

Australian CFD Forum Limited

27 March 2014

Barton Hoyle
Senior Lawyer
Strategy and Policy
Australian Security and Investments Commission

By email: barton.hoyle@asic.gov.au

Dear Mr Hoyle,

Report 384: Regulating Complex Products

On behalf of the Australian CFD Forum, we are pleased to have been invited to provide comments to you on Report 384: Regulating Complex Products (the "Report").

1. Australian CFD Forum ("CFD Forum")

The CFD Forum is an industry association for OTC CFD providers in Australia that was incorporated in 2013. It currently comprises three members who make up over 60% of OTC CFD market share.

The CFD Forum members are:

- IG Markets Limited - AFSL 220440
- CMC Markets Asia Pacific Pty Ltd - AFSL 238054
- GFT Global Markets UK Ltd - AFSL 344086

2. Executive Summary

- A. The OTC CFD sector has a predominantly retail client base which will distinguish it from the primary client base of other complex products. We note that issues affecting retail investors are the main focus of the Report.
- B. The CFD Forum strongly supports ASIC's product disclosure model but submits that this should be accompanied by a regulatory safety net that safeguards retail client money;
- C. In our view the most urgent, effective and beneficial change to the regulation of OTC CFDs would be to ensure retail client money cannot be used by CFD providers as they are currently permitted pursuant to section 981D of the Corporations Act 2001;
- D. Decisive retail client money reform should be no barrier to enabling a well regulated robust OTC CFD sector that can offer competitive pricing to informed and appropriate investors, while still protecting their client money.

3. Response to Report 384

The CFD Forum fully supports ASIC's aim to promote confident and informed investors as well as fair and efficient markets.

We read with interest the information contained within the report that supports our long held views that while clear, concise and effective product disclosure is a worthy goal and one wholly endorsed by the CFD Forum, in some circumstances, it is not a complete answer.

We would like to specifically respond to the feedback request on page 10 of the Report.

4. What are the risks posed to retail OTC CFD investors and the extent of those risks together with the options for mitigating these risks?

Retail Client Money

In our view, the primary risk posed to retail OTC CFD investors is not due to the complexity of the product or any kind of disclosure failure or shortfall, but the legislative loophole at section 981D of the Corporations Act 2001 ("Act") which means their client money may not be segregated and protected.

As you will be aware, section 981D of the Act states:

Money related to derivatives may be used for general margining etc. purposes

Despite anything in regulations made for the purposes of section 981C, if:

- (a) the financial service referred to in subparagraph 981A(1)(a)(i) is or relates to a dealing in a derivative; or*
 - (b) the financial product referred to in subparagraph 981A(1)(a)(ii) is a derivative;*
- the money concerned may also be used for the purpose of meeting obligations incurred by the licensee in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives by the licensee (including dealings on behalf of people other than the client).*

While members of the CFD Forum are all committed to the full segregation and protection of retail client money, section 981D is the source of many OTC CFD providers ability to use client funds for hedging purposes, in lieu of their own funds, thus placing those retail funds at risk.

The legislative origins of this section come from section 1209(5) of the old Corporations Law and predate the offering of OTC CFDs in Australia. This original section existed in a context where futures brokers interacted with futures exchanges and clearing houses and contracts were "given up" to those third parties meaning client moneys were still protected. This is completely different to the OTC CFD sector which operates on a principal to principal basis.

Risk Generally: OTC CFD Providers

Our view of the most likely circumstances that might lead to a CFD provider getting into financial difficulty and ultimately failing, together with the likely circumstances that may lead this to happen, is as follows:

1. **Client default** – when markets are volatile there is an increased likelihood of "gap risk" and the rate of client default given that CFDs are leveraged instruments. This in turn will put pressure on the financial resources of a CFD provider. Please note that different business models adopted by providers have little or no influence on the levels of client default.

2. **Misappropriation of client funds / fraud** – when the legal requirements are not followed there is clearly a great risk of client funds being lost in the case of a company default.
3. **Proprietary trading / position risk** – We are not aware of any CFD provider that takes proprietary market positions however some providers, including members of the CFD Forum, aim to internally match client positions to reduce its own hedging costs in backing off client positions. This practice has allowed the CFD industry to offer trading commissions at levels significantly below that of traditional stock brokers and futures brokers. There is however a risk of this practice being managed poorly and the firm exposing itself to market risk.
4. **Poor capitalisation** – Appendix 8 of RG 166 sets out the financial requirements stipulated for OTC CFD issuers including the NTA levels that must be met. These financial requirements are low compared to their international equivalents and, when combined with the fact that section 981D permits CFD providers to use client money for their own hedging purposes, means that there are, in our view, some poorly capitalised OTC CFD providers operating in Australia who are not adequately motivated to ensure robust and effective risk systems are in place that ensure their businesses remain solvent.

In our view, the four factors noted above are the main factors that affect the likelihood of a firm defaulting. All CFD providers, regardless of business model or hedging policy, are exposed to some if not all of these factors.

In all such cases the full protection of client money offers a robust solution to mitigate the risks posed.

Risk Generally: OTC CFD Investors

We note the content of the Report and the considerable efforts made by ASIC in recent years to ensure adequate product disclosure requirements, advertising best practice and benchmark standards (including client qualification recommendations) have been implemented across the OTC CFD sector.

The CFD Forum endorses all of those steps taken by ASIC and we have also attempted to raise the industry bar still higher by establishing an industry association that has certain mandatory admission requirements that go above and beyond both the if not / why not benchmarks (RG 227) as well as our regulatory obligations. For members of the CFD Forum, underpinning all of our standards is the requirement to guarantee the full segregation and protection of retail client money, notwithstanding the content of section 981D of the Act.

We acknowledge that CFDs are a complex product that is offered in a retail context and therefore does require clear and complete disclosure as well as strict regulatory compliance. That said, they are a very popular product among retail clients that has been well received and forms an important part of many retail investment portfolios.

Given ASIC's comprehensive work already undertaken to mitigate risks arising from the complexity of CFDs at product disclosure, product distribution and point of sale stages, we reiterate our view that the most urgent and effective additional protection to retail investors, would be the post sale protection of their client money.

5. A comparison of Australia's OTC CFD client money laws with some international examples

As ASIC is aware, section 981D of the Act is an anomaly in the global regulatory environment. We are in the process of liaising with Treasury about retail client money reform and, as you are also aware, our members have been lobbying for change in this area for many years.

Nevertheless, for completeness, we reiterate that Australia is the only jurisdiction in which any member of the CFD Forum operates that permits the use of retail client money. The only other jurisdiction in the world that we know of that recognizes OTC CFDs as a product (as many jurisdictions do not have an applicable regulatory environment at all) and yet permits the use of retail client money, is Cyprus. It is because of these circumstances and the fact that, with the exception of this loophole, Australia is highly regarded as a sound and robust regulatory environment, we think that an overabundance of CFD providers have entered the Australian market to take advantage of the permissive regulatory regime.

In all of the following jurisdictions retail client money paid to OTC CFD providers is required to be fully segregated and protected:

- UK
- Singapore
- Japan
- United States¹
- South Africa
- All of continental Europe (including Scandinavia).

6. Product Distribution via Intermediaries: Opportunity for further Guidance

The Report refers to the risk of inappropriate investment channels at the "product distribution stage" (refer page 7) together with ASIC's intent to ensure CFD and margin FX issuers are not facilitating the unlawful provision of financial services by unlicensed distributors.

The CFD Forum agrees wholeheartedly with the need to guard against the risk of inappropriate product distribution via intermediaries and has crafted a best practice standard to govern its members' conduct in that regard. We have copied the content of the BPS 15 for your information at Appendix 1 of this letter. The content of this standard may be a useful reference or possible basis for any further industry guidance issued by ASIC. In the development of this standard, CFD Forum members felt that the compulsory due diligence process, including around the AFSL in the case of the provision of general or personal advice, was particularly important.

7. Client Qualification

The Report (refer bottom of page 7) also refers to client qualification and the possibility of using investor self-assessment tools.

Please note that the CFD Forum supports an issuer defined client qualification process such as that described in RG227. Further, we encourage ASIC to complete further industry surveillance on broader industry compliance with that benchmark. While self assessment tools may have some merits we believe that an issuer lead qualification process that (in ASIC's words from the

¹ OTC CFDs in the form offered in Australia are not a regulated product in the United States, but for those derivative products that are authorised, the requirement to fully segregate all "customer funds" is clear and comprehensive.

Appendix 1

CFD Forum: Best Practice Standard 15

Dealing with Intermediaries

Intermediaries are defined as third party distributors of CFDs who provide financial product advice (i.e. either personal advice or general advice) and with whom a Member maintains a relationship, where this relationship is evidenced by a contractual agreement between the Member and the Intermediary.

Intermediary arrangements can include:

- multiple client accounts - where an account is opened for each client of the intermediary;
- white label agency model;
- intermediary acting as trustee for the underlying clients;
- managed discretionary accounts; and
- IDPS/investor directed.

As part of the initial process of establishing an Intermediary relationship, a Member must perform an initial due diligence and authorisation process to ensure Members foster appropriate Intermediary relationships. This initial due diligence process must include the collection from the Intermediary and verification of the following:

- business controls and structure, as evidenced by a business plan or equivalent;
- appropriate authorisation from ASIC in the form of an Australian Financial Services License (AFSL), as applicable. Where it does apply, there must be no restrictions under its AFSL which would not allow the Intermediary to arrange for the provision of products and services offered by the Member;
- as applicable, evidence of being an Authorised Representative (as defined in the Corporations Act 2001) of an AFSL holder;
- evidence of Professional Indemnity Insurance (PII) as required under the Corporations Act 2001,
- names of all individual Authorised Representatives of the Intermediary who are authorised to provide financial services (if any);
- sufficient review of the Intermediary's risk and compliance controls relating to the supervision of its Authorised Representatives to ensure their compliance with relevant law;
- ASIC company searches on the company and directors; and
- confirmation that there has been no adverse media attention or legal proceedings (including on the Intermediary, its directors, Authorised Representatives or key employees).

In addition, the Member must conduct a review at least annually on all Intermediaries as part of the audit process, evidencing any material changes to the collection and verification points above. The review is also to include a certification from the Intermediary disclosing any regulatory surveillance or investigation within the period under review, that the Intermediary retains the authorities under its AFSL (as applicable), and that no restrictions have been placed on it which would limit its ability to arrange for the provision of products and services offered by the Member.

Report) "tests prospective clients' understanding of the features and risks of over-the-counter (OTC) CFDs before they begin to trade" is a far more important regulatory requirement.

8. Concluding Comments

Thank you for the opportunity to respond to the Report. We support ASIC's intentions to ensure complex products are appropriately regulated and that confident informed retail clients are sufficiently protected while still having access to a broad base of financial markets and products.

If you have any questions about this letter or any of the matters stated within, please do not hesitate to contact any of the signatories below personally.

Yours sincerely

Tamas Szabo

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Chair: Australian CFD Forum

Paul Casey

Head of Compliance & Operational Risk
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Operations Director
Member: Australian CFD Forum

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