

MFSA

MALTA FINANCIAL SERVICES AUTHORITY

Notice to applicants for a Category 3 Investment Services Licence that would like to carry out binary options trading in terms of the Investment Services Act, Cap. 370

The Malta Financial Services Authority (the “MFSA”) is hereby setting out its criteria for the licensing of entities that intend to offer binary options trading to clients in terms of the Investment Services Act, Cap. 370 (“the Act”), and the Malta Financial Services Authority Act, Cap. 330 (“the MFSA Act”). This Circular supersedes that issued by the MFSA on 14th July 2015 on the same subject matter.

The issuance of this Circular is intended to give clear guidance to the industry on the criteria required to be satisfied by applicants for a licence as well as on certain of the ongoing requirements. These criteria are additional to those already applicable in terms of the Investment Services Act (the “Act”), the relevant subsidiary legislation issued thereunder and the relevant Investment Services Rules published by the MFSA. The stringency of such additional criteria is a reflection of the high risks associated with binary options trading due to its reliance on automated systems, the complex nature of binary options products, the accessibility to such products by retail investors and other risks.

These criteria are applicable in their entirety and with immediate effect to all new applications submitted to the MFSA after the date of this Circular. Meanwhile, applicants whose application is currently being processed by the MFSA are required to align themselves with immediate effect with all of the criteria outlined below with the exception of the criteria relating to the shareholding structure of the applicant, in respect of which a grandfathering period of one year from the date of publication of this Circular is being granted by the MFSA in order to allow entities the necessary time to regularise their position.

- **Category 3 Investment Services Licence** - An entity that intends to offer binary options trading is required to apply for a Category 3 Investment Services Licence under the Act. In this respect, apart from the conditions set out in Part A of the Investment Services Rules for Investment Services Providers, the additional criteria set out in this document shall apply to any potential applicant for a Category 3 Investment Services Licence who would like to engage in binary options activity.

The MFSA shall not entertain any applications from promoters that do not have an established track record in the industry, including an established good reputation, previous operating experience within a regulated environment, a good track record in handling consumer complaints, tight competence requirements for key personnel and other relevant criteria as appropriate.

- **Capital Requirements** - An applicant for a Category 3 investment services licence is subject to a minimum initial capital requirement of €730,000. However, the MFSA reserves the right, at its discretion and subsequent to licensing, to at any time subject a binary options trading company to an increased capital requirement where it deems that such an increase is justifiable in light of the volume of the licence holder's business.

The licence holder shall also be subject to the Control of Assets Regulations and the Capital Adequacy Regulations.

- **Instruments** - The MFSA must be satisfied at all times that the instruments to be offered by the applicant amount to "instruments" under the Second Schedule of the Act. The MFSA is aware that the term "binary option" is sometimes used loosely to refer to types of instruments or activities that may not have the characteristics of an "instrument" under the Act.

By way of guidance on this matter, the MFSA will take the following into consideration:

(a) Instruments falling within the scope of authorisation

The European Commission considers binary options to fall within the parameters of points (4), (5), (6) and (7) of Section C of Annex I to MiFID. These paragraphs list the financial instruments covered by MiFID and include, amongst others, any derivative contracts relating to securities, currencies, interest rates or yields, or other derivative instruments (paragraph (4)) as well as derivatives relating to commodities that are settled in cash or that can be physically settled provided they have the characteristics of other derivative financial instruments (paragraphs (5), (6) and (7) and Article 38 of the MiFID Implementing Regulation No 1287/2006).

The MFSA's interpretation is consistent with that given by the Commission. Therefore, companies providing services in relation to binary options featuring the characteristics delineated in the abovementioned paragraphs (which correspond to paragraphs (4), (5), (6) and (7) of the Second Schedule to the Act) are required to be licensed as investment firms providing services in binary options trading.

The MFSA emphasises that the qualifying criterion is substance and not nomenclature. Therefore, even when referred to by the market by such terms as "binary bet", a given instrument may be considered to meet the characteristics delineated in the abovementioned paragraphs, and services provided in that regard would therefore require a licence.

On the basis of both the Commission's interpretation of MiFID as well as the provisions of the Second Schedule of the Act, it is to be noted that the tradability or otherwise of an option is not a determining factor in establishing whether an option

is an “instrument” or not i.e. a binary option need not to be tradable in order to qualify as an instrument.

(b) Instruments falling outside the scope of authorisation

Following on from the determinations elaborated on in point (a) above, the MFSA has further determined that a bet/option on the outcome of an event other than one which is of a financial markets nature, even if of a binary nature (for example a bet linked to a double outcome such as a win or a loss in a sporting event) shall not be considered an instrument for the purposes of the Act.

Likewise, a binary bet based on randomly generated indices created by a company’s proprietary software and which is not in any manner, directly or indirectly, related to the performance of any real asset, security, financial index, right, service or obligation shall not qualify as an instrument under the Act and is not licensable by the MFSA.

(c) Instruments that are hard to classify

Where an applicant is in doubt as to whether an instrument may be classified as a binary option or otherwise, or where a product is not a straightforward binary option, or is a variation thereof, the applicant is advised to seek the views of the MFSA at the outset and shall be guided accordingly.

The MFSA further notes that trading in binary options is to be distinguished from spread betting. Under the Act, “spread betting” amounts to a “contract for differences” as established in paragraph 9 of the Second Schedule. Spread betting on market or asset price fluctuations exposes the investors to uncapped losses. The spread betting industry is extremely sophisticated, and spread betting firms will hedge their bets in the same way that traders in futures and options do by entering into contracts for differences. The key difference between binary betting and spread betting is that, in the former case, one would know one’s maximum upside and downside from the outset. Unlike spread betting, binary options trading involves a fixed stake.

- **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, in considering whether to grant authorisation, the MFSA may require 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 following factors will be taken into account by the MFSA in considering the waiving or otherwise of the shareholding participation referred to in this section:

- the shareholding structure;
- the quality and track record of the proposed management team– promoters should ideally demonstrate several years of competence/experience with reputable institutions to be able to carry out their duties in an effective manner to the satisfaction of the MFSA;
- the target market;
- due diligence investigations;
- the capital structure being proposed and
- the level and nature of operational and business risk involved.

The above factors should not be interpreted as an exhaustive list of aspects which may be taken into account by the MFSA. The MFSA reserves the right to impose any condition at any time as may be deemed necessary. Each application is assessed on its own merits.

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.

- **Competence Requirements** – (i) Board of Directors: The members of the board of directors of a binary options trading company are expected to collectively possess the requisite competence and experience, specifically in the field of binary options trading, such that they can effectively contribute towards the decision-making process of the board. The board is also required to include one or more independent directors – also having the necessary competence and experience in binary options trading – who would be able to question and challenge the activities of the executive directors and senior management. The MFSA shall also require that the board include a locally based member in satisfaction of the local presence requirements. This particular member should preferably be one of those having the necessary competence and experience in binary options trading.
- (ii) Other staff: The competence requirement is applicable to individuals occupying senior positions within the binary options trading company and who report directly to the board of directors, such as senior manager, risk manager or head of trading. The majority of these individuals need to prove to the satisfaction of the MFSA that they have an adequate track record with one or more regulated firms that operate within the binary options

industry. The trading of one's own funds is not, on its own, deemed to be sufficient for the purpose of the MFSA's competence assessment and shall not be taken into account in the review of an individual's eligibility to assume any of the abovementioned positions within a binary options trading company. 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).

- **Local Presence and Corporate Governance Set-Up** - The MFSA acknowledges that the bulk of the binary options trading company's business and activities will be carried out through automated means. *This notwithstanding, the MFSA expects that the core licensable activities of the company are carried out in and from Malta.* This also applies to:

- the establishment of trading policies, limits and other parameters;
- the monitoring and control of electronically-generated trades via the licence holder's online trading platform;
- the prospective licence holder's access to and controls over any critical data or information necessary to adequately manage its activities;
- the selection of counterparties and the conclusion of agreements therewith; and
- the establishment of pricing policies.

A combination of elements may be considered in order to determine whether the prospective licence holder would be in line with these requirements, such as the local installation of the company's automated systems or at least local real-time access thereto. Furthermore, the MFSA expects that the licence holder appoints a locally based and full-time risk manager responsible for designing, implementing and monitoring its risk management policies and procedures. No derogation from this requirement will be given irrespective of the volume of business of the binary options trading company, in line with the importance attributed to the risk management function by the MFSA, particularly with regards to Category 3 licence holders.

From a corporate governance perspective, licence holders are also 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, the handling of clients' enquiries and complaints and risk management.

Moreover, a binary options trading company shall only be authorised by the MFSA if it has the requisite number of personnel in place that will ensure compliance with the dual control principle on an ongoing basis. The MFSA 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, the licence holder may be allowed to outsource certain ancillary and non-core activities to third parties. Furthermore, as required by MiFID, the applicant will be required to show to the satisfaction of the MFSA that the licensable activities applied for will actually be undertaken in and from Malta. The MFSA will therefore, where applicable, only consider requests for outsourcing arrangements with appropriate external parties that are time-limited and which are restricted to a limited number of support services, and only in the initial stages of authorisation. In any such case, the licence holder shall remain fully responsible for discharging all obligations related to the outsourced activities. In the case of applicants that will initially rely on a number of support services from their parent company or other third parties, the MFSA expects the submission of a detailed plan for the eventual phasing out of the outsourcing/support services.

- **Liquidity providers/Counterparties** – Applicants that would like to provide binary options trading services to their clients should 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 should be notified to the Authority.

- **Record Keeping** – Whatever the technological medium used to carry out transactions with clients, counterparties and other third parties, the licence holder shall, in Malta, have real-time access to and control over all transactional data. The MFSA would require full access to this data as and when required, including during compliance visits.

The licence holder 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 back-up system for risk management and business continuity purposes.

In addition, the licence holder 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.

- **Systems** - Where an applicant intends to use a proprietary online trading platform, whether this has been developed in-house or not, the MFSA will need to be provided with evidence that such system has been certified by an independent and duly qualified IT auditor or that it has a satisfactory track record as a result of having been used by other regulated binary options companies in the EU/EEA or other recognised jurisdictions.

Applicants that intend 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 MFSA.

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 the company 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 and under the relevant licence conditions, the licence holder shall 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. The licence holder shall also ensure that the MFSA has access to such information or data for supervisory purposes.

The licence holder should 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.

- **Restriction of Activities** - A company applying for a licence to carry out binary options activities under the Investment Services Act shall not carry out any activity other than one licensable under the Act. A licence condition to this effect will be included in the relevant licence.

In this respect, it should be noted that binary options activities are frequently carried out alongside forex activities which are also licensable under the Act. Although there may be similarities in the nature of the services provided, these guidelines do not apply to forex activities.¹ (This does not, however, mean that a binary option may not be based on the performance of an underlying currency, in which case these guidelines would naturally apply).

- **Consumer Protection Measures** - Due to the particular nature of binary options and particularly the fact that they may be offered to retail investors, the MFSA considers it crucial that certain measures are taken with the aim of ensuring enhanced consumer protection. The Board of Directors of the respective licensed entity would need to ensure that the entity takes adequate measures to ensure enhanced consumer protection and awareness of the risks involved in cases where binary option trading is offered to retail investors.

¹ In relation to applications for licenses by online forex trading companies reference should be made to the relevant requirements.

Binary options trading companies are required to abide by the ESMA guidelines on the sale of complex products wherein binary options are specifically referred to as complex products. These guidelines may be accessed through the following link:

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

In addition and without prejudice to the above, the licensed entity shall also abide by the following consumer protection measures:

(a) Display of Warnings

A binary options trading company 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 warnings:

- a warning on the riskiness of binary options as a financial product; and
- a warning that investing in binary options runs the risk of losing the entire sum invested;
- any other warning or disclosure required under the relevant rules or regulations.

The licence holder shall also ensure that the website provides information on binary options as a financial product and on the features of and risk of losses involved in the trading in binary options by also providing worked examples and tutorials on developing trading skills, the placing of online trades and limiting trading risk. Clients may also be referred to other educational websites that provide factual and technically correct information.

The Licence Holder shall also issue additional warnings to clients during a trading session in case of cumulative frequent trades undertaken over a short period of time, highlighting any accumulated losses during that or recent trading sessions and the risk of losing additional money as and where applicable. This may apply, where appropriate, prior to and at the automatic reality checks referred to below.

(b) Trading Limits

A registered customer with a binary options trading company may by written or electronic notice to the company:

- set a limit on the amount that may be invested by the customer within a specified period of time;
- set a limit on the losses that the customer may incur within a specified period of time;

- set a limit on the amount of time spent trading in any one session; or
- exclude the customer from investing in specific types of binary options, for a definite or indefinite period of time.

Any such limits or exclusions shall be capable of revocation or variation by the investor by written or electronic notice to the licence holder. The licence holder shall ensure that a notice increasing or revoking a limit or decreasing the exclusion shall have effect 7 days following receipt of the notice. On the other hand, the company shall ensure that a notice reducing a limit or increasing the exclusion shall have effect immediately on its receipt by the licence holder.

Notwithstanding the above, the MFSA reserves the right at any time to require licence holders to remove the element of investor discretion described above and, instead, to impose on all investors any specific trading limits as may be determined by the MFSA from time to time.

(c) Display of Counters

A binary options trading company shall ensure that its website displays, at all times during an investor's trading session, a counter showing the balance within the investor's account and which is automatically updated throughout the trading session to reflect the changes in such balance.

The licence holder shall also ensure that the website provides investors with automatic reality checks at intervals of one hour within each trading session. An automatic reality check shall carry out the following actions:

- suspend trading;
 - clearly indicate the duration of time for which the investor has been trading;
 - display the investor's profits and losses during such period of time;
 - require the investor to confirm that the message has been read; and
 - provide the investor with the option to either end the trading session or to continue trading.
- **Passporting of Services** - Prior to the passporting to other EU Member States/EEA States of services relating to binary options in terms of MiFID, the binary options trading company shall ensure that the trading of binary options is accepted and permissible in that other EU Member State/EEA State.

The applicant shall ensure that any application for licence submitted to the MFSA is in line with the provisions of this policy and that it would be in a position to comply with relevant conditions upon commencement of its activities and throughout the course of its licence.

Communications Unit
Malta Financial Services Authority
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