FAIR MARKETS

30 September 2019

OTC Intermediary Compliance
Market Supervision
Australian Securities and Investments Commission
Level 7, 120 Collins Street, Melbourne, VIC 3000

By email only: Market.Supervision.OTC@asic.gov.au

Dear Madam/Sir,

ASIC Consultation Paper 322: Product Intervention: CFDs

Fairmarkets Trading Pty Ltd ("**Fairmarkets**" or the "**Company**") welcomes the opportunity to comment on ASIC's "Consultation Paper 322: Product Intervention: OTC binary and CFDs" (the "**Consultation Paper**").

With regards to the questions set out in the Consultation Paper, we respond as follows:

> **Do you agree with our proposal to make a market-wide product intervention order which imposes Conditions 1-8 on the issues 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.**

Condition 1: Leverage Ratio Limits

Fairmarkets opposes leverage limits on the following basis:

1. The desire for high leverage is investor driven, not issuer driven;
2. Clients have not complained about high leverage;
3. Capping leverage limits diversification;
4. Capping leverage means that clients have higher margin requirements for the same economic exposure which could result in detriment and greater loss.

<u>High leverage is investor driven, not issuer driven</u>

When ESMA first introduced leverage limits, it was widely reported that there was a mass exodus of retail clients from European based brokers to offshore brokers, some regulated like in Australia and others not regulated.

ASIC's Consultation Paper confirms this. The number of clients from 2017 to 2019 increased by 121%; gross annual turnover increased 100%; annual transactions increased 186% and client money increased by 45%.

The Company's fear is that should theses leverage standards be introduced, that the desire for higher leverage will drive clients to entities that are completely unregulated run by nefarious individuals leading to investor harm.

Fairmarkets wishes to note that our trading systems allow clients to voluntarily accept lower leverage levels. This rarely occurs, if ever.

<u>Clients have not complained about high leverage</u>

If high leverage were a major issue, the Company would expect a not insignificant level of complaints. However, Fairmarkets has never received a complaint regarding high leverage.

Fairmarkets is not aware of any of its industry peers, in Australia or abroad, who have received complaints regarding high leverage.

In IOSCO's own survey on Retail OTC Leveraged Products, concerns apropos to leverage limits are omitted:

> A number of different concerns reflecting investor complaints about both the relevant products and firms are highlighted in the response to the survey. The two concerns mentioned most often (each concern was reported by 10 respondents) relate to (i) unregulated firms, generally based abroad, and (ii) issues relating to the quality (or integrity) of order execution. Next in terms of the number of respondents mentioning the concern, are difficulties related to the withdrawal of client funds, the poor performance of products (client losses) and aggressive or misleading marketing and sales practices.

Tellingly, leverage is not mentioned in the list of primary complaints that international regulators are receiving from clients.

Capping leverage limits diversification

As a direct consequence of capping leverage, clients are not able to place the same number of trades for a given amount of capital. This limits client's ability to diversify their portfolio, restricting their ability to mitigate their risks.[1]

Lower leverage means greater margin requirements

Lower leverage means that clients will have greater margin requirements for the same exposure to an instrument. This may lead to greater client loss as clients expose themselves to losing a far greater amount of money before being stopped out when the market moves against them.

Condition 2: Margin Close out protection

In respect of the proposed margin close out of 50% of investment, FAIRMARKETS is in principle supportive of this measure.

Condition 3: Negative Balance Protection

Recognises the need for Negative Balance Protection and in principle supports this measure. The Company does, however, wish to highlight two negative externalities created by this condition, namely:

1. Consumer moral hazard;
2. Hedging policy asymmetry.

FAIRMARKETS' view is that Negative Balance Protection creates a moral hazard. The well-informed consumer may open accounts with two brokers before a major event, for example the proposed Brexit on 31 October 2019. The consumer can open two opposing positions where their delta will be zero. Expecting significant volatility, the consumer can expect the price on one contract will gap significantly positively and the other contract will gap to a negative balance, only to be grossed up. Such a circumstance should be deemed unacceptable.

[1] See Markovitz 'Portfolio Selection: Efficient Diversification of Investments' (1959).

Similarly, hedging asymmetry refers to a situation where clients trade with a broker who adopts a straight-through-processing ("**STP**") model. The broker is prohibited from collecting negative balances from its retail clients; however, the broker has made an identical trade with a hedging counterparty who will collect on that debt. In large events, this could lead to insolvencies of many firms and will unfairly penalise clients who have profitable trades but cannot collect due to the broker's insolvency. We believe this measure could create scenarios contrary to the obligations of AFS Licensees to maintain adequate risk management. All brokers should have the ability to hedge their trades in accordance with their risk appetite and policies. This policy inhibits the ability to hedge trades. The Company also expects that average spread may increase as a result of this condition.

Condition 4: Prohibition on inducements

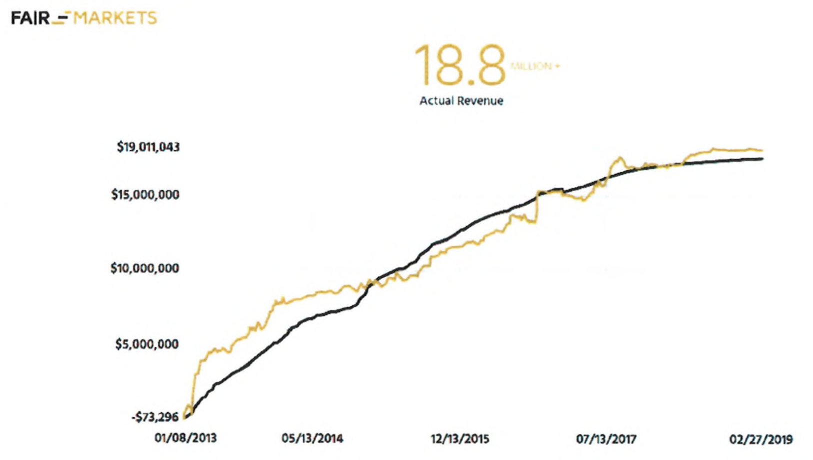
FAIRMARKETS supports this Condition prohibiting inducements.

Condition 5: Risk warnings

FAIRMARKETS <u>does not</u> support this measure. The Company's view is that the figures are misleading to consumers. FAIRMARKETS, as a firm, are strong adherents of random walk theory, which suggests that changes in the prices of financial instruments have the same distribution and therefore take a random and unpredictable path. For foreign exchange contracts, the statistical probability of a profitable trade is 50%. Brokers charge a spread and therefore over the long run should expect profit equal to the total spread charged. These figures will be misleading as a consumer may believe their probability of having profitable trades with one broker who has a higher profitable trade figure is larger than with other brokers with a lower profitable trade ratio. Certus paribus, the probability of a client having a profitable trade with a firm with a higher profit loss ratio is the same as the probability of trading with a firm with a lower profit loss ratio. That is, 50% minus spread. This measure therefore unfairly penalises a broker who due to chance has not experienced observations to the general mean.

Fairmarkets hypothesis that a broker's expected return is the spread which it charges is supported by empirical data over a 6-year time period in which there was 312.7 billion in trading volume and 6.79 million orders filled.

Diagram 1 provides an illustration of our study. In which the black line represents the spread charges and the gold line represents the trade profit and loss.



While the company had profits in excess of USD 1.80 million above the spread charged in January 2013, the trade P&L ultimately converged and was USD 667,000 in September 2017.

This is illustrative of the fact that the clients expected return on investment is 50% minus the spread which is charged.

To avoid statistical randomness benefiting any one OTC derivatives issuer, the Company supports a measure which provides a general warning that "In 2017, on average 63% of clients lost money trading margin FX" and "In 2017, on average 72% of clients lost money trading other CFDs".

Condition 6: Real-time disclosure of total position size

FAIRMARKETS supports this condition, in principle. The Company does have some concerns over the implementation of this condition. Most of our clients trade through third-party software developed by MetaQuotes, namely MetaTrader IV ("**MT4**") and MetaTrader 5 ("**MT5**" or collectively "**MetaTrader**"). In order to effectively implement this requirement, MetaQuotes would need to add a column disclosing the spread.

The alternative to MetaQuotes implementing this requirement would be to develop an Expert Adviser ("**EA**") which could be installed in default when MetaTrader is downloaded. Practically, there are difficulties which would be encountered. These include that clients would have already downloaded MetaTrader would need to be sent the EA and asked to install the EA into the program. The Company is concerned that if clients chose not to install the EA that the company could be at risk of contravening the condition. Additionally, when clients close charts or the program the EA would stop and upon reopening the program, if the EA was automatically resumed the Company would similarly be in breach of the requirement.

Condition 7: Real-time disclosure of overnight funding costs

FAIRMARKETS in principle supports this condition. However, we have some concerns around how this will be implemented. The concerns over the ability to enforce this condition using MetaTrader as a software platform. For the reasons stated in Condition Six, the Company is apprehensive to support this condition without MetaQuotes ensuring either it updates its software to adhere to this condition or allows its software to be open source so that relevant amendments may be made to the software.

This condition is well-intentioned and we support this measure conditional on MetaQuotes making the relevant amendments to their software to comply with the condition. In the absence of this occurring, the Company would be required to spend a significant amount of time and money to develop a solution which leaves much to be desired and cannot be enforced effectively.

A further practical concern it that swaps are often not updated towards the end of day. Therefore, clients who enter trades using current swap rates may enter so on the basis of information which is not relevant to the swap which they will be charged. This would arguably be a contravention of section 12DA of the *ASIC Act 2001* (Cth) which prohibits misleading or deceptive conduct in trade or commerce in relation to financial services.

Condition 8: Transparent pricing and execution

FAIRMARKETS' supports the adoption of this condition. Fairmarkets has developed a tool which enables clients to look up a time at which contracts were filled and the tool enables the client to ascertain if the fill price was within a fair range having regard to the distribution of prices provided by other liquidity providers.

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 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 (operationally

easier) if the CFD issuer is required to close all of the retail client's open CFD position?

FAIRMARKETS supports closing one or more of the retail client's open positions rather than closing all of the retail client's open positions.

FAIRMARKETS believes the regulation should mandate that the open position which is closed is explicated stated as the least profitable position.

FAIRMARKETS' wishes to note that one negative externality of mandating that the least profitable position is closed of is that it could have unintended effects on the investor's hedging strategy. As this already occurs in the market, the concern is moot but one which must be considered.

Condition 5 would require a CFD issuer to provide 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?

As stated above, the Company is supportive of risk warnings of the aggregate loss experienced in the industry and not firm specific. Provided that the risk warning is industry aggregates, Fairmarkets believes that risks warnings should be prominently displayed including on all advertising and marketing material.

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

FAIRMARKETS in principle supports the order remaining in force for 18 months for Conditions which it has agreed to in this letter.

For the reasons outlined, the Company is of the view that changes to the order need to be made, specifically with regard to Conditions 1 and 5.

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 significant consumer detriment? If not, what is an appropriate period?

FAIRMARKETS' view is that on balance the timeline proposed for most of the conditions is adequate. As outlined below the Company refutes that the threshold for significant detriment is met.

Real-time disclosure of overnight funding costs and total positions

In relation to these Conditions, the Company has formed the view that the proposed timeline is insufficient. As the majority of clients and brokers use MetaTrader, the only feasible way to effectively implement this technology is to have MetaQuotes create a software update specific for ASIC. If this can occur within 3-months then the proposed timeline is adequate. If brokers will be required to develop an in-house software solution to be 'bolted-on' to MetaTrader, FAIRMARKETS believes that 6-months is a more appropriate timeline to properly test and implement the conditions.

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?

FAIRMARKETS wishes to comment on a number of aspects identified by ASIC, namely:

- Identifying consumer detriment;
- The identification of the market distribution of customers;
- The identification of 'regulatory arbitrage' as a reason to impose the restriction;
- Failure to recognise the significance of the industry's contribution to the Australian economy; and
- Not taking into consideration the consumer detriment which will occur to the customers from this intervention.

Consumer Detriment

ASIC has not in its Consultation Paper identified what it defines as consumer detriment and has not identified the consumer detriment other than to state that 63% of clients lost money trading in margin FX and 72% of clients lost money trading other CFDs.[2]

[2] Australian Securities and Investments Commission, 'Consultation Paper 322: Product Intervention: OTC binary and CFDs' (22 August 2019).

In a survey carried out by the Consumer Affairs Victoria, the organisation defined consumer detriment as:

> Consumer detriment (to the individual consumer and/or society as a whole) can constitute: • satisfaction (utility) less than was reasonably expected when a purchase was made, whether revealed or not, and • dissatisfaction due to the inability to make desired purchases, because of missing markets, non-credible claims and/ or physical disadvantage.

The fact that a client lost money does not in and of itself mean that consumer detriment occurred. By the very nature of these products, they are risky investments and through the disclosure regime in Australia clients understood the risky nature of these products.

In the absence of spreads and other fees the expected return of these products is 50%. Clients and prospective clients are aware of the fees from these financial instruments and are aware that their expected return is less than 50%. It is because of their high risk appetite that they chose to trade in these products for which they are rewarded handsomely in profitable trades.

Distribution of Income of Consumers

ASIC's identification of the income levels on page 17 of the Consultation Paper, appears misguided. The distribution appears to be a normal distribution of clients. ASIC's statement that 70% of clients earn an annual income of $80,000 or less, which is roughly the median full-time income in Australia. It should be noted that by ASIC's own demographics only 17% of clients are from Australia and the fast majority are from Asia where the median income is much less than $80,000. The graph is a normal distribution and it would be expected to look exactly like this.

Regulatory Arbitrage

The Consultation Paper also notes 'regulatory arbitrage'.[3] ASIC notes:

> We suspect that our relatively lighter touch regulation of binary options and CFDs has resulted in issuers routing overseas clients to their Australian licensed entities. This could help explain the significant growth in clients of Australian issuers between 2017 and 2019 metric reviews.[4]

[3] Ibid, 39.
[4] Ibid.

While FAIRMARKETS has not been routing clients from another entity and there certainly may be significant legal issues with doing so. It is FAIRMARKETS' position that a product issuer who has not been doing so, but has benefitted from clients who prefer to deal with an ASIC regulated entity because of its regulatory regime is completely legitimate.

Regulatory arbitrage is another name for comparative advantage, the term coined by the 19th Century economist, David Ricardo. ASIC should be mindful that in Australia '1 in 5 Australian jobs depend on trade'.[5] The CFD industry is no different and the growth in the industry can be attributed to confidence from overseas investors on ASIC in providing an honest, fair and efficient OTC Derivatives market.

This is consistent with the Australian governments position to transform Australia into a leading regional financial services centre. [6] To this effect, the government established the Australian Financial Centre Forum and in 2009 released the Johnson Report. Taxation changes were implemented to 'attract foreign investment to Australia and promote the use of Australian fund managers by removing tax impediments to investing in Australia."[7] In other words, the Australian Government sort to promote comparative advantage through amendments to the Australian tax system to promote investment from outside of Australia.

In the FX world, Australia is a leading regional financial centre. Australia makes up 17% of the total trades within margin FX.[8] Leading international brands such as Axitrader, FP Markets, IC Markets (the world's second largest FX broker) and Pepperstone have their origins in Australia.

Regulatory arbitrage is not a bad thing. Australia needs to encourage industry and foreign investment as it is our life blood.

Regulatory arbitrage is in our view an irrelevant consideration as to whether the product intervention should be implemented.

Contribution to the Economy

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[5] Scott Morrison, 'G7 Tweet' (26 August 2019) <https://twitter.com/scottmorrisonmp/status/1166215599459991557>.

[6] Johnson 'Australia as a Financial Centre: Building on our Strengths – Report by the Australian Financial Centre Forum' (2009).

[7] Australian Government 'Explanatory Memorandum: Implementing Element Three' <https://treasury.gov.au/sites/default/files/2019-03/C2015-014_EM_Implementing_Element_3_IMR.pdf>.

[8] Victor Golovtchenko 'The Land Down Under? Australian FX Voluments are Skyrocketing' (21 March 2019) <https://www.financemagnates.com/forex/brokers/the-land-down-under-australian-fx-volumes-are-skyrocketing/>.

The CFD industry contributes to Australia's economy greatly. This is not limited to the number of employees directly employed by the 60 firms within the industry. The industry retains lawyers, auditors and accountants. Auxiliary services have flourished including regulatory technology. It seems an absurdity that the government provides grants to one technology firm I am aware of while at the same time regulating the business to the point where it could become unviable.

The Consultation Paper fails to account that the decline in revenue within the industry will result in less competition which as the market goes, generally results in less desirable outcomes for consumers.

Consumer Detriment as a Result of the intervention

It is the Company's view that the product intervention will actually result in consumer detriment. Consumers with a high risk appetite and drive to invest in higher leveraged products are likely to invest in other jurisdictions which don't have a regulator as competent as ASIC to stamp out undesirable behaviour. ASIC's assessment that '[a] component of revenue lost by CFD issuers would be losses avoided by retail clients'[9] is therefore misguided. Clients may invest in unregulated jurisdictions with not leverage caps and may be unable to retrieve their funds which will result in consumer detriment.

Conclusion

We trust this letter has been insightful. Should you have any queries, do not hesitate to contact me via email on [redacted] or alternatively via mobile on [redacted]

Yours sincerely,

J O'Neill

James O'Neill
Executive Director
Fairmarkets Trading Pty Ltd

[9] Ibid.