Product intervention: OTC binary options and CFDs

Submission to ASIC's Consultation Paper 322

Australian Financial Complaints Authority

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afca Australian Financial Complaints Authority

Contents

Introduction

The Australian Financial Complaints Authority (**AFCA**) is the independent external dispute resolution (**EDR**) scheme for the financial sector. AFCA's purpose is to provide fair, independent and effective solutions for financial disputes. It does this not only by providing fair dispute resolution services, but also by working with financial firms to improve their processes and improve industry standards of service, thereby minimising complaints.

In addition to providing solutions for financial complaints, AFCA has responsibilities[1] to identify, resolve and report on systemic issues and to notify the Australian Securities and Investments Commission (**ASIC**), and other regulators, of serious contraventions of the law. More broadly, AFCA plays a key role in restoring trust in the financial services sector.

AFCA welcomes the opportunity to provide a submission[2] in response to the consultation by ASIC on its proposed product intervention relating to the issue and distribution of over the counter (**OTC**) binary options and contracts for difference (**CFDs**).

This submission is informed by the experience of AFCA and its predecessor schemes. It focuses on issues that go to the effectiveness of EDR as a mechanism of redress for consumers, both individual and small business.

Key points

- We strongly support the proposed prohibition on the issue and distribution of binary options to retail clients[3].
- The proposed conditions on the issue and distribution of CFDs to retail clients are a welcome step towards enhancing consumer protections and mitigating the serious harm posed by CFDs.
- CFDs are complex products and come with a high risk of losing money; we do not believe they are appropriate for retail clients.
- The delayed commencement of both proposed orders needs to be shortened. Financial firms who offer these products are already on notice and retail clients will continue to suffer and be exposed to serious harm every day that issuers are able to issue and distribute these products.

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[1] Refer to Part C, Reporting Requirements, of ASIC Regulatory Guide 267: *Oversight of the Australian Financial Complaints Authority*.
[2] This submission has been prepared by the staff of AFCA and does not necessarily represent the views of individual directors of AFCA.
[3] Retail client has the same meaning as defined in s761A of the *Corporations Act 2001*.

1 Overview

Intervention in OTC derivatives is a welcome step to minimising consumer harm

ASIC's proposed intervention in relation to the issue and distribution of binary options and CFDs is a welcome step to protecting consumers from the serious harm that these products can cause.

In our submission in response to ASIC's consultation paper 316, AFCA considered that ASIC should prohibit the sale of OTC derivate products to retail clients. This includes products such as binary options and CFDs. A copy of our submission can be accessed here.

In our experience, the harm that issuer firms are causing to consumers is so significant that they shouldn't be able to provide these high-risk products to retail clients. We recognise that this would have an economic impact and an effect on the industry however, we consider that the harm these products cause warrants intervention.

ASIC is proposing to prohibit the issue and distribution of binary options and impose conditions on the issues and distribution of CFDs to retail clients. Whilst we consider that the sale of both binary options and CFDs to retail clients should be prohibited completely, in the absence of a total ban on the issue of CFDs, we support the action proposed by ASIC to put conditions on the sale of these products as a good starting point towards reducing the serious harm they can cause.

It is essential that if CFDs continue to be available to consumers, further checks and balances are put in place. This is to ensure that the firms offering these products are no longer able to take unfair advantage of consumers by engaging in predatory sales practices and making misleading and deceptive representations.

2 Binary options

E1Q1: Do you agree with our proposal to make a market-wide product intervention order which prohibits the issue and distribution of binary options to retail clients? If not, why not? If you disagree that binary options have resulted in, and are likely in future to result in, significant detriment to retail clients, please provide evidence and data in support of your view.

A market-wide intervention order prohibiting the sale of binary options is appropriate

ASIC is proposing to make a market-wide product intervention order prohibiting the issue and distribution of binary options to retail clients. In our experience, these products are marketed to consumers with little to no experience who are told they can ‘learn to trade’ with the provider. In spite of this, our experience suggests that issuers rarely educate, teach or equip consumers with the necessary skills and knowledge.

Despite ASIC’s efforts and current regulatory guidance to stop this practice occurring, issuers continue to target vulnerable consumers through inappropriate sales practices and bonus offers designed to induce.

AFCA considers that the sale of binary options, their structure and the terms on which they are offered are the product of the provider taking unfair advantage of the consumer. We welcome and strongly support ASIC’s proposal to exercise its product intervention power is this circumstance. AFCA is particularly concerned about issuers making representations to consumers that they routinely fail to meet.

E1Q2: Do you agree with our proposal that the order would remain in force for a period of 18 months? If not, why not?

The order should be in force for the maximum period permitted

ASIC is proposing that the market-wide intervention order be in force for a period of 18 months. This is the maximum period that an initial product intervention order can be in force. This can be extended or made permanent with ministerial approval.

AFCA considers that following the initial 18 months period, ASIC should seek ministerial approval to make the market-wide intervention order permanent to prevent issuers from taking unfair advantage of consumers.

E1Q3: Do you agree that our proposed delayed commencement of the order is appropriate, balancing the time it will take to implement the order and the nature, likelihood and extent of the significant consumer detriment? If not, what is an appropriate period?

Order should commence within 5 business days of its registration

ASIC is proposing that the market-wide intervention order commence 10 business days after it is registered. This is to enable issuers time to implement the order.

AFCA considers that binary options have already resulted in significant consumer harm and will continue to do so every day that issuers are allowed to issue and distribute them to consumers. The significant risk these products pose to consumers must be addressed immediately. It is not fair that issuers are able to continue offering products that are proven to be inappropriate for consumers.

We consider a maximum period of 5 business days should be given to issuers to comply with the order.

E1Q4: Do you agree with our identification of the effects that making the proposed product intervention order will have on competition in the financial system? If not, why not?

Revenue should never be made at the expense of consumer outcomes

ASIC has identified that there is only one provider that exclusively offers binary options, and there are some other issuers who offer them in addition to other products. The effect of ASIC's proposed market-wide intervention order will mean that, as these businesses will no longer be able to offer binary options in Australia, they will no longer generate revenue from them.

AFCA considers that revenue should never be made at the expense of consumer outcomes. This is consistent with the findings of the Financial Services Royal Commission which found that the pursuit of profit was prioritised over providing a service to customers.

3 Contracts for difference (CFDs)

F1Q1: Do you agree with our proposal to make a market-wide product intervention order which imposes Conditions 1–8 (set out in Table 5) on the issue and distribution of CFDs to retail clients? If not, why not? If you disagree that CFDs have resulted in, and are likely in future to result in, significant detriment to retail clients, please provide evidence and data in support of your view.

Conditions on the sale of CFDs to limit consumer harm are welcome in the absence of a total ban

ASIC is proposing to make a market-wide product intervention order imposing 8 conditions on the issue and distribution of CFDs to retail clients. Conditions 1 to 3 are intended to constrain certain product features that may amplify consumer losses. Condition 4 is intended to prohibit inappropriate marketing practices. Conditions 5 to 8 are intended to improve transparency.

Whilst AFCA considers that CFDs are not an appropriate product for retail clients due their complexity and inherently high risk, we do welcome and strongly support the action proposed by ASIC to put conditions on the sale of these products as a good starting point towards reducing the serious harm they can cause.

We consider that if CFDs are offered to consumers, there must be further checks and balances in place to ensure that these high-risk products are appropriately offered to suitable consumers in a fair way. These checks and balances should address issues such as:

- suitability assessments
- pressure selling
- misrepresentations or deceptive conduct in relation to training consumers
- ensuring firms and the people who work for them comply with the law and their licencing obligations
- inadequate compensation arrangements

F1Q2: Condition 2 would require the terms of a CFD to provide that a CFD issuer must close out one or more of a retail client's open CFD positions, if the retail client's funds in their CFD trading account fall to less than 50% of their total initial margin required for all of their open CFD positions on that account. Do you agree with this condition or would it be better for clients (and operationally easier) if the CFD issuer is required to close all of the retail client's open CFD positions?

All open accounts should be closed if consumer funds drop below 50% of initial margin

ASIC is proposing to impose a condition requiring issuers to close out one or more of the consumer's open CFDs if their funds drop to less than 50% of the initial margin. While we acknowledge ASIC's proposal to impose leverage ratio limits, consumers will still be in a leveraged position which means they are exposed to losses beyond their initial investment.

AFCA considers that if the funds in their trading account drops to less than 50% of their initial margin, all of their open CFDs should be closed to minimise further losses. The potential harm that could still occur despite imposing leverage ratio limits is still significant considering the target market for these products. The potential exposure even with leverage ratio limits can still have a significant impact on vulnerable consumers, particularly when they are subject to unfair trading practices.

F1Q3: Condition 5 would require a CFD issuer to provide a prominent risk warning on account opening forms, trading platforms maintained by the CFD issuer, websites and the front page of PDSs. Do you agree with this condition? Do you think a risk warning should also be required on all advertising and marketing material?

All material should contain prominent plain English risk warnings

ASIC is proposing to require issuers to display prominent risk warnings on certain forms, platforms and websites maintained by the issuer.

The intention of condition 5 is to improve transparency and limit practices that may confuse retail clients. To achieve this, AFCA considers that prominent risk warnings should be provided on all sources of information and visualisations seen by the consumers, including platforms, websites, PDSs, advertising and marketing material. This should include material maintained by the issuer or any other party involved in the issue and distribution of CFDs on behalf of, or in connection with, the issuer.

The risk warnings should be clearly visible in locations to which retail clients will be directed and written in plain English to ensure that they are understood by consumers.

F1Q4: Do you agree with our proposal that the order would remain in force for a period of 18 months? If not, why not?

Appropriate for the order to be in force for the maximum period permitted

ASIC is proposing that the market-wide intervention order be in force for a period of 18 months. This is the maximum period that an initial product intervention order can be in force. This can be extended or made permanent with ministerial approval.

AFCA considers that prior to the conclusion of the initial 18-month period, ASIC should conduct an investigation into the effectiveness of the conditions imposed on the issue and distribution of CFDs to see if there has been an improvement in consumer outcomes and reduction in detriment posed by these products.

We consider that, contingent upon the outcome of this investigation, ASIC should either seek ministerial approval to make the market-wide intervention order permanent or consider a new market-wide intervention order proposing a complete ban on the issue and distribution of CFDs.

F1Q5: Do you agree that our proposed delayed commencement of the order is appropriate, balancing the time it will take to implement the order and the nature, likelihood and extent of the significant consumer detriment? If not, what is an appropriate period?

Complete order should commence no later than 30 days following registration

ASIC is proposing a staged commencement of conditions with conditions 1,3, 4 and 5 to commence 20 business days following registration and 2, 5 (trading platform risk warnings), 6, 7 and 8 to commence following a 3-month implementation period.

We acknowledge that the conditions proposed by ASIC will require issuers to undertake significant work to improve their operations. However, we do not consider that issuers should be afforded time at the expense of consumer outcomes. We also do not consider that issuers should be able to continue generating revenue for a period of up to 3-months in relation to a product which is proven to be harmful to consumers.

We believe the order should commence, in relation to conditions 1,3,4 and 5 (except trading platform risk warnings), at a maximum, within 10 business days after it is registered. We do not consider that 20 business days is necessary for issuers to implement these conditions. The consultation process commenced on 22 August and closed on 1 October 2019. Following this, there will be a further period of time that elapses while ASIC considers its next course of action. Issuers are on notice about the requirements associated with the order and they should already be considering their implementation within their businesses.

In relation to conditions 2, 5 (trading platform risk warnings), 6, 7 and 8, we consider a period of 20 – 30 business days to be a more appropriate timeframe for these to be implemented. While we acknowledge that processes and technology systems will need to be enhanced, the reality is that consumers will continue to be exposed to significant risks and harm caused by CFDs. Issuers should be required to act immediately and prioritise implementing these conditions.

F1Q6: Do you agree with our identification of the effects that making the proposed product intervention order will have on competition in the financial system? If not, why not?

Revenue should never be made at the expense of consumer outcomes

Consumers will continue to have access to CFDs, with enhanced protections to mitigate their exposure. This will reduce their potential to gain large exposures, and we consider this to be a significant benefit. Issuers will likely see less revenue as a result, however as with binary options, any revenue lost by issuers would be losses avoided by consumers. As with binary options, AFCA does not consider that revenue should be made at the expense of significant consumer detriment.

Appendix A – About AFCA

AFCA is a free, fair and independent dispute resolution scheme. AFCA's service is offered as an alternative to tribunals and courts to resolve complaints that individual and small business consumers have with their financial firms. We consider complaints about:

- credit, finance and loans
- insurance
- banking deposits and payments
- investments and financial advice
- superannuation

AFCA's role is to assist consumers to reach agreements with financial firms about how to resolve their complaints. We are impartial and independent. We do not act for either party to advocate their position. If a complaint does not resolve between the parties, we will decide an appropriate outcome.

Decisions made by AFCA can be binding on the financial firm involved in a complaint. We can award compensation for losses suffered because of a financial firm's error or inappropriate conduct. There are other remedies we can also provide for superannuation complaints.

Appendix B – Key Terms

Term	Meaning
Binary option	Is a type of OTC derivative which enables consumers to place an 'all or nothing' bet on the likelihood of a specified event within a defined timeframe. For example, the movement in the price of a financial product, a market index or an economic event.
Contract for difference (CFD)	Is a leveraged OTC derivative which enables consumers to bet on the change in value of an underlying asset, e.g. shares or currency. A consumer does not own the underlying asset under a CFD, they only gain exposure to the performance of the underlying asset. The profit or loss is the difference in the price of the underlying asset at the time the CFD was made and the price when the CFD is closed out. If the price goes up, the seller pays the consumer. If the price goes up, the consumer pays the seller.
Derivative	Is a financial instrument that derives its value from an underlying asset, for example, a share, commodity or index.
Leveraged	Means using a small initial investment known as 'margin' to gain exposure to an underlying asset for a proportion of that asset's value, effectively, using debt or 'borrowed funds'. Leverage amount are usually given in fixed amount, that vary depending on the broker. Common amounts are 50:1, 100:1, 200:1 and 400:1. An example using the 50:1 leverage: For every $1 the consumer has in their account, they can make a trade worth up to $50. If the consumer deposited $500 into their account, they would be able to trade amounts up to $25,000 on the market.
Over-the-counter (OTC)	Means the transaction is between two parties (the consumer and the issuer), not on an exchange.