REPORT 246

Response to submissions on CP 146 OTC CFDs: Improving disclosure for retail investors

August 2011

About this report

This report highlights the key issues that arose out of the submissions received to Consultation Paper 146 *Over-the-counter contracts for difference: Improving disclosure for retail investors* (CP 146) and details our response to those issues.

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 licence 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.

This report does not contain ASIC policy. Please see Regulatory Guide 227 *Over-the-counter contracts for difference: Improving disclosure for retail investors* (RG 227).

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Overview/Consultation process

1 Contracts for difference (CFDs) are leveraged derivative products that allow investors trading in them to take a position on the change in the value of an underlying asset.

2 In 2009, ASIC conducted a 'health check' of the CFD market, including examining issuers' business models, disclosure documents and advertising, and investors' attitudes, behaviours and experience. Our findings are summarised in our report *Contracts for difference and retail investors* (REP 205).

3 From this work, we became concerned that many retail investors do not fully understand the risks of trading in CFDs. This is partly due to the inherent complexity of the subject matter. However, we have also found that disclosure documents are often difficult to understand, and do not highlight key information.

Note: This report uses the term 'retail investor' to refer to people who trade in CFDs, with the same meaning as 'retail client' as defined in s761G and 761GA of the *Corporations Act 2001* (Corporations Act).

4 In Australia, most CFDs are not traded on an exchange—they are issued as over-the-counter (OTC) products. They are generally marketed to, and traded by, retail investors. Many of these retail investors do not seek or receive financial advice before deciding to invest, instead relying on advertising and disclosure materials to inform their decision to invest.

5 To address these concerns, we have developed disclosure benchmarks for OTC CFDs. Our objective in doing this work is to improve the quality of disclosure available to retail investors about OTC CFDs, in order to maximise the chance that they will make an investment decision relating to this product that is appropriate for them.

Our proposals

6 We released Consultation Paper 146 *Over-the-counter contracts for difference: Improving disclosure for retail investors* (CP 146) in November 2010. In CP 146, we sought feedback on a proposal to apply the benchmark disclosure model to disclosure documents for OTC CFDs.

7 We first introduced benchmark disclosure requirements for unlisted, unrated debentures in October 2007: see Regulatory Guide 69 *Debentures and unsecured notes: Improving disclosure for retail investors* (RG 69). Since then, we have introduced similar requirements for mortgage schemes (see Regulatory Guide 45 *Mortgage schemes: Improving disclosure for retail*

investors (RG 45)), and for unlisted property schemes (see Regulatory Guide 46 *Unlisted property schemes: Improving disclosure for retail investors* (RG 46)).

8 The benchmark disclosure model:

(a) identifies, for a particular financial product, the key risk areas potential investors should understand before making a decision to invest;

(b) sets a benchmark for how a product issuer should address these risks in establishing its business model and compliance procedures; and

(c) requires an issuer to disclose against the benchmarks on an 'if not, why not?' basis in its PDS and other disclosures.

This model of disclosure provides concrete standards by which retail investors can assess financial products for which there are typically few such external benchmarks.

9 Disclosing on an 'if not, why not' basis means, for each benchmark, stating that the issuer either:

(a) meets the benchmark; or

(b) does not meet the benchmark, and explaining why not.

'Why not' means explaining how an issuer deals with the business factor or concern underlying the benchmark (including the alternative systems and controls the issuer has in place to deal with the concern).

10 Failing to meet one or more of these benchmarks does not mean that a product provided by a particular issuer necessarily represents a poor investment. However, the issuer will need to explain what alternative measures it has in place to mitigate the concern underlying the benchmark.

11 Additionally, it is not a requirement of the law for an issuer to follow the benchmark disclosure model in its disclosure documents if it thinks it can meet its legal obligations in a different way. Nevertheless, if we release such guidance, this is statement about what we think the law requires, and is a strong indication of how we will enforce the law.

12 In CP 146, we proposed to set nine disclosure benchmarks addressing different areas of risk in trading in OTC CFDs.

Responses to consultation

13 We received 10 responses to CP 146 from a variety of sources, including industry bodies and current members of the industry. We are grateful to respondents for their submissions.

14 This report highlights the key issues that arose out of the submissions received to CP 146, and our responses to those issues. Feedback received to CP 146 was used to finalise our policy, which is published in Regulatory Guide 227 *Over-the-counter contracts for difference: Improving disclosure for retail investors* (RG 227). Where relevant, this report explains where we have modified the policy proposed in CP 146 in producing our final guidance.

15 Generally, respondents were supportive of our working to improve standards of disclosure for OTC CFDs. However, a number of respondents had concerns with specific aspects of the proposed benchmarks, and many made helpful suggestions on how we could modify them to strike a better balance between improving disclosure and taking into account reasonable current industry practices. These matters are addressed in Sections A–C of this report.

16 For a list of the non-confidential respondents to CP 146, see the Appendix. Copies of the submissions are on our website at www.asic.gov.au/cp under CP 146.

A Scope of the guidance

Key points

The term 'contract for difference' is not defined in legislation. Some submissions to CP 146 queried whether we intended to apply the benchmarks to products that are similar to CFDs but that are generally known by another term.

RG 227 clarifies that we intend the benchmarks to apply to economically equivalent derivative products, but explicitly lists certain products that are not covered (e.g. options and warrants).

We have also clarified that we do not intend the benchmarks to apply to exchange-traded CFDs at this stage.

Definition of 'CFDs'

17 The term 'contract for difference' is not defined in legislation. In CP 146, we proposed to apply our proposals to leveraged derivative products that allow investors trading in them to take a position on the change in the value of an underlying asset, whether they are marketed as CFDs or by some other name.

18 Some respondents queried whether we intended the benchmarks to apply to similar products, such as margin forex.

ASIC's response

As product development in the derivatives sector is dynamic, it is difficult to develop a precise definition for CFDs that does not inadvertently capture other products. There is also some risk that, if we set a definition that is too precise, products could intentionally be developed to fall outside of its scope.

Therefore, we have left 'CFDs' undefined in RG 227 and clarified that the guide also applies to economically equivalent instruments such as margin forex. We have also made clear that our guidance does not apply to other derivatives such as options, warrants, swaps or futures, or to forwards not offering the same degree of leverage as CFDs or margin forex: see RG 227.2.

We encourage a product issuer to contact us if it is unsure whether the benchmarks apply to it.

Exchange-traded CFDs

19 Most respondents to CP 146 requested that the benchmarks apply to exchange-traded CFDs as well as to OTC CFDs. They argued that, with the exception of the benchmarks relating specifically to counterparty risk, most could apply equally to exchange-traded CFDs. Respondents also argued that imposing stricter disclosure requirements on one sector of the market over another would lead to undesirable market concentration.

ASIC's response

There are certainly arguments for including exchange-traded CFDs within the scope of RG 227, including that the quality of disclosure documents should be as good for exchange-traded as for OTC products.

However, it is also the case that exchange-traded CFDs only make up a very small part of the overall market, and the majority of retail investors trade with OTC issuers. Therefore, we have decided not to alter the scope of our guidance at this stage, while noting that issuers of exchange-traded CFDs may wish to have regard to the benchmarks as a matter of best practice: see RG 227.10.

If we have further concerns about exchange-traded CFDs in the future, we have regulatory tools at our disposal to address an issuer's conduct directly (i.e. our market integrity powers under s798G of the Corporations Act that are not available in relation to OTC issuers), and we may want to use this more targeted approach rather than disclosure guidance.

B The proposed disclosure benchmarks

Key points

CP 146 proposed that an issuer should assess its performance against nine benchmarks in its disclosure documents.

Respondents made a number of comments about most of the benchmarks. Where respondents suggested amendments to particular benchmarks, we have reviewed these comments carefully, and have taken them into account in making the changes discussed in this section.

Client suitability

20 CP 146 proposed that an issuer set criteria to assess potential investors' suitability to trade CFDs (proposed Benchmark 1). The suggested criteria included investors' experience and understanding of CFDs, as well as their income and assets. A number of respondents were concerned that assessing an investor as suitable to trade in CFDs according to these criteria would amount to providing personal advice that they should trade in CFDs.

ASIC's response

We understand that issuers are genuinely concerned not to provide personal financial advice inadvertently in the process of assessing client suitability.

However, given the complexity of CFDs, we think it is important that an issuer plays a role in ensuring that prospective investors are ready to trade in the product, by assessing their previous experience with trading and their understanding of the product. We think that this can be done without providing personal financial advice (i.e. advice considering one or more of a person's objectives, financial situation and needs: s766B(3)).

Benchmark 1 (Client qualification) in RG 227 requires an issuer to assess prospective investors against qualifying criteria that focus on their experience and understanding of the product, but avoids gathering information about the financial situation of investors. We consider that this assessment may be done via an online test, a face-to-face interview or a telephone interview: RG 227.40.

We do not consider such an assessment would constitute personal financial product advice, and RG 227 states this clearly.

From submissions to CP 146, and meetings with industry, we understand that this approach represents the current industry best practice, although not all issuers carry out this kind of assessment.

Opening collateral

21 CP 146 proposed that an issuer should only accept cash or cash equivalents as opening collateral to establish an account (proposed Benchmark 2). This addresses our concern that using leveraged assets to acquire a product that is also leveraged can potentially magnify investors' losses. However, respondents stated that the use of credit cards to open accounts is normal business practice, is not correlated with defaults and enables accounts to be opened in an efficient manner.

> *ASIC's response*
>
> While we are concerned that using a large amount of borrowed funds to open a trading account creates a situation of 'double leverage' that may expose investors to the risks of increased losses, we think setting a limit on funds that may be accepted from credit cards represents a good compromise between recognising the efficiency of this payment method and avoiding double leverage.
>
> Therefore, Benchmark 2 (Opening collateral) in RG 227 states that an issuer should generally only accept cash or cash equivalents as opening collateral, but may accept credit card payments to a limit of $1000: see RG 227.46.

Counterparty risk—Hedging

22 CP 146 proposed that an issuer should publish a policy on the hedging activities it engages in to minimise counterparty risk, including a practice of engaging multiple hedging counterparties, identifying the entities the issuer contracts with, and estimating the probability of hedges not meeting the issuer's exposure to client positions (proposed Benchmark 3).

23 Many respondents stated that they could not reveal the identity of hedging counterparties for commercial confidentiality reasons. They also felt that it would be difficult to estimate the probability of hedges not meeting the issuer's exposure. A small number of respondents also objected to the requirement that they engage multiple hedging counterparties, stating that the most important factor is the quality of the hedging provided by counterparties, and not how many each issuer engages.

> *ASIC's response*
>
> While a number of respondents raised concerns with the form of the proposed benchmark, we think the broader issue of counterparty risk still needs to be highlighted in disclosure. Benchmark 3 (Counterparty risk—Hedging) in RG 227 avoids some of the elements respondents found problematic (e.g. estimating the probability of hedges not meeting the issuer's exposure to client positions), but still requires an issuer to give an

explanation of counterparty risk and the hedging strategy it undertakes to minimise this risk: see RG 227.51.

We have retained the requirement that an issuer disclose the identity of hedging counterparties because of the importance of this information for prospective investors, and the significance of counterparty risk in relation to OTC CFDs.

However, we note that there is a risk that some issuers may not be able to disclose against this benchmark due to confidentiality concerns. If this is the case, an issuer should provide a clear explanation that confidentially concerns prevent it from disclosing hedging counterparties and therefore from meeting the benchmark, and instead provide an explanation of the broad factors it takes into account when selecting counterparties.

Counterparty risk—Capital and liquidity

24 CP 146 proposed two separate benchmarks, dealing with the issuer's strategies to maintain sufficient capital and liquidity, respectively (proposed Benchmarks 4 and 5).

25 A number of respondents stated that the benchmarks appeared to impose more stringent requirements than those in Regulatory Guide 166 *Licensing: Financial requirements* (RG 166), and any such change in policy should be made by amending RG 166, and not via disclosure. A number of respondents also suggested that the two benchmarks should be conflated because they deal with overlapping issues.

ASIC's response

In proposing these benchmarks, our policy intention was not to extend the requirements of RG 166, but to ensure that disclosure highlights the kinds of strategies and resources an issuer devotes to ensuring that it meets its financial resource requirements. This is important information for a prospective investor because trading in OTC CFDs exposes investors to the counterparty risk that an issuer will not be able to meet its liabilities.

However, we have taken into account suggestions that the benchmarks be combined into a single benchmark to more efficiently address the issuer's capacity to maintain adequate financial resources. Benchmark 4 (Counterparty risk—Financial resources) in RG 227 sets a single benchmark dealing with financial resources: see RG 227.59. The benchmark focuses on how the issuer ensures its compliance with RG 166 (as it stands from time to time), including conducting stress testing to ensure it can withstand an adverse movement in the market.

Halted or suspended underlying assets

26 CP 146 proposed that an issuer should not allow new CFD positions to be opened, or existing positions to be varied or closed out, when trading in the underlying asset has been halted or suspended (proposed Benchmark 7).

27 Some submissions queried whether this included the case when trading has been suspended in the ordinary course of events (e.g. because a market is closed overnight), and asked for greater clarification of the meaning of the terms ‘halted’ and ‘suspended’. Other submissions argued that this benchmark should not apply to the closing out of positions because an issuer and its investors may wish to close out positions when trading in the underlying assets has been halted or suspended in a number of cases.

> *ASIC’s response*
>
> We have taken all comments we received into account in revising this benchmark. Benchmark 6 (‘Suspended or halted underlying assets’) in RG 227 clarifies that the benchmark only addresses circumstances where trading has been halted or suspended according to the rules of the relevant market, other than in the ordinary course of events (i.e. it does not apply to situations where trading has generally ceased in the market in the ordinary course of events, such as when a market closes overnight): see RG 227.77.

Margin calls

28 CP 146 proposed that that an issuer should notify investors before closing out positions (proposed Benchmark 8). Submissions noted that, in some cases, clients may not be contactable, but may suffer losses if an issuer does not take immediate steps to close out positions.

> *ASIC’s response*
>
> In proposing this benchmark, it was our policy intention that an issuer should make reasonable attempts to contact investors before closing out positions, while recognising that, in some cases, issuers may need to take prompt action in relation to investor positions to prevent further losses.
>
> Benchmark 7 (Margin calls) in RG 227 explicitly states that an issuer may not necessarily be able to contact clients at all times before closing out positions, but that it should make reasonable attempts to make contact according to a prearranged method: see RG 227.82.
>
> The benchmark also notes that, if an issuer will only communicate with investors via a default method of the issuer’s choosing, this should be made clear to investors: see RG 227.82.

Fees and charges

29 CP 146 proposed a benchmark addressing how an issuer discloses its fees and charges (proposed Benchmark 9).

30 A number of submissions commented that the proposed benchmark appeared to reiterate current legal requirements, and that fees and charges are not an appropriate subject for benchmark disclosure.

> *ASIC's response*
>
> We have decided not to include a benchmark dealing with fees and charges in RG 227. However, as pricing of OTC CFDs is often difficult for prospective investors to understand, we have provided some guidance about our expectations of an issuer's disclosure of fees and charges: see RG 227.27.

C Implementation

Key points

Respondents to CP 146 were generally confident that they could implement the benchmark model of disclosure, providing they had sufficient time to make the necessary changes.

Accordingly, we have given issuers until 31 March 2012 to implement disclosure against the benchmarks.

31 Respondents to CP 146 were generally confident that disclosure against the benchmarks would not pose any great practical problems, assuming they had sufficient time to implement the new benchmark model of disclosure. Respondents generally asked for at least six months from the release of the final regulatory guide to implement the new benchmark model of disclosure.

ASIC's response

We understand respondents' concerns that they be given sufficient time to move to the benchmark model of disclosure. We have given issuers until 31 March 2012 to implement the new benchmark model of disclosure: see Section C of RG 227 for a detailed discussion about implementation.

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Appendix: List of non-confidential respondents

- Australian Financial Markets Association
- AxiCorp Financial Services Pty Ltd
- Financial Ombudsman Service
- IG Markets Limited
- Lazorne Group Pty Ltd

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