POLICY STATEMENT

(PS-01-2019)

SUBJECT: **POLICY STATEMENT ON THE RISK MANAGEMENT ARRANGEMENTS OF CYPRUS INVESTMENT FIRMS PROVIDING INVESTMENT SERVICES IN CFDs**

DATE OF ISSUE: 4 FEBRUARY 2019

PURPOSE OF THIS POLICY STATEMENT

The Cyprus Securities and Exchange Commission, issues this Policy Statement in order to make public its approach in relation to the risk management arrangements of the Cyprus Investment Firms providing investment services in CFDs.

Queries in relation to the content of this policy statement may be addressed to the Policy Department of the Cyprus Securities and Exchange Commission via email at: policy@cysec.gov.cy.

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1. INTRODUCTION

PURPOSE OF THIS POLICY STATEMENT

1.1. This policy statement provides public guidance on CySEC's approach on the risk management arrangements of those Cypriot Investment Firms **("CIFs")** providing investment services and/or performing investment activities in financial contract for differences **("CFDs")**. The aforementioned terms are defined under the Investment Services and Activities and Regulated Markets Law of 2017 **(the "Law")**[1].

1.2. Our approach incorporates the findings of a market-wide review undertaken in April 2018 and has been communicated to affected CIFs via an extensive correspondence since August 2018.

WHO THIS AFFECTS

1.3. Our approach in relation to the risk management arrangements of CIFs, providing investment services and/or performing investment activities in CFDs **("CFD CIFs")**, affects:

i. CFD CIFs operating under a licence providing for the initial capital of article 10(2)[2] of the Investment Services and Activities and Regulated Markets Laws of 2007 to 2016, the provisions of which have been grandfathered under Article 104(2) of the Law **("€125k CFD CIFs")**:

This category includes CFD CIFs that their ability to assume market risk is restricted by the regulatory framework and which transfer the market risk emanating from the CFD transactions of their clients[3] to another entity[4] being subject to prudential regulation and supervision, commercially known as liquidity provider **("LP")**.

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[1] The Law transposes Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU ('**MiFID II**') into Cypriot law.

[2] Transposing Article 29(1) of Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC ("CRD"), into Cypriot Law.

[3] Either retail, professional or eligible counterparty, within the meaning of the Law.

[4] Another CIF, investment firm or credit institution, within the meaning of the Law.

Our approach affects the content of the market risk transfer arrangements of €125k CFD CIFs and their capital requirements, as further described in Chapter 3 of this Policy Statement.

ii. CFD CIFs operating under a licence providing for the initial capital of article 10(1)[5] of the Investment Services and Activities and Regulated Markets Laws of 2007 to 2016, the provisions of which have been grandfathered under Article 104(2) of the Law **("€730k CFD CIFs")**:

This category includes CFD CIFs that act as the clients'[6] direct counterparty to the CFD transactions in both legal and economic terms. Such CFD CIFs are at least authorised for the investment activity of "*dealing on own account*", within the meaning of the Law and hence may retain the market risk emanating from the aforementioned CFD transactions with their clients.

Our approach does not affect the content of the market risk transfer arrangements that such CFD CIFs may have in place, but has an impact on their capital requirements in the way described in Chapter 3 of this Policy Statement.

iii. CIFs not falling under the categories referred to in points i and ii. Such CFD CIFs are still affected by the prohibition of circumvention. For example, CIFs providing only investment advice and/or portfolio management in respect of CFDs, are excluded from the scope of application of this policy statement. However, they remain subject to the circumvention prohibition, as below.

PROHIBITION OF CIRCUMVENTION

1.4. Without prejudice to the above, CIFs , must not engage in circumvention activities that are designed to avoid the scope of our supervisory measures. This includes maintaining complex business models and similar maneuvers based on technicalities to divert or direct (in the form of investment advice or otherwise) clients to entities that are not compliant with the legislation, or that are domiciled in a in a third country rendering their activities a vehicle for solicitation of EEA clients. These prohibitions apply to ensure that CIFs meet their obligation to act honestly, fairly and professionally, and in accordance with the best interests of their clients, provided for in Article 25(1) of the Law.

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[5] Transposing Article 28 of CRD into Cypriot Law.

[6] Be it either retail clients, professional clients or eligible counterparties, within the meaning of the Law.

1.5. In all cases, we apply the "*substance over form*" test, when examining a possible circumvention.

2. RATIONALE FOR SUPERVISORY ACTION

BACKGROUND INFORMATION

2.1. On 30th November 2016 CySEC issued a circular (C168) entitled "*Updated version of ESMA's Q&A document relating to the provision of CFDs and other speculative products to retail investors under MiFID*" **(the "Circular")**. The Circular set out the minimum compliance requirements for CFD CIFs under applicable legislation, which included a requirement for Negative Balance Protection for retail client accounts.

2.2. Following the implementation of MiFID II, MiFIR and of the delegated European Union **("EU")** Acts, ESMA exercised its product intervention powers as applicable to CFDs. ESMA issued the European Securities and Markets Authority Decision (EU) 2018/796 of 22 May 2018 **(the "ESMA CFD Decision")**, in order to temporarily restrict the offer, sale or marketing of CFDs to retail clients in the EU.

2.3. The ESMA CFD Decision was based on Article 40 of Regulation (EU) No 600/2014 of the European Parliament and of the Council **(the "Regulation")**. The ESMA CFD Decision introduced a number of measures which CySEC duly applied, including a Negative Balance Protection Requirement[7] so that retail clients' aggregate liability for all CFDs connected to a CFD trading account with a CFD provider is limited to the funds in the specific CFD trading account.

2.4. The ESMA CFD Decision also defined the term "CFD", which despite its widespread use as a financial product offered by investment Firms throughout the EU, is not defined in MiFID II.

2.5. According to the ESMA Decision, a "*contract for differences*" or "*CFD*" is defined as 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. The term includes Rolling Spot Forex and is further defined in the Questions and Answers on ESMA's temporary product intervention measures on the marketing, distribution or sale of CFDs and Binary options to retail clients **(the "ESMA Q&As")**.

[7] Negative Balance Protection means the limit of a retail client's aggregate liability for all CFDs connected to a CFD trading account with a CFD provider to the funds in that CFD trading account

2.6. Specifically, the ESMA Q&As clarify that the ESMA CFD Decision applies to rolling spot forex that do not qualify as an option, future, swap or forward rate agreement. A forex derivative which a) uses the spot price as reference value; b)automatically rolls over at the end of the contract period; and c) allows a party to terminate the contract other than by reason of default or another termination event is a CFD for the purposes of Article 1(a) of the ESMA CFD Decision.

2.7. Furthermore, the term "*Negative Balance Protection*", which is considered as an intervention measure for protecting retail clients exposed to the consequences of trading in CFDs has also been further defined.

2.8. According to the ESMA CFD Decision: "negative balance protection means the limit of a retail client's aggregate liability for all CFDs connected to a CFD trading account with a CFD provider to the funds in that CFD trading account" **("NBP")**.

2.9. According to the ESMA CFD Decision, NBP has to be viewed, as a measure[8] that must be triggered whenever the so-called "*margin close-out protection*"[9] (which is another intervention measure), cannot be effectively applied due to extreme market events affecting the underlying of the CFD in question.[10]

2.10. The reason for introducing the NBP was that, following the occurrence of such extreme events[11], Retail Clients have owed considerably more than they invested, ending up with a negative balance on their CFD trading account. To this end, Recital (119) of the Decision provides that: "*The purpose of a negative balance protection is to ensure that an investor's maximum losses from trading CFDs, including all related costs, are limited to the total funds related to trading CFDs that are in the investor's CFD trading account. This should include any funds yet to be paid into that account due to net profits from the closure of open CFDs connected to that account. An investor should not incur any additional liability connected with its trading of CFDs. Other accounts should not be part*

[8] As per Recital (120) of the ESMA Decision: "*The purpose of the negative balance protection is also to provide a 'backstop' in case of extreme market conditions.*".

[9] According to the definition given in the ESMA Decision: "*margin close-out protection' means the closure of one or more of a retail client's open CFDs on terms most favourable to the client in accordance with Articles 24 and 27 of Directive 2014/65/EU when the sum of funds in the CFD trading account and the unrealised net profits of all open CFDs connected to that account falls to less than half of the total initial margin protection for all those open CFDs;*".

[10] As per Recital (118) of the ESMA Decision: "*The negative balance protection aims at protecting retail clients in exceptional circumstances where there is a price change in the underlying that is sufficiently large and sudden to prevent the CFD provider from closing out the position as required by the margin close-out protection, such that the client has a negative account value. In other words, large market events can cause gapping, preventing the automatic margin close-out protection from being effective.*".

[11] Recital (118) of the ESMA Decision.

of the investor's capital at risk. In case a trading account also includes other financial instruments (for example, UCITS or shares), only the funds explicitly dedicated to CFD trading, and not those dedicated to other financial instruments, are at risk". Thus, NBP has to be applied as a "*backstop measure*"[12] when the "*margin close-out protection*" is not possible, on a CFD trading account and on a CFD position basis[13].

2.11. The Decision acknowledged that as a result of the imposition of the NBP as a measure for the protection of Clients, CFD providers would face ongoing costs attributable to additional capital or hedging, as part of their risk management[14].

MARKET-WIDE REVIEW

2.12. CySEC has prioritized the effective implementation of the ESMA CFD Decision, including the implementation of NBP requirements by CIFs under CySEC's supervision. In view of the fact that a similar measure was already in place in Cyprus at CySEC's own initiative, CySEC issued correspondence to CFD CIFs by way of CEO letter to inform entities of the following:

i. €730k CFD CIFs must consider and address the risks emanating from the NBP in the context of their ICAAP

ii. €125k CFD CIFs must consider the NBP and the limitations laid down in article 10(3) of the Law, given that the ability to take on market risk is limited and establish the necessary arrangements for not taking up market risk. The said CFD CIFs were requested to reply to CySEC and elaborate on how they have re-structured their business models in practice so as to comply with the NBP but still remain as a €125k firm.

2.13. The majority of €125k CFD CIFs did not demonstrate that they have adequately re-structured their business in practice so as to comply with NBP and still retain the status of a €125k CFD CIF. More specifically, the submission collected by CySEC revealed that the majority of the market risk transfer arrangements in place did not ensure that third parties would assume responsibility for any possible negative balances for retail clients. This rendered the market risk transfer inadequate. Measures such as high margin call and automatic stop out levels, low and intraday trading activity, as well as monitoring leverage limits before major events, are not adequate to this end.

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[12] Recital (120) of the Decision.

[13] Recital (122) of the Decision: "*ESMA decided to adopt negative balance protection per CFD trading account as the way to address this source of potential major detriment while minimising associated costs to firms and investors. In particular, ESMA considered that the imposition of a negative balance protection per each CFD would have risked imposing disproportionate costs on investors and firms.*".

[14] Recital (121) of the Decision.

2.14. When describing their respective business models, a limited number of €125k CFD CIFs referred to policies of internalising their clients' orders and subsequently hedging the residual market risk **(the "Aggregation of Client Orders")**. Such arrangements are unlikely to be compatible with a licence granted to a €125k CFD CIF. The reason is that such arrangements are likely to result in taking up market risk and thus, the limitations of section 10(3)[15] of the Investment Services and Activities and Regulated Markets Laws of 2007 to 2016, the provisions of which have been grandfathered pursuant to Article 104(2) of the Law, cannot be met. This risk is exacerbated by the NBP requirement.

2.15. In addition to the above it was revealed that a number of CFD CIFs were engaging in market risk transfer arrangements with LPs domiciled in non-EEA jurisdictions that do not have or are unlikely to have an adequate prudential regimes.

3. OUR APPROACH

3.1. Following the outcome of the market-wide review of CFD CIFs, CySEC made use of its supervisory powers and initiated a series of communications for the CFD CIFs. The legal basis of these measures were the provisions of Article 70(2)(k) of the Law, Article 70 of the of the Investment Services and Activities and Regulated Markets Laws of 2007 to 2016 (the provisions of which have been grandfathered pursuant to Article 104(2) of the Law), and Paragraphs 29 and 30 of Directive DI144-2014-14.

AGGREGATION OF CLIENTS' ORDERS

3.2. As to the €125k CFD CIFs engaging in Aggregation of Client Orders (irrespective of the client categorisation), these were requested to either cease this trading model or extend their licence to also include the investment activity of Dealing on Own Account, within the meaning of the Law. Where the arrangements undertaken could not ensure the required transfer of market risk, their license was required to be extended to also include Dealing on Own Account, bringing them within the remit of a €730k CFD CIF.

3.3. Depending on the decision taken, the said CFD CIFs were requested to inform CySEC accordingly by submitting a relevant standardized confirmation duly signed by both their Executive and non-Executive Directors, the Head of Dealing, the Internal Auditor, the Head of the Compliance Function and the Head of Risk Management Function, in relation to the issues falling under their respective competences.

[15] Transposing Article 29(2) of CRD.

COMPLIANCE WITH NBP AND WITH THE LIMITATION OF THE AUTHORISATION

3.4. €125k CFD CIFs were informed that they must ensure that market risk is assumed by the LP rather than the CIF, in order to comply with the NBP and still remain as a €125k CFD CIF.

3.5. To this end, €125k CFD CIFs were requested to amend their contractual arrangements with all of their LPs **(the "LP Contractual Arrangements")**, in order to ensure that:

i. The LPs, unequivocally agree:

a. to assume responsibility for the market risk associated with each trading position of the clients (either retail, professional or eligible counterparty) of the €125k CFD CIFs;

and

b. to assume responsibility and cover any negative balances that may appear in the trading accounts of the retail clients of the €125k CFD CIFs, on a per account basis.

ii. The LP Contractual Arrangements do not include any other provisions that may in any way not be aligned or may conflict with the above responsibilities of the Liquidity Provider.

3.6. The LP Contractual Arrangements may be considered to adequately cover the transfer of market risk; however, the remaining risks (counterparty risk etc.) should be evaluated by the €125k CFD CIFs, in the context of their ICAAP, and may be challenged in the context of individual SREP.

3.7. €730k CFD CIFs are not required to restructure their LP Contractual Arrangements in the way referred to in paragraph 3.5 above herein, when they transfer the market risk to a third party (i.e. an LP). However, they must evaluate all the risks associated with NBP requirements, both when internalising or externalising client orders (including the risks referred to in paragraph 3.6), in the context of their ICAAP, which may be challenged in the context of individual Supervisory Review and Evaluation Process ("SREP").

3.8. €125k CFD CIFs affected by paragraphs 3.4 and 3.5 were requested to inform CySEC via a standardized confirmation duly signed by the Executive Directors, the non-Executive Directors, the Internal Auditor, the Head of the Compliance Function and the Head of

Risk Management Function, in relation to the issues falling under their respective competences.

PRUDENTIAL MEASURES IN RELATION TO CIFs WITH SIMILAR RISK PROFILES

3.9. Where a CFD CIF (either a €125k CFD CIF or a €730k CFD CIF) has, irrespectively of the type of its clients, market risk transfer arrangements in place with entities domiciled in jurisdictions that do not have or are unlikely to have an adequate prudential regime, this creates an additional risk that needs to be addressed. This additional risk, exists where a €730k CFD CIF (once again irrespective of the type of its clients), also engages in proprietary trading (i.e. dealing for their own benefit) with entities domiciled in such jurisdictions.

3.10. In CySEC's view, such trading activity in any of the forms described in paragraph 3.9 above, is capable of affecting the firm's overall financial condition and may impair its general capacity to comply with investor protection requirements.

3.11. Based on the results of our market-wide review, CySEC deemed necessary to intervene in a uniform manner for all CFD CIFs under point 3.9 above herein. The reason was that such trading practice was creating similar risk profiles stemming from similar business models or geographical location of exposures and/or that such CIFs were or might have been exposed to similar risks or that they were posing similar risks to the financial system. Furthermore, the extensive scale of such market practice, was in CySEC's view a source of significant risks for the financial system.

3.12. As part of these intervention measures, CFD CIFs of paragraph 3.9 were required to maintain an additional capital buffer of the highest quality of their capital (Common Equity Tier 1 capital) against the risks that such arrangements entail. This capital requirement must be equal to the higher value of either a) €2.000.000, or b) 2% of their total risk exposure. This buffer **(the "Minimum Additional Capital Buffer")** is to be maintained by all CIFs as outlined above, unless they engage in the activities referred to in paragraph 3.9 above, solely with:

i. Credit Institutions or Investment Firms domiciled in a third country for which there is an equivalent decision for the purposes of Article 107(4) of Regulation (EU) No 575/2013[16]; and/or

[16] The relevant articles in the Commission Implementing Decision 2014/908/EU **(the "Commission Implementing Decision")** are:

- Article 1 for Credit Institutions,
- Article 2 for Investment Firms.

ii. EEA regulated entities (Credit Institutions or Investment Firms); and/or

iii. Credit Institutions or Investment Firms domiciled in a member of G20[17].

3.13. The Minimum Additional Capital Buffer should be further evaluated in the context of ICAAP and, if deemed necessary, it should be increased accordingly. It is clarified at this point that the Minimum Additional Capital Buffer may not be reduced in the context of ICAAP (i.e. an adjustment of the Minimum Additional Capital Buffer may take place only where the Minimum Additional Capital Buffer will be increased).

3.14. It is further clarified that the Minimum Additional Capital Buffer intends to alleviate the risks emanating from the trading activity referred to in paragraph 3.9, when such trading activity involves entities domiciled in jurisdictions that do not have, or is unlikely to have, an adequate prudential regime. The Minimum Additional Capital Buffer does not intend to cover the risks emanating from NBP, which need to be taken into account by the €125k CFD CIFs and by the €730k CFD CIFs, in the context of their ICAAP, as outlined in paragraphs 3.6 – 3.7 above.

3.15. CFD CIFs not affected by our approach should assess the risks associated with their risk transferring arrangements, and, if in the context of ICAAP or SREP is deemed necessary, should maintain an additional capital buffer.

3.16. CFD CIFs affected by paragraphs 3.9 and 3.12 were required to comply with the obligation to maintain an additional Minimum Capital Buffer by 30 November 2018 and inform the CySEC accordingly, via a standardized confirmation signed by the Executive

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The annexes of the Commission Implementing Decision are amended from time to time. However amendments are only relevant if they concern either Article 1 or Article 2 of the Commission Implementing Decision. It is provided that in order for CIFs to not be required to maintain an additional CET 1 capital buffer, there must be an equivalent decision in relation to the specific type of entity they collaborate with (e.g. specifically for investment firms if they collaborate with an investment firm).

[17] Where an equivalence decision by the European Commission ("EC") exists in relation to a member of G20, the EC's decision prevails. Therefore, the membership to the G20, is only relevant where there is no equivalence decision by the EC. This element has been incorporated, in order to include jurisdictions that are less likely to have an inadequate prudential regime, as a consequence of the fact that the equivalence evaluation by the EC is performed on a risk basis. In addition to this, such approach would alleviate the impact of a hard Brexit or departure of the UK from the EEA to CIFs. At the moment, a considerable number of CFD CIFs have in place market risk transfer arrangements with entities domiciled in the UK. Even though the EU acquis currently applies in the UK and the national regulatory framework is in line with the EU framework, in the case of a hard Brexit or departure of the UK from the EEA, there will be the need for the EC to issue a decision in relation to the equivalence of the UK framework. In the meantime, our approach might unintendedly disrupt the operations of CIFs. Therefore, we consider such inclusion as a reasonable backstop, based on the assumption that such jurisdictions are less likely to have an inadequate prudential framework.

Directors, the non-Executive Directors, the Chief Financial Officer, the Internal Auditor and the Head of the Compliance Function respectively.

4. IMPACT

4.1. Our approach has significantly enhanced the market structure pertaining to the provision of investment services and/or to the performance of investment activities in relation to CFDs.

4.2. As consequence of our approach, a significant number of €125k CFD CIF have decided to submit an application for extending their authorization in order to become a €730k CFD CIF. The vast majority of CFD CIFs have opted for LPs domiciled in EEA.

4.3. We intend to monitor the compliance of the CFD CIFs with the new requirements on an ongoing basis and where necessary to engage with our EEA and international counterparts, in order to ensure and/or further enhance investors' protection.