MFSA MALTA FINANCIAL SERVICES AUTHORITY

Consultation Document

Consultation on the Implementation of National Product Intervention Measures in relation to Contracts for Difference

This document seeks feedback from the industry on the proposed product intervention measures with respect to contracts for difference which the MFSA proposes to take in the terms of its powers under Article 42 of MIFIR.

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NOTE. The documents circulated by the MFSA for the purpose of consultation are in draft form and consist of proposals. Accordingly, these proposals are not binding and are subject to changes and revisions following representations received from Licence Holders and other involved parties. It is important that persons involved in the consultation bear these considerations in mind.

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Chapter 1: Contracts for Difference

This Consultation Document relates to measures the MFSA is proposing to introduce in relation to 'Contract for Difference' or 'CFDs'

1.1 What is a Contract of Difference ('CFD')?

A CFD is a derivative instrument other than an option, future, swap or forward rate agreement, the purpose of which is to give the holder a long or short exposure to fluctuations in the price, level or value of an underlying, irrespective of whether it is traded on a trading venue. CFDs must be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event. Rolling spot forex contracts are also in scope.

During the last years, the European market has witnessed a rapid increase in the marketing, distribution or sale of CFDs to retail clients across the Union. CFDs are inherently risky and complex products and are often traded speculatively. European regulators have expressed widespread concerns on the increasing number of retail clients trading in these products and having them losing their money. These concerns are also supported by the numerous complaints received from retail clients across the EU who have suffered significant detriment when trading CFDs.

1.2. How do CFDs work?

The following is an example of how CFDs work in practice:

Current Investment Outlook: The current price of Stock A is €100. An Investor is expecting the Price of Stock A to rise. He intend s to buy 1,000 stock of A. The investor can take one of the following decisions:

Decision 1: Buy Stock A directly.

To carry out this transaction the investor would need to pay €100,000 (€100x1000).

Decision 2: Buy CFDs on Stock A.

Here, the price of Stock A's CFD is the same as that of Stock A (the underlying asset) which is €100. However, given that CFDs are leveraged instruments, where only a percentage of the total trade value is required to be deposited (the margin), for example 10%.

To carry out this transaction the investor would need to pay €10,000 (10% of €100,000) rather than the full €100,000.

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The following table depicts the outcome of the Investor's investment in Stock A in a positive scenario and in a negative scenario:

	Decision 1 – Buy Stock A Directly	Decision 2 – Buy CFDs on Stock A
Positive Scenario – Price of Stock A rises by 10%: - New Price of Stock/CFD is €110 - Profit on each Stock/CFD is €10	- Total Profit realised by Investor A is €10,000 - **Profit as a percentage of capital invested is 10%.**	- Total profit on investment is still €10,000 (because the value of the underlying – Stock A- has increased) - **Profit as a percentage of the invested capital is 100% (only €10,000 was originally paid up to purchase the CFDs)**
Negative Scenario – Stock A falls by 10% by the end of the week - New price of stock/CFD is €90 - Loss on each stock/CFD is €10.	- Total loss on investment is €10,000 - **Loss as a percentage of capital invested is 10%. Here the investor will only lose 10% of the money invested.**	- Total loss on investment is still €10,000 (because the value of the underlying – Stock A- has fallen). - **Loss as a percentage of capital invested is 100%. Here the investor will lose all the money paid up to purchase the CFD invested (€10,000).**

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1.3 Are CFDs Complex Instruments?

Data collected in many EU member states show that 74% to 89% of retail investors investing in CFDs lose their money. In view of this situation, many European regulators took measures to reinforce the protection of retail investors with respect to these financial instruments.

CFDs are complex financial instruments, typically not traded on a trading venue. The pricing, trading terms, and settlement of such products are not standardised, therefore impairing retail clients' ability to understand the terms of the product. In addition, CFD providers often require clients to acknowledge that the reference prices used to determine the value of a CFD may differ from the price available in the respective market where the underlying is traded, making it difficult for retail clients to check and verify the accuracy of the prices received from the provider.

The costs and charges applicable to trading in CFDs are complex and lack transparency for retail clients. In particular, retail clients typically find it difficult to understand and assess the expected performance of a CFD, also taking into account the complexity arising from the impact of transaction fees on such performance. Transaction fees in CFDs are normally applied to the full notional value of the trade and investors consequently incur higher transaction fees relative to their invested funds at higher levels of leverage. Transaction fees are usually deducted from the initial margin deposited by a client and high leverage can lead to a situation where the client, at the moment of opening a CFD, observes a significant loss on their trading account, caused by the application of high transaction fees. Since transaction fees at higher leverage will erode more of the client's initial margin, clients will be required to earn more money from the trade itself to realise a profit. This lowers the client's chances of realising a profit net of transaction fees, exposing clients to a greater risk of loss.

In addition to transaction fees, spreads and other various other financing costs and charges may be applied. These include commissions (a general commission or a commission on each trade, or on opening and closing a CFD account) and/or account management fees. Financing charges are also usually applied to keep a CFD open, such as daily or overnight charges, to which a mark-up can also be added. The number and complexity of the various costs and charges and their impact on clients' trading performance contribute to the lack of sufficient transparency in relation to CFDs which hinders retail clients from making informed investment decisions.

Another complexity arises from the use of stop loss orders. This product feature may give retail clients the misleading impression that a stop loss order guarantees execution at the price which they have set (the level of the stop loss). However, stop loss orders do not guarantee a protection level but the triggering of a 'market order' when the CFD price reaches the price set by the client. Accordingly, the price received by the client (execution price) can be different from the price at which the stop loss was set. While stop losses are not unique to CFDs, the use of leverage increases the sensitivity of an investor's margin to price movements of the underlying increasing the risk of sudden losses. Therefore, the traditional trading controls such as stop-losses are insufficient to manage investor protection concern.

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Another key complexity associated with CFDs arises from the relevant underlying market. For instance, with FX trading, clients speculate on one currency against another. If neither of these currencies is the currency used by the client to open a CFD position, any return received by the client will be dependent on the measures taken by the client to assess the movement of these three currencies. This suggests that a high level of knowledge and information related to all the currencies involved is required to successfully navigate the complexities of such currency trading which information and knowledge, retail clients would not normally have.

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Chapter 2: Product Intervention Measures relating to Contracts for Difference

2.1 ESMA Product Intervention Measures

In accordance with Article 40 of MiFIR, ESMA can introduce temporary intervention measures which are valid for a period of three months. Before the end of this period, ESMA will consider the need to extend the intervention measures for a further three months. If ESMA does not renew the measures, they will expire.

In 2018, ESMA formally adopted Product Intervention (PI) measures on CFDs which are essentially a **restriction** on the marketing, distribution or sale of CFDs to retail investors. This restriction consists of: leverage limits on opening positions; a margin close out rule on a per account basis; a negative balance protection on a per account basis; preventing the use of incentives by a CFD provider; and a firm specific risk warning delivered in a standardised way.

For the purposes of these measures, CFDs have been defined as being "a derivative other than an option, future, swap or forward rate agreement, the purpose of which is to give the holder a long or short exposure to fluctuations in the price, level or value of an underlying, irrespective of whether it is traded on a trading venue, and that must be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event."

In particular, the Product Intervention measures adopted by ESMA in relation to CFDs by means of Decision (EU) 2019/679 of the 17th April 2019 include a restriction on the marketing, distribution or sale of CFDs to retail investors, as follows:

1. Leverage limits on the opening of a position by a retail client from 30:1 to 2:1, which vary according to the volatility of the underlying, as follows:
    a. 30:1 for major currency pairs;
    b. 20:1 for non-major currency pairs, gold and major indices;
    c. 10:1 for commodities other than gold and non-major equity indices;
    d. 5:1 for individual equities and other reference values; and
    e. 2:1 for cryptocurrencies;

2. A margin close out rule on a per account basis. This will standardise the percentage of margin (at 50% of minimum required margin) at which providers are required to close out one or more retail client's open CFDs;

3. Negative balance protection on a per account basis. This will provide an overall guaranteed limit on retail client losses;

4. A restriction on the incentives offered to trade CFDs; and

5. Standardised risk warnings, including the percentage of losses on a CFD provider's retail investor accounts.

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The measures were initially applied by all National Competent Authorities, falling under ESMA, as from 1 August 2018. Since then, ESMA has extended these measures for three consecutive times. Accordingly, these will remain in force until the 1 August 2019.

2.2 Proposed National Product Intervention Measures

Under Article 42 of MiFIR, National Competent Authorities have the power to permanently prohibit or restrict the marketing, distribution or sale of financial instruments or a type of financial activity or practice.

The MFSA has carefully considered ESMA's position as well as that of other European National Competent Authorities and is proposing to adopt product intervention measures in terms of Article 42(2) of MIFIR with respect to CFDs. The proposed measure would essentially mirror the temporary measures from ESMA referred to above and which are currently active throughout the EU. The measures proposed to be taken by the MFSA in this regard, would be applicable to investment firms based in Malta and which market distribute or sell CFDs as defined above to retail clients, as well as to investment firms from other EU Member States marketing, distributing or selling such instruments in Malta either through the establishment of a branch in Malta (freedom of establishment) or through the provision of services on a cross border basis (freedom of service).

The MFSA has carried out an analysis of the data it collected from investment firms providing investment services in relation to CFDs to retail clients to assess the impact of ESMA's Product Intervention measures on the provision of such services. The general trends noted by the Authority are the following:

i. A sharp decline in the number of retail clients;
ii. A decline in the total and average volume of trades made by all clients;
iii. A reduction in the total equity of retail clients;
iv. The number of opened retail accounts exceeded those that have been closed;
v. An increase in the average equity per funded retail client;
vi. A decline in the average size per trade of retail clients;
vii. An increase in the average equity per retail client;
viii. A sharp decline in the total exposure and leverage for retail and elective professional clients;
ix. A sharp decline in the automatic close-out positions;
x. A sharp decline in the number and the value of negative equity occurrences for retail clients; and
xi. A virtually constant ratio between profit-making and loss-making active client accounts.

In view of the above, the MFSA is therefore proposing that it adopts Product Intervention Measures with respect to CFDs, in terms of Article 42(2) of MIFIR, which mirror those adopted by ESMA in this regard.

Chapter 3: The Proposed Regulatory Requirements

MFSA is proposing to implement the proposed national product intervention measures as described in Chapter 2 of this Document by including the relevant provisions in the Conduct of Business Rulebook.

Prior to the adoption of the ESMA Product Intervention measures, MFSA already had in place a policy relating to the **Requirements for Category 2 or Category 3 Investment Services Firms distributing or intending to distribute contracts for differences (CFDs) and/or rolling spot forex contracts under the MiFID regime** dated 3rd April 2017.

The Authority will also be including, the requirements contained in the abovementioned policy relating to:

i. Shareholding Structure;
ii. Capital requirements;
iii. Competence requirements;
iv. Local Presence/Corporate Governance set-up;
v. Expert Advisors;
vi. Record Keeping;
vii. Systems;
viii. Liquidity providers/Counterparties; and
ix. Slippage Settings.

shall be included in the relevant parts of the Investment Services Rulebook and the Conduct of Business Rulebook. In this regard, it is important to note that the requirements contained in the abovementioned policy falling under the title of "Consumer Protection Measures" and "Leverage Limits" have been superseded by the ESMA product intervention measures and the proposed national product intervention measures. Accordingly, these will be superseded by the provisions in the Conduct Supervisory Rulebook which implement the national product intervention measures relating to leverage, margin close out, negative balance protection, restriction on incentives offered to trade CFDs and standardised risk warnings.

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Chapter 4: Action Required and Way Forward

The Authority is issuing this Consultation Document to the public to allow all stakeholders to comment, make suggestions and other contributions to the proposals. For this purpose, the following questions may be considered:

A. Do you agree with the permanent product intervention measures being proposed by the MFSA which would apply to persons offering services to retail investors, in relation to CFDs, in or from Malta?

B. If the answer to question A above is "no", please provide reasons.

C. What other measures, in addition to, or in substitution of, the proposed national measures would you suggest to be implemented by the MFSA to mitigate consumer detriment in this area?

Any feedback is to be sent by email to csu@mfsa.com.mt by not later than the 10 June 2019.

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