

2 August 2019

Ashley Brown, Senior Adviser
Strategic Policy
Australian Securities and Investments Commission
GPO Box 9827
Brisbane QLD 4001

By email: product.regulation@asic.gov.au

Dear Mr Brown,

Re: ASIC Consultation Paper 313 *Product intervention power*

Pepperstone Group Limited and Pepperstone Limited (“**Pepperstone**”) welcomes the opportunity to comment on the ASIC’s “Product intervention power” consultation paper (“**CP 313**”).

Pepperstone is a global over-the-counter (“**OTC**”) derivatives broker that was established in 2010. Pepperstone is licensed and regulated by the Australian Securities and Investment Commission (“**ASIC**”), the United Kingdom (“**UK**”) Financial Conduct Authority (“**FCA**”) and was recently granted an in-principle decision by the Dubai Financial Services Authority (“**DFSA**”) in regards to holding a financial services licence in Dubai.

Pepperstone has already experienced the use of product intervention powers on retail OTC derivatives in the UK and across European Securities and Markets Authority (“**ESMA**”) regulated countries. This provides us with a unique perspective regarding the measures that worked well and those that did not. We wish to highlight some key issues with how the product intervention power was used, which may be beneficial to ASIC:

1. ESMA’s intervention power was used to cap leverage on certain OTC derivative products. The FCA and ESMA claimed that leverage caused large investor losses in those products. Industry participants do not agree with how the authorities determined investors’ loss levels and dispute that leverage is the determining factor behind investor harm. Regardless, the levels of loss (as defined by the FCA and ESMA) suffered by investors have not changed since the intervention power was implemented. This suggests that the original assumption that leverage is the primary cause of investor loss is inaccurate; and

2. there is evidence of a large migration of consumers to identical products, offering unrestricted leverage levels, in jurisdictions outside of the regulatory oversight of the FCA and other ESMA regulators with many regulators warning of the risk.¹ Of most concern is the movement of some consumers to entities which are not subject to any regulatory oversight – this highlights a key risk when using product intervention. Where there is strong investor demand for a product, intervention may have an unintended consequence of consumers moving to unregulated providers which may pose an even higher risk to them, in order to continue to access the products under the terms they want.

As a result, it appears that issuers who operate outside of the regulatory remit of the FCA and ESMA have benefitted the most from European product intervention, rather than the consumers that the rules were designed to protect. Product intervention has also had a negative impact on regulated industry providers who have experienced both an increase in costs and a loss of clients to competitors operating outside the regime.

We are happy to provide data and evidence of these specific scenarios if it would assist ASIC in its considerations.

Our response to the specific questions in CP 313 is outlined below.

Response to CP 313 Questions

B1Q1 Are there additional factors that ASIC might take into account in determining whether a product has resulted, will result or is likely to result in significant consumer detriment?

When considering the nature and extent of the detriment

We believe the following factors would assist ASIC in its considerations.

1. Product age

As mentioned in CP313 paragraph 27, ASIC sees the product intervention power on a market-wide basis as a way to:

- (a) address market-wide problems causing significant consumer detriment more quickly than law reform; and
- (b) deal with 'first-mover' issues that may inhibit industry-led responses to products that are causing significant consumer detriment.

We consider that the age of a product should therefore be taken into consideration in the assessment. If a product has been offered in the same way for a long period of time, for example a number of years,

¹ See Autorité des marchés financiers, *CFDs and binary options: the AMF reminds investors that the purpose of the restriction measures agreed on by ESMA is to protect them*, News release, 11 September 2018 and FCA Consultation Paper 18/38 *Restricting contract for difference products sold to retail clients and a discussion of other retail derivative products*, December 2018.

then it would seem inconsistent to use the product intervention power which is designed to facilitate swift remedies. Formal law reform should be used to address any shortcomings with a product that has been operational in a standard way for a long time period.

Likewise, it would also be difficult to claim consumers had no chance of understanding a product that has managed to be successfully offered to the same type of investors over a long time period. The only way a product continues to be available is where there is consumer demand for that product. This would not happen in scenarios where no one understood the product and/or all suffered significant detriment.

An exception to the above would be where a new, recent aspect to an established product has been introduced or where there is a different consumer market segment that is being targeted by the product issuer, and it is those specific factors or changes that are contributing to the significant consumer detriment that needed to be addressed.

2. Type of financial service additionally provided by (or controlled by) the product issuer or offeror

Consumers are more likely to be vulnerable (and suffer more uninformed detriment) in scenarios where the issuer of the product is also the one considering their personal circumstances and encouraging them to invest.

This was demonstrated by the fact that the most significant consumer losses considered by the Parliamentary Joint Committee on Corporations and Financial Services in 2009,² and then by the Financial System Inquiry in 2014,³ (which ultimately led to the recommendation of the product intervention power) were scenarios where the product issuer was also providing personal advice to retail investors - as was the case with Storm Financial, Opes Prime, and Westpoint.

In the opposing situation, where a consumer has made their own decision independently to invest in a particular product, there is a risk that those consumers will simply seek a similar product (potentially one in a riskier scenario, for example from an unregulated source) if the original product they are demanding is no longer available. The European retail OTC derivatives industry has seen this in investors' responses to the ESMA product intervention measures, as set out on page 2 of this letter.

This therefore suggests it is important to look beyond just the product itself to any related financial service. While we acknowledge that CP 313 contemplates considering distribution of a financial product in its assessment, we believe the consideration of whether there is personal advice given or controlled by the product issuer versus general advice (or where any personal advice provided is independent to the product issuer) is also a factor that is relevant.

² Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into financial products and services in Australia*, November 2019.

³ Treasury, *Financial Systems Enquiry – Final Report*, November 2014.

When considering the impact that the detriment has had, will have or is likely to have on consumers

We believe the following factor is also important for ASIC to consider.

1. How strong is consumer demand for the product as it currently operates?

In order to obtain a complete understanding of a product and how it operates, it is important to consider both regulator and consumer sentiment for a product.

Even where a regulator has a negative view of a particular product, consumer views of the product should also be taken into consideration. If there is no clear evidence of consumers asking for a ban of a product or a certain aspect of a product and additionally there is evidence of strong consumer demand for the product, then there is a risk that a ban will merely move those consumers to satisfy their demand elsewhere, potentially in a way that exposes them to more harm.

The recent ESMA product intervention on retail OTC derivatives appears to have done nothing to discourage investors from wanting to invest in similar high-risk products. The Cyprus Securities Exchange Commission (“**CySEC**”) recently acknowledged this in a press release accompanying further consultation on the ESMA measures:

“Whilst the consumer demand for high risk, speculative trading products shows no sign of decreasing in Europe, Cyprus Investment Firms must continue reforming their business models to ensure investors are adequately protected”⁴

The Autorité des marchés financiers (“**AMF**”) was so concerned about consumers accessing the products outside of its regulatory remit that it found it necessary to publish additional messaging to consumers reiterating the purpose of the ESMA measures:

“the purpose of these measures is to achieve the legitimate objective of investor protection and encourages investors to resist certain online trading platforms’ efforts to circumvent and remove the protections put in place by the regulators.”⁵

Any use of ASIC’s product intervention power should therefore require some consideration of whether the demand for the product may lead to an unintended consequence of consumers moving to other riskier products, potentially even in an environment outside of Australia’s regulatory oversight and protections.

Failure to consider this may simply move the consumer detriment to another product or expose them to more risk, increasing the potential for harm.

⁴ Cyprus Securities and Exchange Commission, Press Release - *CySEC Consults to Impose National Measures to Restrict the Marketing, Distribution and Sale of Contracts for Differences*, 30 May 2019.

⁵ Autorité des marchés financiers, *CFDs and binary options: the AMF reminds investors that the purpose of the restriction measures agreed on by ESMA is to protect them*, News release, 11 September 2018.

B2Q1 Are there any other considerations that we should take into account in determining how we will intervene?

We believe the factors detailed in our response to B1Q1 are also relevant when considering the issues raised in B2Q1.

For example, an established product that has been offered in the same way for a long period of time is more likely to be inextricably integrated into a licensee's systems and processes. Changing aspects of the product may be more costly and difficult compared to a newly established product.

We agree that competition is an important factor to consider when utilising the product intervention power. We believe when looking at this aspect, consideration also needs to capture whether there are similar, alternate products that consumers may invest in should a product be banned or altered, for example:

- a product with similar risk characteristics or structure but which is a more expensive on-exchange product when considering action against an off-exchange product;
- a product that will remain available to wholesale investors, which may encourage consumers to act via a wholesale intermediary (such as a fund manager), which again could add to the cost of the product and potentially expose them to different risks due to not being in control of their investments; or
- the ability for consumers to invest in a similar product in a jurisdiction outside of Australia, particularly where that product is not subject to the stringent regulatory oversight and protections that are provided in Australia.

C1Q1 Do you have any feedback on the information we propose to include in our consultation on a proposed product intervention order and C1Q2 Is there any other information that we should include when we consult on a proposed product intervention order?

We note the following two paragraphs from the draft RG:

RG 000.63 Before making a product intervention order, we must consult persons who are reasonably likely to be affected by the order. As part of this formal consultation process:

- (a) we will identify the product and its availability to retail clients;*
- (b) we will describe the significant consumer detriment that we consider has occurred, will occur or is likely to occur;*
- (c) if we consider significant consumer detriment will or is likely to occur, we will set out our reasons for making this assessment;*
- (d) we will set out our proposed intervention or a description of our proposed intervention; and*
- (e) in some circumstances, we will present a range of options for intervening.*

RG 000.64 The aim of this consultation process is to seek feedback on our proposal to intervene. We will invite broad feedback, including in relation to the significant consumer detriment we have identified. However, we will expect submissions to be supported by evidence and data.

We believe it is important for transparency that ASIC clearly state in the regulatory guide, the information outlined in RG 000.63 will be supported by evidence and data and this evidence will be provided as part of the formal consultation. This would then equate to what is being asked of submissions from interested parties to the consultation process in RG 000.64.

We believe there should also be specific information provided in the consultation outlining the competition issues considered by ASIC in the intervention consideration process, which should include:

- some mention of the potential regulatory impact on those that are to be affected;
- consideration of any similar products or other non-impacted issuers that may be advantaged by an action taken by ASIC; and
- where relevant, why intervention outweighs any anti-competitive concerns.

The importance of competition as a consideration for the use of the product intervention power is demonstrated by the *Treasury Laws Amendment (Enhancing ASIC's Capabilities) Act 2018*, which implemented a regulatory requirement on ASIC to consider the effects that the performance of its functions and the exercise of its powers will have on competition in the financial system.⁶ This piece of legislation in turn came from recommendations from the 2014 Financial System Inquiry ("the **Murray Inquiry**"), which raised the importance of reporting of how regulators balance competition against their core objectives as well as reporting on how they identify barriers to cross-border provision of financial services.⁷ Competition considerations was also highlighted as important for financial stability in the June 2018 Productivity Commission report.⁸

As the product intervention power is also supposed to be a power of last resort where ASIC's regulatory toolbox is not appropriate, it would also seem important for ASIC to disclose the other powers it has considered or has used in addressing the relevant significant consumer detriment and why those other powers are not sufficient.

C2Q1 Do you have any feedback on how we intend to describe the significant consumer detriment?

We believe the information we have outlined in our response to question B1Q1 is also relevant when considering the circumstances of the significant consumer detriment.

C3Q1 Do you agree with our proposed approach to determining whether to delay commencement of a product intervention order? If not, why not?

Yes, we agree that there are likely to be some situations where, as a consequence of the changes that are required, it will be necessary to delay the commencement of a proposed intervention order.

C3Q2 Do you agree with the examples of factors that we should consider when determining whether to delay commencement, and the length of any delay? If not, why not and C3Q3 Are

⁶ Treasury Laws Amendment (Enhancing ASIC's Capabilities) Act 2018 s1.

⁷ Murray et al, Financial System Inquiry — Final report, November 2014 Recommendation 30.

⁸ Productivity Commission Inquiry Report, Competition in the Australian Financial System, No 89, 29 June 2018.

there any other factors that we should consider when determining whether to delay commencement, or the length of any delay?

We note the examples of factors are very high level in nature so we do not have a particular comment in regards to them. More generally, we reiterate that where a product has been offered in a standard way for a long period of time, it will take time to change embedded systems/processes and inform investors of the changes. This is particularly relevant if a change will require an orderly wind-down of current open positions (even though the product intervention powers are not retro-active, an inability to invest in the same product in a similar way could impact current consumer investments).

We believe that this is an important consideration for ASIC in the use of its power and ASIC should be asking for input on this aspect in any consultation to ensure it is fully informed of any potential impact.

Conclusion

It is clear that the outcome of the use of this power could have a major impact on businesses operating in Australia and we would therefore encourage ASIC to be both thoughtful as well as fully transparent when utilising this power, with strong objective evidence used to support their positions. This may also require ASIC to consider not only direct but also incidental consequences of the product intervention power to ensure it is able to act in the best interest of consumers and provide more regulatory certainty and stability to industry.

We are happy to provide more information on any matters that we have raised in this letter if that would assist ASIC in its consultation process.

Yours Sincerely,

A handwritten signature in blue ink, appearing to be 'Tamas Szabo', with a long horizontal stroke extending to the left.

Tamas Szabo
Group CEO - Pepperstone