ASIC
Australian Securities & Investments Commission

Improving practices in the retail OTC derivatives sector

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This is ASIC Report 579

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Examples in this report are purely for illustration; they are not exhaustive and are not intended to impose or imply particular rules or requirements.

Improving practices in the retail OTC derivatives sector

Recent ASIC activities have revealed practices in the retail over-the-counter (OTC) derivatives sector which fall short of our expectations.

These practices include:

- misleading marketing materials
- unclear pricing methodologies
- inadequate risk management practices
- inadequate monitoring of counterparties
- inappropriate referral arrangements.

We will continue to take action to address these risks by raising industry standards and improving issuers' compliance. To better direct our activities, we recently conducted a review of 57 retail derivative issuers to gauge the size of the industry, the products offered and the risks posed to investors.

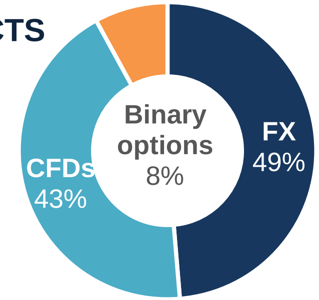
$11 trillion turnover p.a.

Over **450,000** clients

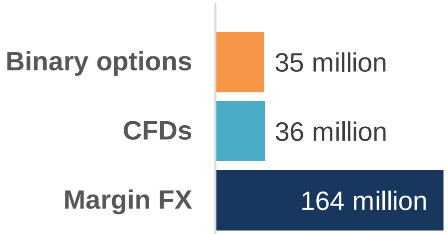
$2 billion+ in client money

97% of clients are retail

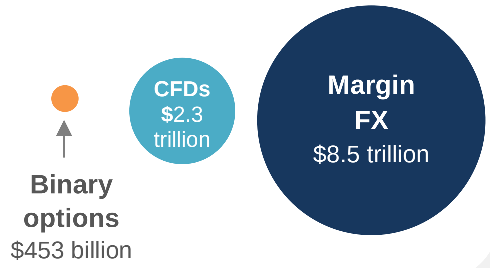
PRODUCTS



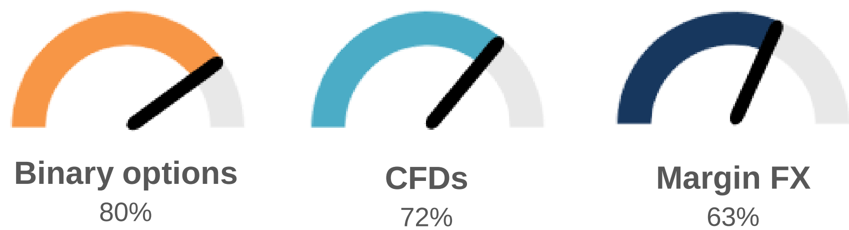
TRANSACTIONS



TURNOVER



UNPROFITABLE TRADERS



Products offered

We identified a number of risks associated with the products offered to retail investors by OTC derivatives issuers.

Of these, a lack of clarity around pricing and misleading claims about profitability in marketing material were the most concerning.

Among the products offered by issuers, **margin FX (foreign exchange)** was the largest and most common with 55 issuers and the highest transaction volume and turnover.

CFDs (contracts for difference) came in second, with index CFDs the most popular offering, followed by single stock equity and commodity CFDs.

New to the market in Australia, cryptocurrency CFDs are now being offered by some issuers. However, the price of these products is extremely volatile because of fluctuations in underlying cryptocurrency assets. Adding leverage further magnifies this volatility.

Pricing and hedging risk from underlying cryptocurrency assets can also be difficult. Issuers that offer cryptocurrency CFDs need to make sure their clients understand the pricing and risks associated wth these products. They also need to make sure they have adequate risk management frameworks and capital to deal with these risks.

We identified nine issuers offering **binary options**. Binary options typically offer the least transparency in terms of underlying pricing, strike prices and payout structures. Our review also found that up to 80% of binary options clients were unprofitable.

We would like to remind issuers that offer binary options to retail investors that they have an obligation to make sure their clients know and understand how these products are priced before they purchase them.

Risk management and reliance on third parties

Reliance on third parties for hedging market risk can increase credit risk to clients.

Approximately one third of issuers are reliant on related parties for pricing and hedging services. As a result, these issuers may pose a greater credit risk to retail investors as all market risk is concentrated in a single counterparty, often located outside Australia.

RISK MANAGEMENT STRATEGIES BY ORDER OF POPULARITY

1. All market risk is hedged with another party
2. Issuer hedges some of their market risk and holds the rest on their books
3. Issuer holds all market risk on their books

Varying strategies for managing financial risk can also give rise to varying risks for the issuer.

For example, moving market risk to another party will reduce market risk, but it will also increase counterparty risk – while holding most or all risk internally will increase market risk.

To manage risk properly, issuers need to make sure they constantly monitor and update their risk management strategies – particularly when offering new products with different risk profiles.

Issuers should ensure they adequately supervise and monitor related parties, as Australian issuers remain responsible for compliance with their Australian financial services licence obligations.

A few issuers have also started to provide wholesale liquidity services to other entities in the industry or have allowed third parties to white label their products. White labelling is when one firm buys another firm's product and then markets it as its own.

Issuers will need to consider whether their risk management and operational capital are sufficient to support these other entities' businesses. Issuers that are white labelling their products by allowing others to act as agents for them will also need to adequately supervise them.

Client money

From 4 April 2018 issuers are no longer able to use client money to hedge their positions with clients.

Our review identified 25 retail OTC derivatives issuers that were using client money to hedge their positions with clients, or had indicated in their product disclosure statements that they may do so.

Issuers that are subject to the new client money reforms should review their capital needs in light of the new restrictions on the use of client money. They should also consider whether their disclosure to investors needs to be updated.

Referrers

Issuers who make payments to referrers on a 'commission' or 'volume' basis must ensure they comply with their obligations.

Where such referrers provide financial product advice, these payments may breach the ban on conflicted remuneration.

Some payments to clients for referrals may also breach the referral selling prohibitions. These may apply where an issuer tells a prospective client that they will receive a rebate, commission or other benefit, in return for:

- providing names of further prospective clients
- helping the issuer to supply financial services to other consumers.

Issuers should also ensure that they are not facilitating unlicensed conduct by referrers. This may occur if unlicensed referrers behave in a way intended to influence a client about a product.

Issuers should also ensure that their referral arrangements do not:

- target clients that are not suitable for the products offered
- breach Australian financial services licence investor protections
- breach financial services regulations in other jurisdictions.