients

85 CP 322 estimated retail clients' net financial losses in 2018 from trading binary options with the five licensed providers in Australia to be approximately $490 million, based on reported gross trading revenue. The providers' gross trading revenue can largely be attributed to a combination

of net client trading losses and spreads, fees and commissions charged to clients in Australia and offshore.

> Note: A provider of a binary option is the counterparty to the client's trade and derives revenue from client trading losses when the provider internalises some or all of the risk arising from the trade. Providers charge spreads to clients on trades which is the difference between the bid and the ask prices of the underlying asset. Providers may charge other fees and commissions.

86 The market has since changed. An ASIC warning to OTC derivative issuers in April 2019 against providing unlicensed or unauthorised services to clients located in certain foreign jurisdictions prompted some binary option providers to cease trading with such clients, significantly reducing the number of retail clients from over 280,000 to under 12,000. More than 95% of remaining retail clients are Australian residents. As such, available data on losses incurred by Australian retail clients may provide the best guide for estimating the likely future financial losses to retail clients resulting from binary options.

87 Based on confidential submissions to CP 322, the aggregate financial losses incurred by Australian retail clients from trading binary options exceeded $7.1 million and we estimate that net financial losses exceeded $6.7 million for the 12-month period from 1 December 2018 to 30 November 2019. This data does not capture all licensed binary option providers and so likely underestimates aggregate and net losses to Australian retail clients from trading binary options in that period.

88 Data showing what proportion of retail clients trading binary options are fully aware of and accept the high likelihood of cumulative financial losses from trading binary options over time due to the product's characteristics is not available. However, six of the 44 consumer submissions to CP 322 that specifically addressed binary options indicated that they trade binary options on an informed basis in pursuit of profits. Data about the proportion of Australian binary option clients' investment portfolios used for binary option trading is not available. In our view, based on the available evidence, the nature and extent of retail clients' financial losses resulting from the inherent characteristics of binary options is significantly harmful.

International experience of harm from binary options

89 We also point to research into client outcomes from trading binary options in other jurisdictions to show that binary options are likely to result in significant detriment to retail clients:

(a) the UK FCA found that:

 (i) in 2016, between 81% and 85% of clients' binary options accounts lost money and, on average, clients made a loss of between £400 and £1,200;

(ii) many of these clients appeared to make a profit from trading but made a loss when taking into account the impact of transaction fees; and

(iii) retail clients collectively experienced an average estimated loss of around £17 million in 2018 when trading binary options (before the products were banned);

(b) the Cyprus Securities and Exchange Commission found that from 1 January 2017 to 31 August 2017, on average, 87% of client accounts made a loss of around €480 trading binary options;

(c) the Polish Komisja Nadzoru Finansowego found that in 2016 86.3% of clients lost money trading binary options and in 2017 86.4% lost money;

(d) the Italian Commissione Nazionale per le Società e la Borsa found that in 2016 up to 74% of Italian retail clients made losses trading binary options, with an average loss of approximately €590; and

(e) ESMA found that in 2015 and 2016 83.3% of retail clients that traded binary options known as ‘up-down’ or ‘fifty-fifty’ binary options lost money and 73.7% of retail clients that traded ‘volatility’ binary options lost money.

Demographics of retail clients who trade binary options, marketing practices and complaints

90 One respondent to CP 322 submitted that ASIC’s data on client demographics, aggressive marketing practices and complaints in Section B of CP 322 relates generally to the retail OTC derivatives market and does not demonstrate significant detriment to retail clients resulting from binary options. The information in Section B of CP 322 about client demographics, aggressive marketing practices and complaints is not relied on as evidence of significant detriment to retail clients resulting from binary options. Section B of CP 322 is relevant to provide market background and colour, and evidences that binary options are available for acquisition by issue to retail clients.

Trust and confidence in Australian financial markets

91 Australian financial markets are well developed and enjoy a strong reputation globally. Maintaining trust and confidence in Australia’s financial markets is critically important for attracting investment in Australia.

92 ASIC is tasked with monitoring and promoting market integrity and consumer protection in relation to the Australian financial system. Among its objectives, ASIC must strive to promote the confident and informed participation of investors and consumers in the financial system.

93 As summarised in this section, we are concerned that binary options have resulted in, will and are likely to result in, significant detriment to retail clients—primarily in the form of financial losses.

94 Australian consumer protection measures in relation to binary options are less stringent than in many peer jurisdictions. Consumer protection concerns about binary options have driven many of ASIC's peer regulators to take strong regulatory action to ban or restrict the issue and distribution of these products: see paragraphs 41–47. IOSCO guidance encourages its members to consider adopting such measures: see paragraph 48.

95 Consumer trust and confidence in the Australian financial system may be broadly promoted by taking regulatory action to address poor consumer outcomes in binary options and by strengthening consumer protections in line with international standards, even though the market for binary options is only a small part of the wider system.

D Consultation

The consultation process

96 On 22 August 2019, ASIC published a public consultation paper, CP 322, setting out a proposal to exercise ASIC's product intervention power in Pt 7.9A of the Corporations Act to make certain market-wide product intervention orders relating to the issue and distribution of OTC binary options and CFDs to retail clients. ASIC's announcement of the proposals was widely reported on by Australian mainstream and financial media outlets (print, television and radio).

97 Some binary option providers communicated the proposals in CP 322 to their clients directly and invited feedback to ASIC.

98 ASIC received over 400 submissions to CP 322. Of those, more than 60 submissions responded to the Proposed Order for binary options, including submissions from providers of OTC binary options, industry bodies, consumer groups, consumers of OTC binary options and members of the public. Following receipt of their submissions, we held further discussions with consumer groups and binary option providers.

Summary of stakeholder views

99 During the consultation, ASIC received responses from a broad range of stakeholders (the respondents), including from binary option providers, CFD issuers, a stockbroker, industry bodies, consumer groups and individual consumers. This RIS does not set out in detail the views of the respondents on each matter covered in our consultation.

100 Respondents' views on whether ASIC should intervene in relation to binary options mainly fell into the following three categories:

(a) a strong majority of respondents supported the Proposed Order, which is discussed under Option 1 in Section E;

(b) one respondent rejected the need for a prohibition and suggested alternative measures to restrict the issue and distribution of OTC binary options to retail clients, which are discussed under Option 2 in Section E; and

(c) 16 respondents rejected the need for intervention (including five consumers who raised general objections to regulation that would restrict consumer choice).

101 The views of each stakeholder group are summarised as follows:

(a) *Binary option providers*—Four binary option providers supported the Proposed Order, including one that has since ceased dealing in binary options.

(b) *CFD issuers*—Six CFD issuers who do not deal in binary options supported the Proposed Order (other CFD issuers who gave feedback to CP 322 did not comment on the binary option proposals).

(c) *Industry bodies*—ACI, the Australian CFD and Margin FX Association, and AFMA submitted individual responses that supported the Proposed Order.

(d) *Consumer groups*—Connect Health and Community and a joint submission by the Consumer Action Law Centre, Choice and the Financial Rights Legal Centre expressed strong support for the Proposed Order.

(e) *Individual consumers*—Forty-four consumer submissions gave feedback specific to binary options. Thirty-three consumers supported the Proposed Order and 11 were opposed. Feedback from the 33 consumers who supported the Proposed Order included that binary options do not provide meaningful investment or economic utility, are unsuitable for retail clients, are designed to put retail clients at a disadvantage and are predatory instruments. However, none of the consumers in support of the prohibition in the Proposed Order presented evidence that they had suffered harm from binary options. Feedback from the 11 consumers who opposed the Proposed Order included that the ‘all or nothing’ payoff structure of binary options is simple to understand and limits the financial risks, binary options can serve a useful purpose for speculation or hedging and that the Proposed Order would be unduly restrictive of consumer choice. In addition to the 44 consumer submissions specific to binary options, five more consumers raised general objections to regulation that would restrict consumer choice, although it was unclear whether these submissions related to the Proposed Order or ASIC’s proposals relating to CFDs or both. Another consumer said binary options are ridiculous but did not wish to comment on the Proposed Order.

(f) *Other stakeholders*—AFCA and stockbroker Bell Potter strongly supported the Proposed Order. AFCA submitted that the sale of binary options, their structure and the terms on which they are offered are the product of the provider taking unfair advantage of the consumer. The Australian Securities Exchange (ASX) said it did not believe the Proposed Order would have a material effect on the operation, or integrity, of public markets in the underlying securities that some binary options reference. One respondent suggested Option 2 if ASIC decided on regulatory intervention.

102 The views of the respondents on particular issues have informed the policy options and impact analysis and are set out where relevant under each option in Section E.

Volatility binary options

103 Volatility binary options are binary options that are quoted at a range of strike prices, each with different probabilities of exercise. One respondent suggested that volatility binary options are different to fifty-fifty or up-down binary options with a 50% probability of exercise. This respondent considered that volatility binary options meet a clear investment need for retail clients who want to speculate on the volatility of an underlying asset with limited risk that is known upfront.

104 We disagree that binary options meet a clear 'limited risk' investment need for retail clients. Describing fifty-fifty binary options and volatility binary options as limited risk products obscures the fact that a retail client's investment risk to a binary option is 'limited' to the entire investment amount, which may be lost entirely in just 30 seconds.

105 While we accept that the simulation in Figure 1 does not directly apply to volatility binary options because they are quoted at a range of strike prices with different probabilities of exercise, our concerns about product characteristics and client losses apply to volatility binary options for the following reasons:

(a) In 2016–17, we found that around 76% of retail clients lost money trading volatility binary options.

(b) Aggregate data obtained by ESMA for three firms in 2015 and 2016 showed that volatility binary options have negative outcomes for retail clients that are similar to other types of binary options. ESMA found that 83.3% of retail clients in Europe that trade up-down or fifty-fifty binary options lose money and 73.7% of retail clients that trade volatility binary options lose money. Therefore, while assumptions and simulations in Figure 1 do not apply to volatility binary options, the proportion of client accounts that lose money is significant for both types of binary options.

(c) ESMA noted in its decision of 22 May 2018 that the provision of continual two-way binary option pricing does not improve an investor's expected return: see paragraph 42. This is because binary option providers typically set the bid/ask spread so that they will make an expected profit. The investor's expected return would therefore remain negative where there is continual two-way pricing.

Our response to consultation feedback

106 Our response to consultation feedback is incorporated in Sections E and F.

E Options and impact analysis

107 This RIS considers the following options:

(a) **Option 1:** Prohibiting the issue and distribution of binary options to retail clients (Proposed Order).

(b) **Option 2:** Imposing conditions on the issue and distribution of binary options to retail clients that require client assessment, disclosure of risk warnings and a pricing methodology and restriction of inducements (respondent-suggested option).

(c) **Option 3:** No change (status quo option).

108 We have not considered the impact of an option to exempt binary options with a contract duration of 30 days or more from any prohibition (compared with, for example, the Canadian provinces and certain EU jurisdictions) because:

(a) we are not aware of any such contracts currently offered in Australia; and

(b) this option is not expected to achieve the policy objectives as the short-term contract duration of binary options offered in Australia is only one of several product features contributing to the significant detriment to retail clients.

109 This section:

(a) discusses the nature of each option;

(b) sets out the impact of each option on consumers, the industry, government and competition; and

(c) summarises the net impact on the Australian community.

110 We recommend Option 1 for the reasons set out in Section F.

Option 1: Prohibiting the issue and distribution of binary options to retail clients

111 Under Option 1, ASIC would exercise its product intervention power in Pt 7.9A of the Corporations Act to make a market-wide product intervention order that:

(a) prohibits the issue and distribution of OTC binary options to retail clients; and

(b) requires that existing retail clients are notified of the terms of the order.

112 The prohibition would effectively mean that OTC binary options would no longer be lawfully available for acquisition by retail clients in Australia.

113 We note that retail clients' existing binary option positions would not be affected by the Proposed Order (s1023C(1) of the Corporations Act) and the Proposed Order would not apply in relation to a client properly classified under the Corporations Act as a 'sophisticated investor' (s761GA), 'professional investor' (s761G(7)(d)) or otherwise as a wholesale client (s761G(7)).

Commencement of the Proposed Order

114 CP 322 proposed that the Proposed Order should commence 10 business days after it is made. Feedback from binary option providers has indicated that 10 days is not sufficient time to implement the Proposed Order. However, we are also concerned about the nature, likelihood and extent of significant consumer detriment for any additional time that binary options are available to retail clients.

115 On balance, we propose a period of at least 20 business days. This should provide enough time for binary option providers to update legal documents, platforms, websites and education and marketing materials.

Duration of the Proposed Order

116 CP 322 proposed that the Proposed Order should remain in force for 18 months, the maximum time permitted under the legislation.

117 We consider an order with the maximum permitted duration is appropriate having regard to the nature and extent of the detriment to retail clients resulting from binary options and the objective to reduce the risk of significant detriment.

118 Twelve respondents agreed with us that the order should remain in force for a period of 18 months, while no respondents disagreed.

Impact on consumers

119 In our view, prohibiting the issue and distribution of binary options to retail clients would achieve the objective of reducing the risk of significant detriment to retail clients resulting from binary options.

120 We consider binary options provide no meaningful investment or risk management utility for retail clients because their characteristics—'all or nothing' payoff structure, short contract durations and negative expected returns—are incompatible with those uses and result in a high likelihood of cumulative financial losses over time: see paragraphs 49–68.

121 Consumer groups, industry groups, AFCA, Bell Potter and 10 consumers agreed with our view that binary options provide no meaningful investment or risk management utility. Another 23 consumers, six CFD issuers and four binary option providers also supported the Proposed Order. Industry group ACI said it has ‘always maintained that binary options serve no use to any end user. They have never been part of the wholesale market and can only be described as [a] tool to fundraise for the issuer. Your intelligence that 80% of retail clients lose money is, in our view conservative’.

122 By contrast, providers’ marketing of binary options as ‘straightforward’ investment products and common use of monetary inducements may distract retail clients and prospective retail clients from the risks of trading binary options and result in unexpected losses: see paragraph 69. AFCA submitted that binary options are marketed to consumers with little to no experience, who are told they can ‘learn to trade’ with the provider, whereas AFCA’s experience suggests that providers rarely educate or teach consumers or equip them with the necessary skills and knowledge.

123 Consumer research and the submissions of the minority of 11 consumers that opposed the Proposed Order indicated belief among consumers that binary options are straightforward, simple to understand products that they will be able to use effectively to generate investment returns or manage investment risks: see paragraphs 72–74.

124 For example, six consumer submissions believed that binary options can be used for speculation or hedging. Six consumers considered that a prohibition would be unduly restrictive of choice for retail clients that are trading binary options on an informed basis. They submitted that the cost of protecting consumers who are ‘uninformed’, ‘ignorant’ or ‘without the proper skillset’ would be that sophisticated or professional traders would lose the opportunity to profit from trading binary options. There was no support among the consumer submissions for the proposition that recreation or entertainment was a motivation for trading binary options.

125 Three respondents to CP 322 considered that speculative investment with binary options was less risky than with CFDs as the financial risks for binary options are more clearly limited and defined. In our view, the comparison discounts the complexity of options pricing and negative expected returns, which are linked to probability theory and market volatility, and the risk that a retail client may lose their entire investment amount on a ‘wrong’ binary option trade.

126 The disparity between these consumer perceptions and the complexity, risks and disutility of binary options may result in unexpected losses. Six of the 44 consumer submissions to CP 322 that specifically addressed binary options indicated that they trade binary options on an informed basis in pursuit of profits. However, data showing what proportion of retail clients are fully

aware of and accept the high likelihood of cumulative financial losses from trading binary options over time due to the product's characteristics is not available.

127 Ultimately, binary options do not provide meaningful investment or risk management utility for retail clients because the characteristics of binary options are incompatible with those uses. As set out in Section C, we are concerned that binary options have resulted in, and will and are likely to result in, significant detriment to retail clients. Further evidence of detriment includes:

(a) Most retail clients lose money trading binary options (e.g. data provided by one provider showed that 78% of its Australian retail clients lost money trading binary options in the period 1 December 2018 to 30 November 2019 and that only 2.7% of its Australian retail clients made a net profit of $500 or more across the period).

(b) We estimate retail clients' net financial losses in 2018 from trading binary options with the five licensed providers in Australia were approximately $490 million, based on reported gross trading revenue.

(c) We estimate net financial losses incurred by Australian retail clients from trading binary options exceeded $6.7 million between 1 December 2018 to 30 November 2019. This data does not capture all binary option providers and so likely underestimates net losses to Australian retail clients from trading binary options in this period.

128 As discussed in paragraphs 86–87, due to licensed binary option providers' actions in 2019 to cease dealing with a significant number of retail clients in foreign jurisdictions, we anticipate there will be a corresponding reduction in aggregate retail client losses and future revenue generated by these providers. As more than 95% of licensed providers' remaining retail clients are Australian residents, we consider that our data relating to Australian retail clients may provide the best guide for estimating likely future financial losses to retail clients resulting from binary options.

129 Without intervention, we consider it likely that Australian retail clients would continue suffering net financial losses trading binary options of at least $6.7 million annually. This would also equate to the annual amount that Australian retail clients can be expected to save following the Proposed Order.

130 We therefore expect average annual savings for Australian retail clients in aggregate to be at least $6.7 million, with total savings of at least $10 million over the 18-month duration of the Proposed Order.

131 Financial losses from trading binary options will affect individuals differently depending on their personal circumstances. Potential harms that may flow indirectly from financial losses, such as difficulty meeting financial commitments and family and relationship stresses (as described by Connect Health and Community in its submission), would be avoided by the

Proposed Order. We do not, however, have sufficient information to quantify the actual and potential social costs and benefits of the Proposed Order.

132 While we accept that the Proposed Order would reduce retail clients' range of financial product choices (as binary options would not be available for acquisition by retail clients in Australia), retail clients would continue to have access to a range of alternative speculative investment and risk management products—for example, exchange-traded options and OTC CFDs. We expect that retail clients would experience an overall benefit from redistributing their investable funds from binary options to other financial products that are more suited to meet their investment or risk management objectives.

133 The Proposed Order would not apply to sophisticated investors, professional investors and other wholesale clients who are afforded fewer consumer protections than retail clients under the corporations legislation. Binary option providers already have client onboarding processes in place to classify clients as wholesale clients, where applicable. We do not expect a significant number of retail clients of licensed binary option providers to be reclassified as wholesale clients if the Proposed Order is made.

134 The Proposed Order would closely align Australia with regulatory measures in force in other jurisdictions, such as the United Kingdom, the European Union, the United States and Canada: see Table 1.

135 Three respondents submitted that, if the Proposed Order is made, Australian retail clients would likely seek to trade binary options with offshore and unregulated providers. Clearly, there are significant, additional risks to Australian retail clients from dealing with unregulated, offshore binary option providers. ASIC has issued, and will continue to issue, strong warnings on the significant risks of dealing with unlicensed providers. However, these warnings may not be effective, in the same way that product issuer risk warnings often prove ineffective with retail clients. ASIC will therefore continue to monitor for any unlicensed dealing in binary options with retail clients, and recently strengthened criminal sanctions and civil penalties would apply to contraventions of s911A or 1023P of the Corporations Act.

136 Finally, the Proposed Order will not affect shareholders of companies listed on financial markets in Australia as the licensed binary option providers are not listed on any Australian financial market.

Indirect impacts

137 Public notice of the Proposed Order may have broader benefits by reducing the risk of fraud, and associated losses, by unlicensed entities soliciting Australian clients to transfer funds on the false pretence of investment in binary options. The Australian Competition and Consumer Commission (ACCC) has warned Australians of high-risk, no-reward investment scams,

and publishes annual *Targeting scams* reports on scam activity. In its April 2019 report, the ACCC noted that one victim of a binary option scam had a reported loss of $50,000. In its May 2018 report, the ACCC indicated that the average loss from binary option scams in 2017 was $43,000.

138 Consumer trust and confidence in the Australian financial system may be broadly promoted by taking regulatory action to address poor consumer outcomes in binary options by strengthening consumer protections in line with international standards, even though the market for binary options is only a small part of the wider system.

Impact on industry

Implementation and compliance costs

139 No respondents to CP 322 objected to the proposed requirement that binary option providers must take reasonable steps to notify their retail clients of the terms of the order within five business days of commencement of the Proposed Order. However, due to potential challenges posed by the COVID-19 pandemic, we recommend extension of the period to within 15 business days of commencement.

140 We expect the direct compliance costs incurred by providers to implement the prohibition under Option 1 would be minimal and one-off. We do not expect these implementation costs to exceed $100,000 for the industry. This includes costs for:

(a) notifying retail clients of the order by email;

(b) disabling the product for retail clients on trading platforms (and, if no other financial products or financial services are provided by a binary option provider, returning money held on behalf of retail clients); and

(c) updating digital material, compliance procedures, terms and conditions and disclosure documents to exclude reference to the offer of binary options to retail clients.

141 The costs account for additional staff resources and the IT cost of updating disclosure material, systems and trading platforms.

142 As these would be one-off costs for the duration of the Proposed Order, the estimated annual regulatory cost for the industry over the 18-month period would be $67,000.

143 The assessment of these implementation costs is based on the assumption that there are four licensed binary option providers operating in Australia. The assessment does not include other indirect costs that providers may incur, including costs for restructuring their business model to service wholesale clients or provide other financial products or costs for closing their business. One confidential submission estimated indirect costs of this

kind but, in any event, most of the four binary option providers already have client onboarding processes in place to classify clients as wholesale clients under existing regulations.

Opportunity costs

144 The main cost to business of the Proposed Order would be the loss of opportunity to derive profit from issuing and distributing binary options to retail clients.

145 We estimated that in 2018 the five licensed binary option providers' gross trading revenue from dealing in binary options with clients located in Australia and offshore totalled $490 million. However, providers' aggregate trading revenues relating to binary options fell significantly in 2019–20 because certain providers ceased dealing with thousands of foreign clients following an ASIC warning in April 2019 (around four months before CP 322 was published) against providing unlicensed or unauthorised services to clients located in certain foreign jurisdictions (such as Japan). As a result, licensed providers' retail clients reduced from over 280,000 to under 12,000. More than 95% of the remaining retail clients trading binary options with licensed providers are Australian residents.

146 While not its purpose, the Proposed Order would have an ancillary benefit of helping to:

(a) ensure that the Australian financial system is not used to undermine or circumvent measures implemented in foreign jurisdictions restricting or prohibiting the offer of binary options; and

(b) maintain, facilitate and improve the performance of the Australian financial system by strengthening ASIC's important relationships with foreign regulators.

Note: See also a warning from the Japanese Financial Services Agency in its *Weekly Review No. 171* (17 November 2015) to Highlow Markets Pty Ltd and others that were operating financial instruments businesses without proper registration.

147 We consider providers' trading revenue from binary options can largely be attributed to a combination of net client trading losses and spreads, fees and commissions charged to clients. The trading revenue can be compared with an economic transfer or redistribution of investable funds from clients to providers, involving limited real economic activity. Further, providers may potentially earn 'supernormal profits' by pricing binary options in a way that increases the negative expected return for their retail clients. The Proposed Order would preclude these trading revenues and this economic transfer.

148 The opportunity cost of the Proposed Order would be felt chiefly by the binary option provider who has the largest market share of the five licensed providers in Australia and does not offer other financial products. However, opportunity cost of the Proposed Order to this provider would be significantly less than its trading revenue or profits earned in prior years as it

now deals only with Australian resident clients and has ceased dealing with a substantial number of foreign clients.

149 One binary option provider who supports the Proposed Order has ceased offering binary options. The three other providers have also provided their support for the Proposed Order and its aim to reduce the risk of significant detriment to retail clients resulting from binary options. They derive only a small proportion of their revenue from binary options with most of their business focused on other product categories. For one binary option provider, binary options made up only 0.002% of its total Australian dollar turnover in the six months to June 2020.

150 Providers of alternative investment products and services may benefit from retail clients' redistribution of investable funds that would no longer be used for trading binary options if the Proposed Order is made. This may offset some of the opportunity costs to binary option providers.

151 Issuance and distribution of binary options to wholesale clients would not be affected by the Proposed Order. This represented approximately 1% of binary option providers' total clients as at 31 March 2019. Binary option providers did not indicate in their submissions to CP 322 whether their business with wholesale clients would remain viable if the Proposed Order affecting business with retail clients is made.

Impact on government

152 ASIC would need to introduce arrangements to monitor and enforce the Proposed Order. This would also provide the basis to assess the effectiveness of the 18-month Proposed Order. However, we expect additional costs to be minimal and managed within existing resources for monitoring and enforcement of illegal, unlicensed offers of binary options to retail clients.

153 We refer to ESMA's observation in a recent report that NCAs reported only limited numbers of non-compliance in relation to ESMA's temporary prohibition: see paragraph 45.

154 It is not possible to estimate these costs as they would vary according to the nature of any contraventions and whether enforcement or administrative action is taken.

Impact on competition

155 Expected effects of the Proposed Order on consumers and businesses are discussed above.

156 The proposed prohibition is targeted to conduct in relation to binary options and retail clients. ASX and the ACI Financial Markets Association agreed with us that no material effect on underlying financial markets is expected.

157 If the prohibition is implemented, retail clients would continue to have access to alternative investment products, including other classes of OTC derivatives (such as OTC CFDs) or exchange-traded products. The redistribution of investable funds from binary options to these alternative products may promote financial innovation and increase competition within the industry.

158 A market-wide prohibition would apply to all binary option providers equally.

Net impact

159 Table 2 sets out the regulatory burden estimate (RBE) for Option 1, with a change in annual regulatory costs of $67,000 per year over an 18-month period resulting from the Proposed Order.

160 The RBE reflects the direct compliance costs on the Australian community as a result of the Proposed Order. We expect that these minor compliance costs would be incurred by the four remaining licensed binary option providers. Further, we expect the regulatory costs of Option 1 to consumers and ASIC to be minimal, as discussed above. We have not identified any regulatory cost offsets under Option 1.

Table 2: RBE: Average annual regulatory costs (from business as usual)—Option 1

Change in costs ($ million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	$0.067	$0	$0	$0.067

161 Option 1 would ensure that retail clients do not suffer significant detriment from this inherently flawed product, which provides no meaningful investment or risk management utility for retail clients because of its characteristics.

162 In addition, potential social costs to the Australian community are discussed in paragraph 131.

163 As discussed in paragraphs 68 and 132, the redistribution of investable funds from binary options to alternative products that are better suited to meet the investment or risk management objectives of retail clients may result in improved outcomes. The extent of any improvement would depend on the retail client's overall investment or risk management strategy.

164 A redistribution of these funds may also encourage financial innovation and increased competition within the industry, as discussed in paragraph 157.

165 Further, we consider the Proposed Order would promote consumer trust and confidence in the retail OTC derivatives sector and in the Australian financial system more broadly, as discussed in paragraph 138.

166 As discussed in paragraphs 144–149, we expect that binary option providers would also experience opportunity cost in the form of lost trading revenue and profits. The opportunity cost would be material for at least one binary option provider that does not offer other financial products.

167 In an economic sense, trading binary options typically involves an economic transfer from retail clients (financial losses) to the licensed binary option providers (trading revenue), as discussed in paragraph 147. Binary option providers may earn supernormal profits as a result of cumulative financial losses suffered by retail clients, involving limited real economic activity by the provider. The Proposed Order would reduce providers' trading revenues and profits and retail clients' financial losses resulting in a net welfare gain.

168 On balance, we consider the Proposed Order under Option 1 would achieve the objective of reducing the risk of significant detriment to retail clients trading binary options. Together, the benefits are expected to outweigh the impact to business and result in an overall net benefit to the Australian community.

Option 2: Imposing conditions on the issue and distribution of binary options to retail clients

169 Under Option 2, as suggested by one respondent to CP 322, ASIC would exercise its product intervention power in Pt 7.9A of the Corporations Act to make a market-wide product intervention order that:

(a) imposes a set of conditions on the issue and distribution of binary options to retail clients; and

(b) requires that existing retail clients are notified of the terms of the order.

170 The conditions in Option 2 would require a binary option provider to:

(a) perform a client assessment in accordance with prescribed standards before onboarding a new client;

(b) display a provider-specific risk warning on the provider's PDS, account opening form, trading platforms and websites relating to binary options;

(c) provide a pricing methodology to retail clients; and

(d) refrain from giving or offering retail clients inducements to open or fund a binary option trading account or to trade binary options.

171 We note that the client assessment proposed by the respondent is intended to assess a client's knowledge and experience relevant to trading binary options rather than give full consideration of their objectives, needs and financial situation.

172 As discussed in the following analysis, we do not consider Option 2 to be a viable option to achieve the objective of reducing the risk of significant detriment to retail clients resulting from binary options. It was not an option presented for public comment in CP 322 or in subsequent consultation meetings with the binary option providers who supported Option 1.

Impact on consumers

173 Under the alternative measures, binary options would continue to be available to retail clients who are able to satisfy a provider's client assessment. One respondent submitted that client assessments 'may go some way to weeding out unsuitable clients' and 'generate better outcomes for both the client and the product issuer'. It said retail clients would be less likely to choose to trade offshore or deal with unregulated providers under Option 2 than if the Proposed Order was implemented.

174 The respondent suggested that alternative measures could include standards for assessing retail client suitability and the number of questions to be asked. Client assessments and restrictions on inducements would likely divert some retail clients away from trading binary options, while others that satisfy the assessment would be at risk of suffering significant detriment resulting from the product. The respondent that proposed the alternative measures said it did not have sufficient information to estimate how many retail clients would satisfy a client assessment. The evidence before us suggests that very few retail clients have success trading binary options: see paragraphs 82–83.

175 Assuming that a client assessment may take 15 minutes for a retail client to complete, we estimate consumers' costs of compliance with the proposed client assessment would be approximately $90,000 (12,000 clients x $30 per hour x 0.25 hours). As we have treated this as a one-off cost for the purposes of our analysis, the estimated average annual compliance cost for consumers over the 18-month period would be approximately $60,000.

176 The respondent further submitted that mandated risk warnings (similar to those proposed for CFDs in CP 322) would leave consumers 'with no doubt as to the risk profile of the product' and that measures requiring disclosure of pricing methodologies and restrictions on the offer of inducements 'will reduce the level of risk associated with binary options'.

177 We do not agree that the alternative measures would effectively address concerns relating to binary options. In REP 632, ASIC and the AFM agreed that while disclosure can and does contribute to better financial markets, it has limitations. For example:

(a) disclosure does not solve the complexity in financial services markets;

(b) disclosure must compete for consumer attention;

(c) the effects of disclosure vary depending on context; and

(d) in certain cases, disclosure may be counterproductive.

178 ASIC and AFM presented a strong evidence base and 33 case studies where disclosure has had limited, or a negative, effect on consumer outcomes from financial products. As discussed in paragraph 79, two key reasons why disclosure and warnings can fail, which are identified and evidenced in REP 632, are that they do not solve complexity and can be crowded out or manipulated by financial product providers—for example, through their advertising and marketing efforts. Both of these limitations are highly relevant to the sale of binary options. For instance, in 2019 one binary option provider paid trading inducements to clients equivalent in value to 14% of its trading revenue and incurred marketing expenses equivalent to 6.6% of its trading revenue.

179 Also, as noted in REP 632, there is some evidence of the ineffectiveness of warnings on human understanding of risk, and in encouraging people to avoid unsuitable or harmful products. For instance, one case study in the report refers to research by Professor Hazel Bateman and colleagues into product dashboards for superannuation products. The research found that even simplified risk information about superannuation products was irrelevant to the decisions made by a majority of study participants. Instead, the 'dashboard' type of disclosure that was tested backfired because participants generally did not match risk-adjusted returns to their own risk profile.

180 In addition, as noted in REP 632, in practice humans can ignore, overlook, misunderstand or misremember warnings. One reason could be 'warning fatigue', as suggested by UK FCA researchers, due to the over-proliferation of warnings about many different risks in a consumer's day-to-day life.

181 A joint submission by the Consumer Action Law Centre, Choice and the Financial Rights Legal Centre strongly supported the Proposed Order (Option 1). Commenting on the CFD risk warning proposals in CP 322 (which were the basis for the suggested risk warnings in Option 2), they said 'it is entirely reasonable a risk warning should exist on all forms of promotion and marketing. Risk warnings are not, however, a substitute for safe products—written in a broad way, they are unlikely to have an effect on consumer decision making. Many CFD websites we visited already have some warnings in small print at the bottom of the page, possibly to comply with requirements from other jurisdictions. They are clearly not convincing people of the risk, given how many clients lose money'.

182 Although it is not possible to reliably predict all potential risks and benefits of the alternative measures and it is difficult to isolate the causal impact of risk warnings and disclosure of pricing methodologies on the decisions of real investors, we have strong doubts that additional risk warnings and disclosure of pricing methodologies would be effective in reducing the risk of significant detriment to retail clients.

183 On the basis of existing relevant evidence, we expect that—if the alternative measures were to deliver any benefit at all, and not backfire—the benefit

would be minimal. The evidence indicates they would be weak and potentially counterproductive remedies, and they would not address:

(a) the product features contributing to the significant detriment to retail clients, such as the high likelihood of cumulative losses from binary options because of their 'all or nothing' payoff structure, negative expected return and short contract duration; or

(b) our concerns about binary options having no meaningful investment or risk management utility.

184 Accordingly, in our view the alternative measures in Option 2 are unlikely to be as effective as the Proposed Order in reducing the risk of significant detriment to retail clients resulting from binary options.

185 Further, the alternative measures would involve less stringent consumer protection measures than the prohibitions and restrictions in force in Canada, the United Kingdom and across Europe (e.g. the Netherlands, Germany and France). Notably, the measures were assessed as having been effective: see paragraphs 41–48.

Impact on industry

Implementation and compliance costs

186 We expect that the direct compliance costs incurred by binary option providers under Option 2 would be significantly more than Option 1. However, unlike Option 1, this option would not impose a prohibition on binary options.

187 Option 2 would involve both one-off implementation costs and ongoing costs following implementation. Using information received from respondents to CP 322, we have estimated the expected costs for a binary option provider complying with the following conditions:

(a) incorporating a risk warning disclosing client profitability ratios across its disclosure material, systems and platforms would involve $75,000 in upfront costs, with a further $36,000 in annual monitoring costs;

(b) disclosing its pricing and execution methodology on its website would involve $92,000 in upfront costs and a further $47,000 in annual monitoring costs; and

(c) restricting the types of inducements offered to retail clients would involve $57,000 in upfront costs and a further $27,000 in annual monitoring costs.

188 The costs account for additional staff resources and the IT cost of updating disclosure material, systems and trading platforms.

189 On this basis, the estimated upfront and ongoing costs to each binary option provider implementing all these conditions would be approximately $390,000 over an 18-month period. As there are currently four licensed binary option providers in the industry, the total estimated cost for the industry would be approximately $1.56 million over an 18-month period.

190 As these are a mixture of upfront and ongoing costs for the duration of the Proposed Order, the estimated average annual regulatory cost for the industry over the 18-month period would be approximately $1.04 million.

191 While most binary option providers have client assessments in place, a condition mandating a standardised assessment would likely require providers to update their processes. We therefore expect that this condition would have some cost impact. However, we do not currently have sufficient information to provide a cost estimate for this condition.

Opportunity costs

192 The main cost to business of Option 2 is the loss of opportunity to derive trading revenue because binary option providers:

(a) would not derive any revenue from retail clients who do not satisfy a client assessment (however, three of the four binary option providers already undertake client assessments at onboarding);

(b) may derive less revenue from lower retail client trading volume due to the restriction on certain inducements;

(c) would no longer derive revenue from retail clients who cease trading binary options after reading the risk warning, pricing and/or execution methodology disclosures. However, this is difficult to quantify and, as noted in REP 632, the impact of disclosure may be counterproductive where the product is complex.

193 As discussed under ‘Impact on consumers’ (paragraphs 173–185), we estimate that any benefits to consumers (financial savings) under Option 2 would be minimal. Accordingly, the revenue impact of these alternative measures on the industry would be significantly less than under Option 1.

Impact on government

194 ASIC would need to introduce arrangements to monitor and enforce the conditions imposed on the offer of binary options. This monitoring would also aid assessment of the effectiveness of the product intervention order under Option 2.

195 The level of monitoring required for Option 2 would depend on the types of conditions imposed but we expect that it would be substantially greater than Option 1 and greater than Option 3. This is because the alternative measures

considered under Option 2 would require binary option providers to make broad changes to their disclosure, client onboarding and trading systems. ASIC would need to prepare detailed standards for client assessments during client onboarding.

196 Monitoring and enforcement of these changes would involve detailed supervision and assessment. Further, additional consumer complaints may arise in relation to alleged contraventions of these alternative measures by providers, which may vary in complexity.

197 It is not possible to estimate these additional monitoring and enforcement costs as they would vary according to the nature of any suspected contravention and whether it would involve enforcement or administrative action.

Impact on competition

198 We do not anticipate that the alternative measures would have any adverse effect on competition in the financial system. They may improve transparency of binary option pricing methodologies and promote competition based on providers' product offerings rather than on trading inducements that can distract retail clients from the risks of binary options. However, under Option 2, there is a risk that issuer-specific risk warnings showing percentages of loss-making accounts could be used inappropriately as a comparison and marketing tool to attract retail clients.

Net impact

199 Table 3 sets out the RBE for Option 2, with a change in annual regulatory costs of $1,100,000 per year over an 18-month period resulting from the alternative measures in Option 2.

200 The RBE reflects the direct compliance costs on the Australian community as a result of Option 2. We expect that this cost would be incurred by the four remaining licensed binary option providers and Australian retail clients. We have not identified any regulatory cost offsets under Option 2.

Table 3: RBE: Average annual regulatory costs (from business as usual)—Option 2

Change in costs ($ million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	$1.04	$0	$0.06	$1.1

201 The RBE for Option 2 is substantially greater than for Option 1. As discussed in paragraphs 194–197, we also expect that ASIC would incur greater costs as a result of monitoring and supervision work under Option 2 compared with Options 1 and 3.

202 In addition, we expect that binary option providers would experience an opportunity cost in the form of reduced trading revenue. As discussed in paragraphs 192–193, it is not possible to precisely quantify these opportunity costs, although we expect these costs to business would be less than under Option 1.

203 Similarly, it is not possible to precisely quantify the expected financial savings to Australian retail clients from the alternative measures under Option 2 and their focus on improving disclosure standards. However, as discussed in paragraphs 177–184, we do not expect these disclosures to be effective in reducing the risk of significant detriment to retail clients resulting from binary options.

204 Any retail client who trades binary options would be exposed to the risks associated with the product's characteristics, including negative expected returns and the likelihood of cumulative losses over time. There does not appear to be any material benefit to Australian retail clients under Option 2 that would offset or outweigh the regulatory and opportunity costs incurred by the binary option providers.

205 For these reasons, our view is that Option 2 would not result in a net benefit to the Australian community.

Option 3: No change (status quo)

206 Under Option 3, ASIC would continue to take action in response to misconduct by individual binary option providers but would not make a product intervention order.

207 We do not recommend this option. We are concerned that, despite our regulatory actions in relation to binary options over several years, significant detriment to retail clients continues. In our view, Option 3 would not achieve the objective of reducing the risk of significant detriment to retail clients resulting from binary options.

208 One respondent considered that the product intervention power is intended to be used as a last resort. We do not agree with this view. The product intervention power is intended to enable ASIC to take action before harm, or further harm, is done to consumers.

209 The availability of other regulatory powers and tools does not preclude the use of the product intervention power, if it is considered appropriate to do so. The product intervention power is one of several regulatory tools available to ASIC to improve consumer outcomes.

210 The respondent also submitted that ASIC should not make the Proposed Order because the design and distribution obligations in Pt 7.8A, commencing on 5 October 2021, may operate to remedy any structural

issues with binary options. The design and distribution obligations are intended to help consumers obtain appropriate financial products by requiring issuers and distributors to have a consumer-centric approach to the design and distribution of products. In particular:

(a) issuers must design financial products that are likely to be consistent with the likely objectives, financial situation and needs of the consumers for whom they are intended;

(b) issuers and distributors must take ‘reasonable steps’ that are reasonably likely to result in financial products reaching consumers in the target market defined by the issuer; and

(c) issuers must monitor consumer outcomes and review products to ensure that consumers are receiving products that are likely to be consistent with their likely objectives, financial situation and needs.

211 Proactive use of the product intervention power to reduce the risk of significant detriment to retail clients resulting from binary options is consistent with the object of the power and ASIC’s objectives. In our view, it would be a more direct and timely response and so have greater efficacy than adopting a ‘wait and see’ approach sometime after the commencement of the design and distribution obligations in October 2021.

212 ASIC contemplated the future combined effect and use of the powers in draft guidance on the product intervention power in Consultation Paper 313 *Product intervention power* (CP 313):

> When the design and distribution obligations come into force for financial products, it is likely that in at least some cases—when there has been significant consumer detriment such that we have needed to intervene using the product intervention power—this will have been caused by the financial product being inappropriately distributed to consumers due to a breach of the design and distribution obligations. In such cases, as well as intervening prospectively using the product intervention power, we will be able to take enforcement action for the breach of the design and distribution obligations.

Impact on consumers

213 As stated above, maintaining the status quo under Option 3 would not achieve the objective of reducing the risk of significant detriment to retail clients resulting from binary options.

214 We have observed that binary options have resulted in significant detriment to retail clients even if the individual providers complied with all applicable laws. This is because the characteristics of binary options, by design, are inherently unsuitable for investment or risk management uses by retail clients.

215 Retail clients’ choice to trade binary options would not be restrained under Option 3. Nevertheless, various substitute financial products may be used by retail clients desiring high-risk, short-term speculation or risk management. Consumer groups emphasised that money lost by retail clients trading binary

options cannot be used for other products and services in the Australian financial services markets.

216 If ASIC pursues Option 3 and does not intervene, we consider that Australian retail clients will, and are likely to, continue suffering net financial losses trading binary options of at least $6.7 million annually. Further, Australia's consumer protection measures in relation to binary options would remain less stringent than measures in the United States, Canada, the United Kingdom and several European jurisdictions.

Impact on industry

217 We do not expect binary option providers to incur any direct compliance costs or any other costs to business in relation to Option 3 as it would preserve the status quo.

218 Under Option 3, a reactive supervisory approach that focuses on investigation of, and enforcement action against, any misconduct by individual binary option providers involves its own costs to business but would not directly address the product flaws and risks of binary options to retail clients on a comprehensive and systemic basis.

219 If these products remain available to retail clients, it is likely that more variants of harmful binary options will be offered and new providers will enter the Australian market to exploit the differences between regulatory settings here and in comparable markets.

Impact on government

220 ASIC has incurred significant costs in taking action and applying its regulatory tools to address our concerns about the issue and distribution of binary options to retail clients, which we expect would continue under Option 3, including:

(a) enforcement action against identified misconduct;

(b) public warning notices and other statements;

(c) surveillance projects and thematic reviews;

(d) stronger regulations; and

(e) retail client education campaigns about the risks of trading binary options.

221 Our view is that the current costs to ASIC under the status quo are less than the costs expected under Option 2, but more than Option 1, as monitoring and supervision of binary option provider conduct and compliance with regulatory obligations would continue.

Impact on competition

222 We consider that the nature of binary options does not support meaningful competition for the benefit of consumers. An industry body observed that the evidence presented in CP 322 indicates a highly competitive market for the selling of binary options which resulted in a selling environment that encouraged vigorous promotions of the product benefits over a more cautious statement of their risks.

223 Due to the inherent features of binary options, we expect that the high percentage of retail client accounts incurring net trading losses is likely to continue.

224 If poor consumer outcomes from binary options persist in Australia and consumer protection standards are not raised to international standards, trust and confidence in the retail OTC derivatives sector could be eroded. This may affect consumer trust and confidence in Australian financial markets more broadly.

F Conclusion and recommended option

225 We recommend Option 1 for the reasons set out below:

(a) Option 1 would best achieve the objective of reducing the risk of significant detriment to retail clients resulting from binary options, compared with Options 2 and 3, because:

(i) Option 1 would reduce the risk of significant detriment to retail clients comprehensively and systemically by prohibiting the issue and distribution of binary options to retail clients. As set out above, we estimate that Australian retail clients would benefit from annual financial savings of at least $6.7 million and total savings of at least $10 million over an 18-month period as a result of the Proposed Order;

(ii) the suggested alternative measures in Option 2 would leave the inherent risks associated with trading binary options largely unchanged and would likely be ineffective in reducing the risk of significant detriment to retail clients and so are unlikely to be of net benefit to the Australian community and economy;

(iii) maintaining the status quo under Option 3 would not achieve the objective of reducing the risk of significant detriment to retail clients resulting from binary options.

(b) Clients properly classified under the Corporations Act as ‘sophisticated investors’ (s761GA), ‘professional investors’ (s761G(7)(d)) or otherwise as wholesale clients (s761G(7)) are not affected by Options 1 and 2 (and are generally afforded fewer consumer protections than retail clients under the corporations legislation).

(c) Option 1 is consistent with regulatory measures in force in peer jurisdictions, which would promote trust and confidence in the Australian financial system more broadly.

(d) We expect that Option 1 would result in an overall net benefit to the Australian community because the benefits would outweigh the costs. The benefits include financial savings for consumers and improved trust and confidence in the Australian financial system and the economy over time through greater foreign investor confidence. The costs include increased costs to the four binary option providers (compliance costs and opportunity costs) and reduction in consumer choice of high-risk, speculative financial products.

(e) Compliance costs to binary option providers from the suggested alternative measures in Option 2 are likely to be substantially higher than the modest compliance costs of Option 1.

(f) The Proposed Order in Option 1 would likely have little to no effect on competition in the financial system because:

   (i) binary options do not support meaningful competition for the benefit of consumers;

   (ii) of the relative size of the binary options market and considering there are four binary option providers and around 12,000 retail clients;

   (iii) various substitute financial products may be used by retail clients desiring high-risk, short-term speculation or risk management.

(g) A prohibition on binary options under Option 1 would not have any material effect on underlying financial markets.

226 Consistent with our recommendation, consumer groups, AFCA, industry bodies, Bell Potter, four binary option providers and a 3:1 majority of consumer submissions supported the Proposed Order (Option 1).

G Implementation and review

227 We recommend that ASIC's delegate under s1023D(3) of the Corporations Act exercise the product intervention power in Pt 7.9A of the Corporations Act to make the proposed market-wide product intervention order.

228 Market-wide product intervention orders that apply to a class of products are made by legislative instrument.

229 In summary, the Proposed Order would:

(a) prohibit entirely the issue and distribution of binary options to retail clients; and

(b) require that existing retail clients are notified of the terms of the order.

230 Section 1023G(2) of the Corporations Act provides that a product intervention order remains in force for 18 months or any shorter period specified by the regulations or any shorter period specified in the order. No relevant period has been specified in the regulations.

231 Balance is required between the need for the Proposed Order to commence promptly to avoid significant detriment to clients and the requirement for binary option providers to adjust their systems.

232 We recommend that the Proposed Order would take effect at least 20 business days after it is made and remain in force for 18 months. Submissions to CP 322 agreed that if ASIC does implement the Proposed Order then it should remain in force for a period of 18 months. Ministerial approval is necessary to extend a product intervention order beyond that period.

233 Binary option providers would be required to take reasonable steps to notify their retail clients of the terms of the order within 15 business days of the registration and commencement of the order.

234 We propose that ASIC would conduct a consumer campaign with information about any product intervention order (if made) and issue appropriate consumer warnings on the Moneysmart website. However, we acknowledge that such warnings may not be effective, in the same way that product issuer risk warnings often prove ineffective.

235 We would closely monitor the impact of any product intervention order (if made) and may require AFS licensees to report to ASIC on a regular basis information about their financial services business and financial services provided.

236 We will monitor the market for 'product arbitrage' (i.e. the creation of new products with characteristics or risks similar to binary options) and other potential avoidance practices by providers to undermine or attempt to work around the intended purpose of the Proposed Order.

237 We will also conduct surveillance of providers' reclassification of retail clients to wholesale clients to ensure compliance with existing laws. It is important for consumers to understand that wholesale clients do not receive the same protections under the law as retail clients.