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Dear Ms Yul

OVER-THE-COUNTER CONTRACTS FOR DIFFERENCE: IMPROVING DISCLOSURE FOR RETAIL INVESTMENTS

AxiCorp Financial Services Pty Ltd welcomes the opportunity to provide comments on Consultation Paper 146.

1. Opening Remarks

We are the holder of AFSL number 318232, and under our licence we deal and make a market in foreign exchange contracts and derivatives in the form of foreign exchange contracts and contracts for difference (CFDs) which are based on indices, bullion (gold and silver) and a commodity (oil). We do not issue share CFDs.

We commenced operations in December 2007. Whilst we may be regarded as a relatively new entrant to the CFD market, I have been involved in it since 2001 when I headed up the management team of a foreign company that was one of the first to

introduce CFDs into Australia. As ASIC has pointed out on a number of occasions, the CFD market has grown considerably since its inception in Australia and I, and our management team, are experienced and well across the issues that the regulator and participants must confront in order to maintain confidence in the integrity of the market.

Against this background, we provide the following comments on the Consultation Paper.

2. Overview

A CFD is a derivative within the meaning of that expression in section 761D of the Corporations Act. It allows investors to speculate or hedge on the underlying instrument or asset movements, without the need for ownership or physical settlement of the underlying instrument. A CFD generally mirrors the underlying instrument based on its price movement.

The Consultation Paper essentially deals with those CFDs that are traded over-the-counter (OTC) and proposes, wrongly in our view, that exchange-traded CFDs should be excluded from the proposed regulatory measures.

It is stated in RG000.1, after acknowledging that the expression "contract for difference" is not defined in legislation that:

> "This Regulatory Guide applies to leveraged derivative products that allow investors trading in them to take a position on the change of the value of an underlying asset, whether they are marketed as CFDs or by some other name"

The assets or instruments underlying CFDs come in various forms and can be any financial asset or instrument. But the existing Australian market comprises shares, indices, commodities, currencies and bullion, and this raises the question as to whether a one size fits all approach to the issues raised in the Consulting Paper is appropriate.

In the light of RG000.1, we assume that margin foreign exchange contracts are included within the scope of the Paper, as they have the same legal characteristics as CFDs. However, we must point out that our experience is that investors in margin foreign exchange contracts have different profiles, trading patterns and experience levels than those investing in share CFDs, which constitute the area of most concern to ASIC in its Report 205 and the Consultation Report. We, therefore, submit that ASIC should consider a more "light touch" client suitability policy to foreign exchange prospective participants.

Also, relevantly, the Corporations Act distinguishes between retail and wholesale (including sophisticated) clients. CFD providers do not generally distinguish between them, and we do not, because of the need to simplify internal processes.

Importantly, CFDs are counterparty transactions involving the issuer and the client and existing Commonwealth and State legislation provide mechanisms for correcting any imbalance between the bargaining situations of the respective parties. Also, there is a risk/reward premium that is part of any investment or trading activity that has to be taken into account.

As the Chairman of ASIC said in his address of 21 July 2010 titled, "Implications of a fast changing regulatory landscape" when speaking of the efficient markets hypothesis:

> "The underlying philosophy of these theories and hence of the Act is to allow markets to operate with a minimum of interference and to allow risk and investors to price risk. Regulation should be kept to minimum and directed towards:
>
> - using disclosure as the way to keep markets, investors and consumers informed; and
>
> - prohibiting certain types of misconduct (for instance, insider trading and market manipulation)."

He went on:

> "ASIC's role in this regime (see section 1(2) of the ASIC Act) is limited and focused on oversight and enforcement of regulated conduct. I liken our role to a road traffic authority or police force. Basically ASIC oversees and enforces the laws and couples that with extensive work to guide and educate those who travel on the roads"

In short, ASIC's role is not to protect investors against losses.

We believe that in performing its role ASIC has to be concerned that it does not impose excessively onerous restrictions and controls on CFD issuers that are not imposed on other financial product issuers. Telling a provider that it has to hedge a certain percentage of its transactions, that it has to have a certain number of counterparties of a standard acceptable to ASIC with which it hedges etc, may be argued as excessive regulatory intervention. ASIC has to be careful not to impose standards that lead to excessive compliance costs, anti-competitive effects, market concentration and barriers to entry.

The reasons given in the Paper for excluding exchange-traded CFDs is that investors are provided with appropriate protection against counterparty failure, which protection may or may not be available in the case of OTC products. But counterparty protection is only one of the areas on which ASIC is focussing and this approach assumes that clients who deal in exchange-traded CFDs do not require any client suitability protection. There is no basis for this assumption and the exclusion of Exchanges from having to comply with enhanced disclosure and other requirements is selective and anti-competitive.

In short, there is no logical basis for their exclusion.

Before we answer the questions posed in the Consultation Paper, we make some general comments in relation to counterparty risk.

Counterparty risk for margin foreign exchange contracts and CFDs fall into three categories:

1. The risk that the product issuer is unable to meet its contractual liabilities and obligations to clients.
2. the risk that the product issuer is unable to meet its contractual liabilities and obligations to its counterparties with whom it enters into hedging arrangements (offsetting transactions).
3. the risk that the counterparty is unable to meet its contractual liabilities and obligations to the product issuer.

The way a product issuer will manage the risk associated with each financial product overlaps with the way it manages market risk, its process for managing traders and its processes for conducting due diligence investigations of hedging counterparties. These risks will be prioritised and managed in accordance with information provided to ASIC at the time of applying for a licence and in accordance with compliance procedures adopted by the product issuer and documented in compliance plans.

Fundamental to the issuer's risk management will be the hedging of its exposure to clients and the processes to determine when to hedge and when not. The product issuer will manage product exposure by various methods, including the setting of trade limits on all clients, the monitoring of the profit and loss positions on a live basis, and, the use of risk models.

Disciplines will be imposed on traders who are involved in hedging activities and they will be required to use professional risk management tools, such as the effective use of stop losses that follow recognised trading principles.

We agree in principle with the proposed regulatory approach to the control and management of counterparty risk that is the basis of Benchmarks 3, 4 and 5.

We would not, therefore, support the alternative approach of requiring an issuer to hold capital or surplus funds additional to the existing financial requirements of its licence, as to do so would be anti competitive, lead to market concentration and create

barriers to entry in the market for well managed, efficient and effective medium sized enterprises, who provide liquidity to the market.

Turning to ASIC's questions and our feedback.

3. The Benchmarks

Scope of the benchmarks

B1Q1: The proposed scope of the benchmarks is not wide enough. For the reasons stated above, exchange-traded CFDs should be included.

B1Q2: As also explained above, it is imperative that ASIC recognise the nature and different characteristics of each CFD and adopt a balanced approach. Excessive investor protection may result in some issuers exiting the market or the exclusion of them from offering particular products, thus increasing concentration in a market that should provide investors with a wide choice. Excessive market concentration will not benefit investors.

B1Q3: Whilst we acknowledge generally that the proposals (including the benchmarks) will improve behaviour, and improve performance in the market, it is problematic whether they will affect investor behaviour in a manner that ASIC would want. We welcome the issue of the ASIC investor guidance "Thinking of trading contracts for difference (CFDs)" as an education tool. Education also comes from disclosure documentation. But no matter what you do, you will not prevent losses and you will not prevent people who cannot afford losses engaging in transactions: see Sonray, Storm and Westpoint.

B1Q4: It is our belief that the existing licensing conditions are adequate. (see below).

B1Q5: We do not believe any further guidance is required.

The Proposed Benchmarks

Before answering the ASIC questions, we make the following comments.

Benchmark 1: Client Suitability

We agree that an issuer must maintain and apply a written client suitability policy. But it must relate specifically to the products that it issues and will vary, we believe, in relation to each financial instrument or asset upon which the CFDs are based. We agree that information must be sought in relation to a potential client as of the assets, previous trading experience (including trading volumes) and details of those with whom they have traded, and that the issuer should have a practising account system in place.

However, we do not believe that an issuer should be required to act as an examiner and put in place a prospective investor knowledge test. Furthermore, what investor will acknowledge that they are not prepared to monitor and manage the risks of trading. It should be noted that issuers of CFDs do not generally provide personal financial advice, nor should they be required to do so. Overseas regulators do not require issuers of CFDs to go to these lengths.

In short, we repeat that it is not the issuer's responsibility to protect a potential client against losses. Its responsibility is to warn them properly of the dangers and risks associated with their investment. In this respect, as stated above, ASIC has a role and we welcome its guide.

Benchmark 3: Counterparty risk – Hedging

A CFD issuer will not hedge its exposure to all liabilities to clients. But a prudent CFD issuer will have appropriate policies in place to determine when and when not to hedge and this will depend, inter alia, on its exposure to the client in the transaction and its risk profile that will have been constructed by reference to its financial position.

There can be no argument that the issuer's policy should be disclosed in the PDS and updated, using its website as an appropriate location. However, it should be acknowledged that issuers may have objection to providing the information required by RG000.52. If by requiring information as to the nature and extent of the hedges, ASIC will be requiring some quantification, legitimate objection might arise from a business standpoint. The nature of the hedges will generally be in the form of entering into offsetting transactions with the counterparty and the extent of these will be determined by the issuer's policy in relation to its decision when to hedge and when not to hedge. Where an issuer uses a risk model, it may be prepared to disclose that model. But there should not be any compulsion to do so.

We have difficulties in a CFD issuer being compelled to name its counterparties.

First, there is the issue of obtaining its consent under section 1013K of the Corporations Act to the issue of a PDS in which statements about it are made. The counterparty will want its lawyers to vet the PDS, leading to additional costs, which are passed on to the issuer.
Secondly, and more importantly, hedging transactions are solely between the issuer and the counterparty and the latter may have legitimate commercial reasons for not disclosing the relationship.

We should, therefore, have no objection to a benchmark proposal that requires an issuer to disclose the criteria or standards a counterparty must meet and the compliance measures the issuer takes in the monitoring of a counterparty.

In general we believe that a hedging counterparty should meet the following criteria:

- a good reputation and be a leader in the industry;
- it must be financially strong, well capitalised and have the financial resources to offer the requisite margin and leveraging support;
- it must exhibit first class understanding of the foreign exchange, securities and commodities businesses;
- it must have efficient and effective front office and back office systems

(including accounting and reporting supported by first class systems and interface and internal control);

- it must operate and administer secure and segregated client accounts.

Benchmark 4: Counterparty Risk – Capital

The only comment we wish to make is in relation to RG000-64. It is not clear what financial statements are to be made available to prospective investors. Are they to be the last audited financial statements? If so, these statements are lodged with ASIC and we should have thought that a statement in the PDS as to where a prospective investor can obtain them should be sufficient.

Benchmark 5: Counterparty Risk – Liquidity

The only basis for imposing a requirement additional to that included in the present licensing conditions (3 months) is that the exposure of the issuer to clients is greater than other financial products. We are not sure that this is true.

The forecasting of anticipated revenue and liabilities in this industry is difficult for any period and will not ensure that an issuer has sufficient resources to manage liabilities over that period. We ask the question, would such a requirement have prevented the Sonray losses? Clearly, the answer is no.

We now answer the specific questions.

B2Q1: ASIC has identified all relevant benchmarks.

B2Q2: For a benchmark approach to be relevant and achieve its objectives it is important that it be carefully framed and be product specific. The danger of such an approach is that over time, it will become prescriptive and will not lead to clear, concise and effective disclosure.

B2Q3: We believe the existing period of 3 months is sufficient and there is no reason to single out CFD issuers for special treatment. see above

The 'if not, why not' approach

B3Q1: See our response to B2Q2.

B3Q2: Other than as stated in our introductory remarks to B1, we cannot see that there are any practical problems for CFD issuers in meeting ASIC disclosure expectations.

B3Q3: Even if we are required to implement your proposed approach to guidance and all your proposals in full, we do not foresee any changes in the products we issue or to the structure of our business.

B3Q4: If your proposed approach to guidance and all your proposals are adopted in full, changes will have to be made to our disclosure documentation and practices. We cannot at this stage assess the time involved and costs.

Generally, we believe that the existing disclosure regime, particularly in relation to product disclosure statements, works in relation to margin foreign exchange contracts and CFDs, other than those based on shares.

Ongoing Disclosure

B4Q1: Subject to our concerns about the effective operation of the benchmarks, we do not see any practical problems with ongoing disclosure and performance and we would do what you have asked.

B5Q1: Subject to our concerns about the effective operation of the benchmarks, we do not see any practical problems with ongoing disclosure and performance and we would do what you have asked.

Timing for implementing disclosure against the benchmarks

B6Q1: We have no objections to the timetable.

B6Q2: We cannot see any practicable problems in complying with the timetable.

B7Q1: We do not see any objection to the timetable.

B7Q2: We cannot see any practicable problems in complying with the timetable.

Advertising OTC CFDs

B8Q1: We do not believe there are any other statements that should be included in advertisements for CFDs.

B8Q2: The proposed approach to advertising should not cause any practical difficulties for our business.

B8Q3: No.

B8Q4:

(a) Only minor changes would be involved.

(b) It is difficult at this stage to estimate the time and the costs involved.

We should be happy to discuss any aspect of our submission with you.

Yours sincerely

Goran Drapac