Additional Reading Material For Topic 3
In Relation To
Contract For Difference (CFD)

(Issued in May 2018)

Relevant For

1. Module 16: Rules & Regulations of Derivatives

2. Module 17: Securities and Derivatives Trading (Rules and Regulations)

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(This document consist of 17 pages including the cover page)

Topic 3: Regulation of Over The Counter (OTC) Derivatives: Contracts for Difference (CFD) in Malaysia

Contents Page

Overview

Introduction

In this topic, we examine the regulatory framework for CFD derivatives in Malaysia and the legislation and obligations governing the industry players. We will look at not only the specific provisions of the relevant CFD legislation, but also at the rationale for these provisions.

In approaching this topic, it is important to realise the distinctive nature of CFD derivatives transactions and the regulations governing them, as opposed to the other types of derivatives described in the previous chapter. However, in line with the evolving landscape, the laws and regulations in this area are continually being updated, therefore you should consult the latest versions of the legislation/rules before making any relevant decisions.

Topic Objectives

At the end of this topic, you should be able to:

- list the principal aims of the CFD regulatory framework in Malaysia
- explain the rationale of making the CFD available only to sophisticated investors
- describe the definition of CFD
- describe the parameters for offering CFD
- identify the requirements to be fulfilled by CFD Providers
- explain the obligations of CFD Providers to their clients
- list the practices prohibited under the offence provisions of the CMSA
- explain the Capital Market Compensation Fund in relation to CFD

1 Overview of the CFD Regulatory Framework

1.1 Introduction of CFD in Malaysia

The introduction of the CFD framework in April 2018 is one of the growth strategies under the Securities Commission Malaysia's (SC) Capital Market Masterplan 2 (CMP2) to broaden the derivatives market products and services offerings. The development of a vibrant and comprehensive derivatives market is crucial to reinforce dynamism in other segments of the Malaysian capital market which in turn plays a critical role in invigorating Malaysia's economy.

The CFD framework is intended to widen the range of investment products to cater to the different and evolving needs and risk appetites of investors. Moreover, the CFD framework is also in recognition of the increasing level of sophistication of Malaysian investors, while at the same time provides additional opportunities to licensed capital market intermediaries.

1.2 The CFD Regulatory Framework

In April 2018, the Guidelines on Contracts for Difference (Guidelines) was issued by the SC (effective July 2018) under section 377 of the Capital Markets and Services Act 2007 (CMSA) to provide a regulatory framework for OTC CFD in Malaysia. The Guidelines sets out the CFD definitions and concepts in the Malaysian capital market context, the provider requirements, the product requirements and the compliance, disclosure and reporting requirements that a CFD provider and all parties to the contract must comply and adhere to.

Amongst the requirements to take note of is that CFDs may only be offered to sophisticated investors as provided under Part 1 of Schedule 6 and 7 of the CMSA.

Any breach or non-compliance with these Guidelines can result in the SC taking any appropriate action under the securities law. Furthermore, failure on the part of a licensed person and a registered person to observe these Guidelines will also be taken into account in the fit and proper assessment of a licensed person or a registered person.

Hence, the broad coverage of the CFD guidelines extend to both the product and the provider, as well as, the disclosures and submissions required for and from them.

The Licensing Handbook provides that intermediaries who wish to offer CFDs will be required to be licensed for the regulated activity of dealing in derivatives or dealing in derivatives restricted to CFD. It also sets out the financial and `fit and proper' requirements to fulfilled in order to be be licensed to offer CFDs.

2 Contracts for Difference in Malaysia

2.1 Definition

The business of offering CFD is to carry out the activity of 'dealing in derivatives'.

Under the Guidelines, CFD means contract for difference and is defined as `***a contract made between a buyer and a seller to gain exposure in the allowable underlying instrument whereby differences in settlement are made through cash payments'.***

Essentially, a CFD is a leveraged derivatives product that tracks the price movement of an underlying instrument. Unlike options or futures contracts, CFD does not have an expiry date and an investor's position can be closed by making a 'reverse' trade with the CFD provider.

The CFD offered by a CFD provider is traded over-the-counter (OTC) or off-exchange. Thus, it is a bilateral trade where the CFD provider will be the investor's counterparty.

2.2 CFD Product Requirements

Underlying instruments

CFD offered in Malaysia are only allowed to be based on shares and indices that meet the specified criteria prescribed in Chapter 3 of the Guidelines on Contracts for Difference.

Generally, the underlying shares have to meet the average daily market capitalisation requirement and the underlying companies listed are in compliance with the exchange's listing rules. For indices, the underlying index must consist of constituents that are listed on an exchange and is a recognised benchmark, amongst others.

Margin requirements

The SC is imposing minimum margin requirements on CFD depending on the underlying instrument. The minimum margin requirements are necessary to prevent excessive leverage by investors.

The minimum margin requirement for different types of CFD is dependent on the underlying instrument as follows:

Types of CFD	Minimum margin
Single equity CFD	• 10% for index shares • 20% for non-index shares
Index CFD	• 5%

For avoidance of doubt, a CFD provider may opt to set more stringent margin requirements.

When there is a trading halt on the underlying instrument, or trading in the underlying instrument has otherwise been suspended in accordance with the rules of the relevant securities exchange, the CFD provider is prohibited from creating new CFD positions.

A CFD provider must provide its clients with clear information on its procedure to address open position on CFD where the underlying instrument is suspended, halted or delisted.

A CFD provider must make available stop loss measures for its clients. In relation to a stop loss order, a CFD provider must set out clear information, including additional cost imposed, if any.

Mode of settlement

A CFD must only be settled in cash and not by delivery of the underlying instruments.

An equity CFD offered shall neither carry any voting rights nor embedded options for the conversion into the underlying equity shares

3.1 CFD Providers

Entities who wish to offer CFD will be required to be licensed for the regulated activity of dealing in derivatives, or dealing in derivatives restricted to CFD, and comply with the requirements as specified in the Licensing Handbook.

Existing licensed intermediaries who are licensed for dealing in derivatives are allowed to offer CFD with prior notification to the SC. Other licensed intermediaries who wish to offer CFD must vary their licence to add on the required regulated activity.

Licensing, Financial and Other Requirements

A new applicant must complete the relevant forms as specified in the Licensing Handbook and direct the application for licence to SC's Authorisation & Licensing Department.

A license application by existing licensed intermediaries must be made online to the SC via the Electronic Licensing Application system (ELA).

The detailed forms and application procedures are available on the SC website.

The relevant fees for the lodgement and registration of PHS and disclosure document is provided under the Capital Markets and Services (Fees) Regulations 2012.

Financial Requirements

Regulated Activity	Minimum Financial Requirement
Dealing in derivatives	**TP** • Minimum paid-up capital of RM5 million • Minimum adjusted net capital: The higher of - RM500,000; or - 10% of aggregate margins required at all times. **TP with trading kiosks or branch offices** • Minimum paid-up capital of RM10 million • Minimum adjusted net capital: The higher of - RM500,000; or - 10% of aggregate margins required at all times. **TP and offering CFD** • Minimum paid-up capital and shareholders'

	funds of RM10 million • Minimum adjusted net capital: The higher of - RM500,000; or - 10% of aggregated margins required at all times.
	Offering CFD only • Minimum paid-up capital and shareholders' funds of RM10 million • Minimum 50% total shareholders' funds in the form of liquid capital at all times.

Requirements/Obligations of CFD Providers
Licensing requirements:

The offering of CFD may only be carried out by:

(a) a CMSL holder for dealing in derivatives; or

(b) a CMSL holder for dealing in derivatives restricted to CFD

CFDs can only be offered exclusively to sophisticated investors.

Risk management practices

A CFD provider must practice the basic principles of prudence and ensure that it has adequate:

(a) infrastructure for risk management including processes and contingency arrangements in the event the CFD provider is unable to carry out its operations

(a) risk management process that integrate prudent risk limits, continuous risk monitoring and regular management reporting

(c) comprehensive internal control and audit procedures.

The board of directors and/or senior management of the CFD provider must ensure that adequate personnel are in place with the necessary skills and knowledge to perform the risk management function. The CFD provider must have in place a system, which facilitates identification and training of key personnel, without any gaps in capability to manage risks at any time.

The board of directors and/or senior management of the CFD provider must approve written policies and procedures which describe the overall framework for managing risks including the following aspects:

(a) Identification, measurement and management of risks involved

(b) Risk measurements and reporting methodologies that commensurate with the CFD provider's business strategies, size and complexity of its operations and risk profile of the product on an on-going basis

(c) Clear delineation of lines of responsibility for managing product-related risks

(d) Provision of sufficient resources, which include competent staff and information technology system and infrastructure to support the risk management and daily operations

(e) Regular review of product's risk exposures to ensure all material risks are identified and monitored when market condition changes

(f) Reviews of stress scenarios, prepared by the business line responsible for risk monitoring that measure the impact of market conditions that may cause volatility swings or reduced liquidity

(g) Comprehensive and regular reports to the board of directors and/or senior management that include the degree of compliance with policies and procedures for managing product risks, current assessment of product risks and any change in the direction of risks.

Managing conflict of interest

A CFD provider must put in place supervisory and internal control procedures and systems to ensure that:

(a) any potential conflict of interest is addressed

(b) there are adequate and effective Chinese walls between the various divisions of the CFD provider's business.

A CFD provider must take all reasonable measures to avoid situations that are likely to involve a conflict of interest. Where such a conflict exists, the CFD provider must:

(a) take all possible steps to resolve or adequately mitigate the conflict and make full disclosure to its clients in the disclosure documents and PHS, of the nature of the conflict of interest and the steps taken to address the conflict or

(b) withdraw from or decline from being a CFD provider for the contract concerned, where it is not possible to resolve or adequately mitigate the conflict.

Segregation of clients' assets

For a CFD provider who also offers other derivatives contracts, the clients' assets for CFD trades must be further segregated from the client's other assets.

Re-hypothecation of clients' assets by a CFD provider is prohibited.

White label arrangements

A CFD provider who enters into any white label agreements for purposes of CFD offerings in Malaysia, must trade as principal to its client and adhere to the outsourcing requirements as set out in the Licensing Handbook.

The transaction entered into between the CFD provider and the entity who provides the white label solutions must be separated and must not involve the client's transaction.

3.2 Who can CFDs be offered to in Malaysia?

CFD can only be offered exclusively to sophisticated investors, which means persons prescribed under Part 1 of Schedules 6 and 7 of the CMSA.

Suitability assessment on clients

A CFD provider is required to conduct a suitability assessment on an investor who wishes to invest in CFD.

Where a CFD provider allows the opening of a trading account online, an online questionnaire may be part of the process of account opening, to assess the client's risk profile, experience and suitability.

A CFD provider must record all information gathered during the suitability assessment exercise and updates thereto, including any recommendation made.

Sales and marketing practices

A CFD provider must have a set of policies and procedures on product marketing and sales activities for its CFD. The CFD provider must ensure that clients are fully informed through the appropriate disclosures on the key features and risks associated with the product, prior to client's account being approved.

A CFD provider must highlight in its website that CFD are leveraged products and the risks of trading CFD.

Advertisement and marketing materials

A CFD provider must ensure that any advertising and marketing material is consistent with the information provided in the PHS.

A CFD provider is required to have a written warning in each advertising and marketing material for CFD, explaining the risk of losing substantially more than the initial investment and that the investors do not own or have any rights over the underlying instruments.
Advertising and marketing materials must be clear and not contain any hedge clause or disclaimer which is confusing, or attempts to disclaim responsibility for the contents of such material or opinion expressed in the material which is inconsistent to such communication.

Education requirements

A CFD provider must have in place continuous educational programmes which may include seminars or workshops, media briefings and interviews to educate investors on CFD. The seminars/workshops must be carried out at least on a quarterly basis.

The educational programmes must include, at a minimum, the following:

(a) Product features

(b) Type of underlying instruments available and the different characteristics, when based on different underlying

(c) Risks associated with CFD, especially:
    (i) Counterparty risk
    (ii) High leverage or gearing of the product
    (iii) Possibility of additional margin call and unlimited losses

(d) Methods investors can use to trade CFD

(e) Margin requirements and implications of having different underlying instruments

(f) Numerical scenarios highlighting potential profits and losses

(g) Effects of corporate activities of the underlying instruments on the CFD

(h) Fees structure.

Disclosure requirements – Product Highlight Sheet, Risk statements

General

A CFD provider must, prior to opening an account for a client:

(a) furnish the client with a disclosure document and a Product Highlight Sheet ("PHS")

(b) receive a signed acknowledgement by the client stating that he has received the disclosure document and PHS, and understood the nature of the Risks Statements attached to the CFD. As guidance, a sample template is provided in Appendix 2.

The minimum information to include in a disclosure document and PHS is set out in Appendix 1 and 2.

A CFD provider must also disclose additional relevant information, as may be necessary to enable investors to make an informed decision. The SC may require for additional information if deemed necessary.

Any revision to the documents originally deposited with the SC must be updated and furnished to the SC accordingly.

Full accountability for the accuracy of all information in the disclosure document and PHS and the responsibility to ensure there is no omission of facts which would make any of the statements therein misleading, remains with the CFD provider.

The SC may take action against any person who fails to comply with any of the provisions in these Guidelines.

Complaints and dispute resolution

A CFD provider must put in place a system for handling customer complaints.

Clients can initiate a dispute resolution process with SIDREC. In addition, regardless of any dispute resolution process initiated with SIDREC, clients can direct complaints to the SC's Consumer and Investor Office.

4 Trading Offences under the CMSA

Please refer to Topic 2: Regulation of Derivatives Subtopic 4: Trading Offences under the CMSA

5 Capital Market Compensation Fund

Please refer to Topic 2: Regulation of Derivatives Subtopic 5: Capital Market Compensation Fund

6 In Summary

This topic covers the regulation of the OTC CFD industry in Malaysia. The regulation of OTC CFD industry is namely governed by the CMSA, the Licensing Handbook, the Guidelines on Contracts for Differences and all other relevant guidelines.

This topic commenced with the rationale for the introduction of the OTC CFD regulatory framework, the definition of CFD under the CMSA and the Guidelines on Contracts for Differences followed by a discussion on the CFD product requirements and obligations to be fulfilled by CFD Providers to their clients highlighted.

Finally, this topic looked at the limitations set out in the regulations where CFD can only be offered to sophisticated investors and the disclosure documents that the sophisticated investors would need to be provided with to make informed decisions.

6.1 Key Terms

Now that you have completed this topic, review each of the following terms and make sure you understand their meaning.

OTC

CFD

CMSA

Derivatives

Holder of a CMSL

Product highlight sheet

Risk management

Sophisticated investors

Suitability assessment

Systemic risk

Transparent market

White label arrangements

6.2 Review Questions

Question 1

CFDs may be offered to retail investors in Malaysia.

True or False

Question 2

The minimum margin requirements for an Index CFD is ______.

(A) 5%
(B) 10%
(C) 20%
(D) 30%

Question 3

When the Securities Commission Malaysia takes actions to protect client's assets, the SC can do so without giving the CMSL holder any opportunity to be heard.

True or False.

Suggested Answers to Review Questions

Question 1

CFDs may be offered to retail investors in Malaysia.

True or False

Answer: False

Question 2

The minimum margin requirement for an Index CFD is ______.

(A) 5%
(B) 10%
(C) 20%
(D) 30%

Answer: (A)

Question 3

When the Securities Commission Malaysia takes action to protect client's assets, the SC can do so without giving the CMSL holder any opportunity to be heard.

True or False.

Answer: False