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

OTC Intermediary Compliance
Market Supervision
Australian Securities and Investment Commission
Level 7, 120 Collins Street
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Submission in response to Consultation Paper 322 – Product intervention: OTC binary options and CFDs

Thank you for the opportunity to make a submission in response to ASIC Consultation Paper 322 (**CP 322**).

1. Introduction

1.1 HNLaw Pty Ltd ACN 068 367 046 (trading as Holley Nethercote Commercial & Financial Services Lawyers) acts for a large number of retail OTC Derivatives issuers (**CFDs issuers**[1]) in Australia and has provided legal services and compliance training to the industry for more than 12 years. During this time, we have acted for over 30 of Australia's issuers, some of which are among the largest CFDs issuers world-wide.

1.2 We have extensive technical and regulatory knowledge of the CFDs industry and provide this submission on behalf of 5 our clients, including Vantage Global Prime Pty Ltd and AETOS Capital Group Pty Ltd. The remaining three clients wish to remain anonymous. We have included some of their comments in this submission.

2. Summary of main concerns

2.1 We appreciate ASIC's recognition that CFDs can serve legitimate trading, investment and risk management purposes where appropriate protections are in place for retail clients and agree that it is appropriate for ASIC to use its product intervention powers to protect retail customers.

2.2 Our clients' main concerns with CP 322 and ASIC's proposed order are:

(1) ASIC has not yet published its final guidance on what constitutes significant detriment and, until this time, we are unable to provide a thorough response to ASIC's question in relation to significant detriment;

(2) the leverage ratio limits should be increased and go further than necessary to protect retail clients. The proposed ratios do not appropriately balance the interests of those retail clients who suffer detriment as a result of trading in CFDs, with the negative effect on the Australian CFD industry and those retail

[1] Our submissions are on behalf of issuers of margin foreign exchange contracts and contracts for difference. We have adopted ASIC's definition of CFDs to refer collectively to both derivative types. Both product types are traded over-the-counter, and meet the definition of derivatives in the *Corporations Act 2001 (Cth)*. Our clients are, relevantly, authorised to provide general advice, deal-issue and make a market in relation to derivatives to retail and wholesale clients.

clients who benefit from higher leverage. The proposed ratios are unnecessarily low, particularly given the suite of other consumer protection mechanisms proposed; and

(3) industry requires more time than ASIC is proposing to implement any final order that ASIC makes.

3. Scope

3.1 This submission is limited to the CFD sector and does not comment on each proposal and question listed by ASIC on page 70 of CP 322.

3.2 We have set out the relevant questions and our responses below.

4. *F1Q1: (Significant detriment and leverage): 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.*

4.1 Our clients do not agree with Condition 1 (leverage ratio limits) of ASIC's proposed order and therefore do not agree with ASIC's proposal to make the market-wide product intervention order in its current form. Specifically, it is our view that Condition 1 goes further than reasonably necessary to protect retail clients against potential detriment.

Significant detriment

4.2 The industry widely acknowledges that, as with any investment product, CFDs have the potential to cause detriment to retail clients.

4.3 Our clients acknowledge that ASIC provided draft guidance on what constitutes significant consumer detriment as Attachment 1 to Consultation Paper 313 in June 2019, and that it plans to publish final guidance in September 2019.

4.4 As at the date of this submission, final guidance has not been published which has impacted our ability to respond to ASIC's request to comment on significant detriment. For example, it is not clear what ASIC will consider in determining whether a detriment is significant, including whether ASIC it will take consumers' risk profiles into account or determine a minimum threshold for significance. We have applied the ordinary meaning of 'significant detriment' in our response.

4.5 Our clients do not object to ASIC's use of its product intervention powers to protect retail clients against significant detriment; however, ASIC should use a measured approach when using its powers so that it does not unduly impact the Australian CFDs industry and their retail clients.

4.6 ASIC should take account of the various categories of retail investors, including those that benefit from trading CFDs, in its consideration of significant detriment. Although there is a category of uninformed investors that speculatively trade CFDs and suffer detriment,[2] many retail clients use CFDs for investment and hedging purposes and

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[2] Barber, B.M., Y.T. Lee, Y.J. Liu, and T. Odean, 2009a, *Just how much do individual investors lose by trading? Review of Financial Studies 22*, 609-632.

significantly benefit from leverage.[3] For example, results of a study conducted in 2014 found that, in some circumstances the average investor in ASX-listed CFDs experiences better trade performance than the average investor in the same underlying stocks.[4] Specifically, the study found that ASX-listed CFD market order buy trades outperform their sell trades over a one-day holding period, inclusive of the bid-ask spread. This short-term outperformance is contained in both small and large trades, even after financing costs.[5]

4.7 In addition, the existing Australian regulatory regime has extensive measures in place to protect retail investors who suffer significant detriment, including the requirement for licensees to provide their financial services efficiently, honestly and fairly and for licensees to be a member of an external dispute resolution scheme. Introducing blanket industry-wide restrictions to address the malpractice of a small number of CFD operators, is not the most effective or fair way to address the significant detriment suffered by retail clients as a result of such operators.

Condition 1: Leverage

4.8 ASIC's proposed Condition 1 is disproportionate and does not fairly balance the interest of reducing the risk of retail clients suffering detriment with the impact on the competitiveness of the Australian CFDs industry and consumer choice, particularly given the suite of other consumer protection mechanisms proposed.

Clients

4.9 Retail clients trade in CFDs for several reasons, some of which will be impacted by restricted leverage ratios. IG Group, which has provided CFDs to retail clients for 44 years and is one of the world's largest CFD providers, conducted a survey in early 2017 in which it asked its client about their motivations for trading CFDs. In the survey, 13 per cent of clients cited hedging as the main reason for trading CFDs and 49 per cent responded they had used CFDs to hedge on at least one occasion of the past year.[6] Implementing such restrictive leverage ratio limits disadvantages these retail clients because it requires them to put more capital at risk to achieve the same hedging goal. To put forward the additional capital required, the retail client may be forced to stop out prematurely and crystalise loss, or to sell underlying assets they hold (for example, BHP shares), to the client's detriment. Restrictive leverage limits are also a disadvantage to retail clients who effectively use CFDs for exposure to comparatively expensive financial assets at a lower cost than other forms of investment.

4.10 We have set out some example scenarios of how a 5:1 leverage ratio compared to a slightly higher, but still reduced, leverage ratio of 20:1 may impact retail clients.

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[3] Appendix 4, *IG Group Response to ESMA Call for Evidence on Potential Product Intervention Measures on CFD and Binary Options to Retail Clients*, 5 February 2018.
[4] A. D. Lee, S. Choy, *Contracts for dummies? The performance of investors in contracts for difference*, Accounting and Finance 54 (2014), page 986.
[5] Ibid, page 991.
[6] Appendix 4, *IG Group Response to ESMA Call for Evidence on Potential Product Intervention Measures on CFD and Binary Options to Retail Clients*, 5 February 2018.

Example: Customer A owns 10,000 shares in BHP Group Limited. Customer A has available $20,000 in liquid funds and wants to reduce exposure to the share market during volatile market conditions. Customer A opens a CFD trading account, depositing at least $20,000, with the aim of halving exposure in BHP Group Limited. BHP price is set at $38.30 for the purpose of this example.

Scenario 1: Price increase in the underlying assets with 20:1 leverage ratio

4.11 Under current conditions of a 5% margin requirement, Customer A would need an initial margin of $9,575 to open a short position of 5,000 units in BHP Group Limited. In this situation, Customer A could cover a loss of up to $15,212.5 or approximately 8% before a stop out event (50%).

Change in underlying assets	Equity value ($)	CFD account value	Total value	Comparison to scenario 2 ($)
No change	383,000	20,000	403,000	0
5% increase	402,150	10,425	412,275	0
10% increase	421,300	4,788	426,088	3,938
15% increase	440,450	4,788	445,238	9,575
25% increase	478,750	4,788	483,538	11,490

Scenario 2: Price Increase in the underlying assets with 5:1 leverage ratio

Under the proposed conditions of a 20% margin requirement Customer A would have an initial margin requirement of $38,300. Customer A is not able to cover the initial margin requirement with liquid cash so decides to sell approximately 500 BHP shares with potential tax implications and fees to raise $19,150. Customer A deposits $39,150 to cover half of his original exposure, shorting 4,500 units of CFDs on BHP Group Limited. The initial margin requirement is $34,470. Customer A could cover a loss of up to $21,915 or approximately 12% in price movement before a stop out event (50%).

Change in underlying assets	Equity value ($)	CFD account value	Total value	Comparison to scenario 2 ($)
No change	363,850	39,150	403,000	0
5% increase	382,043	30,533	412,575	0
10% increase	400,235	21,915	422,150	-3,938
15% increase	418,428	17,235	435,663	-9,575
25% increase	454,813	17,235	472,048	-11,490

Scenario 3a: price decrease in the underlying asset with 20:1 leverage ratio

Under current conditions of a 5% margin requirement Customer A would need an initial margin of $9,575AUD to open a short position of 5000 units in BHP Group Limited.

Change in underlying assets	Equity value ($)	CFD account value	Total value	Comparison to scenario 3b ($)
No change	363,850	20,000	383,850	0
5% decrease	345,658	28,618	374,275	3,617
10% decrease	327,465	37,235	364,700	7,235
15% decrease	309,273	45,853	355,125	10,852
25% decrease	272,888	63,088	335,975	18,087

Scenario 3b: price decrease in the underlying asset with proposed 5:1 leverage ratio

Under the proposed new conditions of a 20% margin requirement Customer A would have an initial margin requirement of $38,300. Customer A is not able to cover the initial margin requirement with liquid cash and is not willing or able to sell his shares to raise cash potentially because of tax or legal reasons. Customer A decides to deposit the $20,000 liquid cash available and opens the maximum short position available shorting 2611 units of CFDs on BHP Group.

Change in underlying assets	Equity value ($)	CFD account value	Total value	Comparison to scenario 3a ($)
No change	363,850	20,000	383,850	0
5% decrease	345,658	25,000	370,658	-3,617
10% decrease	327,465	30,000	357,465	-7,235
15% decrease	309,273	35,000	344,273	-10,852
25% decrease	272,888	45,000	317,888	-18,087

4.12 From the above scenarios, the following conclusions can be drawn:

(1) In Scenario 2 Customer A needed to place more capital at risk in order to achieve his hedging goals of 50% reduced risk.

(2) In Scenario 2 Customer A needed to pay additional execution fees and may have incurred undesirable tax implications after being required to sell a portion of his shareholdings in BHP to achieve the same result in hedging.

(3) In Scenario 1 Customer A was stopped out much earlier than in Scenario 2; he was able to hold his original amount of shares and benefit from its appreciation in share value.

(4) In Scenario 3 part (b) which is under the proposed 5:1 leverage restriction, Customer A could not cover as much hedging and was worse off overall than if he had been able to hedge more market risk with leverage at 20:1.

4.13 Our clients appreciate that the ability for retail clients to leverage their positions may expose some of them to greater loss than they would otherwise be exposed to on the basis of their margin. However, the client detriment metrics that ASIC has proposed in Condition 2 and Condition 3 which our clients do not oppose, adequately address these risks.

4.14 In addition, requiring clients to put forward significantly more capital to achieve the same hedging position may expose retail clients to greater loss. More cash will be required to be held with CFD issuers, which may increase the risk for clients if a broker goes into liquidation and client monies have not been properly held and managed.

4.15 Finally, data shows that overly-limited leverage ratios are likely to drive a large number of retail clients to trade in other jurisdictions, some of which offer minimal protection.[7]

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[7]CP 322.137. We understand that ASIC has industry data on the increase in clients trading with Australian CFD issuers after restrictive leverage ratios were introduced in the UK and Europe. Also see *IG Group Response to ESMA Call for Evidence on Potential Product Intervention Measures on CFD and Binary Options to Retail Clients*, 5 February 2018.

In particular, those clients who wish to use CFD trading in a highly speculative manner with high leverage for “big wins” (which are ordinarily the more vulnerable clients who suffer the most detriment) will still access unregulated or lightly regulated jurisdictions which do not offer a comparative level of protection to Australia. Insofar as possible, ASIC should encourage retail clients to remain with Australian-regulated CFD issuers, and limiting Australian-regulated CFD issuers to offer some of the lowest leverage ratios will have the opposite effect.

Industry

4.16 Condition 1 is likely to have a substantial negative impact on Australia’s competitiveness in the CFDs international market.

4.17 The FCA, ESMA, the CFTC and the United States’ National Futures Association conducted research prior to determining the restricted leverage ratios in their respective jurisdictions.[8] Each jurisdiction settled on a higher leverage ratio than what is currently proposed by ASIC and has been successful in curbing harm suffered by retail clients.[9] Our clients therefore question the basis and reason for ASIC’s more restrictive approach.

4.18 ASIC referenced Australia’s geographical location in the Asia-Pacific region and noted that regional alignment may assist to limit regulatory arbitrage.[10] CFDs trading is international; transactions occur online, and deposits are made using global payment service providers. CFD issuers are situated within multiple locations, and often run 24-hour support desks. As noted by ASIC, 83 per cent of Australian CFD issuers’ client base is located overseas. [11] Therefore to the contrary, the risk of regulatory arbitrage is exacerbated by Australia having leverage limits that are lower than Europe, the UK and the USA. Asia accounts for 62 per cent of Australian CFD issuers’ client-base.[12] If leverage ratio limits are introduced that are the same as, or lower than, the clients’ home jurisdiction, it is likely these clients will cease trading in Australia and instead open accounts with CFD issuers located in the UK, Europe or the USA where they can access higher leverage ratios whilst maintaining a level of consumer protection granted by those regions’ regulatory regimes.

4.19 Australia’s regulatory environment is more similar to the UK and Europe, than it is to Asian jurisdictions. Given the online and international nature of the CFD industry and its client base, ASIC’s determination in relation to leverage ratio limits should not be dictated by Australia’s geographical location.

4.20 CFDs may also have a beneficial impact on Australian markets through the addition of new liquidity provided by CFDs’ leverage.[13] A study conducted by Cian Twomey and Shaen Corbet[14] found that the initial inclusion of CFDs on the ASX exchange was associated with a reduction in volatility, and that volatility increased by 3.55% after the

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[8] See for example ESMA’s ‘simulation results informing leverage limits’ which the FCA also utilised in its report: ESMA, *Product Intervention Analysis: Measures on Contracts for Differences* (1 June 2018) 29.

[9] See for example CP18/38 at paragraph 2.25: https://www.fca.org.uk/publication/consultation/cp18-38.pdf.

[10] CP322.164 and 322.181, Table 6.

[11] CP322.55.

[12] CP322.55.

[13] Corbet, S., Twomey, C., *Quantifying the effects of the inclusion and segregation of Contracts for Difference in Australian equity markets*, International Journal of Economics and Financial Issues, 4(2), 2014.

[14] Ibid.

segregation of CFDs. The authors suggested that, with CFDs accounting for eight to fourteen per cent of total exchange liquidity, the reduction may have caused volatility increases through a simultaneous decrease in liquidity.[15]

Proposed leverage ratios

4.21 There are effective alternative mechanisms to limit client detriment, including margin close-out protection (proposed Condition 2) and negative balance protection (proposed Condition 3), providing clients with appropriate risk warnings (already required, and included within proposed Condition 5) and providing clients with appropriate information (proposed Condition 6-8).

4.22 Our clients propose the following leverage ratios:

(1) 50:1 for CFDs over currency pairs or gold;
(2) 30:1 for CFDs over stock market indices;
(3) 20:1 for CFDs over commodities (excluding gold);
(4) 2:1 for CFDs over crypto-assets; and
(5) 20:1 for CFDs over shares or other underlying assets.

4.23 The proposed limits are still significantly more reduced than the current limits. In our view, they will improve client outcomes, including by reducing losses per trade and reducing total transaction fees as a function of lower volumes of trading.

5. *F1Q3 (Risk warning): 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?*

5.1 Our clients do not agree with the proposal to provide *further* risk warnings.

5.2 CFD issuers are already required to provide extensive warnings to retail clients, including on their website, application form and marketing material, and our clients question the effect of an additional warning requirement.

5.3 Retail clients often have a strong resolve, are overly confident and are not easily deterred by announcements or warnings.[16] It is more important to provide retail clients with clear information about product mechanics to enable them to make an informed decision. This is addressed by ASIC within conditions 6, 7 and 8.

5.4 Risk warnings are difficult to implement on some mediums. Many CFD issuers use third-party software (such as MT4 and MT5 offered by MetaQuotes) and will require cooperation with those third parties to comply with the proposed requirements. We are instructed that MetaQuotes currently refuses to add wording to some of its software platforms. If ASIC chooses to implement this condition, it should scale back the requirement to include the warning on the platform itself.

5.5 We also refer to the comments in relation to timing in paragraph 6 directly below.

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[15] Ibid, page 420.
[16] Heimer R., Simsek A., *Should Retail Investors' Leverage Be Limited?* Journal of Financial Economics, 132(3) (June 2019), pages 19-20.

6. ***<u>F1Q5</u> (Timing): 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?***

6.1 No. More time is required for CFD issuers to effectively and comprehensively implement the proposed changes. It is paramount that these changes are properly implemented to achieve the desired consumer-protection outcomes, and adequate time for their implementation should be given.

6.2 Many of the proposed conditions implicate third party service providers and are therefore highly time consuming. Given the entire CFDs industry will be required to make these changes, there are likely to be resourcing issues that are out of the control of CFD issuers and which would impact their ability to comply with the short timeframes.

6.3 CFD issuers need time to ensure the proposed changes are implemented properly, without affecting current retail clients. The short timeframe will require several issuers to divert their compliance and technology resources, which may negatively impact the resources available to provide the same level of customer service to existing retail clients. In addition, CFD issuers will need to amend their client terms and conditions, which is likely to be a time-consuming process, and which will require appropriate notice to be given to existing retail clients.

6.4 The Instrument will fall within the definition of the financial services laws and therefore CFD issuers will need to update and create new AFSL compliance procedures terms and conditions, and disclosure documents to incorporate the changes. The proposed timeframes do not provide sufficient time for this to be done properly.

6.5 ASIC has not yet released its final guidance on what constitutes ‘significant detriment’. ASIC has indicated that this guidance will be published in September 2019, and industry needs adequate time to consider it in relation to the proposed order.

6.6 The consequences of non-compliance under chapter 7 and the Instrument are substantial and include civil penalties and administrative action for a breach of an AFS licence. CFD issuers should be given an appropriate amount of time to fully implement and comply with the changes.

6.7 Clients with open positions when order comes into effect will need time to either reduce their exposure or find additional capital to hold their open positions. It is likely that the reduced leverage ratios will alter several clients’ trading strategies; clients should be afforded adequate time to seek advice and consider how the changes will impact them.

<u>Appropriate period</u>

6.8 Our clients propose:

(1) 3 months for the leverage restrictions (Condition 1); and

(2) 6 months for the remaining conditions.

7. ***<u>F1Q6</u> (Effects of product intervention): 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?***

We refer to and repeat the comments at paragraphs 4.8 and 4.15-20 above.

If you have any questions about this submission, please contact Paul Derham on [redacted] or email [redacted]

Yours sincerely,

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