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CP 322 Product intervention: OTC binary options and CFDs

The Australian Financial Markets Association (AFMA) is making comment on Consultation paper 322 Product intervention: OTC binary options and CFDs (CP 322). The paper sets out ASIC's proposals to exercise its product intervention power in Pt 7.9A of the Corporations Act to make certain market-wide product intervention orders relating to the issue and distribution of over-the-counter (OTC) binary options and contracts for difference (CFDs) to retail clients.

The determination by ASIC of 'significant detriment to retail clients' meets the statutory test enabling intervention. As it is the obligation of ASIC to provide the information to the public in the form of CP 322 that leads to this determination, we do not have a factual basis to arrive at a different conclusion. We express concern with the derivative nature of the analysis used to arrive at this conclusion as it is based on the substantive research work done in the European Union by ESMA rather than stand alone Australian research. Much of the Australian related material is anecdotal in nature and only refers to losses without corresponding analysis of gains. AFMA is also concerned with the impugning of the reputation of investors in binary options and CFDs.

1. Definition of CFD

CFD is broadly defined by the draft instrument and may include other derivative products if their value is based on the amount or value of an underlying between acquiring and terminating if they do not have a fixed determination date or if fixed are terminated early, the holder has a right to terminate, and on termination it is cash or by set-off settled. In addition, CP 322 says that other leveraged OTC products which exhibit similar characteristics or risks are being examined.

To ensure that a wider range of products is not inadvertently caught by the definition of CFD, we propose that the content of Note 2 to the definition of CFD is incorporated into

the definition itself, rather than being an interpretive note. This approach would be consistent with the approach of ESMA in their definition of CFD. We would propose amending the wording as follows:

> *CFD means an arrangement that is an over-the-counter derivative, other than an option, future, swap or forward rate agreement, in relation to which the following apply:*

2. Impugning reputation of investors

ASIC is mandated to protect investors. It is therefore concerning that in a number of places in the consultation paper statements are made about investors in binary options and CFDs and their motivations which impugns their reputation.

The language of gaming is used by analogy and in a pejorative way in several instances to describe the users of binary options. Gaming is a lawful activity and a widely understood accepted activity in the Australian community. Wagering on a structured prediction is seen as a legitimate and popular way to make money in this country, despite the statistical analysis showing that losing money is more likely than winning.

It is also indicated on page 13 that users of binary options are not pursuing legitimate trading, investment and hedging purposes. While the regulation of issuers and regulation of financial products is subject to regulation and generally accepted, language suggesting that investors can have legitimate and illegitimate uses of financial products is outside the regulatory mandate.

There is also problematic use of statistics. In the description of client demographics, it is pointed out that 62% of investors are outside Australia. By their nature, offshore investors are non-residents for Australian taxation purposes and only their Australian derived income needs to be declared here. Therefore, it is not surprising to see that 70% of clients earn annual incomes of less than $80,000 and 32% had incomes of less than $37,000. It would be an astonishing jump of logic to infer that a third of CFD investors are low income as suggested by the text. CFDs are not likely to be high on the list of priorities for those struggling to make ends meet.

It is suggested that ASIC adopt neutral language when describing investors in binary options and CFDs and not make assumptions about their social status or intelligence.

3. Binary Options

E1

We propose to exercise our product intervention powers in Pt 7.9 of the Corporations Act to make a market-wide product intervention order, in force for 18 months, which prohibits the issue and distribution of binary options to retail clients and requires that existing retail clients are notified of the terms of the order. We propose that the product intervention would take effect 10 business days after the day on which the legislative instrument is registered.

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.

Binary options began as semi-official investment product, open only to banks and other institutional investors in the US OTC markets. They were introduced by the Chicago Board of Exchange as a way to address complexity associated with trading options. Binary options trading was evolved as a less complicated way of trading options. They formed part of larger and more complex contracts. There was no separate liquid market for trading binary options. They only became popularised in the US after 2008 when they were made more accessible and they did not require knowledge about the underlying option theory in order to make simple choice on the direction of the asset price movement and they proved attractive to retail investors. Australia as is often the case followed the US retail investment trend.

The information provided by ASIC in CP 322 provides the basis on which to accept that the statutory test is met of 'significant detriment' to retail clients, justifying triggering the prohibition being imposed. Risk alone is not necessarily a source of investor detriment, if an investor takes on risk because they reasonably expect higher returns. On the analysis presented binary options do not compensate investors for the risk they take on by offering commensurate expected rewards. For this reason, the high level of risk arguably represents retail investor detriment outweighing investor choice.

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 restriction will be a practical experiment to see what happens and should be time restricted for this reason. Eighteen months is a reasonable period for this purpose.

It is unclear what metrics will be used to assess this temporary restriction and how this might be done. The restriction will obviously stop the use of binary options so there will be no gains or losses. A resulting conclusion that there will be no retail clients losing money from using binary options provides no additional information to what we know now. Rather the focus needs to be on the needs of investors who currently use binary options. The restriction on their freedom of choice needs to be assessed based on feedback from this group as to whether they are dissatisfied with the restriction or it is unimportant to them.

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?

For firms providing binary options a reasonable notice period is required to make orderly client arrangements for the withdrawal of the product from the market and system changes.

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?

The prohibition will reduce competition in market. AFMA finds puzzling the proposition put in CP 322 that CFDs are a substitute alternative product, given the markedly different product features. The obvious alternative product upon which competition analysis should be based are exchange traded options (ETO). From a retail investor perspective binary options are a simpler product to understand than ETOs because of the range of option strategies available and pricing calculation complexity associated with the latter. So they may not be a direct substitute for such investors in practice.

The evidence presented in CP 322 indicates a highly competitive market for the selling of binary options which resulted in a selling environment that encouraged vigorous promotions of the product benefits over a more cautious statement of their risks.

A product access prohibition, removing consumer choice, clearly indicates that consumer protection consideration concerns outweigh preserving a competitive market and the result will be less competition in the market.

4. CFDs

F1

We propose to exercise our product intervention powers in Pt 7.9 of the Corporations Act to make a market-wide product intervention order, in force for 18 months, which imposes Conditions 1–8 (set out in Table 5) on the issue and distribution of CFDs to retail clients and requires that existing retail clients are notified of the terms of the order.

The order and Conditions 1, 3, 4 and 5 (except trading platform risk warnings) will take effect 20 business days after the day on which the legislative instrument is registered. All other conditions will take effect three months after the day on which the legislative instrument is registered.

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.

The response to this question depends on the information provided by ASIC in CP 322 and Report 626 as this is the only publicly available Australian information on which to make an assessment. The information provided in CP 322 is anecdotal in nature and does not present a fully developed objective presentation of information, which would need to present comments on client gains as well as losses. For example, it is unclear to what extent investors obtain a net benefit from their gains to offset their losses over a series of positions. No metrics are given on retention of CFD accounts as this would be a persuasive indicator, on the basis that if investors were dissatisfied with CFDs because their losses are significantly outweighing gains they would be expected to quickly abandon the product based on experience.

For an authoritative, independent assessment of significant detriment AFMA has looked to ESMA's analysis in its report: *Product intervention measures on contracts for difference*, 1 June 2018, ESMA50-162-215, which is based on detailed analysis using quantitative modelling, academic research and qualitative analysis.

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?

Close out of client open positions when their funds fall to 50% of the margin needed to maintain their open positions on their CFD account is consistent with rules in place in European jurisdictions. A standard close out threshold for client close out rather than ones based on their individual positions will result in providers being uniform in their approach giving the market consistency.

However, there one point to be made about the practical operation of this requirement. CFD issuers should have the option to implement the margin close-out rule based on either (a) the initial margin; or (b) the variation margin.

Under the variation margin close-out approach, a CFD issuer will close a client's positions when the client's funds fall below 50% of the total margin required to maintain all open CFD positions; not the initial margin required to open the positions. It is this approach, that the UK's Financial Conduct Authority (FCA) elected to adopt as part of its suite of

rules relating to the sale, marketing and distribution of CFDs to retail customers as it is reflective of best practice.

The following examples illustrate the differences between the two margin close-out approaches, and the shortfalls of using the initial margin close-out approach to calculate a client's close-out level -

i) A client acquires a $1 CFD contract on the ASX 200 when it is trading at a level of 6000. The initial margin required to open the CFD position is $400 using both the initial margin approach and the variation margin approach. In the event the ASX rallies to a level of 7000, the margin requirement under the variation margin approach increases to $466 in line with the risk associated with the position. Under the initial margin approach, the margin requirement is fixed at the initial opening level and remains at $400. Therefore, the client is effectively trading with higher leverage than the mandatory minimum leverage ratio proposed in CP 322.

ii) A client buys a share CFD with a 20% initial margin requirement, and over time the value of the share falls by 90%. Under the initial margin approach, the client has a margin requirement that is now double the overall risk on their position. This margin calculation would in practice generate a margin requirement in excess of the maximum loss on certain positions. This would clearly be detrimental to affected investors and regulatory rules should not harm consumers.

iii) A client buys a CFD of 100 shares with a 20% margin requirement at a price of $100, and subsequently buys another 100 shares at $120. The price rallies to $150 and the client decides to close half of their position. The client can free up significantly different amounts of margin for the exact same trade; $2,000 if they close their initial trade, and $2,400 if they close the second trade.

These examples illustrate why the initial margin approach is not always effective in managing a client's risk and can result in poor client outcomes. Such outcomes include incentivising clients to close their losing position prematurely only to immediately reopen the position, taking advantage of the lower margin rate while incurring additional trading costs (unnecessarily) in the process, as demonstrated by the second example.

The merits of the prevailing market price close-out method over the initial margin close-out approach are open to debate, but its needs be recognised that many CFD issuers currently adopt initial margin close-out approach and may not be able to implement the prevailing market price close-out model.

To address this point, the proposal is that that CFD issuers should be able to choose which close-out approach to adopt, and close out client positions in the event the client's funds fall below 50% of:

(a) the initial margin required for all open positions; OR

(b) the prevailing market price required for all open positions.

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?

The appropriate place for risk warnings is where they CFD may be acquired and a PDS provided. Inclusion on the PDS is the most important place as this is the document used by the investor to understand and assess a financial product before making the decision to acquire it.

Risk warnings on advertising and marketing material are just clutter that research suggests has little impact as it is filtered out as irrelevant when viewers are quickly scanning websites and other media for relevant information[1].

It is further noted that Conditions 5, 6 & 7 apply only those CFD issuers that maintain their own platform. Our members advise that approximately only 10% of CFD issuers maintain their own platform. Therefore, it is unclear from CP 322 then how the following conditions will apply to the majority of CFD issuers:

(1) *Risk warning:* At the time the CFD issuer issues the CFD, a risk warning must be displayed in a prominent position on any CFD trading platform maintained by the CFD issuer (s7(8)(b)).

(2) *Notional value of CFD:* The CFD issuer must, in a prominent position on each CFD trading platform maintained by the CFD issuer, display to the retail client the total notional value, calculated and updated on a real-time basis, of all the open CFDs in relation to the retail client's CFD trading account.

(3) *Disclosure of overnight funding costs:* The CFD issuer the CFD issuer must, in a prominent position on each CFD trading platform maintained by the CFD issuer, display to the retail client the overnight funding costs for the CFD.

ASIC is asked to clarify its expectation around application disclosure conditions, as there are a number of comments made in CP 322 which indicate that the regulatory intention is for conditions to apply to all issuers of CFDs equally.

F1Q4

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

Consistent with the response to question E1Q2, a temporary period of 18 months gives time to observe effects of the limitations imposed on CFDs. The views of CFD investors should be broadly surveyed to determine the value of the limitations to them and whether they should continue past the 18 months temporary period. Investor views should not

[1] The FCA provides a useful summary article on the question of the utility of risk warning for financial product: https://www.fca.org.uk/insight/dont-look-here-do-risk-warnings-really-work

just be judged from the number of complaints, as this is a highly skewed sample of investors. 18 months should give enough time for users to experience operating under the limitations and whether they are favoured.

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?

Yes. CFD providers need to make changes to systems to conform to the new rules. Sufficient time needs to be allowed to make the necessary IT changes.

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?

The limitations will impose uniformity of practice on the market. This reduces the ability of CFD providers to differentiate their service offerings. Such uniformity may not suit some CFD investors who have looked to find providers whose services most closely fit their needs and higher desires. Competition and consumer choice are restricted by a one size fits all approach.

Please contact David Love either on [redacted] if further clarification or elaboration is desired.

Yours sincerely

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