

MFSA

MALTA FINANCIAL SERVICES AUTHORITY

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

The Malta Financial Services Authority is hereby setting out its updated criteria regarding the requirements that entities which offer or would like to offer contracts for differences (CFDs) and/or rolling spot forex contracts under the MiFID regime as transposed in Maltese law, shall apply. This Circular supersedes the Notices issued by the MFSA on 20th October 2014, 14th July 2015 and 30th July 2015 on the same subject matter.

Status:

The adherence to the requirements established in this Policy Paper are mandatory for Category 2 or Category 3 Investment Services Licence Holders authorised or in the process of being authorised to distribute complex speculative products (hereinafter referred to as ‘firms’).

Applicability:

These requirements are applicable with immediate effect to all firms, subject to the transitory provisions referred to below, both at application stage as well as when effecting material changes to the firms’ business set up approved by the Authority at application stage.

With respect to the requirement dealing with Shareholding Structure, this shall apply to all new applicants as well as to current licenced entities when these undertake a change in their qualifying shareholding. In the latter case, such a change will be deemed to constitute a new application for the purposes of these requirements. Accordingly, reference to the term “*an applicant for business*” in paragraph 1 below, shall be construed to refer to an Investment Services Licence Holder in the case of a change in the qualifying shareholding of a Licenced entity in terms of Article 10 of the Investment Services Act.

Accordingly, in addition to the conditions set out in Part A and Part BI of the Investment Services Rules for Investment Services Providers, the following requirements shall also apply to the firms in question.

Requirements:

1. Shareholding Structure

Where an applicant for business is not authorised as an investment services provider either in Malta or in its own country of origin, and is therefore not subject to supervision, the MFSA shall only accept an application for a Category 2 or a Category 3 Investment Services Licence for the purposes of offering contracts for differences (CFDs) and/or rolling spot forex contracts, if there is an active participation by way of shareholding interest by an investment services institution of repute or by any other entity involved in the provision of financial services regulated activities, which is regulated to a level satisfactory to the MFSA and whose activities are relevant in the context of the application in question. The shareholding interest by the said regulated institution is required to be a qualifying holding in terms of Article 10 of the Investment Services Act.

In addition, the Authority may also require active participation in the management of the proposed entity by the qualifying shareholder/s. Applicants should therefore be aware that the participation by another regulated entity by way of shareholding and /or active participation in the management of the proposed entity is applicable at the outset.

The MFSA may request any applicant to submit audited accounts, prepared by one of the major audits firms, in respect of any corporate shareholders in the proposed shareholding structure and/or entities with which the promoters are involved.

Furthermore, the Authority, in order to achieve comfort regarding the source of funds of the promoters, reserves the right to request a promoter (who is also the ultimate beneficial owner of the applicant) to provide it with a statement of wealth that should be signed by a person holding a warrant of a certified public accountant under the Accountancy Profession Act (Cap. 281) or holds professional qualifications of similar standing of an institute of repute recognised by the Authority.

2. Capital requirements

Firms holding or applying for a Category 2 licence are hereby subject to a higher minimum initial capital requirement of €730,000, similar to the initial capital requirement for Category 3 licence holders. This is because in effect, the Category 2 firms would still be assuming a significant element of risk as Category 3 Investment Firms, albeit for a very short period of time until such instruments are transferred to the respective counterparty. The said capital should be satisfied on an ongoing basis and not just at licensing stage.

3. Competence requirements

i. Board of Directors

The members of the Board of Directors are expected to collectively possess the requisite competence and experience specifically in the field of CFDs and/or rolling spot forex contracts. For this purpose, the Authority needs to be provided with comfort that the proposed Board members of these firms collectively have the necessary competence to be able to effectively contribute to the decision-making process of the Board.

ii. Other staff

The competence requirements are applicable to individuals occupying senior positions with the firm and who report directly to the Board of Directors, such as Senior Manager, Compliance Officer, Risk Manager or Head of Trading. These individuals need to prove to the satisfaction of the Authority that they have an adequate track record with one or more regulated firms that operate within this industry. The trading of one's own funds is not deemed to be sufficient for the purpose of the Authority's competence assessment and shall not be taken into account in the review of an individual's eligibility to assume any of such position within a firm. The level of skills and expertise required of such employees will be considered in detail, taking into account the particular circumstances of the applicant in question (including the nature of the instruments to be traded, the type of clients to be targeted and the nature of the investment services to be provided).

4. Local Presence/Corporate Governance set-up

Whilst the Authority acknowledges that the bulk of such firms' business and activities is carried out through automated means, firms are expected to dedicate sufficient human resources as well as put in place adequate internal controls for the day-to-day management of their business, the monitoring of trades, handling of clients' enquiries and complaints and risk management.

The risk management function is considered to be an important function in such a business and is therefore a requirement for these firms. In such scenarios, the Authority expects that firms establish a locally based risk management role responsible for designing, implementing and monitoring their risk management policies and procedures. In this regard, no derogation from the requirement to appoint a locally-based Risk Manager will be given to firms, irrespective of the volume of business. While in the case of Category 2 IS Licence Holders the Authority may consider the outsourcing of such function to locally based entities, Category 3 IS Licence Holders are required to have a full-time dedicated risk management function in place.

Moreover the Authority expects that the core licensable activities (including the setting of trading policies and parameters and monitoring of the execution of electronically generated trades via the applicant's online trading platform/s) of such firms are carried out in and from Malta.

With respect to Category 3 licence holders, the Authority also expects that the following activities/ functions are carried out in Malta:

- The selection of counterparties and conclusion of agreements therewith;
- The establishment of trading limits and other parameters;
- The setting of pricing policies; and
- The monitoring and control of transactions undertaken with clients.

The Board of Directors of such firms is expected to have collective acumen in the area of CFDs and/or rolling spot forex contracts. In addition, the Board of Directors should include one or more independent directors having the necessary competence and experience in the area concerned and who would be able to question and challenge the activities of the executive directors and senior management. The Authority also requires that a locally based Board member (who ideally has the necessary competence and experience) is always appointed in satisfaction of the local presence requirements.

Moreover, the firm shall only be authorised by the Authority to commence its business if it has the requisite number of personnel in place such that it will ensure compliance with the dual control principle on an ongoing basis. The Authority shall not accept operational set-ups whereby the licensable activities, as well as the key functions of the licence holder, are concentrated in one individual.

With respect to outsourcing, although investment services providers are allowed to outsource some of their functions, the extent of outsourcing should not be such as to reduce the company to a shell entity. As required by MiFID, the applicant is required to show to the satisfaction of the Authority that the licensable activities applied for will actually be undertaken in or from Malta. The MFSA may, with respect to a limited number of support services, consider requests for time-limited outsourcing arrangements with appropriate external parties in the initial stages. In the case of applicants that will initially rely on a number of support services from their parent company or other third parties, the Authority requires the submission of a detailed plan of the eventual phasing out of such outsourcing/support services arrangements.

5. Expert Advisors

Firms are required to have a clear policy on the use by its clients of Expert Advisors as part of their trading strategy, which should be clearly communicated to the firms' clients at the outset.

6. Record Keeping

Whatever the medium used to carry out transactions with clients, counterparties and other third parties, the Authority requires:

- a. firms in Malta to have real time access to and control over all transactional data; and
- b. full access to this data granted to it as and when it requires, including during Compliance Visits.

The firm shall, moreover, have this data fully preserved in its records on an ongoing basis at its head office in Malta and shall have in place an appropriate offsite backup system for risk management and business continuity purposes.

In addition, the firm shall ensure that all other information, data and records held at its offices in Malta are consistent with the provisions the Investment Services Act and the MFSA Act, and any regulations or rules issued thereunder.

7. Systems

If the firm intends to use a proprietary online trading platform, whether this has been developed in-house or not, the Authority requires evidence that such system has been certified by an independent IT Auditor duly qualified and that it has a satisfactory track record as a result of having been used by other regulated entities operating in this industry within the EU/EEA or other recognised jurisdiction. The certification by the independent IT Auditor as to the adequacy of the systems is required on an annual basis.

Firms offering or intending to offer online trading platforms which are well-renowned in the industry or which are used by regulated entities in this sector will be considered more favourably by the Authority.

In no case shall the use of proprietary or third party platforms compromise the conditions that are required to be in place with respect to transactional data.

The Authority also requires that the core systems of these firms be based at the company's offices in Malta. To the extent only that the management of any activities is permitted to be outsourced or carried out via third party platforms in accordance with this Policy Paper and

under the relevant licence conditions, the firm is required to ensure that it has access to and control over any critical data or information necessary to properly manage its licensed activities in Malta at all times. Firms shall also ensure that the MFSA has access to such information or data for supervisory purposes.

In addition, firms shall take all the necessary measures so as to ensure that all of its employees are provided with the necessary training on the trading platform(s) to be offered to clients.

8. Liquidity providers/Counterparties

Firms shall only appoint regulated financial services firms as their counterparties/liquidity providers, provided further that these are already authorised by the relevant competent authorities in an EU, EEA or other jurisdiction that has the equivalent regulatory framework as in Malta for the provision of the service/s in question. Details and regulatory status of the liquidity providers/counterparties are to be provided to the Authority as part of the application review process.

Any changes to counterparties/ liquidity providers post-licensing shall be notified to the Authority in advance of the change.

9. Consumer Protection Measures

The Board of Directors of the respective firms is required to ensure that the entity takes adequate measures to safeguard consumer's interest, including adequate consumer protection measures and awareness of the risks involved in cases where the firm offers its services to retail clients.

Without prejudice to the above, the licensed entity will be required to display at all times and in a prominent place on the homepage of its website and on any promotional or advertising material, the following:

- a. a warning on the riskiness of trading in CFDs and/or rolling spot forex contracts;
- b. a warning that trading in CFDs and/or rolling spot forex contracts runs the risk of losing the entire sum invested; and
- c. any other warning or disclosure required under the relevant rules or regulations.

Firms shall also ensure that their web-portals contain the appropriate educational material aimed at guiding consumers who are new to this kind of trading, including inter alia on the nature and specificities of these instruments; provide a clear explanation of how an online trade can be made over the system and explain what type of skills are required to carry out online trading activity and to limit trading risk.

Firms are also required to abide by ESMA guidelines on the sale of complex products. These guidelines may be accessed through the following link:

http://www.esma.europa.eu/system/files/ipisc_complex_products_-_opinion_20140105.pdf

10. Leverage Limits

Firms distributing or intending to distribute complex speculative products (including CFDs and/or rolling spot forex contracts) are required to set the following leverage limits:

- a. For retail clients – 1:50;
- b. For retail clients electing to be treated as professional clients in terms of MIFID – 1:100;
and
- c. For all other clients – no leverage limits.

In this context, it is important for firms to adhere to the procedures in the Rules issued by the MFSA, which deal with the option granted to retail clients to be treated as professional.

Furthermore, firms are requested to indicate, in their respective COREP returns, a breakdown in the classification of their clients, including the number of retail clients electing to be treated as professional. The COREP will be updated accordingly.

11. Slippage Settings

Firms are required to implement procedures which would prohibit them from cheating, defrauding, or deceiving or attempting to cheat, defraud or deceive any other person. Such procedures should include the establishment of slippage parameters in order to ensure that orders are filled in a symmetrical manner.

In this way, firms are hereby prohibited from engaging in any manipulative acts or practices regarding the price of any underlying financial instrument.

Transitory Provisions:

The requirements of this Policy Paper are to be adhered to by licensed investment services firms offering CFDs and/or rolling spot forex contracts within six (6) months from the date of this paper.

Applicants shall ensure that any application for a licence submitted to the MFSA is in line with the provisions of this Policy Paper and that they are in a position to comply with relevant conditions upon commencement of their activities and on an ongoing basis.

It is the Authority's intention to incorporate the requirements of the aforementioned policy in Rules to be issued in due course.

**Communications Unit
Malta Financial Services Authority
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