ASIC

Australian Securities & Investments Commission

REPORT 205

Contracts for difference and retail investors

July 2010

About this report

This report summarises the results of a ‘health check’, conducted by ASIC in 2009, on the contracts for difference (CFD) market in Australia. It provides a review of CFD issuer business models, market dynamics, advertising, disclosure documents, investor attitudes and behaviour and investor complaints data.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a license or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Disclaimer

This report does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

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Executive summary

Introduction

1 Contracts for difference (CFDs) are a highly leveraged, derivative product marketed to and traded by retail investors.[1] CFDs are essentially a leveraged bet on future changes in the market price of a share or commodity, or the value of an index or a currency exchange rate. With a long CFD, investors are looking to profit from increases in the market price of a particular asset. With a short CFD, they are seeking to profit from falls in the market price of the asset. As CFDs are derivatives, investors do not actually invest in the underlying asset, but rather in a contract whose value is determined by reference to the market price of the underlying asset.

2 The vast majority of CFDs are issued and traded over the counter (OTC). The size of the CFD market has grown rapidly in recent years, driven by intensive marketing by CFD issuers, including extensive advertising in the financial and general press (on television, in print, and online) and via seminars.

3 We decided to conduct a 'health check' of the CFD market because of the rapid growth of this market in recent years, and the predominance of retail investors in the CFD trader pool. Our mandate to promote confident and informed participation by investors and consumers in the financial system, and to ensure the efficient and effective operation of financial markets, has informed our review of the CFD market.

4 The majority of investors do not seek or receive personal financial advice prior to investing in OTC CFDs. Investors are attracted to CFDs because of the leveraged opportunities they offer, the low initial capital required to commence trading and the perceived ease of trading.

5 OTC CFDs entail a number of risks for retail investors, including:

- the potential for great losses due to high leverage ratios;
- unanticipated or poorly managed margin calls;
- significant counterparty risks (i.e. the risk that the issuer or another party fails to meet their obligations to the investor);
- 'gapping' that can result from time delays between the placement and execution of trader orders;

[1] The report uses the terms 'retail investor', 'investor' and 'trader' interchangeably. All terms are used to refer to people who currently trade CFDs or have done so in the past or who may consider commencing trading CFDs in the future. These terms do not refer to professional traders who may trade CFDs or other financial instruments as part of their employment.

- limitations of the explanation of key risks and operational features of CFDs in many disclosure documents; and
- the risk that CFDs are likely to be an inherently unsuitable investment for some retail investors.

6 The complex structure of CFDs and the risks associated with them mean that they are unlikely to meet the investment needs and objectives and the risk profile of many retail investors. Our research into the current operation of the OTC CFD market in Australia has indicated that many retail investors:

- are confused as to how CFDs operate, and do not appreciate the risks associated with trading CFDs;
- often do not receive sufficient information to make an informed decision about whether or not to acquire CFDs;
- have difficulty understanding the information they do receive due to bias, poor presentation and subject complexity; and
- as a result, do not always make informed and confident financial decisions about whether CFDs are a suitable investment for them.

7 Consumer research indicates that some investors are trading CFDs even though their circumstances suggest that CFDs are unlikely to be a suitable investment for them. Approximately 15% of current CFD traders have between 50 and 100% of their investment portfolio in CFDs.[2] Qualitative research also revealed some investors are trading CFDs within their self-managed superannuation funds, and some investors are using their retirement savings as trading capital. These behaviours are all a cause for concern as the highly leveraged nature of the product means that small market movements could easily result in margin calls which traders may be unable to meet.

Purpose and scope of this report

8 This report presents the findings of a 'health check' conducted by ASIC in 2009 on the operation of the CFD market in Australia. This health check focused primarily on the OTC CFD market.

9 It includes the findings of a qualitative investor research project commissioned specifically for this project, and the results of primary analysis by us of CFD issuer advertisements, seminars, Product Disclosure Statements (PDSs) and complaints received regarding CFDs.

10 This report is comprised of the following sections:

[2] Investment Trends, *2009 Contracts for difference report*, July 2009.

Section A: CFD market—Issuers and business models

11 This section reviews how CFDs operate and how they compare to other leveraged or derivative investments. We also review the main business/pricing models used by issuers, including a summary of the differences between exchange-traded and OTC CFDs and the main risks involved when investing in CFDs.

Section B: CFD investor research

12 We review qualitative data commissioned for the purposes of this report. This data establishes the profile, trading patterns and experience of current and prospective CFD traders. We find that traders are attracted to CFDs primarily because these investments are highly leveraged and perceived to be easy to trade. While traders on average have higher levels of education, wealth and investment experience than the broader population, and high levels of self-confidence, the research reveals several common knowledge gaps and misunderstandings in regard to key aspects of CFDs.

Section C: Advertising by CFD issuers

13 This section reports on our analysis of the print and broadcast advertising material issued by Australian OTC CFD issuers between January and September 2009. This review assessed the advertising material for accuracy and clarity of information about key product features, particularly risks and costs, and whether issuers have engaged in misleading and deceptive conduct. This review found several problematic trends in OTC CFD advertisements issued over this period, particularly in regard to disclosure of the risks of OTC CFD trading and the use of asterisks, terms and conditions and qualifiers to clarify or restrict headline and promotional claims.

Section D: CFD seminar surveillance

14 As part of our investigation into the operation of the CFD market, we attended advertised seminars by OTC CFD issuers. We chose to attend seminars in order to understand the ways in which issuers or their representatives promote their products in this forum. We found that while most CFD seminars were advertised as educational, they were primarily directed at marketing the issuer's products. As would be expected given this marketing focus, the risks of CFDs were downplayed in relation to the potential benefits in many of these seminars.

Section E: CFD Product Disclosure Statements

15 We examined the PDSs of several OTC CFD issuers in terms of the *Corporations Act 2001* (Corporations Act), the 'good disclosure principles'

as set out by ASIC in Regulatory Guide 168 *Disclosure: Product Disclosure Statements (and other disclosure obligations)* (RG 168) and the findings of recent Australian and international research on enhanced disclosure. Our review looked at both:

- whether the PDSs met relevant statutory requirements; and
- the effectiveness of CFD PDSs as communication and information documents for retail investors.

We found several deficiencies in content and presentation across many PDSs. In particular, PDSs were often difficult to read and navigate and contained insufficient or confusing explanations of key product features such as significant risks, fees and costs.

Section F: Retail investor complaints about CFDs

16 This section provides a high-level analysis of complaints about CFDs and issuers that have been made to ASIC and the Financial Ombudsman Service (FOS). This review does not consider the legal resolution of complaint investigations, but rather catalogues the issues raised by retail investors and the perceptions and misperceptions held. This complaints data gives us an indication of where things are going wrong and, subjectively, how investors' CFD trading expectations are formed and areas where investors have found their experience of trading CFDs has not lived up to those expectations.

Section G: Future action

17 This section outlines the steps we are taking to address the risks faced by retail investors in OTC CFDs and to address the issuer conduct and disclosure issues raised in this report. We will continue to review all aspects of OTC CFDs. Should we feel that additional mechanisms are required, we will pursue these, which may include proposing law reform.

Appendix: Comparison of exchange-traded and OTC CFDs

18 The Appendix contains a more detailed comparison of the key features of exchange-traded and OTC CFDs. This comparison covers how the different CFD types operate, and the features and risks of each type. It discusses the additional risks involved with OTC CFDs—in particular, the additional counterparty risks.

Summary of main issues identified

19 Our analysis of the OTC CFD market using the data sources identified above revealed several issues of concern for ASIC in its market regulation and retail investor protection roles. While individual issues may not appear significant, in combination the potential for damage to investor confidence and for market detriment is significant.

20 Consistent with the risks to retail investors discussed in paragraph 5, the main issues we have identified are as follows:

Supply-side concerns

- OTC CFDs are complex derivative products, involving significant counterparty and other risks for investors.
- Issuers are focused on growth and customer acquisition and, therefore, market broadly and directly to retail investors in the mainstream media, including prime time television. This untargeted marketing presence creates an overall impression for retail investors that CFDs are easy to use.
- Information provided by OTC CFD issuers in disclosure documents, advertising and seminars is generally not sufficient for retail investors to make informed investment decisions.
- Because OTC CFD issuers only provide factual information or general advice, the onus for assessment of the appropriateness of CFDs as an investment for an individual client rests with the client. Many investors do not appear well equipped to make this decision. As a result, OTC CFD issuers may be offering CFDs to investors for whom the product is not appropriate or suitable.

Demand-side concerns

- Many retail investors do not understand how CFDs work and the significant risks involved in trading them. Many investors consider CFDs to be analogous to investment products such as equities.
- There is a lack of independent, clear, accessible information on CFD features, operation and risk. This inhibits the education of retail investors and causes them to rely disproportionately on issuer marketing materials for information.
- Retail investors do not seek professional advice about these products before investing in them. Therefore retail investors must make their own assessment of whether or not CFDs are appropriate for them and are likely to meet their investment objectives.
- Many retail investors appear to be over-confident in their understanding of CFDs and their ability to successfully trade them.

Future action

21 We are committed to undertaking further work to address the risks faced by retail investors in CFDs, to address our investor protection concerns and to improve the overall operation of the OTC CFD market. Table 1 below outlines how each of these actions address specific risks faced by retail investors in OTC CFDs.

Client money

22 We are releasing, together with this report, Regulatory Guide 212 *Client money relating to dealing in OTC derivatives* (RG 212). This provides guidance for OTC derivative issuers on:

- the treatment of client money which is paid to, or left with, an issuer;
- the timing and basis of any payments out of the client money account;
- any use of client money to meet an issuer's trading obligations for other clients; and
- the treatment of interest earned on client money.

Monitoring and addressing compliance issues in advertisements, disclosure and conduct

23 We will continue to actively monitor CFD issuers' advertisements, disclosure documents, seminars and conduct, and the volume and nature of complaints made to ASIC regarding CFDs. In particular we will continue to check that the key features, risks and benefits of CFDs are accurately represented to investors by issuers. We have already raised specific concerns that we have with several issuers, and worked with them to rectify deficiencies in their disclosure documents. Should our monitoring raise any new areas of concern, we will raise these with issuers, and/or consider taking enforcement actions, such as issuing stop orders on defective PDSs.

24 Given the complexity of CFDs, CFD issuers should take into account their target audience when advertising and promoting seminars. This includes consideration of when and where an advertisement is published, as well as its content.

Enhanced disclosure standards

25 To address some of our broader concerns regarding CFD PDSs, we propose to introduce disclosure benchmarks for OTC CFDs. A consultation paper outlining our proposals will be released for public consultation in the future. Compliance with the benchmarks would not be mandatory, but PDSs must address the benchmarks on an 'if not, why not' basis.

26 These benchmarks will address concerns we have regarding gaps in disclosure and will help improve standards of disclosure across many CFD PDSs. For example, we will recommend an enhanced disclosure benchmark on issuers' policies on assessing the suitability of investors to trade CFDs. We are also considering benchmarks to improve disclosure of issuers' policies on making and communicating margin calls and CFD trading when trading in the underlying asset is suspended. Adoption of the benchmarks will improve the usefulness and effectiveness of CFD PDSs, enable investors to better compare the products offered by different issuers and contribute to an improved investor understanding of key aspects of how CFDs operate, and the risks and benefits involved.

Making clear and independent information available to investors

27 We are publishing an investor guide to CFDs to improve retail investor understanding and to address the large and unmet investor need for clear, independent and accessible information about this product. This investor guide will be released shortly following the publication of this report. It will be available to download from ASIC's consumer website FIDO. We encourage CFD issuers to refer clients and potential clients to this investor guide.

Client suitability

28 We are only aware of a few OTC CFD issuers with clear and consistent client suitability policies. Given the findings in this report regarding retail investor knowledge and understanding of CFDs (see Section B), we strongly encourage all OTC CFD issuers to develop client suitability policies and procedures.

We will consider other regulatory solutions

29 Table 1 outlines how we plan to address the risks faced by retail investors when investing in CFDs. We will continue to review all aspects of OTC CFDs. Should we feel that additional mechanisms are required, we will pursue these, which may include proposing law reform.

Table 1: How we are addressing the risks faced by retail investors in OTC CFDs

Risk for retail investors	How we are addressing this risk
The potential for great losses due to high leverage ratios	Monitoring and addressing compliance issues in advertisements, disclosure and conduct to ensure this risk is communicated clearly to investors Publication of an investor guide which explains and highlights this risk, including the risk of an investor losing much more than their initial capital
Unanticipated or poorly managed margin calls	Monitoring and addressing compliance issues in advertisements, disclosure and conduct to ensure the risk of margin call is communicated clearly to investors Enhanced PDS disclosure benchmark encouraging issuers to explain their margin call policy and identify any discretions they have Publication of an investor guide which explains how a margin call works and what it could mean for an investor
Significant counterparty risks (i.e. the risk that the issuer or another party fails to meet their obligations to the investor)	Release of RG 212, which provides guidance on how ASIC expects issuers to comply with the client money provisions of the Corporations Act Monitoring and addressing compliance issues in advertisements, disclosure and conduct to ensure that counterparty risk is communicated clearly to investors Enhanced PDS disclosure benchmarks to encourage issuers to disclose how they manage liquidity so as to ensure they can meet their obligations to clients Publication of an investor guide which explains what counterparty risk is, and what it could mean for investors
'Gapping' that can result from time delays between placement and execution of trader orders	Monitoring and addressing compliance issues in advertisements, disclosure and conduct to ensure this risk is communicated clearly to investors Publication of an investor guide which explains and highlights this risk and the implications for investors
Limitations of the explanation of key risks and operational features of CFDs in many disclosure documents	Release of RG 212, which provides guidance on how ASIC expects issuers to disclose more clearly how they comply with the client money provisions of the Corporations Act Enhanced PDS disclosure benchmarks to raise the standards of CFD PDS disclosures Publication of an investor guide which provides clear, independent and accessible information about these products
The risk that CFDs are likely to be an inherently unsuitable investment for some retail investors	We are only aware of a few OTC CFD issuers with clear and consistent client suitability policies. Given the findings in this report regarding retail investor knowledge and understanding of CFDs (see Section B), we strongly encourage all OTC CFD issuers to develop client suitability policies and procedures. Enhanced PDS disclosure benchmarks encouraging issuers to spell out clearly how they identify whether clients are suited to trading CFDs Publication of an investor guide which aims to help investors make an informed decision as to whether CFDs are a suitable investment for them

A CFD market—Issuers and business models

Key points

CFDs have some similarities with other leveraged and derivative investments but they involve additional risks. Some of these risks are not well understood by traders.

The number of OTC CFD issuers and traders is growing rapidly, with many newer issuers 'white labelling' the services of established providers.[3]

CFD issuers derive a large amount of their revenue from trading activity, and therefore are strongly focused on customer acquisition and encouraging more frequent and higher-value trading. This is particularly important, given the high rates of customer churn between issuers.

What are CFDs?

30 CFDs are a highly geared derivative product that allows traders to take a position on the change in the value of an underlying asset or security. In Australia, they are primarily used by retail investors and are generally distributed OTC,[4] although the Australian Securities Exchange (ASX) also operates a listed CFD market.

31 CFDs allow traders to take a short or long position on changes in the value of underlying assets through entering into a swap-style arrangement with the CFD issuer. A trader entering into a long position (buying a CFD) on BHP Limited, for example, is betting that the price of the underlying share will move higher relative to today's price. In contrast, a trader taking a short position (selling a CFD) is betting that the price will move below today's price.

32 Depending on the issuer, CFDs are available on domestic and international equities, commodities, indices and foreign exchange. Most CFD trades are only held open for a very short time—generally less than one week and, commonly, for only one or two days.[5]

[3] 'White labelling' refers to the practice of a new CFD provider utilising the infrastructure and platform of an existing provider but rebranding it with their own logo, marketing materials, etc. This practice enables new players to enter the market without needing to start from scratch when creating platform and trading infrastructure.
[4] Distribution and trading 'over the counter' refers to the trading of financial products directly between two parties (in this case the CFD issuer and the retail investor) rather than via an exchange (such as the ASX).
[5] Investment Trends, *2009 Contracts for difference report*, July 2009.

What are the risks of CFDs?

33 ASIC regards CFDs as a complex product that entails a number of risks for retail investors, with many of these risks being poorly understood, underappreciated or ignored. As can be seen in Table 2, CFDs share a number of similarities with options and margin loans—notably, the use of leverage and the potential for margin calls or additional collateral to be required. However, CFDs have a number of further unique risks, which are discussed below.

Table 2: Risks of CFDs versus options and margin loans

Loss potential	Margin call	Counterparty risk	Gapping
CFDs			
For short CFDs: High Short positions have unlimited loss potential. This is because there is no upper limit on the price of the underlying asset on which the value of the CFD is based and there is no fixed expiry date. *For long CFDs:* Moderate–High With a long CFD you can lose not only your initial deposit or collateral, but you can be liable for the full face value of the position.	High CFDs are marked to market, usually daily. Potential for margin calls is high since small price movements in the underlying share or security can lead to large changes in the value of the CFD position.	Moderate–High Most CFDs are traded OTC, which means that traders are subject to the risk that the issuer may not fulfil their counterparty obligations. It is very difficult for traders to assess the counterparty risks involved when trading with a particular issuer from the information that is publicly available. ASX-listed CFDs carry significantly lower counterparty risk exposure, due to centralised clearing and settlement processes. The exchange clearing house acts as a counterparty to each trade, minimising counterparty risk.	Moderate–High If market liquidity is constrained or under pressure, the potential for gapping is fairly high.
Exchange-traded options			
If you write an option: Moderate–High Writers of options can lose much more than the premium they receive for writing the option. If the writer does not own the underlying shares or does not have offsetting positions, the losses are potentially unlimited. Unlike CFDs, however, options have a fixed expiry date. If you buy an option: Low–Moderate Maximum loss for an option buyer is the initial price they paid for the option, which is only a small fraction of the underlying asset value.	High Options are marked to market daily. There is a high potential for margin call, since small price movements in the underlying share or security can lead to large changes in the option premium.	Low Similarly to ASX-listed CFDs, all options are traded on a central exchange, which acts as the counterparty for any trades that may fail.	N/A

Loss potential	Margin call	Counterparty risk	Gapping
Margin loans			
Moderate–High If the portfolio value falls to zero, maximum loss potential is the amount of the initial deposit plus the amount of the loan outstanding.	Moderate–High If close to the maximum loan-to-valuation ratio (LVR), a relatively small market fall will trigger a margin call.	Low–Moderate There is a risk that the margin lender will fail to meet their obligations to you—however, these obligations are limited. If the loan is used to invest in instruments that involve counterparty risk, then the investor takes on this additional counterparty risk exposure.	N/A

34 CFDs are a highly geared product. This means traders will generally only be required to commit a fraction of the market value of the underlying assets they are contracting to buy or sell. For example, the issuer may let traders borrow up to 95% of the value of their contract. This results in much greater leverage than is generally permitted with other geared investments such as margin loans. The initial payment (or margin percentage) of 5% of the underlying value of the contract can be characterised as a deposit or cash collateral for the trade or as an outright payment for opening the OTC CFD position, depending on the terms of the CFD.

35 CFD positions are marked to market on a regular basis. The main risk for traders is that if the position moves sufficiently against a trader (meaning the position is losing money and eroding the posted margin), traders can be required to add cash into their account within 24 hours to restore the margin to the required percentage for the particular contract (known as a margin call).

36 As summarised in Example 1, an adverse movement of 10%, for example, in a $100,000 long position with a 5% margin requirement would result in a margin call of $10,000 (twice the amount of margin the investor needed to open the trade). In this worked example, the 10% fall in market value of the asset underlying the price of the CFD results in a $10,000 decrease in the net value of the position (from $95,000 to $85,000). The client would be required to post additional cash or sell a portion of their position to cover this fall. If this is not done within a specified period, the provider will typically close out the investor's position and can pursue them for the additional amounts outstanding.

Example 1: Worked margin call example for a long CFD position

Step 1—Buy CFDs

The current offer price for Beta Limited is $10 per CFD. The CFD issuer requires a trader to deposit a 5% margin. A trader places an order at 11 am to buy 10,000 Beta CFDs, and $5,000 is withdrawn from their CFD account by their provider as the initial 5% margin. The total value of their contract is 10,000 x $10 (the reference price) = $100,000.

In addition, a commission of 0.1% of the total contract value (i.e. $100) is debited from the trader's account.

Step 2—Margin call

By 3 pm that day, the price of Beta Limited has fallen 10% to $9. At the close of business, the CFD provider marks the trader's open CFD position to the market bid price, which is still $9.

To keep the position open, the CFD issuer requires additional margin to be lodged. The additional margin required is equal to the change in the CFD price multiplied by the number of CFDs held. In this instance, the price has fallen by $1 and the trader holds 10,000 CFDs. The CFD provider makes a margin call for $10,000, requiring the trader to immediately deposit more funds into their account.

To keep the position open overnight, the trader also has to pay interest, which is levied against the total contract value. The interest rate is 7%, so the trader's account is debited by (7%/365) multiplied by the end-of-day contract value ($90,000) = $17.26.

At 3 pm the next day, the trader decides to close out their position. The price remains stable at $9. The trader places a sell order for 10,000 Beta CFDs. This order is accepted and filled by their issuer at $9 per CFD, resulting in a contract value of $90,000. To cover the trader's loss, $10,000 is retained by the issuer from the $15,000 margin they have put up ($5,000 initial margin plus the additional margin).

A commission of 0.1% (i.e. $90) is again charged by the issuer on this transaction.

Overall trading outcome

A 10% fall in the price of the underlying asset (Beta Limited) over two days results in a gross return of -200% on the trader's initial capital. After commission and interest are taken into account, the trader's return is -204.1%. In other words, the trader has lost more than double the initial capital they put into this trade. These losses could have potentially been much higher if lack of market liquidity or extreme price volatility resulted in 'gapping' of their sell order, or if their issuer declined to accept their sell trade or would only accept the trade at an inferior price, which OTC CFD issuers may reserve the discretion to do.

Table 3: Worked margin call example for a long CFD position

A Contract value	B Initial 5% margin	C Net value of position (loan size)	D 10% fall in contract value	E New contract value	F Net position value	G Margin call
		(A–B)		(A+D)	(C+D)	(D)
$100,000	$5,000	$95,000	-$10,000	$90,000	$85,000	$10,000

37 Because CFDs are much more highly geared than other leveraged investment vehicles, such as a margin loan, relatively small gains in the underlying investment value can result in much larger returns for CFDs than other leveraged investments. Example 2 shows how small market movements can result in a significant positive return for CFD investors. However, for the same reason, relatively small losses in the underlying investment value can more quickly result in losses that equal or exceed the investor's capital. Because margin loans involve less leverage, it takes much more extreme (and therefore much rarer) market movements to result in a complete loss of capital, whereas with CFDs the likelihood of losing all of, or more than, your capital is far higher.

38 With a long position, the maximum loss is the total face value of the position (comprising the initial margin put up by the trader plus the value of the rest of the position). With a short position, the indefinite duration of the contract means that investor losses are potentially unlimited. With both long and short CFDs, traders are liable to lose much more than their initial investment.

Example 2: Worked example of a CFD trade with a positive return

Step 1—Buy CFDs

The current offer price for Gamma Limited is $20 per CFD. The CFD issuer requires a trader to deposit a 5% margin. A trader places an order at 11 am to buy 5,000 Gamma CFDs, and $5,000 is withdrawn from their CFD account by their provider as the initial 5% margin. The total value of their contract is 5,000 x $20 (the reference price) = $100,000.

In addition, a commission of 0.1% of the total contract value (i.e. $100) is debited from the trader's account.

Step 2—Sell CFDs

At midday Gamma Limited makes an announcement about a new contract and releases greatly improved forward earnings forecasts. By 3.30 pm the price of Gamma Limited has risen by 10% to $22.

The trader decides to close out their position. They place a sell order for 5,000 Gamma CFDs. This order is accepted and filled by their issuer at $22 per CFD, resulting in a contract value of $110,000. The trader's profit from this trade is $10,000.

A commission of 0.1% (i.e. $110) is again charged by the issuer on this transaction.

Overall trading outcome

A 10% rise in the price of the underlying asset (Gamma Limited) within one day results in a gross return of 200% on the trader's initial capital. After commission is taken into account, the trader's return is 195.8%. The trader's ability to realise this return was dependent on their issuer being willing to accept the trades at the prices given, and on the issuer meeting all counterparty obligations to the trader, including crediting the positive proceeds following the closing of a position and releasing unapplied monies to the trader on request.

Table 4: Worked example of a successful CFD trade using a long position

A Contract value	B Initial 5% margin	C Net value of position (loan size)	D 10% rise in contract value	E New contract value	F Net position value	G Gain on trade
		(A–B)		(A+D)	(C+D)	(F–C)
$100,000	$5,000	$95,000	+$10,000	$110,000	$105,000	$10,000

39 Since a CFD is a derivative product, traders do not own the underlying shares or other securities. Research with current and potential CFD traders (discussed in Section B) suggests that this may not be understood well by retail investors considering these products. CFDs generally have no expiry date and the only way that a trader can exit their position is for them to take the opposite side of the contract. For example, a trader with a short position (having sold a CFD) in BHP Limited would have to take an equivalent long position (buy a CFD) in that same share to unwind the position. The trader's ability to exit a position by taking an opposing contract is dependent on the issuer being willing and able to offer that contract when requested to by the trader, which may be problematic in times of extreme volatility or lack of market liquidity.

40 Investing in OTC CFDs also exposes traders to significant counterparty risk, which refers to the potential for the CFD issuer or party on the other side of their position to be unable to fulfil their obligations, resulting in loss for the investor. Traders must rely on CFD issuers to apply monies in their accounts to trades when requested, credit notional dividend and interest cash flows when due, credit any positive proceeds following the closing of a position and release unapplied monies to the trader on request. The complex nature of CFD contracts, the variation in contract terms and conditions between different issuers, and the absence of prudential oversight mean these counterparty risks are very significant. Traders' ability to assess the level of risk associated with trading with different issuers is limited by the lack of publicly available information (such as financial statements) about the creditworthiness and financial standing of issuers.

41 The counterparty risks incurred in trading ASX-listed CFDs are significantly less than for OTC CFDs due to the fact that the Sydney Futures Exchange (SFE) Clearing Corporation provides central counterparty clearing for the ASX listed CFD market. In addition, in the event of the default of one or more Clearing Participants, traders on the ASX listed CFD market may be protected by the Clearing Guarantee Fund.

42 There is also a range of transactional risks associated with potential time lags between orders placement and execution, and with the use of systematised trading strategies. The risk of a time lag between placement and execution is known as ‘gapping’ and describes a situation where the market price of the CFD moves before the order is executed by the issuer (no opportunity to trade), which can result in the trade being executed at a worse price than at the time the order was placed. Although the most obvious causes of gapping are related to market liquidity—periods of high buying or selling pressure, high volatility or a lack of liquidity in the market for a particular CFD—the OTC nature of most CFD transactions means that delays can arise because of issuer difficulties in matching counterparties.

43 Many CFD issuers promote stop-loss or conditional orders as a means of reducing the potential for gapping and as a way of capping losses (or locking in profits). A stop-loss order is a trading strategy that relies on a pre-set price to close out (buy or sell) a CFD position. These orders are sometimes called ‘contingent orders’ as they only take effect once the price of a CFD reaches the level chosen by the trader.

44 Nonetheless, reliance on stop-loss orders can itself be a source of risk. The availability of stop-loss orders can give the impression of providing security against losses, when in fact execution of these orders is generally not guaranteed. This is because the stop loss is triggered at a price nominated by the investor, resulting in the placement of a buy or sell order, which may or may not be executed by the issuer at that price. While some providers do offer guaranteed stop losses for an additional fee, investor research shows that many CFD investors assumed that all stop losses were guaranteed when this is not the case. See Section B for further details on this research.

45 There is a significant possibility that the position will not be closed out at the nominated price, particularly if trading volume is thin (notably, that no one wants the other side of the position) or the CFD price gaps vary widely. Only guaranteed stop-loss orders promise to be completed at the agreed price, but much higher fees are charged and these are not offered by all issuers. Traders who use guaranteed stop losses are also reliant on the issuer to deliver on the guarantee if the stop loss is triggered, which is a further source of counterparty risk exposure. Moreover, most issuers usually require stop-loss orders to be based on trigger prices that are a minimum distance from the CFD price, usually in the order of 5%, so they cannot be used to protect against all losses.

46 An example of the difference between a regular and a guaranteed stop-loss order is illustrated in Table 5. A long CFD with a regular stop-loss order set at $2.37 was triggered when the price of the CFD hit that level but was not executed until the price was $2.10. In contrast, a guaranteed stop-loss order (at the same level) was triggered when the CFD price hit that level and was executed at that level.

Table 5: Worked example of a regular versus a guaranteed stop-loss order

Stop loss	Initial CFD price	Stop loss trigger price	Execution price	Difference between nominated and execution price
Regular	$2.50	$2.37	$2.10	$0.27
Guaranteed	$2.50	$2.37	$2.37	$0.00

Australian CFD market

Market overview

47 According to industry consultation undertaken by ASIC in early 2009, CFD issuers managed approximately $350 million of client money.

48 The market for CFDs is dominated by two issuers. Many current CFD traders have more than one account, so the two largest issuers have account relationships with almost 70% of current CFD traders.[6]

49 Most CFD issuers are local offshoots of UK parent companies that have been operating in the UK market since the mid-1990s. Most CFD issuers are non-banks, and therefore not prudentially regulated by the Australian Prudential Regulation Authority (APRA). Most have backgrounds in futures broking or UK spread-betting, which are retail derivatives similar to CFDs that receive favourable taxation treatment in the United Kingdom. Recently, a number of US-based leveraged foreign-exchange (FX) issuers have also started offering CFDs to Australian investors.

50 The barriers to entry in the OTC CFD market appear to be low, and new entrants often utilise ‘white label’ services from established issuers. Smaller licensees are using and on-selling the services of established CFD issuers.

51 The CFD market is characterised by a high level of client churn. CFD traders cite the following concerns as reasons for switching between issuers:[7]

- issuer pricing models;

[6] Investment Trends, *2009 Contracts for difference report*, July 2009.
[7] Investment Trends, *2009 Contracts for difference report*, July 2009.

- platform issues;
- customer service issues;
- fees and costs; and
- the number and variety of CFDs and other products offered by the issuer.

Issuer business models

52 The industry can be roughly separated into three business/pricing models: market maker (MM), direct market access (DMA) and ASX-listed CFDs.

- MMs quote their own prices for each instrument over which they write CFDs. Traders are expected to be price takers. As a market maker, client orders create a corresponding position, which the issuer may retain or hedge. MMs can write CFDs against synthetic assets such as indices or real assets, even if there is little or no liquidity in the underlying market. As a result they tend to offer a wider range of CFDs than other providers.
- DMA issuers automatically place each client order into underlying markets and therefore do not carry any market risk from the trade. As a result these issuers rely on there being volume in the underlying market in order for them to issue CFDs. Using programs that capture exchange data feeds, traders can actually see the matching orders placed by their DMA issuer into the underlying market.
- ASX-listed CFDs are listed instruments. The SFE, which is part of the ASX Group, is responsible for the registration, clearing and processing of all ASX CFD trades. Trades in ASX CFDs over an ASX-listed equity do not result in trades in the underlying ASX market. The SFE Clearing Corporation acts as counterparty to all ASX CFD transactions, so even though buy and sell orders must be matched for a trade to occur, both buyer and seller contract with the SFE Clearing Corporation and not directly with each other.[8] The ASX listed CFD market is a separate market from the underlying equity market.

We note that one issuer claims to have a hybrid model that provides DMA for most CFD products as well as 'market making' on volume of CFDs offered rather than price. This means that the issuer can make more contracts than is possible given the number of underlying shares or securities in the market.

53 The Appendix to this document contains a more detailed comparison of the features and operation of OTC CFDs (including both MM and DMA CFDs) with ASX-listed CFDs.

[8] For further information about the SFE clearing process and clearing guarantee, see http://www.asx.com.au/professionals/clearing/financial_integrity/guarantee.htm

54 Both MM and DMA issuers offer CFDs OTC. Issuers who use either the MM or DMA pricing model comprise the vast majority of the CFD market. Although the ASX has created listed CFDs, at this stage this market remains small.

55 It is also evident that CFD issuer revenues are derived primarily from client trading activity, either through spreads or commissions or both. This means that issuers have a strong interest in increasing the number of client trades (higher volume) and encouraging larger average trade sizes (higher value). This, in turn, implies a need to encourage existing clients to trade more frequently or in larger amounts or both. It also implies that issuers need a constant stream of new clients.

56 Most CFD issuers do not provide personal financial advice to traders. As is discussed in Section B, only a very small number of CFD traders seek personal financial advice before trading CFDs.

57 There is little evidence that institutional investors make use of CFDs.

Client acquisition

58 CFD issuers' business models appear to rely heavily on acquiring new clients and encouraging increased trading volume among existing clients. CFD issuers are very visible across online, newspaper and television advertising, and at investment seminars, and are increasingly providing market commentary and updates in the media. Many issuers also offer 'webinars' (online seminars that are either pre-recorded or streamed live) on CFDs and trading strategies. Sections C and D contain further information on CFD issuer advertising and seminars respectively. Current and potential traders usually report that seminars and 'word of mouth' are the main ways they became aware of particular CFD issuers.

59 Once investors have signed up with an issuer, CFD issuers use marketing and seminar messages to encourage more frequent trading and also to encourage trading of non-equity CFD products (e.g. FX and commodities).

60 Research shows that there is a high degree of churn among CFD traders. As discussed in Section C, many CFD traders cited concerns about genuine pricing (particularly among those whose provider was a market maker) and platform issues (such as time lags between order placement and execution) as reasons for switching providers.[9] Trader complaints which have been made about these issues are discussed in Section F. The use of promotions and special offers for new accounts (such as cash bonuses of $200 or more for opening an account) also serves to encourage churn between providers.

[9] Investment Trends, *2009 Contracts for difference report*, July 2009.

B CFD investor research

Key points

Qualitative research commissioned by ASIC found that most CFD traders were quite confident in their knowledge and ability—however, further probing reveals some significant gaps in investor understanding.

The ability to maximise returns through leverage is widely perceived by investors as the main benefit of trading CFDs.

The majority of investors do not seek personal financial advice before investing in CFDs. The most commonly used sources of information are seminars and the internet.

Research background and objectives

61 Understanding the profile of investors who trade CFDs, have traded them in the past, or intend to trade them in the future is an important aspect of our review of these products.

62 To sufficiently understand retail investor experiences and expectations of these products, we determined that we needed to supplement existing information with an in-depth qualitative assessment of CFD market drivers and retail investor behaviour.

Qualitative research

Research approach

63 The qualitative research commissioned by ASIC consisted of a series of 30 in-depth interviews with a mix of current, former and future traders of CFDs. It also included a representation of retail investors who had considered trading CFDs but decided not to do so (deliberate non-traders). The in-depth interviews were conducted by Colmar Brunton Social Research (CBSR) over the phone and face to face between 15 December 2009 and 29 January 2010.

Self-assessed knowledge and confidence

64 The study found that current traders displayed a moderate-to-high level of confidence in their ability to trade CFDs. For most traders this confidence in their trading abilities existed when they first started trading CFDs, and grew over time. In many instances this degree of confidence appeared out of step with their understanding of key aspects of how CFDs operate. Furthermore,

once they had begun trading, investors appeared to undertake limited additional investigation into how CFDs work, with any further research focused on specific CFD trades.

65 Despite this, current and former traders often indicated that, based on their share trading history and their investigation of CFDs, they felt well informed and confident enough to start trading CFDs.

> I'm pretty confident. I'd be the first to admit I'm not going to get everything right so I don't go into a trade thinking that it's always going to pay off. I'd call myself educated and understanding what I'm getting myself into but I can see the pitfalls as well. [Current trader]

> To be quite honest with you I didn't think that it was terribly different from trading a share. [Former trader]

66 Many research participants had a long share-trading history before trading or considering trading CFDs. A number of traders and future traders felt that, given their level of experience, CFDs were a reasonably natural progression from the investments they already held. Many traders did not recognise the significant additional risks involved in trading CFDs in comparison to trading shares.

67 All respondents in the study were asked what sort of person they thought would be well suited to trading CFDs and, conversely, what sort of person would not be well suited. The answers to these questions were useful as they reflected the experience of respondents who had actually traded CFDs or who had undertaken serious consideration of trading CFDs. Common responses are listed in Table 6.

Table 6: Suitable CFD investors (as described by respondents)

Investors well suited to trading CFDs	Investors not well suited to trading CFDs
Intermediate–to-experienced share traders who are familiar with the share markets	Novice or beginner share traders
Have experience in making a loss on trades and how this occurs	Investors who are risk averse or conservative
Average intelligence level or financial acumen	Investors who can become emotionally attached to the investment outcome or who experience stress/worry when investments go the wrong way
Ability to tolerate a reasonable level of risk	People who are just attracted by the advertising gimmicks
Have a threshold to avoid stress/emotion when a trade is going the wrong way	People who are gamblers, impulsive or not responsible with their money
Patient	Indecisive investors
Takes the time to learn properly about the nature of the product and the market	
Informed on the stock market and familiar with some of the blue-chip or frequently traded stock	
Confident in their own investment ability	
Full-time traders	
Committed to learning about the products and doing the research	

Trading strategies

68 Current CFD traders utilised a variety of trading strategies, some of which were based on emotion or intuition. Traders reported using ‘gut feeling’, trading on trends, and using highly specific technical analysis or systematised strategies. Most traders described strategies based on some form of technical analysis such as charting or trend analysis. Some traders reported using quite specific strategies, based on software systems or strategies learned at educational seminars, to choose their trades.

69 Many traders in this study had the majority of their market investments in shares and stated they were using CFDs to diversify their portfolio. Many saw CFDs as a way to easily generate additional returns in a shorter time frame. It must be noted that, even if investors allocate only a small proportion of their investment portfolio to CFDs, the very high leverage involved means they are taking on a considerable amount of risk, and they could jeopardise some or all of the rest of their investment portfolio. For example, an investor can use $5,000 to invest in CFDs—however, if the margin requirements on the CFDs they invest in are only 5%, this $5,000 gives them a $100,000 investment exposure. If the investment is not successful, the trader can be liable for the full $100,000 face value, plus any interest or other costs.

70 Several participants in this study were retirees who were using some of their retirement savings to trade CFDs, and one participant was trading CFDs within their self-managed superannuation fund. In addition, prior quantitative research found that approximately 15% of current CFD traders have between 50% and 100% of their investment portfolio in CFDs.[10] These behaviours are a cause for concern for ASIC, as the highly leveraged nature of the product means that small market movements could easily result in margin calls, which traders may be unable to meet due to the lack of additional capital.

Marketing and information sources

71 Research participants reported that CFD issuers were quite prolific in marketing their products. Traders recalled hearing about CFDs from multiple sources, including extensive print advertising in financial newspapers and magazines.

72 In addition to marketing from CFD issuers, many traders first became interested in CFDs via word-of-mouth (including discussions on trading blogs and chat rooms) from other traders they knew. The retail investor network proved quite strong in raising awareness of the emergence of CFDs among share traders.

73 Seminars were attended by over half of the research participants. Seminars attended included those provided by CFD issuers themselves and also those delivered by providers of software and trading systems. Traders reported that these seminars typically provided a good explanation of the product—however, the information was biased towards the positive aspects of CFD trading rather than the risks. There was limited reference to financial experts for advice on the suitability of these products.

74 The main source of information for traders and future traders was the internet. The internet was considered to be the most appropriate place for potential traders to gain information. While the CFD issuer websites were considered to be a good source of information, they were typically less focused on highlighting the potential risks. Traders perceived a lack of independent information on CFDs.

75 Only a few research participants proactively sought information on alternative investment options to CFDs. Very few research participants spoke to any form of financial expert, such as a broker, accountant or financial adviser, when considering CFDs.

76 Several of the research participants had used demonstration or trial accounts provided by a CFD issuer.

[10] Investment Trends, *2009 Contracts for difference report*, July 2009.

Knowledge gaps

77 Despite high self-reported confidence among many traders, this study identified several specific knowledge and understanding gaps among all trader segments.

78 One of the core concepts that traders and future traders did not clearly understand was the different business/pricing model (i.e. MM or DMA) being used by the different CFD issuers and the implications of these models for CFD trading (pricing, liquidity, stop losses etc.). Only a small number of participants in the research were able to articulate which model their issuer was using.

79 There also appeared to be a high degree of confusion about the security offered by stop-loss orders. While approximately half of traders used stop losses, only one participant in the research had used a guaranteed stop loss. Despite this, research participants talked about stop-loss mechanisms in a definitive manner.

80 There was limited commentary from research participants in regard to interest calculations and margin calls. Responses indicated that while these terms and concepts were broadly known, the specifics of how they operate were not well understood.

81 Many future traders believed that CFD trading was similar to trading ordinary shares. The main difference identified between CFD trading and share trading was the bigger opportunity to make a profit within a short time period and the leverage of CFDs. Other key differences were not commonly understood.

82 Finally, there was significant confusion among traders as to how CFDs were regulated. Knowledge-based questions at the end of the discussion found that only four out of 30 research participants were aware that most CFD issuers were not regulated by the ASX.

CFD features and expectations

83 Leverage and the resulting opportunity for higher returns over a shorter time were the most appealing benefits of CFDs according to traders and future traders. This message caught their attention and was the primary reason they commenced trading or considered trading CFDs.

> The main benefits are obviously the leverage you can have, with a small amount of money to control a large amount of stock. It’s inexpensive to trade as well, brokerage is quite cheap and although interest is involved, if you hold them longer than a day when you’re buying that is, it’s still minimal considering the possible benefit you can receive from it. [Current trader]

> A fact that attracted them to me was the opportunity to make a little bit of money and to make it in a short time frame. To be honest with you an analogy I'd use is it kind of felt like share trading on speed. I mean everything just kind of encapsulated in a very short-term time frame and yeah that's what kind of attracted me to it. [Former trader]

84 Only a few participants had previously used a margin loan. Many traders and potential traders did not find margin loans appealing as they preferred to use their own capital rather than 'borrowing to trade'. It was interesting that these respondents did not see leverage in CFDs as 'borrowing to trade'. Some traders also believed that trading CFDs provided greater flexibility compared to using margin loans.

Risks of CFD trading

85 It was acknowledged that the greater potential to maximise returns also resulted in a greater potential to suffer large losses in a short time period, although many traders felt confident that they could implement strategies to avoid this risk. The speed and magnitude of potential losses was a core concern, and traders and future traders were relatively conscious of this risk—however, many traders did not believe they would suffer extreme losses themselves. Most traders felt confident that these risks could be adequately managed by using strategies such as stop losses and systematic selection of trades. Despite these strategies, almost every trader experienced occasions where they lost a reasonable amount of capital on trades.

86 Aside from the risk of loss, very few other risks were mentioned by traders. Counterparty risk was not mentioned by any of the traders in our study. In hindsight, many current and former traders indicated they would have liked a better understanding of the potential risks associated with CFDs before they began trading.

87 Both current and former traders who participated in the research believed that to trade CFDs safely and successfully, individuals should do a reasonably high level of research, and trades should be monitored closely when placed. They believed that a large time commitment was necessary to trade CFDs, even if they had not realised this originally.

Expectations versus experience

88 There were a number of expectations that some traders had prior to actually trading that were not realised. These are summarised in Table 7.

89 As with retail investors generally, CFD traders and future traders placed the onus of responsibility for their investment choices on themselves. They considered that to trade successfully in the CFD market, a trader had to be willing to commit the time and effort to learning and developing a suitable trading strategy.

Table 7: Expectations of CFDs versus trading experience

Expectation	Reality
CFDs are easy to trade and don't require a lot of effort.	Traders found that trades need to be regularly monitored. If no stop loss is used, this monitoring occurs very frequently. When a stop loss was used, there was still a reasonable amount of research and checking that went into most trades.
CFDs generate high returns.	Many traders reported that, overall, they just break even or are just slightly profitable over time. While many saw large returns on individual trades, these were counterbalanced by losses on others.
Trading CFDs is similar to online share trading.	While the platforms are similar to online share trading, traders quickly found out that the interaction with the platform was more substantial and constant, and that the nature of CFDs was quite different to shares.
Education seminars are going to provide the necessary skills for traders and/or access to advice.	A number of traders who had used education seminars still reported having to do a significant amount of learning on the products and ongoing trading.

Implications of investor research

90 These research findings have several retail investor protection implications. There is a divergence between traders' self-reported confidence and understanding and their actual knowledge of key aspects of CFDs. Trader confusion regarding the differences between shares and CFDs, different issuer pricing models and the security of stop-loss orders indicates that traders do not clearly understand the key risks and benefits of CFDs, and so may not be making good decisions about whether or not to trade them.

91 The divergence between traders' prior expectations of CFD trading and their experiences, as outlined in Table 7, indicates that many investors do not have a clear grasp of how CFDs work before they begin to trade.

92 The low utilisation of professional financial advice before investing in CFDs, and the high demand for further education and reliable independent information about them, indicates that the features and operation of CFDs may not be sufficiently understood and that currently available information may be insufficient or deficient.

93 The identification of leverage and the ability to short sell as key attractive features of CFDs suggests that particular attention needs to be paid to ensuring that the possible downsides and risks associated with these product features are adequately appreciated by CFD investors.

94 While half of CFD traders have between 1% and 10% of their investment portfolio in CFDs, approximately 15% have between 50% and 100% of their

investment portfolio in CFDs.[11] The latter group is a cause for concern, as the highly leveraged nature of the product means that small market movements could easily result in margin calls that traders may be unable to meet since they have little or no other investments to draw on. The high degree of churn between issuers, and the reasons cited for that churn, suggests that issuers may be focusing their efforts mainly on acquiring new investors, as discussed in Section A.

[11] Investment Trends, *2009 Contracts for difference report*, July 2009.

C Advertising by CFD issuers

Key points

OTC CFD issuers advertise extensively in traditional media and online.

Our review of CFD advertisements highlighted several issues of concern about the form and content of advertising.

Risk disclosure was generally inadequate either in prominence or in the content of most advertisements reviewed for this report.

Many advertisements relied heavily on asterisks to indicate terms and conditions or qualifiers to headline promotional messages. This reliance on less prominent clarifying disclosure is of concern to us.

Advertisements used promotions and offers to attract investor attention.

Rationale for advertising review

95 As discussed in Section A, advertising is an important mechanism for CFD issuers to recruit new investors, generate interest in CFD trading and create awareness of the product.

96 Because most CFD issuers distribute directly to investors rather than through advisers, the information contained or implied in advertisements is often the first, and may be the only, information that an investor uses to decide whether or not to trade CFDs and which issuer to use.

97 All advertisements we reviewed were from OTC CFD issuers. Our review found that the content of advertisements focused on:

- general features of CFDs (such as leverage or the ability to gain exposure to overseas financial markets);
- specific product features of the relevant issuer (e.g. low spreads, trading software/platform features, demonstration accounts, industry awards won);
- themes of partnership (‘we’ve got you covered’), access (‘trade all the markets’) and opportunities (‘profit in any conditions’); and
- promotions, such as free education seminars, zero-loss trade days and zero commissions for a specified period.

ASIC's approach to advertising reviews

98 At the core of most of the legislative provisions regarding financial product and financial services advertising, as contained in the Corporations Act and the *Australian Securities and Investments Commission Act 2001*, is a fundamental requirement that issuers must ensure that their advertising and conduct is not misleading or deceptive or is not likely to mislead or deceive.

99 We considered the following key legal principles in whether or not a CFD advertisement is misleading or deceptive or is likely to mislead or deceive:

- There is no requirement that the issuer have the intention to mislead, or to show that investors have actually been misled. What is relevant is the likely effect on the investor and whether or not the advertisement is in fact misleading or likely to mislead.
- The likely audience and its characteristics must be identified and it must then be considered whether an ordinary and reasonable member of that audience (i.e. encompassing a range of capabilities, excluding the extremes of that class, being those who are unusually astute and those unusually unintelligent or gullible) is likely to be deceived or misled.
- The overall impression created by an advertisement when viewed for the first time is what counts; individual aspects or messages which form part of an advertisement cannot be assessed on their own.
- The medium in which the advertisement is placed can have an impact on what impression is created in the mind of retail investors and how information is understood.
- Subsequent disclosure is not sufficient to rectify an advertisement that is misleading or deceptive or likely to mislead or deceive when viewed for the first time.

100 In our review we considered advertisements by OTC CFD issuers first published or broadcast between 1 January 2009 and 16 September 2009.

101 In total we reviewed 98 print and television advertisements by four OTC CFD issuers. Most advertisements were targeted broadly, either towards the general public or towards members of the public with an interest in financial matters.

102 The television advertisements reviewed were broadcast on Channel 9 and SBS and in prime-time slots, including during the evening news. While the most popular location for print advertisements was the *Australian Financial Review*, print advertisements were also published in the mainstream newspapers, such as *The Age*, *The Australian*, *The Sun Herald* and *The Sunday Age*.

103 This untargeted marketing presence creates an overall impression for retail investors that CFDs are easy to use. Given the complexity of CFDs, CFD

issuers should take into account their target audience when advertising. This includes consideration of when and where an advertisement is published, as well as its content.

Specific issues identified

Disclosure of risks

104 Risk disclosure was generally inadequate in most advertisements reviewed. Most advertisements made some reference to the risks of CFD trading in general terms—however, it was always in a smaller font and in a less prominent position than the other information in the advertisement.

105 While risk warnings are not mandatory, we consider that they are important given the nature of the risks involved in CFDs—in particular, the real risk of retail investors being liable for losses greater than their initial investment. Also, most advertisements strongly emphasised the potential benefits of CFDs, and so acknowledgement of the risks incurred in order to access these potential benefits is necessary to avoid the misleading impression that these benefits could be obtained without risk.

106 In general, risk warnings need to have greater prominence and express more starkly the risks involved. Specific examples of these issues in the advertisements we reviewed include the following:

- Several issuers disclosed risk warnings in the fine print where they could be easily overlooked.
- One issuer’s warnings disclosed that CFDs were ‘risky’ but did not elaborate on what the main risks were, thus limiting the usefulness and impact of this warning.
- Some issuers had quite extensive and comprehensive risk warnings—however, the effectiveness of these warnings was compromised by their placement in the ‘fine print’.

The dynamic nature of television advertisements needs to be considered when incorporating risk warnings into advertisements. A risk warning displayed in static small text at the bottom of the screen, while the promotional messages contained in the advertisement are conveyed via voice-over or dynamic imagery, is likely to be ineffective and easily overlooked.

Disclosure of fees

107 The majority of advertisements contained very limited or no disclosure of the fees and charges that apply to CFD trading. Some advertisements promoted free products or services that they were offering such as a free

demonstration trading account. A number of advertisements described fees and costs in very general terms such as 'competitive spreads' or 'low cost trading'.

Representations or claims that provide an incomplete picture

108 One key issue arising from our review was the heavy use of asterisks to indicate terms and conditions or qualifiers to specific promotional messages used in the advertisement.

109 This is of concern because often the headline claims are so strong that it is likely that no separate qualification can modify the potentially misleading impression. In addition, the fine-print qualifiers are not sufficiently prominent or do not contain sufficient information to encourage a complete understanding of the limitations of the claims.

110 The trend for referral to the issuer's website to view detailed terms and conditions of promotional offers may also be problematic where there is no indication in the fine print of how the terms and conditions will limit the headline promotion.

111 Some examples follow of inappropriate use of asterisks and qualifiers we found in our review:

- During the period, an issuer ran a series of print advertisements that focused on the benefits of trading with them, including the product feature of automated trailing stop losses. An asterisk was used in the body of the advertisement to refer to a statement in the fine print at the bottom which stated that stop losses were subject to market conditions. In our view, this advertisement is potentially misleading in that it implies that the stop losses will always and automatically come into effect when in fact they are not guaranteed and may not be executed in volatile markets (a significant limitation).
- Another issuer ran several advertisements (both in print and television) promoting a specific trial offer. The print version of the advertisements did not contain any terms and conditions of the offer, and instead referred retail investors via an asterisk to the issuer's website for the offer terms. Similarly, only one television advertisement disclosed a key limitation of the offer (and this was in almost illegible static text at the base of the advertisement).
- Another advertisement contained three lines of promotional messages with a symbol linking to the qualification 'terms and conditions apply' only at the end of the third line. In our view, this disclosure is inadequate. The first two headline promotional statements contained no asterisks or qualifiers, which could create in the viewer's mind the impression that no significant qualifications applied to the offer. This

was not remedied by the symbol linking to the disclosure at the bottom of the advertisement that unspecified terms and conditions apply.

- Another issuer ran a promotion focusing on a commission-free offer. These advertisements noted, via an asterisk that linked to the fine print, that terms and conditions apply and, in most cases, referred readers to the issuer's website for details. The advertisements implied that the offer was quite broad and unrestricted when in fact, based on conditions outlined in some print advertisements, but not others, it was restricted to certain CFDs, for certain time periods and up to a fixed monetary limit. The asterisk does not resolve this issue.

112 All advertisements referred readers to the PDS and most indicated that the PDS should be considered before a decision is made to invest in the product. Generally a web address or telephone number that could be used to obtain the PDS was provided. Although this reference is mandated by law, it is worthwhile to note as, in the execution-only environment, the PDS is the main disclosure document available to potential investors.

Other comments

113 Some issuers sought to emphasise volatile market conditions as a reason to look at trading CFDs. In particular, these advertisements emphasised the ability to use CFDs to profit from market volatility or to make profits despite falling markets. This type of promotion is problematic in that it could have the effect of encouraging retail investors to trade CFDs to attempt to recoup losses without an appropriate consideration of the risks.

D CFD seminar surveillance

Key points

Seminars are a key channel through which OTC CFD issuers acquire new customers.

CFD issuers promote their seminars as educational, although they are primarily a marketing tool. Seminars tended to downplay or not fully disclose the risks of trading CFDs.

Background and overview of findings

114 Given the prominence of seminars as a means for investors to find out about CFDs and for issuers to market CFD products, we considered it worthwhile to attend public seminars by major CFD issuers.

115 ASIC staff attended a total of eight seminars from six different OTC CFD issuers.

116 It was clear to ASIC staff that the central purpose of most seminars was marketing and sales rather than education.

117 Most seminars emphasised the advantages and benefits of CFD trading (particularly through the issuer's particular platform) and devoted limited time to the discussion of the disadvantages and risks associated with trading CFDs.

118 The combination of the sales focus and the minimal discussion of risk is problematic given the obvious lack of trading experience of some retail investors that were attending these seminars. Our analysis of complaints made by retail investors (see Section F) indicated that lack of understanding about the risks of CFD trading was a key factor in many complaints.

119 Our surveillance also raised a number of other concerns, as follows:

- inadequate use of general advice warnings—in many seminars the warning was delivered briefly, quickly and sometimes dismissively;
- CFD seminar presenters fostering an impression that the CFD issuer is working in 'partnership' to maximise the clients' personal wealth through CFD trading;
- incomplete explanation of the complexities and nature of CFDs and inaccurate or incomplete comparisons with other financial products;

- in some instances, seminars were focused on 'up-selling' further training at premium prices; and
- in general, most seminar issuers did not adequately discuss fees and costs (including commission structures).

Specific issues identified in review

120 As previously indicated, our surveillance gave rise to some specific issues. While not all of these issues were technical breaches of legislative provisions, they are examples of conduct we consider to be less than ideal from the perspective of retail investors. Table 8 sets out particular issues observed at the seminars attended.

Table 8: Specific issues observed

Issuer A	Issuer B	Issuer C
Advertising free training when investors must actually open an account to access this Counterparty risk not clearly explained	No general advice warning at start of presentation	Risks of products either not addressed or not properly explained Very minimal discussion of fees and costs (including commission structures)
Issuer D	**Issuer E**	**Issuer F**
No general advice warning at the start of the presentation Offer of free account credit if account opened on night of seminar Fees and costs (including commission structure) not clearly discussed Discussion of risks subordinate to discussion of benefits and advantages of trading CFDs	Sales strategy involved downgrading the virtues of shares to accentuate the power of leverage of CFDs, without adequate explanation about the risks of leverage Unrealistic estimation of likely returns of CFD training Heavy promotion of further educational workshops, which came at significant cost	Downside risks of CFD trading, including the risks of leverage, not adequately covered Risks associated with stop losses not discussed. Client money provisions not accurately explained

E CFD Product Disclosure Statements

Key points

PDSs play a vital role in communicating key information about CFDs to retail investors.

The PDSs reviewed in this section generally did not work effectively as communication documents. In general, we found the information contained in them to be complex, confusing and difficult to read. In addition, several PDSs did not clearly or effectively address some key disclosure requirements under the Corporations Act.

As a result of our review, we have written to a number of issuers about our concerns, and continue to work with issuers to rectify and improve their PDS disclosure.

Rationale for PDS review

121 Given that most CFD traders do not receive personal financial advice, the PDS is critical to both outlining the issuers' obligations to clients and providing the client with necessary information about the product.

122 Our key objective in undertaking this review was to assess how effectively PDSs work as a tool for retail investors to make a decision about whether or not to open a CFD account. As a result, our approach looked at both:

- the effectiveness of PDSs as communication documents; and
- compliance with the other relevant disclosure requirements in the Corporations Act.

123 In general, we found the standard of disclosure in CFD PDSs needs improvement, given their important role in communicating the key features of a product to retail investors, the majority of whom do not have the benefit of personal financial advice. We have had discussions with CFD issuers on disclosure of counterparty risk in PDSs, focusing in particular on how counterparty risk is explained and on the need to enable a prospective retail investor to assess the issuer's financial position—for example, by providing financial statements on request. We are currently engaging with industry on the broader issues raised in this section. In addition, we have written to a number of issuers about specific concerns relating to their PDSs. Some have issued new PDSs as a result and we are currently working with other issuers to rectify and improve their PDS disclosures.

Other related work on PDSs

124 ASIC has recently undertaken consultation with industry in relation to the client money provisions in Pt 7.8 of the Corporations Act (Consultation Paper 114 *Client money relating to dealing in OTC derivatives* (CP 114)).

125 Following on from this consultation, we are issuing Regulatory Guide 212 *Client money relating to dealing in OTC derivatives* (RG 212), which contains guidance on how we expect issuers who deal in OTC derivatives (including CFDs) to comply with client money provisions. In particular, RG 212 clarifies our expectations in relation to disclosure of some aspects of issuers' handling of client money. Our PDS review did not encompass compliance with this guidance as it was not yet released—however, we will monitor CFD PDS disclosures in this area in the future. Our review did reveal several instances where issuers' client money disclosure was a cause for concern, and we have contacted individual issuers to address these concerns.

126 We have also recently undertaken a review of a number of PDSs for capital-protected products and other structured or derivative products marketed to retail investors. The findings of this review will be released shortly in a separate report. As CFDs are a retail derivative product, some of the findings of that review are also relevant to CFD issuers and may assist them to improve their PDSs and meet their disclosure requirements.

Communicating information effectively in PDSs

127 In reviewing PDSs we drew on the Corporations Act and ASIC's good disclosure principles, as contained in RG 168. We also drew on the findings of investor research and the work of international regulators on how disclosure documents can communicate information most effectively. Our review focused particularly on information about risks, benefits and costs.

128 The good disclosure principles are directed towards ensuring that the legislative intention of Pt 7 of the Corporations Act is realised. Paragraph 14.28 of the Explanatory Memorandum of the Financial Services Reform Bill 2001 states:

> … the broad objective of point of sale obligations is to provide retail investors with sufficient information to make informed decisions in relation to the acquisition of financial products, including the ability to compare a range of products.

ASIC regulatory guidance

129 RG 168 contains our views on good disclosure principles, summarised as follows:

- disclosure should be timely;
- disclosure should be relevant and complete;
- disclosure should promote product understanding;
- disclosure should promote product comparison;
- disclosure should highlight important information; and
- disclosure should have regard to retail investors' needs.

Further principles for good disclosure

130 Retail investor research conducted in Australia and overseas into the effectiveness of disclosure documents for financial products shows that many of these documents are often not particularly effective in informing retail investors.

131 Retail investor research, undertaken internationally and in Australia under the auspices of the Financial Services Working Group, has indicated some further features that characterise 'more effective disclosure' for financial product disclosure documents, as follows:

- adopt a clear, logical and consistent document structure;
- use a clean and visually appealing layout;
- provide investors only with 'salient' and relevant information;
- use appropriate language and tone; and
- work with people's behavioural biases.

Key findings of CFD PDS review

132 We reviewed a total of 15 PDSs, issued by 13 CFD issuers.

133 Our review of PDS content and effectiveness focused on the following issues:

- document structure and language;
- length and readability of the PDS;
- clarity of loss warnings;
- clarity of explanation of key characteristics, including issuer pricing model and client money handling;
- clarity of significant risks, including counterparty risk;
- clarity of fees and costs;
- clarity of taxation implications; and
- accessibility of the issuers' PDSs on their respective websites.

Document structure and language

134 In the main, the PDSs reviewed did not have a clear, logical or consistent structure. This was reflected in the large number of sections and an inconsistent structure that required people to flip between sections and look up definitions in the glossary.

135 Most of the documents were excessively long, overly wordy and made limited use of elements of good design. Although attempts were made to group like subjects under similar headings, readers were inevitably required to follow cross-references or access external documents or a website to obtain complete information.

136 The language and tone used in the PDSs tended to be fairly complex. Given that the structure of CFDs is complicated, the language and tone used in many PDSs made it hard for investors to understand the product. While some attempts were made to use simpler descriptions and terms and to reduce the degree of formality, this was not done universally.

Document length and readability

137 Even in terms of their physical dimensions, the PDSs we reviewed left a lot to be desired in terms of their capacity to communicate effectively to retail investors. In most cases, the information was dense, cluttered and the text difficult to read.

138 The PDSs we reviewed average around 65 pages in length (cover to cover). In addition, the PDSs by and large contained small typeface that was often densely packed. This had the effect of making the content more difficult to engage with.

139 The PDSs reviewed were also generally over-laden with technical jargon (e.g. gapping) and ambiguous words or phrases.

Clarity of loss warnings

140 Given the high leverage embedded in CFDs, it is important that a warning about the risk of loss beyond the initial investment be displayed clearly. However, we found that most PDSs failed to highlight the loss warning and distinguish it from other information. More often than not, the warning operated as a perfunctory counterpoint to representations about the virtues of the product.

141 Loss warnings are relevant and important information that should be clearly directed to the attention of retail investors. Where important information is concerned, we consider that the size of the typeface, the layout, the use of colour and graphics, the order in which information is presented, as well as the location and boldness of information, are all relevant to whether or not a

retail investor's attention is likely to be drawn to the information most needed.

142 The PDSs we reviewed, by and large, failed to consider these issues to meet the needs of the retail investor. *It is very important that investors understand that they can be liable for amounts greater than their initial investment if they suffer trading losses.*

Clarity of key characteristics explanations

143 We believe that issuers need to provide clear and simple explanations of the general and issuer-specific characteristics of CFDs, including the issuer's arrangement for client money handling and which pricing model (MM or DMA) the issuer uses.[12] This is important because CFDs are not a commonly understood product. In addition, retail investors need a reasonable information base to compare CFD product offerings between different issuers and across an issuer's product range.

144 We found that there was a high degree of variability across issuers in regard to the clarity and simplicity of explanations provided on key general and issuer-specific characteristics of CFDs.

Key general characteristics

145 All PDSs identified that a CFD was a derivative and did not convey ownership of the underlying asset. However, in our view, only two PDSs presented clear and simple explanations of this characteristic. The clarity of the explanations was aided by the use of direct phrasing.

146 All PDSs identified that the direction of dividend flows and franking credits for share CFDs was different for short and long CFD positions. However, the clarity of the explanation was hindered in some cases by the lack of detail provided as to why this was the case. For example, a couple of PDSs did not clearly explain how dividends are adjusted for tax (franking credits).

Key issuer-specific characteristics

147 The explanations of the various CFD offerings of the issuer, such as CFDs over equities, FX and commodities, were unclear in most PDSs. Although most PDSs tried to simplify the explanations through the use of textual devices such as bullet points or tables, clarity was hindered by the use of superficial explanations, dense paragraphs, cross-referencing to a glossary or covering several different derivative products in the same PDS.

[12] See Section A for an explanation of the different pricing/business models.

148 The explanations of account opening procedures, including any special conditions, were generally clear, as were the explanations of margin requirements, such as initial and ongoing margin requirements and the consequences of not meeting these requirements (a margin call). However, the timing and process for being notified of a margin call, and the time frame in which the margin call must be met, were not clearly explained in a number of PDSs.

149 The explanations of how and when to trade the CFD products offered by the issuer were clear and simple in only one case. A particular issue for clarity and understanding was the provision of incomplete information on trading hours, particularly for offshore markets, and the location of information on order types and placement.

150 The explanation of the order placement and execution process was generally complex and potentially confusing for many retail investors. In one case, this information was contained in the customer agreement rather than in the body of the PDS. Moreover, most explanations of potential lags in trading, order priority and the potential for gapping were very limited.

Clarity of significant risks

151 Issuers need to clearly and simply explain the key risks of trading CFDs to prospective clients. This is important because the risks associated with CFDs are unlikely to be easily appreciated or understood by retail investors.

152 Few PDSs explained the risks using simple language or through the use of clear worked examples. Moreover, none of the risk sections could be described as stand-alone; there were numerous cross-references to other sections of the PDS or to the issuer's website. In a few cases, risk disclosures were scattered throughout the PDS with no cross-references to the main risk section. In some cases, relevant risk information was only detailed in the customer agreement (or terms and conditions) document rather than the PDS.

153 In our view, the explanations of the risks of trading CFDs in the PDSs were complex and relatively abstract. This was particularly the case for counterparty risk. Many PDSs did not explain counterparty risk clearly and prominently. There was a significant variation in terminology used from one PDS to another, making it difficult for investors to compare any differences in risk across different issuers. Prospective CFD traders of an issuer, who were effectively being asked to assess the issuer's credit risk and insolvency potential (i.e. their counterparty risk), would have found it extremely difficult to gauge that risk, let alone understand the description of that risk. Also, in some instances, the products can involve an investor bearing counterparty risk to a material party other than the issuer (e.g. hedging counterparty). This was not clearly or effectively disclosed.

154 We have found poor disclosure of counterparty risk in PDSs to be evident not only in CFD PDSs but also in PDSs for other retail derivative products. Our forthcoming report on PDSs for capital-protected products and other structured or derivative products marketed to retail investors contains further information on our concerns regarding counterparty risk disclosure in PDSs.

155 A particular concern is that there was a great deal of variation in the terminology used to describe a margin call. Various terms were used instead of margin call, including ‘payment of variation margin’, and the explanations associated with these terms were complex and likely to be confusing. Further, explanations of what happens if a margin call is not met, and particularly the risk of being ‘closed out’, were not clear in many documents.

156 Another concern is the complexity of the explanations around gapping, which is the risk that during periods of high market volatility there may be a substantial time lag between order placement and execution, such that the execution price may be significantly lower (or higher) than the price at which the sell (or buy) order was placed. It also was not necessarily clear that a standard stop loss (as opposed to a guaranteed stop loss) was effectively a ‘trigger price’ to place a trade and did not mean that it would be executed at that price.

157 Most of the PDS risk sections could best be described as ‘boiler plate’ lists of numerous possible risks from trading CFDs. In our view, little attempt had been made to provide retail investors with a framework to assess the likelihood and consequences of each risk for them.

Clarity of fees and charges

158 Fees and charges are often key considerations for retail investors when making financial product decisions and research shows that it is often the most difficult information for retail investors to understand.

159 In particular, we consider that issuers need to clearly explain the following fees and charges to prospective clients:

- basic trading commissions;
- specialist trading commissions or additional fees for strategies such as guaranteed stop losses;
- price spreads;
- account fees, such as monthly charges, entry and exit fees or statement fees; and
- interest charges and how they are calculated.

160 The clarity of the explanation of the level and structure of fees and charges in most PDSs was likely to have been inadequate for many prospective clients.

161 While most fees and charges sections contained information on trading commissions, spreads and account-based charges, the way in which the information was presented was likely to be confusing for many prospective clients. In particular, the usefulness of summary tables was compromised by the inclusion of too much or too little detail in both the table and the accompanying explanatory text.

162 The explanation of financing charges was also likely to be confusing. Even though most PDS fees and charges sections contained worked examples for long and short positions, they tended to be fairly complex and used inconsistent terminology. References to the source of the underlying base interest rate were also difficult to find or understand in many cases.

Clarity of taxation

163 All the PDS documents we reviewed contained a section devoted to the taxation implications of trading CFDs. In some cases, the PDS merely stated that CFD trading has tax implications, that taxation legislation is complex and that clients should seek independent taxation advice. We do not believe that such disclosure would satisfy the statutory requirement for the PDS to disclose the significant taxation implications of the financial product. In these instances, we have notified issuers of our concerns, and sought a rectification to the wording in the PDS.

Accessibility of the issuer's PDS on their website

164 We found the accessibility of PDS documents on issuer websites to be unsatisfactory. The two following approaches were observed.

165 The first involved providing a link to the PDS, located at the bottom of the opening page of the website. This means the investor needs to scroll down the opening website page to the bottom of the page. Often the link is embedded in text in a font size smaller than the font sized used for the body of the web page.

166 The second approach involved locating the PDS documents under the 'Open an Account' section of the website. This means the PDS becomes available only after the retail investor begins the process of applying for an account. Furthermore, the approach usually involves three to four clicks of the mouse. Our objection to this presentation of the PDS is that it requires the client to form an informal opinion about the product prior to having access to the PDS. They must advance to the point of opening an account on the basis of the information available on the website and do not have access to the PDS until the point of application.

F Retail investor complaints about CFDs

Key points

ASIC and FOS complaints data indicate that some retail investors trading CFDs in Australia are facing the following problems:

- misguided assumptions regarding the interests and motivations of CFD issuers;
- issuer platform software and administrative issues; and
- perceived issuer misconduct.

Rationale for complaints review

167 This section reviews complaints about CFDs that were referred to ASIC's Misconduct and Breach Reporting team during February 2008–August 2009 and, separately, to FOS during July 2008–August 2009.

168 The purpose of the review is to better understand the problems some retail investors have experienced when trading CFDs (bearing in mind that the complainants thought that these problems were grave enough to escalate to an external complaint). It must be noted that complaints did not necessarily result in findings against the issuer. Some complaints were resolved by agreement, dismissed due to inadequate evidence or remain under current investigation. The findings of this review should not be taken as a summary of findings against issuers but rather of retail investor perceptions and experiences.

169 While not all retail investors necessarily experience these difficulties, this review provides a window on some of the issues associated with retail investors trading a relatively complex product.

Methodology

170 We collected and reviewed 2008–09 data from:

- ASIC's database on complaints regarding CFDs received by the Misconduct and Breach Reporting team; and
- FOS data on complaints regarding CFDs received by the Investments, Life Insurance and Superannuation Division (ILIS Division) of FOS.

171 Our focus was not the final outcome of any complaint made to ASIC or FOS. Our focus was retail investor perception and experience of CFDs with respect to product complexity, trading problems (in terms of software problems and administrative problems), and issuer conduct.

Overview of data

172 While the total number of complaints to ASIC and FOS are not high, they do nonetheless afford cogent case studies, highlighting the problems that some retail investors have been facing—and are likely continuing to face—when trading CFDs in Australia.

173 Some key themes emerge from the two sets of data. These themes may be broadly set out as follows:

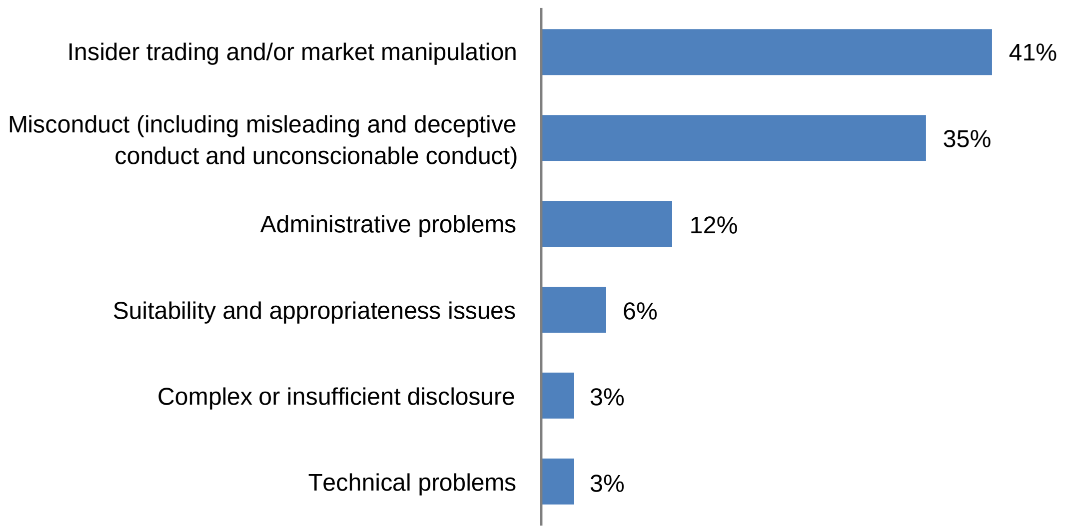
- mistaken assumption about issuers' interest in clients' wealth building—clients sign up under the assumption that the platforms will act in the clients' best interests and, therefore, the platform will do everything in its power to seek trading outcomes that will benefit the clients;
- platform software (technical) issues—clients experience difficulty with the trading platform software;
- platform administrative issues—clients experience difficulty with the administration of their accounts; and
- issuer misconduct—clients experience misconduct (including misrepresentations) on the part of their issuer.

ASIC data

Data breakdown

174 Figure 1 sets out the approximate percentages of total complaints reported under each of the ASIC categories.

Figure 1: Proportion of complaints (%) by dispute type—ASIC data



FOS data

175 The ILIS Division of FOS usually deals with complaints involving complex financial products and services, including CFDs. The usual process by which complaints reach the ILIS Division is as follows:

- the client complains to the product issuer about an anomaly or a conduct issue—internal dispute resolution path;
- the product issuer sends a letter to the client, explaining the circumstances of the anomaly or conduct and referring the matter to FOS should the client wish to further pursue the matter;
- the client complains to FOS—external dispute resolution path; and
- FOS conducts an investigation of matters within its jurisdiction, involving both parties throughout the process—FOS may either find no fault on the part of the product issuer or it may progress the matter to conciliation and/or arbitration.

Data breakdown

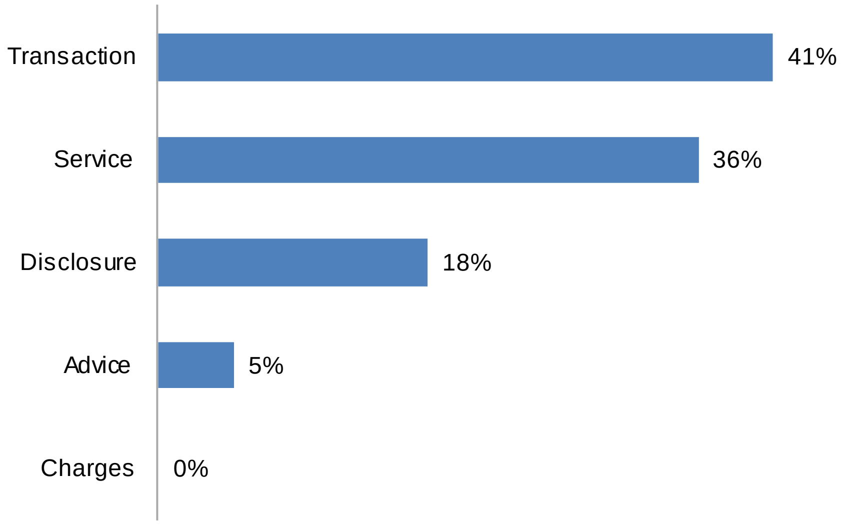
176 Table 9 sets out the issues reported under each category.

Table 9: FOS reported issues by dispute category

Service	Transaction	Advice	Disclosure	Charges
Failure to follow instructions Incorrectly processed instructions Failure to abide by contract clauses Management of client details Incorrect balance provided Loss of documents Loss of safe custody Incorrect claim or bonus charges Handling of complaints Handling of claim Delay in following instructions, processing transactions, assessing claims and handling complaints	Unauthorised transactions Dishonoured transactions Chargebacks Incorrect repayment figures Incorrect benefit payments Incorrect deductible excess	Unsuitable advice Incorrect advice	Misleading and deceptive conduct in relation to product and service disclosure Incorrect product and service information Insufficient product and service information	Incorrect fees/costs Incorrect premiums Incorrect commissions Incorrect deductible excess

177 Figure 2 sets out the approximate percentages of total complaints reported under each FOS category.

Figure 2: Proportion of complaints (%) by dispute type—FOS data



Key findings of complaints review

178 As discussed earlier, our review of ASIC and FOS complaints data revealed a set of issues or themes regarding retail client perceptions, platform performance and management issues and issuer conduct. This section outlines those issues.

Client assumption about issuers' interest in clients' wealth building

179 Many of the complaints showed that clients were generally under the impression that their CFD issuer was there to look after them and help and train them to trade CFDs. This led to an impression in the mind of the retail investor that their issuer was acting in their interest and would proactively help them to learn to make significant amounts of money trading CFDs. This view was generally formed by retail investors that attended promotional seminars.

180 Consequently, a number of complaints were made when the traders lost money and felt that the issuer had not done enough to help them, given the impressions they formed in the sales phase of the product cycle.

181 Part of the reason for this mistaken impression may also reflect the level of financial literacy and trading ability of some of the clients. CFD issuers are not required to take into consideration the personal circumstances of their clients before opening an account.

Platform software (technical) issues

182 The kinds of technical problems investors are encountering include delayed execution of buy or sell orders, incorrect orders being placed against accounts, orders not being executed and so on. While in most contexts, these sorts of bugs in software performance may be brushed off, where CFD trading is concerned, they may lead to significant losses due to the high leverage involved.

Platform administrative issues

183 Platform administrative issues generally involve the automated or manual administration of investor accounts, including delayed responses to investor instructions or queries regarding the administration of investor accounts. This may include incorrect account transactions, failure to provide correct invoices and so on. Some clients experienced administrative issues that resulted in incorrect or inaccurate account-keeping, misunderstandings and actions by issuers leading to losses.

Issuer misconduct

184 Issuer misconduct may include unconscionable or misleading or deceptive conduct on the part of the issuer and their authorised representatives. The ASIC and FOS complaints data reveal alleged misconduct only. There were several instances where complainants alleged they were misinformed by their issuer in relation to key aspects of CFDs in general or the issuer's product in particular.

G Future action

185 We are committed to undertaking further work to address the risks faced by retail investors in CFDs, to address our investor protection concerns and to improve the overall operation of the OTC CFD market. Table 10 below outlines how each of these actions address specific risks faced by retail investors in OTC CFDs.

Client money

186 We are releasing, together with this report, Regulatory Guide 212 *Client money relating to dealing in OTC derivatives* (RG 212). This provides guidance for OTC derivative issuers on:

- the treatment of client money which is paid to, or left with, an issuer;
- the timing and basis of any payments out of the client money account;
- any use of client money to meet an issuer's trading obligations for other clients; and
- the treatment of interest earned on client money.

Monitoring and addressing compliance issues in advertisements, disclosure and conduct

187 We will continue to actively monitor CFD issuers' advertisements, disclosure documents, seminars and conduct, and the volume and nature of complaints made to ASIC regarding CFDs. In particular we will continue to check that the key features, risks and benefits of CFDs are accurately represented to investors by issuers. We have already raised specific concerns that we have with several issuers, and worked with them to rectify deficiencies in their disclosure documents. Should our monitoring raise any new areas of concern, we will raise these with issuers, and/or consider taking enforcement actions, such as issuing stop orders on defective PDSs.

188 Given the complexity of CFDs, CFD issuers should take into account their target audience when advertising and promoting seminars. This includes consideration of when and where an advertisement is published, as well as its content.

Enhanced disclosure standards

189 To address some of our broader concerns regarding CFD PDSs, we propose to introduce disclosure benchmarks for OTC CFDs. A consultation paper outlining our proposals will be released for public consultation in the future. Compliance with the benchmarks would not be mandatory, but PDSs must address the benchmarks on an 'if not, why not' basis.

190 These benchmarks will address concerns we have regarding gaps in disclosure and will help improve standards of disclosure across many CFD PDSs. For example, we will recommend an enhanced disclosure benchmark on issuers' policies on assessing the suitability of investors to trade CFDs. We are also considering benchmarks to improve disclosure of issuers' policies on making and communicating margin calls and CFD trading when trading in the underlying asset is suspended. Adoption of the benchmarks will improve the usefulness and effectiveness of CFD PDSs, enable investors to better compare the products offered by different issuers and contribute to an improved investor understanding of key aspects of how CFDs operate, and the risks and benefits involved.

Making clear and independent information available to investors

191 We are publishing an investor guide to CFDs to improve retail investor understanding and to address the large and unmet investor need for clear, independent and accessible information about this product. This investor guide will be released shortly following the publication of this report. It will be available to download from ASIC's consumer website FIDO. We encourage CFD issuers to refer clients and potential clients to this investor guide.

Client suitability

192 We are only aware of a few OTC CFD issuers with clear and consistent client suitability policies. Given the findings in this report regarding retail investor knowledge and understanding of CFDs (see Section B), we strongly encourage all OTC CFD issuers to develop client suitability policies and procedures.

We will consider other regulatory solutions

193 Table 10 outlines how we plan to address the risks faced by retail investors when investing in CFDs. We will continue to review all aspects of OTC CFDs. Should we feel that additional mechanisms are required, we will pursue these, which may include proposing law reform.

Table 10: How we are addressing the risks faced by retail investors in OTC CFDs

Risk for retail investors	How we are addressing this risk
The potential for great losses due to high leverage ratios	Monitoring and addressing compliance issues in advertisements, disclosure and conduct to ensure this risk is communicated clearly to investors Publication of an investor guide which explains and highlights this risk, including the risk of an investor losing much more than their initial capital
Unanticipated or poorly managed margin calls	Monitoring and addressing compliance issues in advertisements, disclosure and conduct to ensure the risk of margin call is communicated clearly to investors Enhanced PDS disclosure benchmark encouraging issuers to explain their margin call policy and identify any discretions they have Publication of an investor guide which explains how a margin call works and what it could mean for an investor
Significant counterparty risks (i.e. the risk that the issuer or another party fails to meet their obligations to the investor)	Release of RG 212, which provides guidance on how ASIC expects issuers to comply with the client money provisions of the Corporations Act Monitoring and addressing compliance issues in advertisements, disclosure and conduct to ensure that counterparty risk is communicated clearly to investors Enhanced PDS disclosure benchmarks to encourage issuers to disclose how they manage liquidity so as to ensure they can meet their obligations to clients Publication of an investor guide which explains what counterparty risk is, and what it could mean for investors
'Gapping' that can result from time delays between placement and execution of trader orders	Monitoring and addressing compliance issues in advertisements, disclosure and conduct to ensure this risk is communicated clearly to investors Publication of an investor guide which explains and highlights this risk and the implications for investors
Limitations of the explanation of key risks and operational features of CFDs in many disclosure documents	Release of RG 212, which provides guidance on how ASIC expects issuers to disclose more clearly how they comply with the client money provisions of the Corporations Act Enhanced PDS disclosure benchmarks to raise the standards of CFD PDS disclosures Publication of an investor guide which provides clear, independent and accessible information about these products
The risk that CFDs are likely to be an inherently unsuitable investment for some retail investors	We are only aware of a few OTC CFD issuers with clear and consistent client suitability policies. Given the findings in this report regarding retail investor knowledge and understanding of CFDs (see Section B), we strongly encourage all OTC CFD issuers to develop client suitability policies and procedures. Enhanced PDS disclosure benchmarks encouraging issuers to spell out clearly how they identify whether clients are suited to trading CFDs Publication of an investor guide which aims to help investors make an informed decision as to whether CFDs are a suitable investment for them

Appendix: Comparison of exchange-traded and OTC CFDs

Table 11 contains a more detailed comparison of the operation, features and risks of exchange-traded and OTC CFDs. While there are many similarities between exchange-traded and OTC CFDs, there are also some significant differences. In particular, trading OTC CFDs exposes investors to significantly more counterparty risk than trading on exchange, where the CFD contract is standardised and listed and the exchange clearing house acts as the counterparty to all transactions.

Table 11: Comparison of exchange-traded and OTC CFDs

		OTC CFDs	
	Exchange-traded CFDs	**MM CFDs**	**DMA CFDs**
Operation	ASX-listed CFDs are listed instruments. The ASX listed CFD market is a separate market from the underlying equity market. Trader orders are entered directly into the ASX listed CFD central market order book where they are matched with opposing orders on a strict price/time priority. The SFE, which is part of the ASX Group, is responsible for the registration, clearing and processing of all ASX CFD trades. The SFE Clearing Corporation acts as counterparty to all ASX CFD transactions, so even though buy and sell orders must be matched for a trade to occur, both buyer and seller contract with the SFE Clearing Corporation and not directly with each other.[13]	MMs quote their own prices for all CFDs they offer. The price offered by the MM may or may not diverge significantly from the market price of the underlying asset. Traders are expected to be price takers. As an MM, client orders create a corresponding position, which the issuer may retain or hedge. MMs can write CFDs against synthetic assets, such as indices or real assets, even if there is little or no liquidity in the underlying market, or an underlying market in the asset does not exist (in the case of indices).	DMA CFD prices correspond directly to the prices in the underlying market. DMA issuers automatically place each client order into underlying markets, and therefore traders are price makers. Issuers do not carry any market risk from the trade. As a result, these issuers will only offer CFDs over an asset if there is sufficient volume in the underlying market. Using programs that capture exchange data feeds, traders can see the matching orders placed by their DMA issuer into the underlying market.
Pricing	Traders are price makers. CFD prices closely follow the market price of the underlying asset, although there may be divergence if there is limited market liquidity.	Traders are price takers. CFD prices are determined by the issuer and may diverge from the market price of the underlying asset.	Traders are price makers. CFD prices are determined directly by the market price of the underlying asset.

[13] For further information about the SFE clearing process and clearing guarantee, see http://www.asx.com.au/professionals/clearing/financial_integrity/guarantee.htm

	Exchange-traded CFDs	OTC CFDs: MM CFDs	OTC CFDs: DMA CFDs
Contract specifications	Standardised by the exchange.	Varies depending on the issuer. Contracts are between clients and individual issuers. They are not standardised or transferable.	Varies depending on the issuer. Contracts are between clients and individual issuers. They are not standardised or transferable.
Replication of trades in the underlying asset market	Not necessarily. Traders have the option, however, of requesting exchange for the underlying asset when closing a trade.	At the discretion of the issuer.	Yes.
Range of CFDs offered	Limited. CFDs are currently offered over some ASX-listed equities, two indices and one commodity.	Extensive. As market makers are not required to enter trades into any underlying market, they can write CFDs over any asset—real or synthetic (as is the case with an index). In addition, they are not constrained by liquidity in trading in the underlying asset, although most issuers require extra margin or charge additional fees for CFDs over thinly traded assets.	Somewhat limited. As DMA providers hedge all trades in an underlying market, they can only offer CFDs over listed assets, although this can include assets listed on foreign exchanges. Many providers decline to offer CFDs over assets that are thinly traded or demand much higher margin levels for these trades.
Margin requirements	Varies depending on the CFD. Initial margins for ASX CFDs are expressed as dollar amounts per CFD, rather than as percentages. Margins for index CFDs tend to be lower than for other CFD types.	Varies depending on the CFD, generally ranging from 0.5% to 100%, or in the range of 5% to 20% for equity CFDs, with lower margins for FX and index CFDs.	Varies depending on the CFD, generally ranging from 4% to 100%, or in the range of 5% to 20% for equity CFDs, with lower margins for FX and index CFDs.

	Exchange-traded CFDs	OTC CFDs MM CFDs	 DMA CFDs
Significant risks	Risk of margin call if the value of the underlying asset moves sufficiently against the investor. Risk of loss that equals or exceeds the investor's initial investment if the value of the underlying asset moves sufficiently against the investor. Gapping or market illiquidity, if there is significant market volatility or lack of traders in the market.	Risk of margin call if the value of the underlying asset moves sufficiently against the investor. Risk of loss that equals or exceeds the investor's initial investment if the value of the underlying asset moves sufficiently against the investor. Gapping or market illiquidity, if there is significant market volatility or lack of traders in the market. Risk of unfavourable or opaque pricing, relative to the underlying market. Risk of pricing re-quotes. Risk that the issuer defaults on their obligations to investors (counterparty risk). This risk could result in payments due to investors not being made, orders not being filled or executed, or proceeds of successful trades not being returned to investors.	Risk of margin call if the value of the underlying asset moves sufficiently against the investor. Risk of loss that equals or exceeds the investor's initial investment if the value of the underlying asset moves sufficiently against the investor. Gapping or market illiquidity, if there is significant market volatility or lack of traders in the market. Risk that the issuer defaults on their obligations to investors (counterparty risk). This risk could result in payments due to investors not being made, orders not being filled or executed, or proceeds of successful trades not being returned to investors.

Key terms

Term	Meaning in this document
AFS licence	An Australian financial services licence under s913B of the Corporations Act that authorises a person who carries on a financial services business to provide financial services
AFS licensee	A person who holds an AFS licence under s913B of the Corporations Act
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ASX	Australian Securities Exchange
CFD	Contract for difference
conditional order	An order that is only triggered once a specified condition is met—for example, the price of a CFD reaches a certain level
Corporations Act	*Corporations Act 2001*, including regulations made for the purposes of that Act
DMA	Direct market access
FOS	Financial Ombudsman Service
FX	Foreign-exchange
ILIS Division	Investments, Life Insurance and Superannuation Division of FOS
LVR	Loan-to-valuation ratio
MM	Market maker
OTC	Over the counter
PDS	Product Disclosure Statement
RG 168	An ASIC regulatory guide (in this example numbered 168)
SFE	Sydney Futures Exchange
stop loss	A stop-loss order, which is designed to close out a client's trade once the market price reaches a certain level. Stop-loss orders are a type of conditional order used by traders to try to limit their potential losses

Term	Meaning in this document
trader (or retail trader)	People who currently trade CFDs or have done so in the past or who may consider commencing trading CFDs in the future. The term does not refer to professional traders who may trade CFDs or other financial instruments as part of their employment
white labelling	The practice of a new CFD provider utilising the infrastructure and platform of an existing provider but rebranding it with their own logo, marketing materials, etc

Related information

Headnotes

CFD advertising, contracts for difference, counterparty risk, exchange-traded CFDs, gapping, margin call, risk disclosure, stop-loss orders, over-the-counter derivatives

Regulatory guides

RG 168 *Disclosure: Product Disclosure Statements (and other disclosure obligations)*

RG 212 *Client money relating to dealing in OTC derivatives*

Legislation

Australian Securities and Investments Commission Act 2001

Corporations Act

Financial Services Reform Bill 2001 (Explanatory Memorandum)

Consultation papers and reports

CP 114 *Client money relating to dealing in OTC derivatives*