Consumer harm from OTC binary options and CFDs

Report 626 | August 2019

About this report

This report provides a snapshot of the market for over-the-counter (OTC) binary options and contracts for difference (CFDs), a description of the consumer detriment we have observed and ASIC's proposed actions to address it.

Industry at a glance

- The Australian retail OTC derivatives sector is **growing at a rapid pace**
- Most clients who trade binary options or CFDs **lose money**
- To address this harm, we propose to use our product intervention power to **prohibit binary options** and **restrict CFDs** offered to retail clients
- Similar measures are in place in many overseas markets

A **binary option** is an 'all-or-nothing' bet on the outcome of an event

A **CFD** is a contract on the difference between the opening and closing price of an asset

In 2017 and 2019, we collected information from 57 and 61 active Australian financial services (AFS) licensees, respectively. **The reviews revealed key insights into the sector** – for example, the number of retail clients trading binary options or CFDs more than doubled in the past two years.

2017 review vs 2019 review

	2017 review	2019 review
Clients	450,000+	1m
Retail clients	97%	99%
Client funds held	$2b	$2.9b
Annual transactions	236m	675m
Gross annual turnover	$11tn	$22tn

Snapshot

- **65 AFS licensees** made up of 64 CFD issuers and five binary option issuers
- **$2b** gross trading revenue in 2018
- **80%** of clients are aged 22–50
- **32%** of clients earn less than $37,000 per annum
- **225,000+** new clients given inducements in 2017 and 2018
- **-$33m** total negative balances of CFD trading accounts in 2018
- **9m** CFD margin close-outs in 2018
- **$131m** marketing expense in 2018 – up from $93m in 2017
- **$281m** paid by issuers for client referrals in 2018
- **60,000+** referrers have arrangements with issuers to refer new clients

Is that gift really 'free'?

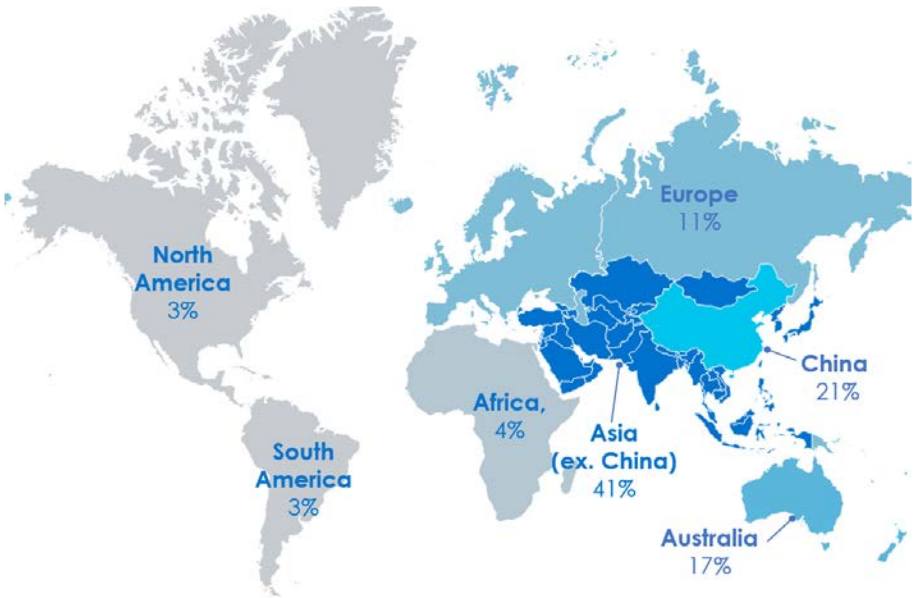
Issuers commonly offer inducements to attract new clients and entice existing clients to trade more (e.g. bonus credits or 'free' gifts).

In 2017 and 2018, **over 225,000** new clients were given inducements for opening an account to trade binary options or CFDs.

The offer of inducements can attract financially vulnerable consumers who underestimate the high risks of these products.

83% of Australian issuers' clients are offshore

Figure 1: Location of binary option and CFD clients

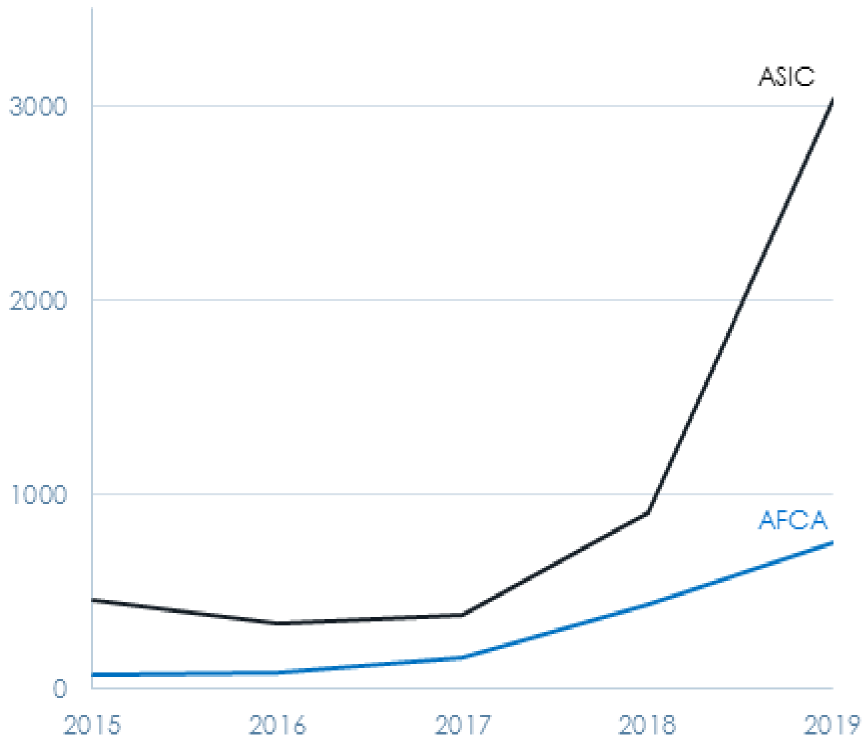


Complaints

Complaints received by ASIC and AFCA about binary options and CFDs have accelerated since 2017.

In 2019 they accounted for over one third of markets-related complaints - disproportionately large for the financial markets sector.

Figure 2: Complaints about binary options and CFDs



Most clients who trade binary options lose money

of clients who trade binary options lose money*

Features of binary options are causing significant detriment:

› negative expected returns
› high likelihood of cumulative losses
› unsuitability as an investment or risk management product, with product characteristics similar to gambling.

Example 1: Binary options

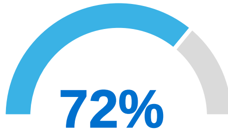
Tom makes 150 binary option bets each with a potential payout of $180. If he wins a bet he gets $180, otherwise he gets nothing.

Tom has a 92% chance of losing money on his 150 binary option bets, and Tom's most likely return on this investment is a **loss of $1,500**.

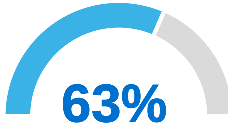
This example assumes equal odds of winning or losing, which is more generous than the reality of betting on binary options.

* This data was collected from our 2017 review of the retail OTC derivatives sector. These figures are broadly consistent with data reported by European regulators before the introduction of product intervention measures by the European Securities and Markets Authority (ESMA).

Most clients who trade CFDs lose money



of clients who trade CFDs lose money*



of clients who trade margin FX lose money*

Features of CFDs are causing significant detriment:

› high leverage ratios amplify losses and costs
› losses can exceed initial investment.

Unclear or confusing presentation of information about risks, pricing and costs are leading to the sale of CFDs that are misaligned with clients' expectations.

Example 2: CFDs

Tim thinks the ASX 200 will rise. He invests $10,000 in a CFD with leverage of 200:1, which gives him a $2 million bet on the ASX 200 index.

› **Transaction costs are amplified by leverage:** Tim pays a $10 commission to open the position and a spread of 0.05% which equates to $1,000 for the position size. The CFD issuer charges a 5% p.a. overnight funding cost which equates to $274. There was no dividend adjustment to Tim's CFD position.
› **Sensitivity to market volatility:** As a result of a global event, the ASX 200 index unexpectedly drops by 1%. Tim incurs a $20,000 loss on his $2 million position size.

Tim has lost more than twice his initial deposit and now **owes $11,284** to the issuer.

Proposed action

We have previously taken strong action to address our concerns about binary options and CFDs, using a range of regulatory tools. However, retail clients continue to suffer significant detriment from these products.

Our product intervention power allows us to intervene when we are satisfied that a financial product has resulted in, will result, or is likely to result in, significant detriment to retail clients.

Prohibit the issue and distribution of OTC binary options to retail clients

Unlike some other derivatives, binary options provide no meaningful investment or economic utility:

- they do not offer participation in the growth in value of the underlying asset
- their 'all-or-nothing' payoff structure makes them unsuitable for risk management arrangements (e.g. hedging).

We believe a complete ban of OTC binary options is necessary to address the significant detriment to retail clients.

Impose conditions on the issue and distribution of OTC CFDs to retail clients

We believe our proposed conditions for CFDs are the most appropriate regulatory action to reduce the significant detriment suffered by retail clients. Our conditions:

- impose leverage ratio limits (**Condition 1**)
- implement a standardised approach to automatic close-outs of retail client positions (**Condition 2**)
- protect against negative balances (**Condition 3**)
- prohibit certain inducements (**Condition 4**)
- require enhanced transparency of CFD pricing, execution, costs and risks (**Conditions 5–8**).

Our proposals, including draft product intervention orders and details on how to provide feedback, are described in more detail in **Consultation Paper 322** ***Product intervention: OTC binary options and CFDs*****.**

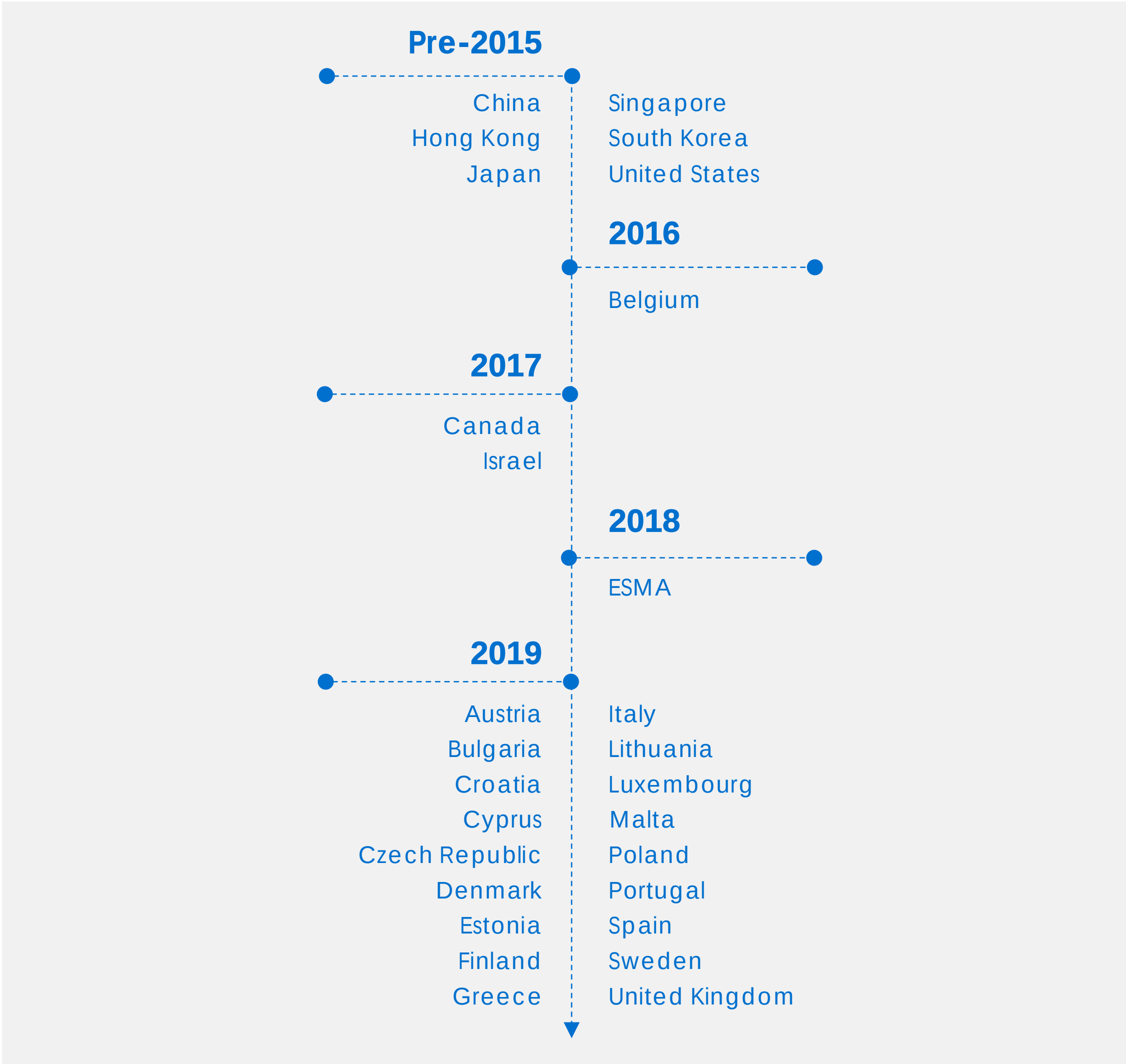
Similar measures are in place overseas

Our proposals are broadly consistent with product intervention measures taken in overseas markets and the guidelines in the IOSCO toolkit:

- **Binary options**: Regulators in Europe and North America have banned or limited the issue and distribution of OTC binary options to retail clients. Some markets have provided restricted exemptions (e.g. for longer contract durations)
- **CFDs**: In some markets there are leverage limits and additional consumer protection measures consistent with the IOSCO toolkit.

Consistency with other markets will help prevent regulatory arbitrage.

Figure 3: Timeline of product intervention in overseas jurisdictions



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