

CONSULTATION PAPER NO.135



REGULATION OF RETAIL OTC LEVERAGED PRODUCTS

16 NOVEMBER 2020

PREFACE

Why are we issuing this paper?

1. The proposals in this Consultation Paper (CP) are designed to provide an appropriate level of protection to retail clients to whom regulated firms offer facilities to trade in highly leveraged over-the-counter (OTC) derivative products, or market such products. These products include contracts for differences (CFDs) but may use different labels. Collectively, they are referred to as Restricted Speculative Investments (RSIs).¹
2. RSIs can be complex, and retail clients may not easily or necessarily understand the risks associated with them. For example, RSIs carry the potential for retail clients to incur significant losses, due to leverage, where the initial funds required to get into these products (called the margin) is quite small. Our proposals aim to provide additional protection to retail investors in this area, in line with the recommendations of the International Organization for Securities Commissions (IOSCO), and the developments in major jurisdictions, including the UK, EU, US and Australia.

Who should read this paper?

3. The proposals in this paper will be of interest to:
 - a) Authorised Firms who offer to retail clients trading in RSIs, such as dealers or brokers;
 - b) Authorised Firms which deal as agent, arrange, advise on, or act as Representative Office relating to RSIs that are offered or marketed to retail clients;
 - c) persons conducting or proposing to conduct Financial Promotions relating to RSIs;
 - d) persons interested in applying for a DFSA licence to conduct the activities referred to in a) and b) above;
 - e) other industry participants, such as third party service providers or those who intend to provide such services to regulated firms in a) and b); and
 - f) persons who obtain, or intend to obtain, the services from firms as referred to in a) and b).

Terminology

4. Defined terms are identified by the capitalisation of the initial letter of a word or of each word in a phrase and are defined in the [Glossary Module](#) (GLO). Unless the context otherwise requires, where capitalisation of the initial letter is not used, the expression has its natural meaning.

What are the next steps?

5. All comments should be submitted to the DFSA using the [online response form](#). The DFSA reserves the right to publish, including on its website, any comments you provide. However, if you wish your comments to be kept confidential, you must expressly request

¹ RSIs include rolling spot forex contracts, binary options and spread bets. They may also have labels such as 'turbo certificates', 'knock out options' and 'delta options'. See the proposed definition of RSIs in Proposal 1.

at the time of making comments that this should be the case and your reasons for requesting so.

6. The deadline for providing comments on this consultation is 16 January 2021. Following public consultation, we will proceed to make the relevant changes to the DFSA's Rulebook. You should not act on the proposals until the relevant changes to the laws and DFSA Rulebook are made. We shall issue a notice on our website telling you when this happens.

Structure of this CP

Part I – Background

Part II – Definition and application of RSI Proposals

Part III – Proposals relating to RSIs

Appendix 1 – Draft amendments to GEN

Appendix 2 – Draft amendments to COB

Appendix 3 – Draft amendments to REP

Appendix 4 – Draft amendments to GLO

Annex 1 – Questions in this Consultation Paper.

Part I – Background

7. In 2017, the DFSA issued a Dear SEO letter, setting out guidance and recommendations to DFSA licensed firms offering and selling highly leveraged OTC products, such as CFDs to retail clients. This letter was issued due to concerns the DFSA had identified through its supervisory work, which included that:
 - a) many retail clients who entered into CFDs lost money;²
 - b) where leverage was high, many retail clients lost more than their initial investment or margin;
 - c) fees and costs lacked transparency, and had the tendency to significantly deplete a retail client's profits (if any); and
 - d) confusing and unclear pricing methodologies were used, in a manner that was not aligned with the needs, expectations and understanding of retail clients to whom these products were offered.
8. Since the issue of that Dear SEO letter, IOSCO has published a toolkit³ containing recommendations that can be adopted by regulators to address concerns arising from the offer and sale of highly leveraged OTC products to retail clients. These include measures relating to leverage limits and pricing methodologies, restrictions on certain marketing activities and prohibitions relating to types of highly leveraged OTC products offered to retail clients.
9. We found that many major jurisdictions, such as the EU, UK, US, Singapore, Hong Kong and Australia, have recently introduced detailed conduct standards for regulating intermediaries who offer and trade leveraged OTC products in retail markets. These jurisdictions found that retail investors faced higher risk of loss where firms have offered increased leverage in their CFDs.⁴ Further, they found that the growth of the number of firms active in the CFD market in recent years has intensified competition between existing firms and new entrants, resulting in business practices which are not necessarily in the best interest of the clients.⁵
10. The DFSA has a clear mandate to protect the users of Financial Services offered in or from the DIFC. This encourages us to adopt international best practice in the area of conduct of business and consumer protection. Our mandate also requires the DFSA to monitor carefully products and services where there is potential harm to retail investors. The proposals in this paper address the concerns that led to the issuance of the Dear SEO letter in 2017, while drawing upon the IOSCO toolkit, and the regimes adopted in other major jurisdictions, particularly in the UK, EU and Australia.

² We undertook a further short survey with relevant firms as part of developing these proposals. We found that between 60% and 84% of retail client accounts suffered cumulative losses from CFD trading between 1 April 2019 and 1 April 2020. This is broadly similar to reported losses in other jurisdictions. For example, the UK FCA found that, in 2017, between 81% and 85% of clients lost money.

³ See IOSCO Report available at <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD613.pdf>

⁴ Different regulators have taken different approaches. Due to the nature of some of these products, the Hong Kong regime regulates them under their gambling legislation. Other jurisdictions, such as MAS in Singapore, so far have applied a general principles-based approach to CFDs, but, are now considering whether any further refinements to their regulatory framework are required to address retail protection needs.

⁵ For example, some firms seeking to gain a market share by offering smaller account sizes and incentives (e.g. bonuses or credits) to attract higher numbers of inexperienced retail clients to offset the high turnover of clients closing their accounts after losing their money.

Part II – Definition and application of the RSI proposals

Definitions

11. Highly leveraged OTC products, such as CFDs, to which the proposals in this paper apply, are Derivatives. Derivatives are a type of Investments as defined in GEN App 2.⁶

Proposal 1

12. The DFSA proposes to refer to the financial products to which the proposals in this paper apply as Restricted Speculative Investments (RSIs). The definition of a RSI will list and define the various OTC derivative contracts that are covered, such as CFDs, rolling spot forex contracts and other binary options.
13. Some of the contracts that may fall within the definition of RSIs may include products such as spread bets and binary options.⁷ As with any products that a Firm proposes to market or sell, the Firm needs to satisfy itself that the product is permitted under all relevant legislation (e.g., the UAE Penal Code); we propose to issue Guidance to this effect.

See draft COB Rule 6.16.2 at Appendix 2.

Question 1:

Do you agree with our proposed definition of Restricted Speculative Investments? If not, why not?

Application

14. The proposals in this paper apply where Restricted Speculative Investments are offered or marketed to retail clients by persons:
- Dealing in Investments as Principal (including those dealing on a Matched Principal basis – see paragraphs 56 – 60);
 - Dealing as Agent;
 - Advising on Financial Products;
 - Arranging Deals in Investments;
 - Acting as a Representative Office; and
 - conducting Financial Promotions.
15. Most of the proposals in this paper apply to firms trading in RSIs, who are dealers in Investments as principal. However, firms dealing as agent in Investments, arranging and advising on Investments or acting as Representative Offices also attract some of the proposed requirements, which are designed to ensure that retail clients are not put into RSI contracts issued by other firms outside the DIFC where they are not subject to equivalent protections as applied to issuers of RSIs under these proposals. We expect firms to be appropriately authorised to provide Financial Services relating to RSIs, depending on whether they are the issuers of RSIs to retail clients, or dealing as agent,

⁶ CFDs are a type of Derivative that fall within the second part of the definition of Futures in GEN Rule A2.3.1(b)(ii). See also Guidance item 3 under GEN Rule A2.3.1(b).

⁷ A binary option involves an option under which the parties to it make a pay-out of a fixed monetary amount or specified asset, or nothing at all.

arranging or advising on RSIs, or acting as a Representative Office relating to RSIs to retail clients.

Proposal 2

16. We propose to limit the application of the proposals relating to RSIs to persons referred to in paragraph 14.

See draft COB Rules 6.16.1 at Appendix 2 and draft Rep Rule 4.10.1 at Appendix 3.

Question 2:

Do you agree with our proposal in paragraph 16? If not, why not?

Part III Proposals relating to Restricted Speculative Investments (RSIs)

Appropriateness Assessment

17. Under the current regime, an Authorised Firm must not recommend a financial product or financial service to a client, or execute a transaction on a discretionary basis for a client, without having a reasonable basis for considering the recommendation or the discretionary transaction to be suitable for the client. For that purpose, the firm must undertake a suitability assessment of the particular client's needs, objectives and financial situation (see COB Rule 3.4.2(1)). However, this obligation does not usually apply to an Authorised Firm offering trading in RSIs with retail clients, as such a firm typically offers 'execution only' services, and does not make recommendations, or undertake discretionary transactions, relating to RSIs.
18. RSIs are high risk and, often, complex products. It is not easy for retail clients to understand either the risks inherent in these products or the potential for significant losses that can result from trading in RSIs, especially due to market volatility or sudden changes. Leverage makes the losses much more than a retail client would normally expect to lose, or have the capacity to absorb.
19. The UK and EU jurisdictions have an appropriateness test that regulated firms must apply before retail clients are put into products such as RSIs.⁸ Further, the IOSCO toolkit recommends such an assessment to be carried out by firms offering and marketing trading in OTC leveraged products such as RSIs.

Proposal 3

20. We propose to require an Authorised Firm, before it allows a retail client to trade in RSIs with the firm, to undertake an appropriateness assessment to ascertain whether the client has adequate skills and expertise relating to RSIs of the kind offered to that client, and the ability to absorb significant losses that could result from trading in RSIs, especially due to leverage. We also propose to add guidance relating to the factors that an Authorised Firm needs to take into account when assessing appropriateness for a retail client to trade in RSIs, and the need for the firm to be able to demonstrate to the satisfaction of the DFSA that the firm has undertaken that assessment.

⁸ See the appropriateness assessment under the UK regime COBS 10A (non-advised services), and also Article 25(3) of the EU Directive 2014/65/EU.

See draft COB Rule 6.16.3 at Appendix 2.

Question 3:

Do you agree with the DFSA's proposal to require an appropriateness assessment before a firm allows a retail client to trade in RSIs with the firm? If not, why not?

Risk Warnings

21. As noted before, retail clients do not often understand the high probability of losing significant sums of money in trading in RSIs due to leverage. For example, the UK FCA found that over 80% of clients lost money on CFD products over a year.⁹ Other EU jurisdictions have had similar experiences.
22. Our current regime¹⁰ does not go so far as to require firms trading in RSIs to provide specific warnings relating to risks associated with RSIs. The IOSCO toolkit, and the requirements in the benchmarked jurisdictions, support clear risk warnings being given to retail clients, together with additional disclosure relating to the loss/profit ratio across all the firm's retail RSI trading accounts. These measures are designed to mitigate the risk that firms and retail clients have a tendency to focus on prospective profits, rather than the high probability of losses.

Proposal 4

23. The DFSA proposes that an Authorised Firm, before entering into any arrangement or agreement to provide trading in RSIs to retail clients, must issue to such persons a stand-alone risk warning stating that:
 - a) RSIs are complex financial products, and trading in them does not involve trading in the underlying reference asset;
 - b) trading in RSIs comes with a high probability of losing money rapidly due to high leverage;
 - c) retail clients often lose money, rather than make profit, by trading in RSIs – with disclosure of the general performance, in terms of profits and losses, across all retail client accounts for trading in RSIs (as set out in paragraph 25); and
 - d) the person should, before entering into an arrangement to trade in RSIs with the firm, carefully consider whether they understand the features and the risk profile of RSIs offered, and how they work, and whether the person can afford to take the high risk of losing money.
24. The DFSA also proposes that an Authorised Firm gives the stand-alone risk warning in good time before opening a trading account for a retail client to trade in RSIs. The retail client needs to be given sufficient time to consider the information in the warning before signing the agreement to trade in RSIs. The warning and disclosure must be prominently displayed, in whatever the medium or format in which they are given.

⁹ See UK FCA CP 16/40.

¹⁰ Under the current regime, firms are subject to obligations that require firms communicating with clients and prospective clients with regard to financial products and financial services to take reasonable steps to ensure that the communications are, and remain, clear, fair and not misleading (see COB Rule 3.2.1). Financial promotions carried out by any Person which refer to an offer or inducement to acquire or dispose of financial products or services must also be clear, fair and not misleading (see GEN Rule 3.5.1(1)(a)).

25. With regard to the disclosure referred to in paragraph 23c. relating to the ratio of the profits against losses incurred across all retail trading accounts in RSIs, we propose that:
- a) such information covers the past 12 months of the performance of the retail RSI trading accounts of the firm;
 - b) if the firm has been trading in RSIs for a shorter period than 12 months, the firm discloses information for that shorter period, along with the information in b) or c), as applicable to the firm;
 - c) if the firm has been trading in RSIs for a shorter period than 12 months, and it is a member of a Group, and a Group member operates retail trading accounts in RSIs, discloses information relating to profit and loss ratio of such accounts for the past 12 months, until such time as the condition in a) can be met;
 - d) if the firm has been trading in RSIs for a shorter period than 12 months and is not a member of a Group that falls under condition c), discloses general profit and loss ratio in the RSI sector for the past 12 months, obtained from a verifiable independent source;
 - e) the firm obtains an acknowledgement of the receipt of the above warning and disclosure, and keeps the acknowledgements as part of the firm's record keeping obligations to demonstrate its compliance;
 - f) the firm provides such disclosure to its retail clients at least quarterly, with updates as necessary; and
 - g) the firm provides this disclosure in a clear and objective manner, without cherry picking, so that it does not breach its obligations to communicate with its clients in a clear, fair and not misleading manner.
26. The DFSA also proposes to provide Guidance, for the purposes of disclosure referred to in paragraph 23 c). relating to the manner in which Authorised Firms need to calculate profits and losses incurred in retail RSI trading accounts of the firm or its Group member, as relevant.

See draft COB Rule 6.16.4 at Appendix 2.

Questions:

- 4. Do you agree with the DFSA proposal to require the issue of risk warning relating to trading in RSIs? If not, why not?**
- 5. Do you agree with the DFSA proposal to require disclosure of profit and losses incurred across all RSI trading accounts of the firm, if the firm is a start-up, of a Group member and if not, general profits and losses in the RSI sector? If not, why not?**

Fee Disclosure

27. Authorised Firms are required to disclose fees, costs and other charges and the basis upon which the firm will charge those fees as part of the key information to be included in the Client Agreement.¹¹ To provide clarity relating to the disclosure of fees and charges that would generally be incurred by retail clients trading in RSIs, we propose to

¹¹ See COB App A2.1.2(e)

give Guidance relating to disclosure that Authorised Firms need to give retail clients, covering the following aspects:

- a) any commissions charged, whether a general commission or a commission on each trade, i.e., on opening and closing a contract;
 - b) the amount of any mark-up added to market prices the firm receives from an external source;
 - c) financing charges, such as daily and overnight financing charges;
 - d) the amount of any mark-up when calculating financing charges; and
 - e) costs and charges to be applied if a client is seeking to sell or exit early.
28. We also propose to include Guidance that, if there are any material changes to the fees and charges disclosed previously, an Authorised Firm needs to provide fresh disclosure to the retail clients relating to the new fees and changes, well before those new fees and charges are introduced.

Proposal 5

29. The DFSA proposes to include Guidance as proposed in paragraphs 27 and 28 relating to the disclosure of fees and charges incurred by retail clients trading in RSIs.

See draft guidance to COB Rule A2.1.2 at Appendix 2.

Question 6:

Do you agree with the DFSA proposal to include detailed Guidance relating to the disclosure of fees and charges relating to trading in RSIs? If not, why not?

Minimum Margin Requirements

30. RSIs allow a person to get an exposure to a class of underlying assets that significantly exceeds the invested amount. While leverage can be beneficial to clients when the market moves in their favour to generate higher profits, leverage can equally result in higher losses than the client's invested amount. As a result, leverage comes at a cost to the client.
31. In line with the practices adopted in the benchmarked jurisdictions, where minimum margin requirements are set directly related to the price volatility of the underlying assets, we propose to set minimum margin requirements. Under these, the more volatile the price movements of the underlying reference asset, the higher the margin required for a retail client to open positions under such contracts. Based on the volatility of the underlying asset class, the UK FCA allowed crypto currency derivatives with a high margin of 50%, but, has just moved to ban the sale of crypto currency derivatives altogether.

Proposal 6

32. The DFSA proposes to introduce minimum margin requirements that will reduce the amount of leverage the firm is able to offer to a retail client for a given amount of exposure, as per Table A.¹²

Table A. Minimum Margin Requirement for RSIs

RSI Underlying Asset	Minimum Initial Margin Required
Major currency pair	3.3%
Non-major currency pair, major equity index, or gold	5%
Non-major equity indices or a commodity other than gold	10%
Cryptocurrency	50%
Any other asset	20%

See draft COB Rule 6.16.6 at Appendix 2.

Questions:

- 7. Do you agree that the DFSA should introduce a minimum margin requirement for RSIs offered to Retail Clients? If not, why not?**
- 8. Do you agree with the proposed minimum margin requirements set out in Table A? If not, what should they be?**
- 9. Are there other underlying asset classes relating to which minimum margins should be set? What are they, and what should be the minimum margin?**
- 10. Should the DFSA ban the sale of crypto currency derivatives as the UK FCA has done? If not, why not?**

Margin Close-out Requirement

33. A margin close-out is designed to provide protection to retail clients trading in RSIs. This is because such clients do not have the knowledge and the ability to take prompt action to limit losses resulting from adverse market movements relating to the class of underlying assets, particularly given the high leverage involved in such contracts. The benchmarked jurisdictions apply margin close out protection for retail clients trading in RSIs.

¹² There is no restriction against a firm requiring a higher margin than the prescribed minimum margin for a retail client to gain exposure to the particular class of underlying asset.

Proposal 7

34. The DFSA proposes that Authorised Firms dealing in RSIs with a retail client must:
- close out any of the client's open positions in the client's RSI trading account when the client's net equity for that position falls below 50% of the margin required to maintain that open position; and
 - do so as soon as practicable, and on the best possible terms for the client.
35. We also propose to define net equity, for calculating the 50% threshold for closing out an open position, as the client's deposited margin to maintain the position in a RSI contract.

See draft COB Rule 6.16.7 at Appendix 2.

Question 11:

Do you agree with the DFSA proposal in paragraph 34 to introduce a margin close-out requirement? If not, why not?

Negative Balance Protection

36. Negative balance protection provides to retail clients trading in RSIs an additional level of protection against incurring large debts to the counterparty to the contract, which is generally the Authorised Firm. This mitigates the risk of a retail client incurring large losses that far exceed their funds in the account, comprising their deposited margin and unrealised gains and losses of all open positions in their trading account.¹³
37. Most benchmarked jurisdictions, including the EU, UK and Australia, include the negative balance protection measure, thereby limiting a firm's right of recourse to the funds held in the retail client's RSI trading account.

Proposal 8

38. The DFSA proposes to introduce a negative balance protection requirement so that a retail client's liability for losses resulting from trading in RSIs are limited to the client's funds in the trading account.

See draft Rule in COB 6.16.8 at Appendix 2.

Question 12:

Do you agree with the DFSA proposal to introduce a negative balance protection requirement? If not, why not?

¹³ During large market events, a sudden price change in the underlying reference asset can lead to a significant price difference between the client's expectation and the close out price, resulting in unexpected losses. An example quoted in FCA CP 18/38, at para 3.47, is what happened when the Swiss National Bank ceased pegging the Swiss Franc (CHF) to the euro (EUR), which resulted in a sudden and significant change in the value of the CHF and large losses for consumers. For example, German regulator BaFin reported that one client lost EUR 280,000, from an initial investment of EUR 28,000, during the Swiss Franc event. A UK retail client lost GBP 2.7mn from a GBP 200,000 initial investment.

Prohibition against the use of credit

Credit Cards

39. Some Authorised Firms allow retail clients to fund their margin payments by directly using credit cards. While the DFSA does not generally impose restrictions as to the method of funding, we believe that - in the case of highly leveraged products - it is not prudent to allow retail clients to be allowed to trade in RSIs using credit cards and similar arrangements that may encourage people to make speculative investments with money they do not actually have, and which carry high interest rates, exacerbating the client's potential debt burden.

Proposal 9

40. The DFSA proposes to require an Authorised Firm that offers trading in RSIs with retail clients to take reasonable measures to ensure that the client does not use credit cards and other credit provided by any third parties to fund margins required to open positions in trading in RSIs.

See draft COB Rule 6.16.10 at Appendix 2.

Questions:

13. **Do you agree with the DFSA's proposal to prohibit the use of credit cards and other facilities provided by third parties to fund margins? If not, why not?**
14. **Do you think that the DFSA should prohibit all borrowings, including margin lending, to fund margins in trading in RSIs? If so, why?**

Restrictions relating to the types of RSIs

41. RSIs include a range of products, where some are more risky than others. While the DFSA does not usually restrict the types of products offered to investors, we believe that some RSIs lack the required level of transparency to be appropriate for retail clients. For example, this will be the case where the underlying reference does not have a reliable and transparent pricing mechanism, particularly where it is not a commodity.

Proposal 10

42. The DFSA proposes that an Authorised Firm dealing in RSIs can only offer to retail clients a RSI where:
- it has a transparent pricing mechanism available for determining the price movement of the underlying reference, by reference to which the profit or loss of each party to the contract is determined; or
 - the Authorised Firm provides a two way pricing mechanism that allows the retail client to trade in at the quoted prices during the currency of the RSI contract.

See draft COB Rule 6.16.11 at Appendix 2.

Question 15:

Do you agree with the DFSA's proposals to restrict the offer of certain types of RSIs as proposed in paragraph 42 to retail clients? If not, why not?

Referrals from unregulated persons

43. There is no current prohibition against an Authorised Firm getting referrals of retail clients from unregulated persons.¹⁴ We propose to prohibit Authorised Firms from getting referrals of retail clients from unregulated persons as the practices adopted by such persons to procure clients for Authorised Firms are not transparent and can be detrimental to retail clients' interests. This proposal applies to Authorised Firms trading in, dealing as agent, advising on, or arranging deals in, RSIs for retail clients.

Proposal 11

44. The DFSA proposes to prohibit Authorised Firms from accepting clients from unregulated sources.

See draft COB Rule 6.16.12 at Appendix 2.

Question 16:

Do you agree that the DFSA should prohibit Authorised Firms from accepting referrals from unregulated persons? If not, why not?

Risk Warning on marketing and other communications

45. We consider it important that all communications relating to RSIs, which are made available or directed at retail clients, contain a prominent risk warning setting out the risks associated with trading in the RSIs of the type referred to in the material, in a clear, concise and easy to understand manner. Such communications include marketing or educational material provided on a website or in general media.
46. Although Authorised Firms are subject to an overarching requirement to take reasonable steps to ensure that their communications to clients are clear, fair and not misleading, (see COB Rule 3.2.1), and persons issuing Financial Promotions are also subject to a similar requirement, (see GEN Rule 3.5.1 (1)(a)), we do not consider that these general requirements would suffice to require risk warnings to be included in communications provided or targeted to retail clients. This proposal is in line with the similar requirements adopted in the benchmarked jurisdictions.

Proposal 12

47. The DFSA proposes that all marketing and communications relating to RSIs targeted or aimed at retail clients include clear, concise prominent warnings relating to risks associated with trading in such products.

See draft COB Rule 6.16.5 at Appendix 2, and draft GEN Rule 3.5.3 at Appendix 1.

¹⁴ Financial Promotions are defined widely to capture any communications, however made, which invites or induces a person to enter into an agreement to obtain a financial service or to acquire or dispose of a financial product. However, they do not necessarily prevent an Authorised Firm from being able to have retail clients referred to the firm by an unregulated person.

Question 17:

Do you agree with the DFSA's proposal to require risk-warnings on all marketing materials? If not, why not?

Restrictions relating to the distribution and marketing of Restricted Speculative Investments

48. We consider that Authorised Firms dealing as agent, arranging deals in or advising on RSIs, or Representative Offices marketing their related party financial products and services¹⁵ that are RSIs, should be permitted to do so only if the investments are either regulated under the DFSA regime, or subject to equivalent requirements in another jurisdiction as applied under the DFSA regime. Without such a requirement, there is a risk that firms in the Centre would be able to expose retail clients to RSIs offered by firms in jurisdictions that do not offer adequate protections, i.e. compared to the protections under the proposed DFSA regime.
49. The obligation to satisfy themselves that RSI business in other jurisdictions is subject to equivalent requirements as under the DFSA regime falls on the Authorised Firm. The entity in question will need to keep records of how it has made such an assessment and must make those records available to the DFSA on request.

Proposal 13

50. The DFSA proposes that Authorised Firms dealing as agent, advising on, or arranging deals in RSIs, or undertaking Representative Office activities relating to RSIs, be permitted to do so only if they are reasonably satisfied that those RSIs are subject to substantially equivalent requirements as under the DFSA regime.

See draft COB Rule 6.16.13 at Appendix 2, and draft REP Rule 4.10.1 at Appendix 3.

Question 18:

Do you agree with the DFSA proposal in paragraph 50? If not, why not?

Prohibition against the offer of incentives

51. Offers of bonuses and other incentives to trade in RSIs could be attractive to inexperienced retail investors who may not otherwise choose to invest in these high-risk products. We consider it important that firms do not offer existing or prospective retail clients incentives to trade in RSIs to mitigate the risk that such inducements could unduly influence retail clients to trade in RSIs.
52. Under the current regime, an Authorised Firm must not offer or give inducements that are reasonably likely to conflict with any duty that the firm owes to its clients (see COB Rule 3.5.3). However, there is no express prohibition against the offer of inducements. Generally, a firm dealing in RSIs with a retail client is the counterparty to such a contract and, therefore, we consider such a firm as having a significant conflict of interest if it offers inducements to retail clients to trade with the firm. But, this may not necessarily be evident. In any case, firms dealing as agent in, advising on, or arranging deals in,

¹⁵ Representative Offices are permitted under their licence to undertake marketing activities (e.g. referrals of clients and financial promotions) in relation only to those financial products and services provided by their head office, or members of the Group, located outside the DIFC.

RSIs, or Representative Offices undertaking marketing activities relating to RSIs, may not see offering incentives as a prohibited activity, and hence our proposal to prohibit the offer of incentives to retail clients to trade in RSIs.

Proposal 14

53. The DFSA proposes to prohibit the offer of inducements to retail clients by Authorised Firms who:
- deal, advice or arrange deals in RSIs; or
 - undertake marketing activities as a Representative Office relating to RSIs.

This is consistent with the approach adopted in the benchmarked jurisdictions.

See draft COB Rule 6.16.9 at Appendix 2, and draft REP Rule 4.10.2 at Appendix 3.

Question 19:

Do you agree with the DFSA's proposal to ban the offer of inducements to trade in RSIs? If not, why not?

Persons undertaking Financial Promotions

54. Communications relating to RSIs made in or from the DIFC fall within the definition of Financial Promotions.¹⁶ Financial Promotions can be made by regulated firms, as well as unregulated persons under specified circumstances.¹⁷ There is no current requirement that a Financial Promotion relating to RSIs that are issued or offered by a person outside the DIFC are subject to similar requirements as those applying under the DFSA regime. We consider it important that retail clients are not targeted by Financial Promotions relating to RSIs, unless those products are subject to similar requirements as under the DFSA regime.

Proposal 15

55. To ensure that Financial Promotions can only be undertaken relating to RSIs that are subject to similar regulation as under the DFSA regime, the DFSA proposes to amend the Financial Promotions rules to include that requirement.

See draft GEN Rule 3.5.3 at Appendix 1.

¹⁶ The Regulatory Law prohibits the conduct of Financial Promotions in or from the DIFC unless in accordance with the regulatory requirements set out in the DFSA Rulebook. Financial Promotions are defined widely to capture any communications, however made, which invites or induces a person to enter into an agreement to obtain a financial service or to acquire or dispose of a financial product (see Article 41A(3) of the Regulatory Law).

¹⁷ Financial Promotions are permitted (a) if made or approved by an Authorised Firm, (b) in the case of a Representative Office, if the promotion relates to related party financial service, (c) if made by an entity regulated by a UAE regulator, or (c) if it is an 'exempt Financial Promotions' (e.g. communications directed at professional clients or reverse solicitations, see GEN Rule 3.4.1(4)). GEN section 3.5 requires Financial Promotions to be clear, fair and not misleading and contain details of the persons responsible for the information and products and services.

Question 20:

Do you agree with the DFSA's proposal relating to Financial Promotions in paragraph 55? If not, why not?

Prudential Categorisation for dealing in Restricted Speculative Investments

56. Under the DFSA's prudential regime, Authorised Firms that issue or act as a counterparty to a client in a Restricted Speculative Investment contract are Dealing in Investments as Principal. These firms fall under Prudential Category 2, if Dealing as Principal on a proprietary basis, and Prudential Category 3A when dealing on a matched principal basis.
57. The requirements relating to 'Matched Principals' in PIB Rule 1.3.3(2) are designed to address the difficulty encountered by brokers who are, in substance, Dealing in Investments as Agent. These are brokers who undertake matching transactions to fulfil their client orders to buy or sell securities, particularly on exchanges where only 'principal to principal' transactions can be undertaken by members of the relevant exchange.
58. Such brokers would have been subject to the full proprietary dealers' prudential requirements, which are higher than those applicable to firms dealing as agents, without the Matched Principal Prudential category. As firms dealing on a Matched Principal basis do not incur the type of risks associated with proprietary dealing, it was considered appropriate to create that category, on par with prudential requirements applicable to firms dealing in Investments as agent.
59. To benefit from the lower prudential requirements under the Matched Principal category,¹⁸ a firm has to meet the following four criteria, which are designed to distinguish proprietary dealing from dealing on a Matched Principal basis. These criteria are that the matched principal:
- enters into transactions as a principal only for the purpose of fulfilling its Client orders;
 - holds own account positions only as a result of a failure to match its Clients' orders;
 - does not hold positions where the market value of such positions is more than 15% of the firm's Tier 1 Capital; and
 - holds positions that are incidental in nature and are strictly limited to the time reasonably required by the firm to carry out a transaction of that nature.
60. We are of the view that a firm trading in Restricted Speculative Investments, with back-to-back positions entered into, generally with its parent or another group member, is not acting within the letter or spirit of the requirements relating to Matched Principal dealing as set out in paragraphs 58 and 59. This is because the hedging transactions it enters into are not for the purpose of fulfilling its client's orders and, consequently, any own account positions are not resulting from a failure to match a client's order.

¹⁸ See PIB Application Table A (Branch) and B (DIFC incorporated firm) for the applicable prudential requirements for CAT 2 and 3A firms available at:
https://dfsaen.thomsonreuters.com/sites/default/files/net_file_store/DFSA1547_17395_VER370.pdf

Proposal 16

61. We seek public comment on whether, and to what extent, Authorised Firms are using the Matched Principal model for trading in RSI and, if so, how their activities fit within the parameters for dealing on a Matched Principal basis under PIB Rule 1.3.3(2).

Questions:

- 21. Do you agree with the DFSA's position with regard to Matched Principal dealing? If not, why not?**
- 22. Do you think that firms should be able to trade with clients on a Matched Principal basis by entering into hedging positions with another counterparty? If so, how do such firms meet the criteria for Matched Principal dealing in paragraph 59?**

Other proposals

62. Authorised Firms need to maintain records to be able to demonstrate their compliance with the DFSA requirements. Therefore, we propose that firms maintain proper records relating to compliance with the applicable RSI related requirements.
63. Authorised Firms trading in, dealing as agent, arranging, advising on, or marketing RSIs would be affected by the proposed requirements if implemented. For example, if those firms do not have systems and controls to ensure that they meet the proposed requirements as applicable to them, they will need to implement changes to their existing systems and controls.

Proposal 17

64. To address the issues noted in paragraphs 62 and 63, we propose to:
- require Authorised Firms to maintain proper records relating to their compliance with the applicable RSI requirements; and
 - provide a 6-month transition period to Authorised Firms in relation to existing clients to enable them to meet the proposed new requirements, from the date of implementation of the proposals.

See draft COB Rules 6.16.14 and 6.16.15 at Appendix 2.

Questions:

- 23. Do you agree with the DFSA's proposal relating to record keeping and transitional arrangements in paragraphs 64? If not, why not?**
- 24. Do you have any concerns or issues which are not addressed in the proposals in this paper? If so, what are they, and how should they be addressed?**

Annex 1: Questions in this Consultation Paper

Question 1:

Do you agree with our proposed definition of Restricted Speculative Investments? If not, why not?

Question 2:

Do you agree with our proposal in paragraph 16? If not, why not?

Question 3:

Do you agree with the DFSA's proposal to require an appropriateness assessment before a firm allows a retail client to trade in RSIs with the firm? If not, why not?

Question 4:

Do you agree with the DFSA proposal to require the issue of risk warning relating to trading in RSIs? If not, why not?

Question 5:

Do you agree with the DFSA proposal to require disclosure of profit and losses incurred across all RSI trading accounts of the firm, if the firm is a start-up, of a Group member and if not, general profits and losses in the RSI sector? If not, why not?

Question 6:

Do you agree with the DFSA proposal to include detailed Guidance relating to the disclosure of fees and charges relating to trading in RSIs? If not, why not?

Question 7:

Do you agree that the DFSA should introduce a minimum margin requirement for RSIs offered to Retail Clients? If not, why not?

Question 8:

Do you agree with the proposed minimum margin requirements set out in Table A? If not, what should they be?

Question 9:

Are there other underlying asset classes relating to which minimum margins should be set? What are they, and what should be the minimum margin?

Question 10:

Should the DFSA ban the sale of crypto currency derivatives as the UK FCA has done? If not, why not?

Question 11:

Do you agree with the DFSA proposal in paragraph 34 to introduce a margin close-out requirement? If not, why not?

Question 12:

Do you agree with the DFSA proposal to introduce a negative balance protection requirement? If not, why not?

Question 13:

Do you agree with the DFSA's proposal to prohibit the use of credit cards and other facilities provided by third parties to fund margins? If not, why not?

Question 14:

Do you think that the DFSA should prohibit all borrowings, including margin lending, to fund margins in trading in RSIs? If so, why?

Question 15:

Do you agree with the DFSA's proposals to restrict the offer of certain types of RSIs as proposed in paragraph 42 to retail clients? If not, why not?

Question 16:

Do you agree that the DFSA should prohibit Authorised Firms from accepting referrals from unregulated persons? If not, why not?

Question 17:

Do you agree with the DFSA's proposal to require risk-warnings on all marketing materials? If not, why not?

Question 18:

Do you agree with the DFSA proposal in paragraph 50? If not, why not?

Question 19:

Do you agree with the DFSA's proposal to ban the offer of inducements to trade in RSIs? If not, why not?

Question 20:

Do you agree with the DFSA's proposal relating to Financial Promotions in paragraph 55? If not, why not?

Question 21:

Do you agree with the DFSA's position with regard to Matched Principal dealing? If not, why not?

Question 22:

Do you think that firms should be able to trade with clients on a Matched Principal basis by entering into hedging positions with another counterparty? If so, how do such firms meet the criteria for Matched Principal dealing in paragraph 59?

Question 23:

Do you agree with the DFSA's proposal relating to record keeping and transitional arrangements in paragraphs 64? If not, why not?

Question 24:

Do you have any concerns or issues which are not addressed in the proposals in this paper? If so, what are they, and how should they be addressed?