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Saxo Capital Markets (Australia) Pty Ltd - Submission on ASIC CP 322 - Product intervention: OTC binary options and CFDs

The purpose of this document is to provide the Australian Securities and Investments Commission ("ASIC") with Saxo Capital Markets (Australia) Pty Ltd's response to the list of proposals and questions in the Consultation Paper 322 released by ASIC on 22 August 2019 ("Consultation Paper").

Background

Saxo Capital Markets (Australia) Pty Ltd (**Saxo**) is part of the Saxo Bank Group. The Saxo Bank Group is a leading trading, investment and technology company, supporting an international client base from our headquarters in Copenhagen and offices in financial centres around the world including London, Singapore, Paris, Zurich, Dubai, Sydney, Hong Kong and Tokyo. Established in 1992, Saxo Bank A/S was one of the first financial institutions to develop an online trading platform for the private investor. Saxo's vision has always been to democratise investment and trading and to facilitate multi-asset trading by providing access to global financial markets, cutting-edge technologies, and industry-leading expertise. We enable clients to trade FX, CFDs, ETFs, stocks, bonds, futures and options.

Saxo's Response to CP322

Regarding E1: Prohibition on the issue and distribution of binary options to retail clients

ASIC proposes the following:

"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."

Please find answers to questions related to E1 in Q&A table below:

Table A – Q&A to E1

Question	Saxo Response
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***	We agree with the ASIC's proposal to remove Binary Options to Retail Clients. We agree that in many situations these products can be confusing for unsophisticated clients.
E1Q2 ***Do you agree with our proposal that the order would remain in force for a period of 18 months? If not, why not?***	As this is the maximum term ASIC can impose a 'product intervention order', we agree with this proposal.
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?***	Saxo does not have any response to this question.

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?***	Saxo agrees with ASIC's identification of the effects making this order will have on competition in the financial system.

Regarding F1: Conditions on the issue and distribution of CFDs to retail clients

ASIC proposes following:

"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. "

Due to the complexity of the questions related to F1 we have chosen not to collect the answers in a Q&A table as above. Instead please find answers below:

Question F1Q1

"Do you agree with our proposal to make a market-wide product intervention order which imposes Conditions 1–8 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."

Saxo's response to F1Q1

As this question relates to all 8 CFD related conditions, Saxo will respond to this question and how it relates to each condition.

1. Leverage ratio limits

   Saxo agrees with the proposed minimum margin requirements which is in line with the Monetary Authority of Singapore, allowing for an adjustable level of leverage ratio, within the defined ratio limits set out in Condition 1. Saxo feels that having a leverage ratio limit would mean, in times of very high volatility or during an event risk situation e.g. Brexit, we would be able to increase the margin levels to protect ourselves and warn the clients of the dangers currently facing the market. This would benefit both Saxo and the client to manage the risk exposure during geopolitical event risks, or a significant increase in volatility is

anticipated or observed. We would also ask ASIC to clarify the following points before issuing any condition on leverage limits:

a) For currency pairs, would this include other currency linked contracts, such as Spot FX and Margin FX?
b) Has ASIC considered the possibility that retail clients will be offered Futures contracts, with some similarities to those subject to the proposed condition controls under CP322, but with a higher leverage level than those proposed by ASIC? The FCA clearly considered the anticipated move from brokers offering CFDs to Futures in CP 18-38.

Saxo has made the strategic decision not to offer clients what we would consider to be irresponsibly high leverage. We ensure that the leverage offered to clients is in line with dynamic market conditions respecting volatility levels and liquidity availability, which from time to time, may require responsible caps on leverage to protect our clients from adverse market conditions.

Offering excessive leverage that is not in line with underlying market conditions is irresponsible in our view. Extreme leverage leads to clients being closed-out of their positions too quickly and too often to be profitable, even with normal daily market price movements. A premature close-out means that a client is cut off from recovering an immediate loss due to short-term market anomalies. It is possible that some brokers use mandatory trade related stop-loss orders as an additional way to force clients to liquidate positions in normal market moves in over-leveraged accounts i.e. the lower the percentage, the fewer client trades are forced into liquidation. See **Supporting Analysis** later in this submission.

Responsible caps on leverage are therefore key to consumer protection, and in this respect our interests are fully aligned with the interests of our clients. Our approach towards fostering an environment that encourages responsible trading habits demonstrates that running a profitable business and being a responsible participant in this market, are not mutually exclusive. Control of leverage cap will give retail clients the same protection and is likely to lead to a more level playing field, with focus increasingly turning to services, platform,

and depth of product offering.

Although Saxo does not offer Crypto-currency derived CFDs, we suggest that leverage on Crypto CFDs should be capped at 1:1 to avoid excessive risk taking among retail clients.

2. Margin close-out protection

   Saxo agrees with the proposed margin close out level. Closing out retail clients with exposure, starting at 50% of margin utilization will help provide further client protection.

3. Negative balance protection

   Saxo agrees with setting in place a system to provide protection against client losses. Saxo has recently introduced "Investor Shield" functionality to our clients. This functionality will allow clients to specify the Account Value at which they would like to trigger a full liquidation of their portfolio of positions, irrespective of loss on any individual trades. When used in conjunction with net position level stop-loss orders, this effectively gives clients control of their maximum intended losses on a position level as well as on an account level. And, very importantly, both triggers are wholly independent of a forced liquidation that would occur due to a breach of margin requirement at account/portfolio level. The provision of this feature is something Saxo sees as increasing consumer protection against unintended losses across their entire portfolio.

4. Prohibition on inducements

   Saxo agrees with this Condition, as it would ensure prospective clients come to trade because it is in line with their objectives and risk awareness, rather than on the promise of free gifts or monitory benefit. Saxo has analysed clients coming to Saxo through recommendation and the majority of those referred, first trade using cash products, such as share trading.

5. Risk warnings

   Please see Saxo's response at 1(b), above and F1Q3, below.

6. Real-time disclosure of total position size

   Saxo agrees with this condition. Currently, the Saxo trading platform already provides a real-time dissection of margins, funds available, profit and loss and exposures of the client's CFD positions. Client can access this information directly on the platform.

7. Real-time disclosure of overnight funding costs

   Saxo agrees with this condition.

8. Transparent pricing and execution

   Saxo agrees with this Condition on transparent pricing and execution. Saxo's Order Execution Policy provides detail explanations of relevant execution factors, by asset type to assist clients to better understand how Saxo executes client orders. This is available on the Saxo web page.

Question 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?"

Saxo's response to F1Q2

Within the Saxo Bank Group there has been measured client protection, by setting the margin close out level, starting at no later than 50% of the minimum initial levels. To facilitate this, most of the Saxo Bank Group entities provide an initial and maintenance margin, with no identifiable client detriment. In setting a prescribed margin close out percentage, there needs to be careful consideration, so that there is some distance between initial and maintenance margin, so the client is not closed out almost immediately after a new position has been opened. This is particularly evident in a volatile market situation.

In answer to this question, Saxo currently closes out all positions, as it is not possible to determine which position the client would have wanted to be closed out, if they had taken action themselves. Saxo has been particularly cautious as the retail client could assume that Saxo is taking a discretionary decision over their account positions, by choosing which positions to close and which to keep open.

If a First-In-First-Out strategy was taken, then there is no assurance that the most suitable position would be closed out, to reduce the client below 50% of margin. It might be simpler to warn the client repeatably that action to close out positions will be taken, then at 50% of margin utilization, close out all margin positions.

We have also found that in many situations, margin close out per-position is not feasible, as many clients are trading related positions, for example hedging beta-exposure with an index. In addition, being stopped out of a single position relating to a wider hedged portfolio might significantly alter the client's overall exposure

and risk. Therefore, margin close out should be viewed on an account basis. This is also in line with the latest European approach (i.e., Art. 1(e) of European Securities and Markets Authority Decision (EU) 2019/679).

Question 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?"

Saxo's response F1Q3

Saxo agrees that there should be risk warnings, covering the complexity, risks and likelihood of losses. However, we think that using the data of percentage of clients that lose money in isolation is of little value. As agreed by the European Securities and Markets Authority in the EU ("ESMA"), the likelihood of losses may change over time and that continuously monitoring its accuracy may be challenging. Alternatively, by using clearer or plainer sentences 'the vast majority of retail client accounts' or 'retail client accounts generally lose money', the risk warning can then provide the real benefit to retail investors (paras. 9-10 of ESMA35-43-1975).

Saxo believes we should find the right balance between the risk warning and the client experience. Therefore, if a prominent risk warning on account opening forms and trading platforms is already required, there should be NO need to require the same warning on all advertising and marketing materials. Despite it being a regulatory practice in the EU to add a risk warning on all advertising and marketing material, the EU requirement does NOT require this warning to be added everywhere (only relevant to '*a communication to or publish information accessible by a retail client relating to the marketing, distribution or sale of a CFD*', Art. 2(e) of European Securities and Markets Authority Decision (EU) 2019/679).

Moreover, the EU industry is still having several issues implementing the risk warning on CFD marketing material: (i) given that marketing could be done in different ways in a digital world, the risk warning is unable to cater to the myriad of channels,

different media and even differing devices; and (ii) it is normal that CFD issuers also offer other non-CFD products and the marketing material should not be always relevant to CFD trading, so this also adds more uncertainties regarding when to add the risk warning.

Question F1Q4

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

Saxo response F1Q4

As 18 months is the maximum time period, Saxo believe this is the most suitable period.

Question 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?

Saxo response F1Q5

Any changes that require notice to clients should both give a reasonable time for communication be prepared and issued. We would consider a period of at least 30 days' notice for the client to consider the impact upon their own trading.

For conditions 6, 7 & 8 we will need to consider in more depth the system build requirements and whether the period provided is sufficient.

Question 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?"

Saxo response F1Q6

Saxo believes that lower leverage builds a lower risk environment for retail clients. We believe that if warnings given to retail clients are clear, concise and do not adversely impact client access to financial markets, then it will be beneficial for both retail clients and financial service providers.

As financial service providers, the service we provide must be in the interest of the clients who trade these financial products. A sophisticated client should have the ability to understand any associated risks and manage these accordingly. A less sophisticated retail client should not be expected to understand the associated risks; which given the losses to retail clients is self-evident that they do not appreciate these risks. We believe that any financial loss to the financial service providers, will be outweighed by stemming the losses many retail clients suffer.

To support ASIC's analysis, on the negative impact of higher leverage, Saxo has undertaken its own extensive analysis. This has shown a marked impact, as leverage is increased.

Supporting analysis

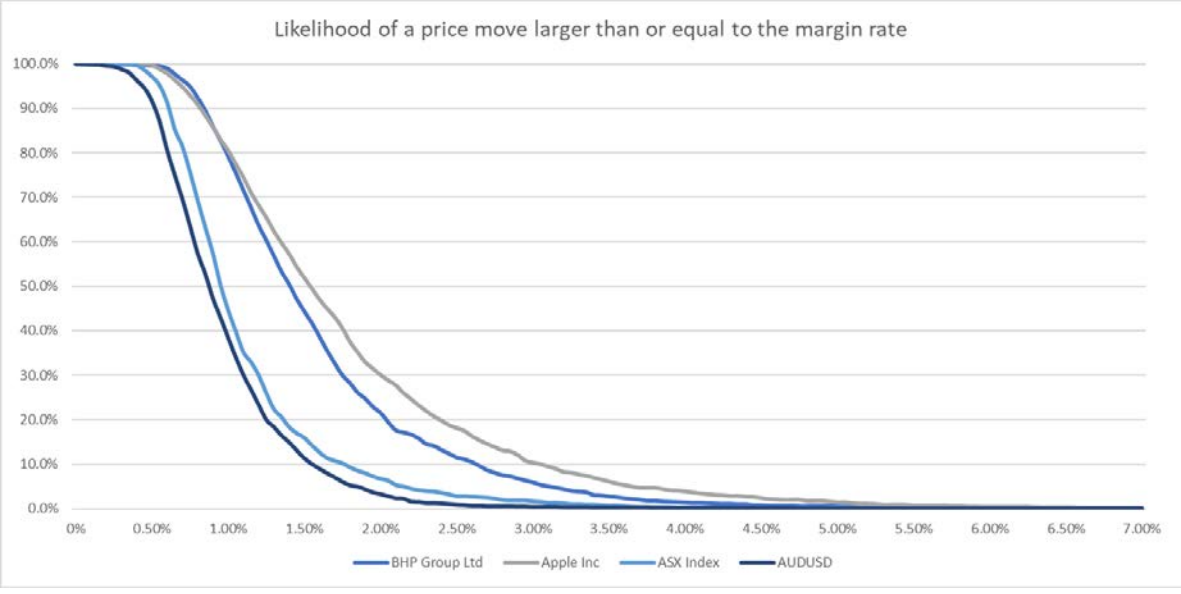
Why high leverage is a problem

Offering high leverage leads to clients being stopped out of their positions too quickly and too often to be profitable. A premature stop out means that the client is cut off from recovering an immediate loss due to short-term market anomalies. To give an example: if a broker offers 1:200 leverage, the position will only have to move 0.5 percent in the opposite direction for the clients to be stopped out. Even if the client is on the right side of the market - long a rising stock market for example - a minor fluctuation in the market can force the client to be stopped out. Even if the client got the market analysis right and made the right market call, excessive leverage would lead the client to lose money. That is why avoiding unnecessary stop-outs is crucial to being successful in trading and investing and also why caps on leverage are very effective consumer protective measures. The below analysis illustrates the risk of being stopped out prematurely, across instruments and margin levels (likelihood of a price move larger than or equal to the margin rate based on observed market data over the past 5 years). Higher leverage exponentially increases the risk of premature stop outs, conversely, diversification and hedging strategies reduces the risk of premature stop outs.

Looking at diversification, the below graphs (4 and 5) also show how the probabilities of stop-outs – and hence risk - drop as investments are diversified or hedged. It is a well-known truth that diversification across asset classes and sectors are key to an optimal portfolio and limits risk of losses. Trading products like CFDs and FX are a good way of maximizing market access as well as hedging and diversification.

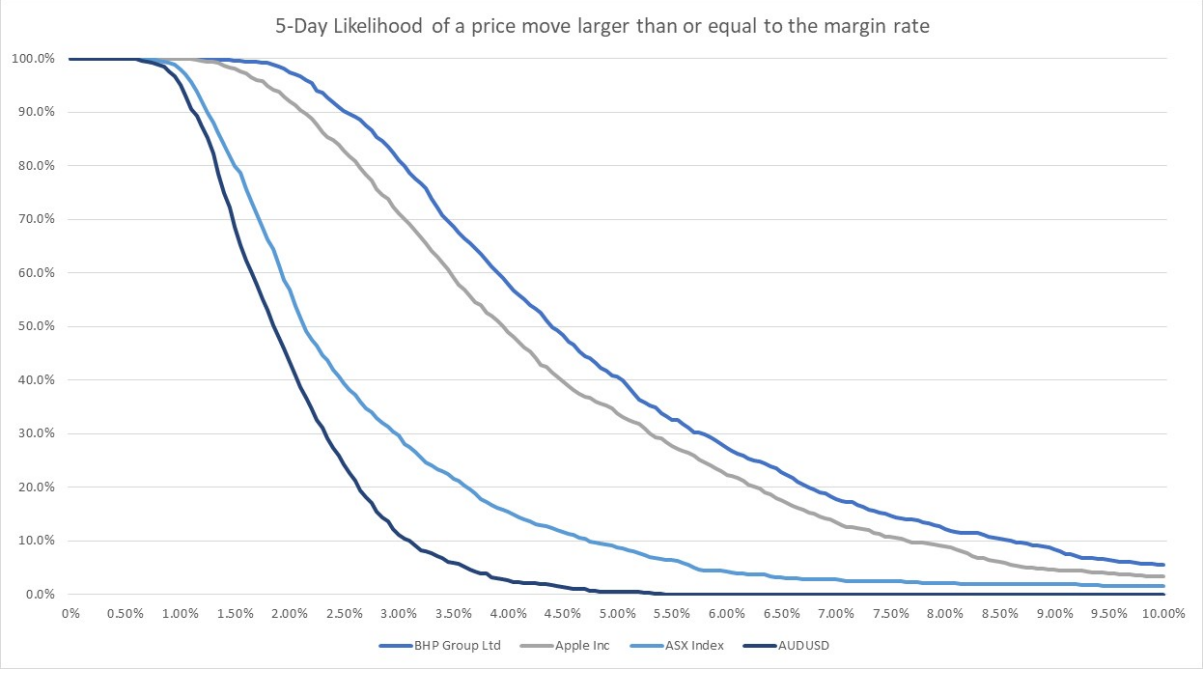
In the following examples we have used data from between September 2014 and September 2019

Example one



Graph is showing maximum intraday volatility in BHP Group, Apple, ASX 200 and AUDUSD. The likelihood of being stopped out is assuming that any client may open a position at the worst possible price, in the wrong direction, with full leverage. The margin rates on the horizontal axis show the difference between the initial margin requirement at opening, down to the stop-out, when 50% of the initial margin is lost. (Lower margin rate = Higher Leverage)

Example two



The graph is using the same assumptions as example 1, on a 5-day horizon.

Example three

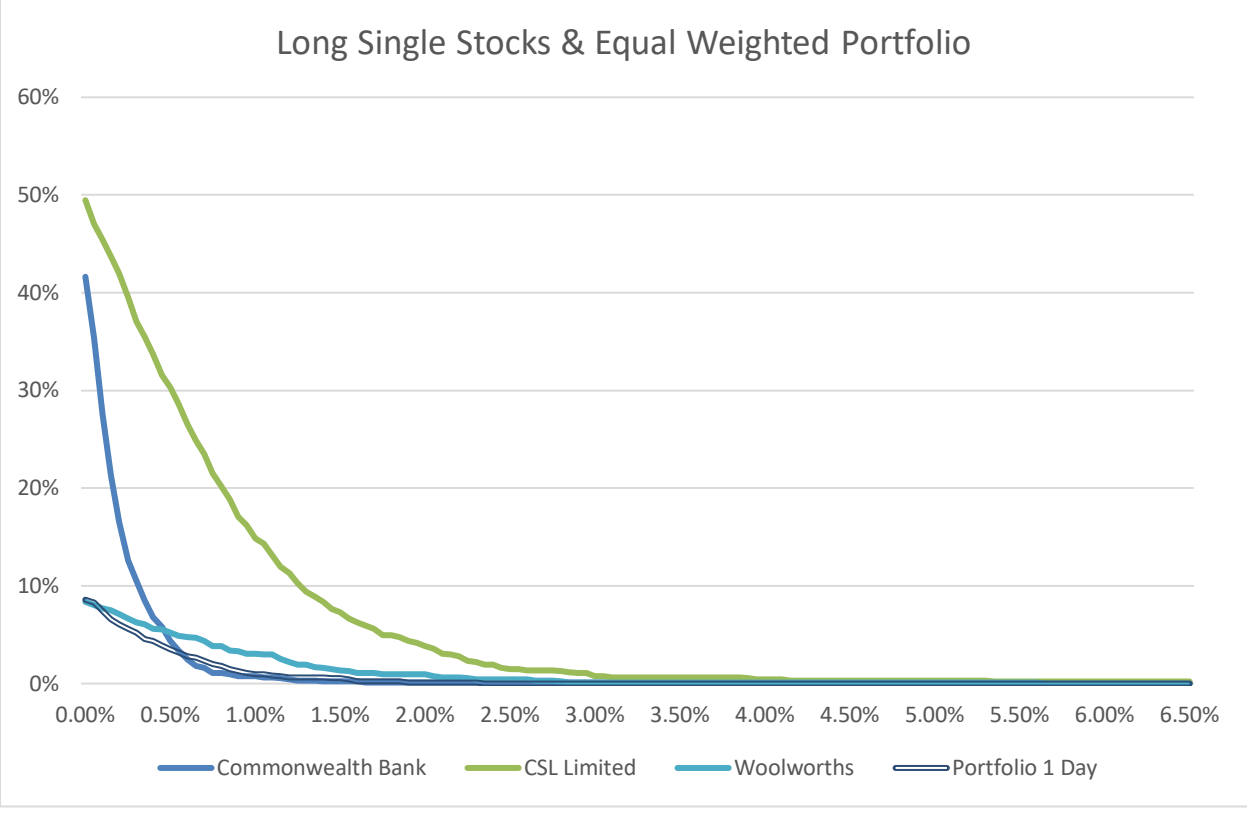
The graph is using the same assumptions as example 1 & 2, on a 20-day horizon.

Part 2: Benefits of diversification and hedging in portfolios

Example four

In this example, we looked at the likelihood of stop-out for a long stock and a short index position individually, and as an equal-weighted portfolio. The example is assuming equal margin rate for both instruments in the portfolio.

Example 5



This example shows the effect of diversification in long single stock positions, with the likelihood of being stopped out on the vertical axis and the margin rate on the horizontal. The portfolio is an equal weighted composition of CSL, WOW and CBA. Assuming all instruments have the same leverage.

Key Findings

The proposal for currencies being margined at 5% initial and 2.5% maintenance gives clients trading AUDUSD a probability of stop out of 0.8% intraday, 24% on a 5-day basis and 75.5% over 20 days following the opening at exposure. In contrast, some brokers today offer 1:100, 1:200 and even 1:400 times leverage, the respective probabilities of stop-out is outlined in the below table:

	Probability of stop-out		
Leverage	1 Day	5 Days	20 Days
100x	38.3%	95.2%	99.8%
200x	91.6%	100.0%	100.0%
400x	99.4%	100.0%	100.0%

For CFD indices, the proposal of initial margin of 6.67% and maintenance margin at 3.33%, gives a trade in the ASX 200 index a probability of stop-out of 1%, 24.1% and 69.9% over the time horizon of 1, 5 and 20 days. In comparison, we looked at the current market where we see leverage offered from 1:50 to 1:200:

	Probability of stop-out		
Leverage	1 Day	5 Day	20 Day
50x	6.7%	56.8%	95.8%
100x	44.6%	98.0%	99.8%
200x	97.1%	99.9%	99.9%

We observe higher volatility for single stock CFDs, especially when positions are held over longer periods of time. The proposal of stocks being given a minimum margin of 10% and a maintenance margin of 5% on BHP Group for instance, would give a likelihood of only 0.7% of being stopped out intraday. Over 5 days this rises to 40.7%, and over 20 days it rises to 93.4%. We compared this to leverage levels of 1:50, 1:100 and 1:200:

	Probability of stop-out		
Leverage	1 Day	5 Days	20 Days
50x	21.6%	97.5%	100.0%
100x	79.2%	100.0%	100.0%
200x	99.5%	100.0%	100.0%

Summary of lessons learned following implementation of lower leverage

Leverage must be set in line with market conditions and excessive leverage leads to premature stop-outs and client losses.

Following the implementation of lower leverage:

- Clients have been more profitable when trading leveraged products
- Clients are less frequently stopped out of the positions
- Average client AUM has increased significantly
- Average client tenure with Saxo has increased

Conclusion

The focus of ASIC's Consultation Paper is primarily on Binary Options and CFDs, for which there is current and reliable data. While the Consultation Paper separately identifies Binary Options due to its evidently detrimental effect on retail clients, we believe that by narrowing the scope to CFDs, ASIC is providing an opportunity for new derivative CFD-like products to be created; which are not CFDs, so not captured by this proposed order.

CFDs are not a defined financial product within the *Corporations Act 2001*, unlike many other financial products. They do however meet the definition of an OTC derivative product (*s761D*), so are captured as such within legislation. By restricting this proposed order to CFDs, this will allow the opportunity for another OTC derivative product to be created that is not a CFD, but is still a leveraged derivative product. Such a product would have no leverage restrictions and would cost ASIC and industry time and effort consulting on another regulatory order to close the loophole.

A similar derivative product, but not known as a CFD, is a Margin FX contract (separated out as a product under the *Corporations Amendment (Client Money) Regulations 2017)*:

> *1.37 "AFSLs with permission to issue retail OTC derivatives provide a range of financial services, including contracts-for-difference (CFDs), binary options and margin foreign exchange (margin FX or forex)."*

Under the FCA Handbook, CFDs are a specific and defined financial product:

> *"… specified in article 85 of the Regulated Activities Order (Contracts for differences etc), .."*

Within European Securities and Markets Authority Decision (EU) 2019/679):

> *"'contract for differences' or 'CFD' means a derivative other than an option, future, swap or forward rate agreement, the purpose of which is to give the holder a long or short exposure to fluctuations in the price, level or value of*

an underlying, irrespective of whether it is traded on a trading venue, and that must be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event;"

In our opinion, since CFDs are not a defined financial product within the *Corporations Act 2001*, to deter regulatory arbitrage (on the creation of new products, similar characteristics or risks as CFDs), the proposed order should be on a product defined in Australian Legislation. If the order were to state, that "*any OTC derivative product based on specific assets classes would have the following restrictions*", then this would leave no room for confusion or the creation of a loophole. In our opinion, conditions 2-8 are suitably broad reaching, but condition 1 should be re-worded to state.

"For any current or future OTC derivative contract financial product, over any of the following underlying asset class, the following leverage restrictions would apply:

- *20:1 linked to or derived from the price of any currency or gold;*
- *15:1 linked to or derived from the price of stock market indices;*
- *10:1 linked to or derived from the price of commodities (excluding gold);*
- *2:1 linked to or derived from the price of crypto-assets; and*
- *5:1 linked to or derived from the price of shares or other underlying assets."*

Risk taking v flow book model

Saxo does not use the risk-taking model ("b-book"), but instead uses a pro-client flow book model ("A- & C-book"). In this model Saxo is principle to the client's trades, but instead of taking the opposite side of the transaction on most of them, the flow book model is based on a principle of matching trades and aggregating them followed by an optimized hedge in the market either with tier one liquidity providers or directly in the primary markets. The average holding time of a position before either hedged or matched is usually seconds and no longer than minutes.

“B-booking” and why it is a problem

We believe the broker’s profit and loss should not be positively impacted by client losses. Brokers running a b-book take the opposite side of the client’s trade and client losses are therefore often profits for the broker. Running a b-book incentivises the broker to put their own interest before those of the client. Therefore, Saxo does not run a “b-book” which creates a clear conflict of interest. It is our philosophy, that when our clients succeed, we succeed and we have the incentive to work with our clients, educate them about risk and benefits of diversification.

When running a b-book the broker is incentivised to offer the client excessive risk - for example by offering too high leverage and or setting stop orders close to open price – because client losses lead to broker gains. Running a “b-book” might seem like a technical detail but it is an absolutely key incentive to be aware of. Many providers in the margin trading industry have a very high turnover or ‘churn’ of their client base, no growth in client AUM and annual net revenues of more than half of their clients’ assets. All signalling that some businesses are not operated with clients’ interest at heart.

We thank you for the opportunity to provide a response to the Consultation Paper and let us know if you require any further information.

Yours faithfully,

Saxo Capital Markets (Australia) Pty Ltd

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