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OTC Intermediary Compliance
Market Supervision
Australian Securities and Investments Commission

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

1 October 2019

Dear OTC Intermediary Compliance

Response of IG Markets Limited to Consultation Paper 322 Product intervention: OTC binary options and CFDs

IG Markets and IG Group

By way of brief background, IG Markets Limited (IG) deals in securities and over-the-counter (OTC) contracts for difference (CFDs) on a broad array of financial instruments, to a retail and wholesale client base. IG is the world's No. 1 CFD provider.[1]

In Australia, IG is regulated by the Australian Securities and Investments Commission (ASIC) and is a wholly owned subsidiary of an ultimate parent company, IG Group Holdings plc (IG Group), which is a market leader in on-line trading. IG Group has a primary listing on the London Stock Exchange where it is an established member of the FTSE 250.

Around the world, IG Group companies are regulated by:

- UK's Financial Conduct Authority;
- Monetary Authority of Singapore;
- South African Financial Services Board;
- US Commodity Futures Trading Commission;
- US National Futures Association;
- Swiss Financial Market Supervisory Authority;
- Japanese Financial Services Agency;
- Japanese Ministry of Finance;
- New Zealand's Financial Markets Authority;
- Germany's BaFin; and
- Dubai Financial Services Authority

[1] Based on revenue excluding FX (published half-yearly financial statements, June 2019)

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To meet the high expectations of our global regulators, promote a strong culture and mitigate the risk of poor conduct, we have a developed framework which focuses on our clients. We strive to ensure our products and services result in good outcomes for both our clients and the financial markets.

We firmly believe and support proportionate regulation that delivers good client outcomes as we feel this leads to a better, long-term sustainable industry. To meet these regulatory requirements, we ensure that we have at all times: (i) a robust governance structure, (ii) products that are designed to meet the needs of IG's target market, (iii) marketing that is appropriately targeted and (iv) dealing practices that deliver best execution.

Executive summary

We are supportive of ASIC's work on protecting Australian retail clients from practices within the financial services industry that result in consumer detriment. We firmly believe in robust and proportionate regulatory oversight of financial products and services in Australia, and we fully support initiatives that are designed to strengthen protections for retail consumers.

We fundamentally agree with the outcomes CP322 is aiming to achieve. However, we propose amendments to several of the conditions which we believe will ensure better outcomes for retail consumers while equally maintaining a fair and competitive Australian financial services industry.

In summary, our feedback is:

(i) several of the conditions proposed apply unequally to the CFD industry; most notably, the platform obligations which ASIC intends to impose only on the minority of CFD issuers that maintain their own platforms. We support the inclusion of enhanced platform disclosures, however for such disclosure to have a meaningful and positive impact on client outcomes, it is essential that these obligations apply to all CFD issuers equally, regardless of whether the CFD issuer maintains its own platform or a platform provided by a third party. We have therefore proposed alternative options, which we believe will achieve the same aims, for ASIC's consideration.

(ii) we are supportive of the introduction of proportionate leverage restrictions. However, we believe that some clients will find the leverage restrictions proposed by CP322 to be overly restrictive. Our analysis demonstrates that ASIC has overestimated the impact of leverage on client outcomes and underestimated (a) retail clients' desire to trade with leverage; and (b) retail clients' willingness to contract with offshore brokers. We include our analysis on appropriate leverage restrictions below, for ASIC's consideration.

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Proposed intervention for CFDs

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

Condition 1: Leverage ratio limits

We agree with ASIC that excessive leverage can cause poor consumer outcomes, and therefore it is appropriate to set some limits on leverage, especially for a retail audience. The leverage level at which consumer detriment occurs is a matter of significant debate. From ASIC's consultation paper, regulators around the world take different views on the appropriate leverage for a retail audience. We have also conducted a significant amount of data and economic analysis to reach our own views on this subject. Our analysis is extensive and presented at the end of this paper.

In short, we believe that the leverage restrictions proposed by CP322 are overly restrictive in order to prevent the harm caused by excessive leverage. Given that demand for leverage among the retail trading audience is strong, we believe that a more proportionate balance should be struck. We include our analysis on appropriate leverage restrictions below, for ASIC's consideration.

Condition 2: Margin close-out protection

We agree with this condition, with one caveat: 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, and the approach that we consider to be best practice.

Client experience using the variation close-out approach vs the initial margin close-out approach

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:

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(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 CP322.

(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. We identified 391 trades from IG's UK retail clients subject to margin close-out during the period from June 2019 to August 2019 where this margin calculation would have generated a margin requirement in excess of the maximum loss on the position. This is clearly illogical.

(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; $2000 if they close their initial trade, and $2400 if they close the second trade.

Example	Margin Model	Opening Price	Leverage Ratio	Size	Opening Margin	New Market Level	New Margin	New Leverage Ratio	Comparison with proposed leverage ratio limits
Example 1	Initial	6000	15:1	$1	$400	7000	$400	**17.5:1**	**Higher**
Example 1	Variation	6000	15:1	$1	$400	7000	$466	15:1	Same
Example 2	Initial	1000	5:1	1 share	$200	100	$200	1:2	Lower
Example 2	Variation	1000	5:1	1 share	$200	100	$20	5:1	Same
Example 3a	Initial	100	5:1	100 shares	$2,000	150	$2,000	**7.5:1**	**Higher**
Example 3a	Variation	100	5:1	100 shares	$2,000	150	$3,000	5:1	Same
Example 3b	Initial	120	5:1	100 shares	$2,400	150	$2,400	**6.25:1**	**Higher**
Example 3b	Variation	120	5:1	100 shares	$2,400	150	$3,000	5:1	Same

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 variation margin approach reflects the margin approach in the institutional markets

To our knowledge, there is no precedent in the wider market that is known for basing margin rates on the opening level of a position.

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All IG's hedged positions on FX and equities are margined based on notional currency exposure at current (rather than initial) rates. Further, IGs hedged positions on futures are margined at a fixed per-lot rate which is updated periodically in line with underlying volatility and notional exposure (i.e., based on risk).

The cost of updating to an initial margin approach is disproportionate

If the margin close-out condition is required to be based on initial margin, the cost to implement from a development perspective is put at around 150-man days, or over 4 months of work.

There in an additional but unquantifiable cost associated with clients needing to get used to a new and less intuitive margining system that will be difficult to explain or justify. This should not be dismissed as immaterial or underestimated. Further, there is an opportunity cost associated with stopping value-add development work to improve our client offering. In this case, any work on this would require us to stop the current scheduled jobs to support our business.

Notwithstanding our belief that the prevailing market price close-out model is the superior model, we understand that many CFD issuers currently adopt the initial margin close-out approach and will be unable to comply with the prevailing market price approach. **Therefore, we propose 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.**

The intention of CP322 is to *"protect retail clients from excessive losses in their CFD positions from unexpected sudden changes in the price of underlying assets*" (para 183). We believe that the variation margin close-out approach provides better outcomes for clients, is easier to understand, and is an approach based on the monetary risk the client is exposed to. In our view, this should be the default approach used to margin CFD positions, which we explain in detail below.

Notwithstanding this view, we propose an either/or approach to margin close-out protection because many CFD issuers who use third party platforms would be unable to comply with the prevailing market price close-out model.

Condition 3: Negative balance protection

We agree with this condition

Condition 4: Prohibition on inducements

We agree with this condition.

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Condition 5: Risk warnings

We wholly agree with the aim of ensuring that all consumers who trade CFDs are aware of the risks involved and have an accurate appreciation of their chances of trading the instruments profitably.

Furthermore, we agree with disclosing a loss-making account percentage and think doing so will be invaluable in counteracting misleading marketing carried out by irresponsible firms and ensuring that all CFD clients are appropriately informed about the risks they may be taking. However, as currently proposed (a) the condition does not apply equally to all CFD issuers; and (b) the condition does not consider the impact of affixing the risk warning to a mobile application. We believe that ASIC would be able to generate the same outcomes for consumers by addressing the following:

(i) The rules regarding display of the risk warning should take into account the practical problems associated with small screen sizes on mobile devices

The stipulation in 7(8)(a)(iii) and (iv) that the risk warning must be provided on any webpage maintained by the CFD issuer that relates to CFDs, and in a prominent position on any CFD trading platform maintained by the product issuer, is unworkable in the context of a mobile device, where the warning will constantly occupy much or even most of the available screen space. The risk warning should be deployed proportionately.

While we agree that a retail client should be presented with the full risk warning at the time the client visits a relevant web page, we propose that the risk warning on a mobile device should be dismissible, or partially dismissible, so that the client may dismiss the warning once it has been read.

This approach will ensure the risk warning doesn't take up a disproportionate amount of space on any given mobile device and disrupt the user experience unnecessarily.

To illustrate how this approach can work in practice, we refer to Appendix 2 which contains examples of the risk warnings used by IG Markets' UK business, in accordance with the FCA regulations. Crucially, the full risk warning is presented each time a client returns to the website.

(ii) The requirement to display a risk warning must apply equally to all firms

The proposal to require CFD issuers to provide a prominent risk warning on the platform does not apply to CFD issuers that maintain their own platform; that is, approximately 90% of CFD issuers will not be required to comply with this proposal. This is fundamentally prejudicial and is contradictory to ASIC's view that *"the benefit of imposing market wide conditions is that it applies to all issuers of CFDs equally. It will set an even bar among all CFD issuers and provide consistency with measures introduced overseas." (CP322 para 215) and "Our conditions will standardise certain practices across all CFD issuers" (CP322 para 162).*

In order to achieve an even bar and promote consistency across the industry, and to ensure that this proposal has a meaningful and positive impact on client outcomes, we suggest that CFD providers must include prescribed risk warnings in a prominent position on the following:

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(1) Front page of the PDS;
(2) Account opening forms; and
(3) Website pages maintained by the CFD issuer relating to CFDs.

By adopting this approach, at the time the client accesses the live trading platform the client would have (a) potentially viewed an advertisement for the CFD issuer; (b) visited the CFD issuer's website to apply for an account; (c) been provided with a copy of the PDS prior to applying for a CFD account; and (d) completed an application form. Therefore, at each point during the account acquisition journey, the client would have been presented with at least three prominent risk warnings prior to being able to acquire a CFD. Importantly, our suggested prominent positions are all controllable by firms regardless of whether the firm maintains its own platform or licenses it – thereby the risk disclosure will be received by all clients regardless of the firm they choose.

CP322 clearly states (para 193) that the condition requires CFD issuers to draw retail clients' attention to the risk of losing money trading CFDs. We believe that this aim is achieved by delivering the warning to prospective CFD traders in an impactful way at (i) the point of first considering CFD trading (e.g. advertisement, website material, and PDS), and (ii) the point of actual account opening.

Condition 6: Real-time disclosure of total position size

We wholly agree with the requirement to disclose the total size of a client's position in real-time.

However, as the condition is currently proposed, this requirement only applies to CFD issuers who maintain their own platform; therefore, approximately 90% of CFD issuers will be exempt. We therefore reiterate our view that such measure should apply equally to CFD issuers, not just 10% that maintain their own platform. The most widely used platform by CFD issuers, MT4, already contains this feature and therefore we do not think it would be burdensome for the measure to apply to the whole industry.

Condition 7: Real-time disclosure of overnight funding costs

We agree with this condition.

However, we consider that the definition of 'fee' is unclear and requires clarification. To illustrate this point, consider a position held overnight on an undated Oil CFD. The equation for calculating the overnight adjustment is broken down into two parts, (i) the daily movement along the futures curve (basis); and (ii) the CFD issuer's charge. The basis equates to the daily movement of our undated price along the futures and may be a credit or a debit. This will either be a positive or negative number depending on the direction of the client's trade and the slope of the forward curve. It is important to note that the basis movement is reflected in the movement in the price and is therefore offset in the running P&L on the position and is not a charge. The overnight adjustment = number of contracts x contract size x (basis + CFD issuer charge).

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Although the CFD issuer's charge may reference a fixed rate multiplied by the price of the contract divided by 365 days, the basis calculation is applied to create a cash neutral futures curve adjustment; an adjustment that will be offset in the running profit or loss on the position. The draft instrument is unclear in this regard, and we request that ASIC clarifies whether the requirement to display a fee as an annualised rate and value relates solely to the CFD issuer's charge, or to the combined adjustment and charge.

Furthermore, in the case of a spot FX position that rolls from one spot day to the next, the cost of carry is determined with reference to the market determined 'tom-next rate' plus or minus a CFD issuer administration fee. Therefore, we suggest that ASIC provides a clear definition of what constitutes a 'fee' so that CFD issuers have clarity on whether the requirement to display a fee as an annualised rate and value solely to the CFD issuer's charge, or to the combined adjustment and charge.

Finally, we reiterate our comments made with respect to condition 6 regarding the requirement only applying to the small number of CFD issuers that maintain their own platforms. To ensure this condition applies equally to all CFD issuers, we suggest that this information should be made available to clients through (a) transaction confirmations[2]; or (b) a webpage updated on a daily basis.

Condition 8: Transparent pricing and execution

We agree with this condition.

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?

We agree with this condition, with one caveat: 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.

We have outlined our concerns with respect of the initial margin calculation in our answer to F1Q1.

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?

[2] Provided to clients in accordance s1017F Corporations Act 2001 (Cth)

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Although RG 234 already mandates the requirement for a "sufficiently prominent warning" outlining the risks of trading CFDs[3] the risk warning is not prescribed and therefore it is up to each CFD issuer to determine the appropriate risk warning for CFD advertising and marketing material.

To promote consistency across the industry, and to ensure that risk warning have a meaningful and positive impact on client outcomes, a standard risk warning should be prescribed for marketing and advertising material.

With respect of the requirement to include a prominent risk warning on platforms, we reiterate our comments made with respect on condition 6 regarding the requirement only applying to CFD issuers that maintain their own platforms.

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

Yes, we agree.

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?

The total cost to IG for implementing these conditions is estimated to be of the order of 350 – 390-man days of development work, with an estimated cost of $175,000-$195,000.

The two conditions requiring the most significant amount of work are (i) the margin close-out rule (as explained above IG adopts the variation margin close-out model); and (ii) the real time overnight funding disclosure. Initial estimates for implementing these conditions are at least 4 months of development work, which exceeds the proposed 3-month implementation timeframe.

All the other conditions can be implemented within the proposed transition periods, but further consideration should be given to time required for clients to understand and respond to proposed 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?

We do not believe that CP322 sufficiently considers the impact that several proposed conditions will have on competition in the financial system, specifically conditions 2, 5, 6 and 7.

[3] RG234.45, example 16

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Each of these conditions apply only those CFD issuers that maintain their own platform. As explained in detail above, CP322 proposes the following requirement on these issuers that will not 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

To our knowledge, approximately only 10% of CFD issuers maintain their own platform. Therefore, 90% CFD issuers will not need to comply with these conditions. This is fundamentally prejudicial and is contradictory to ASIC's view that *"the benefit of imposing market wide conditions is that it applies to all issuers of CFDs equally. It will set an even bar among all CFD issuers and provide consistency with measures introduced overseas." (CP322 para 215) and "Our conditions will standardise certain practices across all CFD issuers" (CP322 para 162)*

We also believe that if ASIC elects to impose these conditional on only a small subset of CFD industry, ASIC will have failed to comply with its statutory obligation to consider competition.[4]

Other comments

Definition of 'CFD'

We agree with having a detailed definition of 'CFD' in the draft instrument per attachment 2 of CP322. We note that ASIC has confirmed in paragraphs 24 to 36 of CP 322 that the exercise of its product intervention powers as proposed in CP322 is targeted at OTC binary options and CFDs, and that any concerns with a broader range of financial products would be dealt with by a separate exercise of ASIC's product intervention powers. We support this approach. However, in order 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:"

[4] s1(2A)) Australian Securities and Investments Commission Act 2001 (Cth)

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F1Q1 – Condition 1: Leverage Ratio Limits

We support the introduction of leverage ratio limits on CFDs issued to retail clients. However, we believe the proposed limits are in excess of the limits required to address the impact of leverage on imbalanced client outcomes. We are also concerned that, as leverage is attractive to retail clients, excessive leverage restrictions will drive Australia retail clients to unregulated offshore CFD issuers.

Our analysis of the leverage limits proposed in CP322 is presented in three parts:

(1) the impact of leverage of a retail client's trading activity;
(2) regulatory arbitrage; and

(3) Analysis on leverage, client detriment, and setting leverage limits

1. Impact of leverage on a retail client's trading activity

Speculative trading (or hedging, which is indistinguishable from speculative trading in isolation) is a zero-sum activity, and transaction costs act as a drag on performance, regardless of the instrument being traded. Though individual clients may register significant profits or losses, the average client P&L for IG clients in a typical year is a loss approximately equal to the average transaction fees our clients choose to pay us.

While the leverage level does not impact the expected P&L on a trade, high leverage can negatively impact client outcomes by increasing the probability of losing on a trade. This distortion is only material at extremely high margin rates relative to transaction costs.

By correctly identifying these levels and setting proportional leverage limits, ASIC could have an almost unambiguously positive impact on retail trading clients – minimising both consumer detriment and the risk that Australian clients move to poorly regulated offshore brokers.

A model outlining the effect of leverage on trade outcomes is set out in detail in *Appendix I*. The margin requirements on IG products have been intentionally set at levels at which the detrimental effect of excessive leverage is almost non-existent. Therefore, we believe that any further increases in margin requirements from IG's current requirements will have minimal improvement on client outcomes (defined by the percent of winning trades, or winning clients).

2. Regulatory Arbitrage

The FCA in the UK report a reduction in active retail clients of 72,783 following the introduction of leverage limits. In report 626 ASIC note that in 2019, 11% of the 1 million CFD clients in Australia reside in Europe. That is, there are 110,000 European retail clients contracted with Australian entities. These clients had no incentive to contract with Australian firms before 2018, they have clearly opened Australian accounts following ESMA's product intervention.

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Given Australia is one of many jurisdictions available to these clients, it's not unreasonable to assume that the number of clients trading CFDs in the UK is in fact completely unchanged – they're just trading with offshore firms. We believe that client outcomes for all Australian consumers, contracting with both ASIC licensees and offshore providers, could be better served by finding a balance between consumer demand for leverage and regulatory protections.

4. Analysis on Leverage, Client Detriment, and Setting Leverage Limits

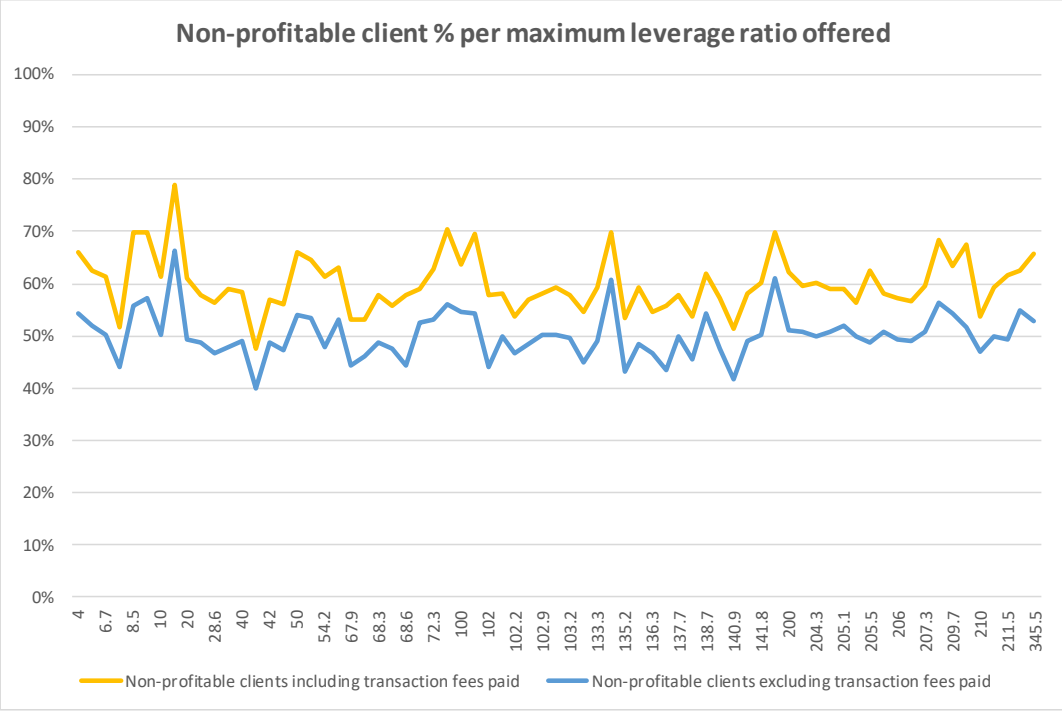
Much of the analysis in the consultation paper is on establishing a link between high leverage and client detriment. We feel additional analysis to identify an optimal minimum leverage restriction would help to provide a balance between consumer demand for leverage and regulatory protections.

4.1 Correlation Analysis

CP322 presents correlation analysis linking leverage to retail client detriment.

In the data we have previously submitted to ASIC **there is no correlation between leverage and client loss ratios**. These are plotted below, with aggregate client loss ratios plotted for each level of maximum leverage offered on each product (to avoid spikes, leverage ratios with a minimum of 100 clients trading at that level were used). A model is not necessary here, by eye it's clear there is no correlation.

Before transaction costs 50% of clients win or lose on any leverage level we offer, and the inclusion of these costs leads to marginally more losing clients than winning ones.



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The absence of a correlation between leverage and client loss ratios in our data suggests either:

(a) ASIC was able to establish a statistically significant link between high leverage and client detriment at firms offering higher leverage than IG, and the leverage levels currently offered by IG are therefore not detrimental to clients. This is supported by the model in Appendix I.

(b) ASIC's analysis is picking up on a collinearity between leverage and increased client trade counts, which is in theory correlated with an increase in the client loss ratio under certain conditions, though we don't see this effect in our data. The data ASIC requested is insufficient to fully analyse this effect in any case, as the trade count would need to be provided at the individual client level to isolate the effect.

It should be noted that using the win/loss ratio for each product as the dependent variable in any linear regression analysis on this data will lead to skewed results, with stocks traded once, by one client, given equal weight as indices or FX pairs traded thousands of times by thousands of clients. Our modelling on the effects of leverage [Appendix 1] also suggests that the relationship between leverage and client win/loss rates is non-linear, and transaction costs are required to complete the picture.

ASIC also establishes a link between increased leverage and margin close-outs, which is logical and replicable. However, as shown in the 2019 data provided to ASIC, margin close-outs make up less than 1% of our client trades.

There is not an epidemic of margin close-outs - our clients are more than capable of funding their account to a level they deem appropriate for the length of trade they envision.

Finally, ASIC presents a statistically significant positive correlation between a firm's revenue per asset, and the leverage offered. In this case, correlation does not mean causation. Margin rates are set based on risk, risk is lower on the most liquid financial products, the most liquid financial products are almost by definition the most popular and clearly therefore the highest revenue earners for the industry.

4.2 Academic Research

The academic research cited in the consultation paper makes a compelling case for the introduction of leverage limits (Rawley Z Heimer and Alp Simsek 2019, 'Should retail investors' leverage be limited?'). The paper presents in effect difference in differences analysis comparing unrestricted leverage with 50:1 maximum leverage and finds an improvement in consumer outcomes on the introduction of the latter in the US. This improvement comes almost exclusively among those traders utilising the highest leverage. This is consistent with the models we have presented on the impact of leverage on trading outcomes – to re-state our position, IG is supportive of proportional leverage restrictions.

This research is certainly relevant. However, there are two key points to note here. Firstly, it is illegal for a client trading foreign exchange in the US to contract with an FX broker that is not registered with the NFA and CFTC – US regulators did not need to worry about citizens contracting with poorly regulated or unregulated offshore firms.

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Secondly, the research addresses the binary question: unrestricted leverage vs. 50:1 leverage and finds an improvement on the latter. It does not attempt to identify the optimal level of leverage which maximises consumer choice and minimises client detriment. We feel that more analysis would prove useful in order to arrive at optimal leverage ratios.

4.3 Introduction of Minimum Leverage Ratios Overseas

In paragraph 170, ASIC cites intelligence from CFD issuers which shows that the introduction of overseas leverage limits led to clients 'trading more profitably'. On the introduction of ESMA's minimum leverage ratios we did not see this effect, and as the global leader in CFD trading with a significant footprint in both Europe and Australia. Prior to ESMA's intervention IG was not offering excessive leverage, so leverage restrictions had no significant impact on the proportion of winning clients: 78.8% of European retail clients lost money in the year preceding

ESMA's intervention and 76.6% the following year. Again, this is evidence that leverage does have an impact on client outcomes, but negative effects are minimised at the levels offered by IG.

4.4 Setting Leverage Ratio Limits

In CP322 ASIC proposes leverage ratios which, broadly speaking, ensure that from a historical perspective no more than 5% of positions held for a day would be subject to a margin closeout. The 5% and 1-day boundaries have been set at levels that do not reflect the nature of CFD trading – 58% of clients trading indices or FX hold their positions for less than a day on average, these clients should be able to manage their leverage in such a way that suits their trading style.

We have reproduced ASIC and ESMA's analysis based on 10 years of data for IG's most popular indices and FX pairs, and have found that the leverage limits are too conservative even by ASIC's proposed method. This is shown in the charts below. As a reminder, this shows the leverage level required to ensure that at least 95% of positions are not closed out on a margin call over various timespans.

This analysis used the 50% margin close out rule proposed in CP322. So, for example, when modelling index positions at 15:1 leverage, the assumption was that the client deposited precisely 6.67% as margin and was closed out if the market moved more than 3.33% (minus transaction fees, which are trivial) against them at any point.

The correct levels by ASIC's method are roughly 20:1 for major indices and 40:1 for major FX.

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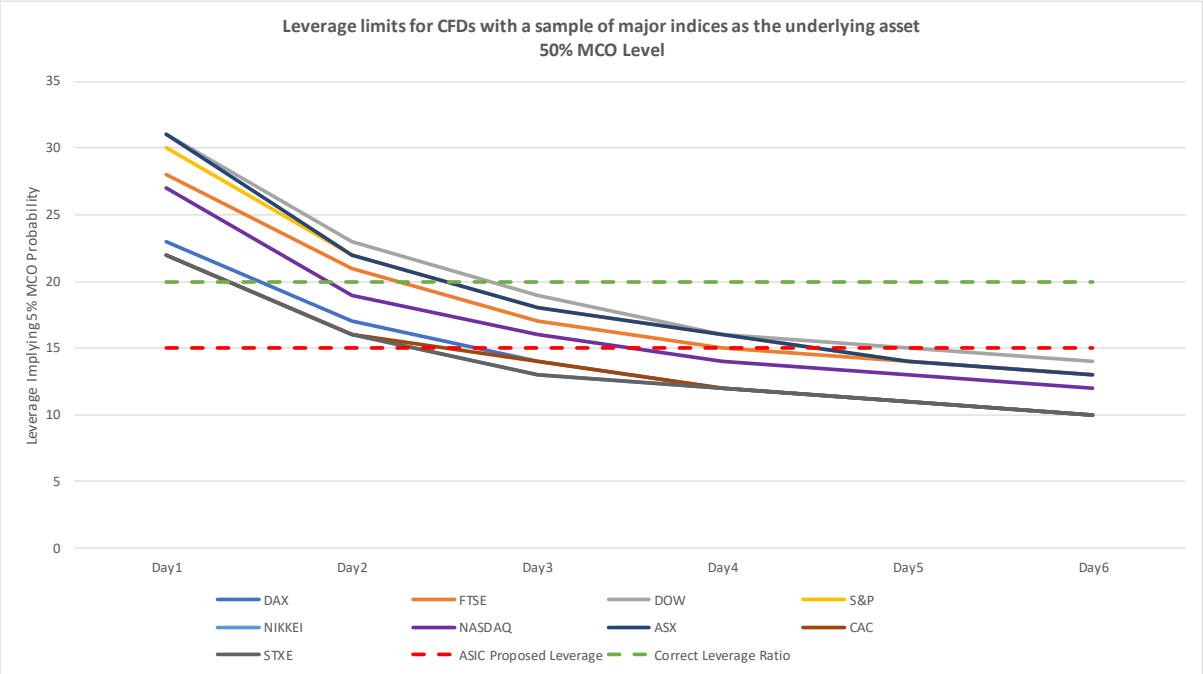

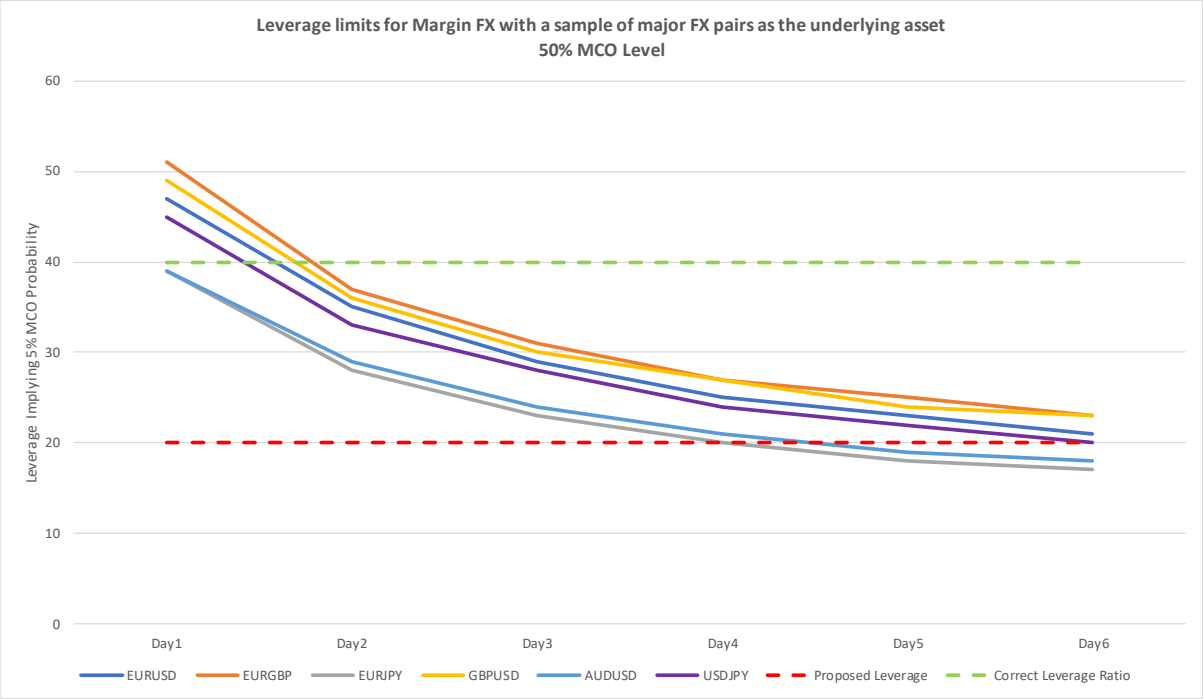

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APPENDIX I: Full leverage analysis, capturing the impact of transaction fees

Section A: Expected P&L, expected probability of profit in a market without transaction fees

Under efficient markets and assuming clients have zero favourable informational advantage, in the absence of transaction fees, trading on even the highest leverage has no effect on (i) a trader's average P&L or (ii) their probability of winning on any given trade, or series of trades.

Without transaction fees, a trader's average P&L is always zero. A trader's probability of winning a trade is driven entirely by their appetite for a large profit, relative to their tolerance for loss. The higher this appetite, the lower their probability of winning but the more they will win if the trade works out (i.e. if they place a close stop and far limit). In general, our clients have a low appetite, leading to the result that most of their trades make money (but average profit size is smaller than average loss size). This would be true even if we never charged spread, commission or funding.

A trader who is willing to suffer a loss of £100 (or willing to deposit only £100) but will only take profits when they have a position that is winning £1000 will lose 10 times for each time they win. Net P&L = £1000 – (£100*10) = 0.

A trader who is willing to suffer a loss of £100 (or willing to deposit only £100) but will take profits when they have a position that is winning £10 will win 10 times for each time they lose. Net P&L = (£10*10) - £100 = 0.

It does not matter how high or low the leverage involved is, or how volatile the underlying market. This line of reasoning always applies in an efficient market. Without it a trader could derive infinite profits simply by selecting the "correct" target-win-size-to-loss-size ratio and placing an infinite series of trades with appropriately-distanced stop and limit orders against each one.

Section B: Impact of transaction fees on client outcomes

Transaction fees change this picture and are the true factor driving poor client outcomes.

Average client losses on any given trade or series of trades will, on average, be the sum of transaction fees paid (spread, commission and funding) over that trade or series of trades.

The probability of a client winning any given trade, or series of trades, remains primarily a function of their preferred take-profit size, relative to their tolerance for losses. However, trading fees reduce this probability of winning. At most levels of leverage, this reduction in probability is very small.

In cases of extremely high leverage, the transaction fees faced by the client begins to approach the value of the deposit charged. In these extreme cases, the probability of a client winning on a trade is materially distorted.

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The average client loss on a highly leveraged trade will still be equal to transaction fees, on average. This is invariant to leverage, for a given characteristic trade size, and represents the price paid by a client to buy a desired market exposure.

However, under extreme leverage they will not be getting value for money for these fees. They will lose much more often (and win much more rarely) than they should expect, given their profit-to-loss size preferences. This is how extreme leverage results in a poor client outcome.

We can accurately model the size of this distortion of winning probabilities.

Define:

Round-trip transaction fees on trade = expected client loss on trade = s
Probability of losing trade = l
Deposit supporting trade = p
Targeted winning amount, as a multiple of deposit = r
Assume a trader will hold a position until either they lose their entire deposit, or they are winning an amount equal to r x p.

These variables are related as follows:

s = [probability of losing deposit x size of deposit] - [probability of profit x size of profit if it occurs]

$s = lp - (1-l)rp$

Or

$l = (s+rp)/(p+rp)$

Or

$l = (1+rx)/(x+rx)$

If we define the deposit used by the client in terms of multiples of transaction costs faced by the client, ($x = p/s$))

We can plot a chart of l for a range of different values of x and r.

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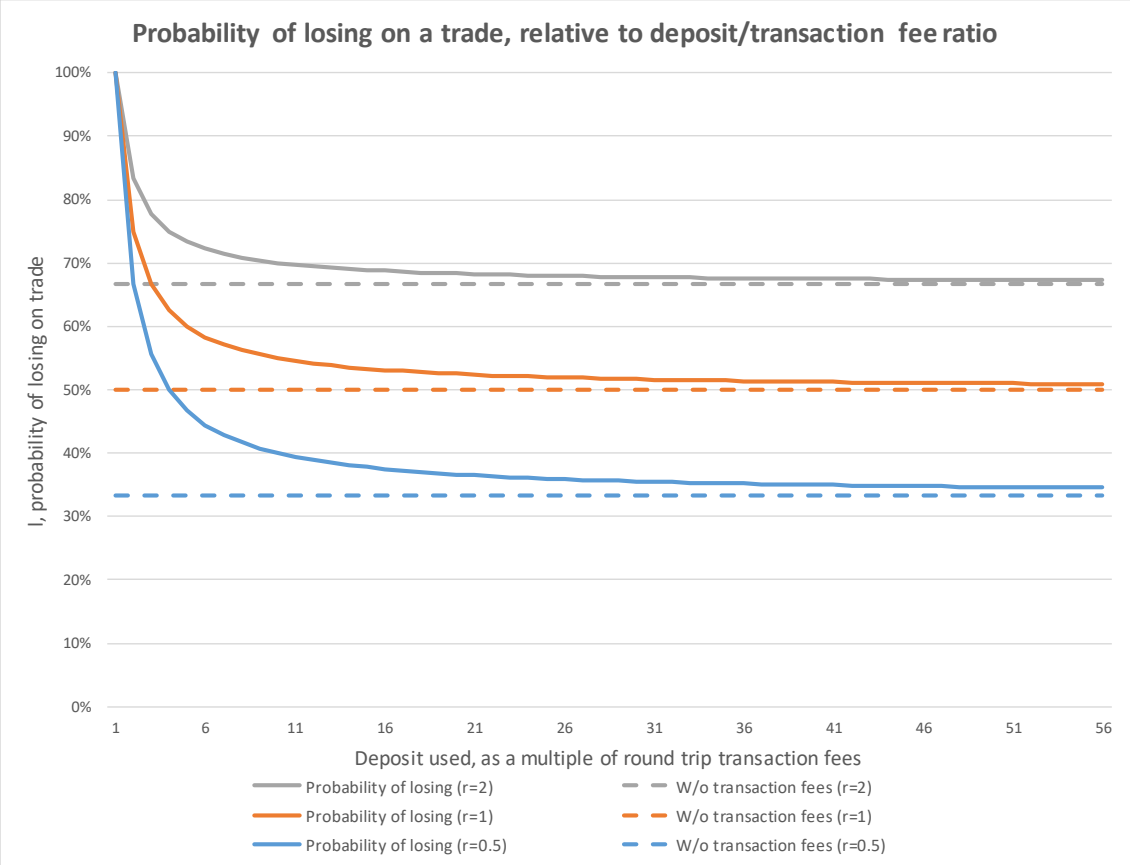

When we plot l, the problem becomes clear:

Each horizontal dotted line shows the correct probability of loss for a client with a certain strategy, in an efficient market and in the absence of transaction fees:

Grey: Client aims to take profit of twice their deposit (r=2). Client therefore loses on 67% of occasions.

Orange: Client aims to take profit of equal size to their deposit (r=1). Client therefore loses on 50% of occasions.

Blue: Client aims to take profit half as large as their deposit (r=0.5). Client therefore loses on 33% of occasions.

The equivalently coloured solid lines show what happens when transaction fees are brought into the reckoning. It is clear that, when the deposit used is of the same order of magnitude as the transaction fees charged, the probability of losing on a position diverges from the costless trade probability, dramatically so as the {deposit size}:{transaction fees} ratio shrinks below 10:1. In extremis, when the ratio is 1:1 (i.e. deposit used is equal to transaction fees) the client is instantly closed out as soon as they trade, 100% of the time and has no possibility of profiting, regardless of trading strategy.

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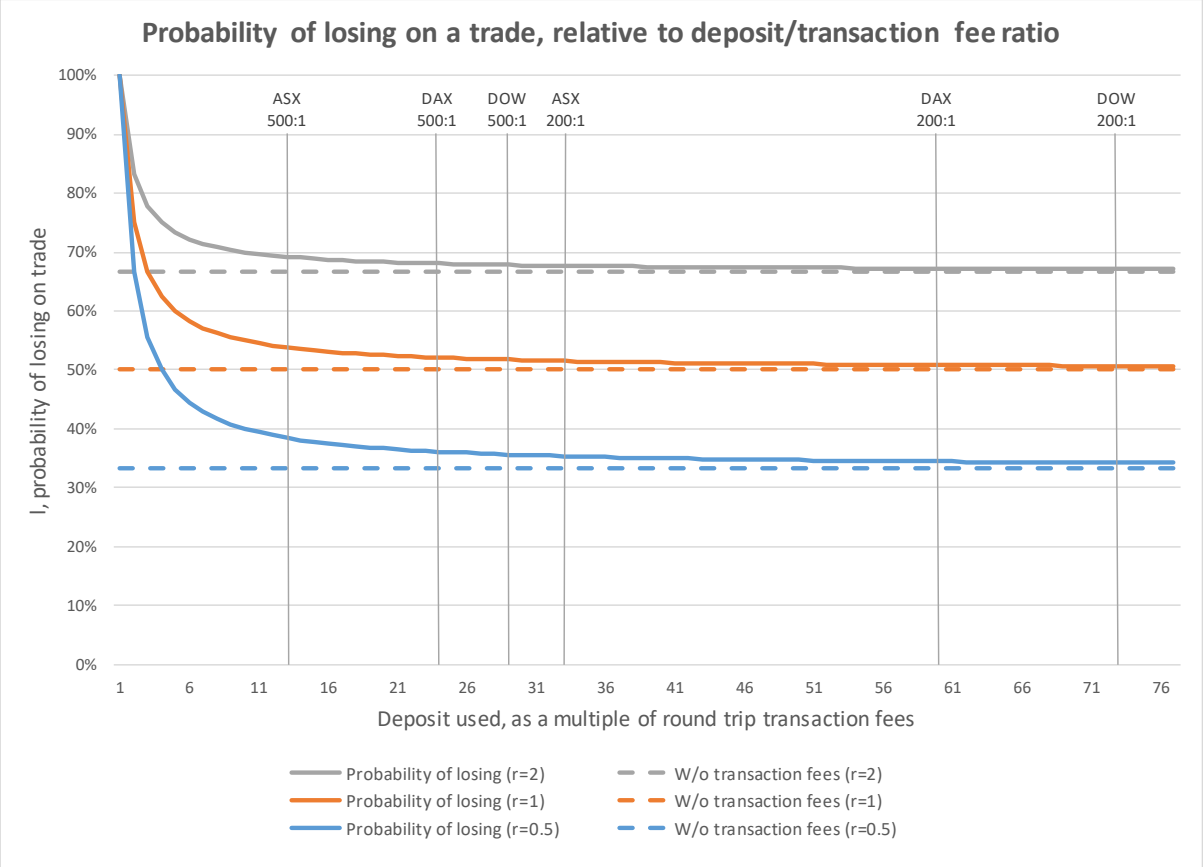
This effect is independent of market volatility. The analysis is constructed around client outcomes, not around assumptions of counterparty credit risk. The distortion of win/loss probabilities is driven wholly by transaction fees in each market and the client's deposit size and take-profit strategy.

Section C: Assessment of leverage currently offered, in context of transaction fees charged

We have marked on the chart below vertical arrows representing the deposit/transaction fee ratio for a client trading 3 different markets (ASX, Dow and Dax), using a deposit size that is equivalent to each indicated leverage ratio and paying IG's typical transaction fees. A market with a relatively high transaction fee, traded on very high leverage, puts clients into a position where their chance of losing is significantly higher than it ought to be, and significantly higher than they might expect:



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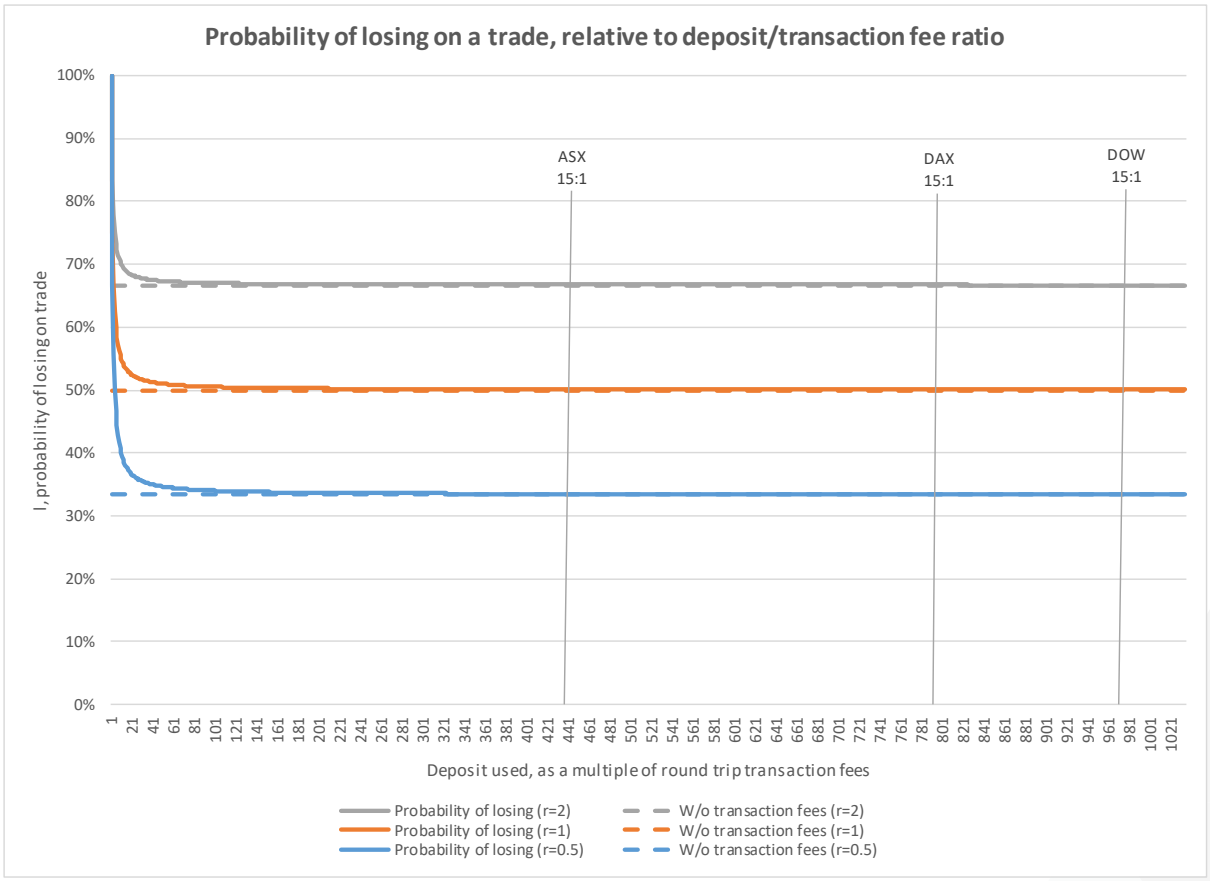
Zooming out, as we do in the table and chart below, it can be seen that the further mitigation provided by the extreme leverage restrictions proposed by ASIC is minimal. There is no meaningful impact on client outcome, defined as a distorted loss probability, from tightening leverage beyond 200:1, even in the most sensitive case of considering the ASX traded with a strategy where r = 0.5 (in reality, r is around 0.8 for a typical IG client):

ASX, r=0.5	Probability of losing trade
Costless Trade	33%
500:1, with fees	38%
200:1, with fees	35%
100:1, with fees	34%
50:1, with fees	34%
15:1, with fees	34%



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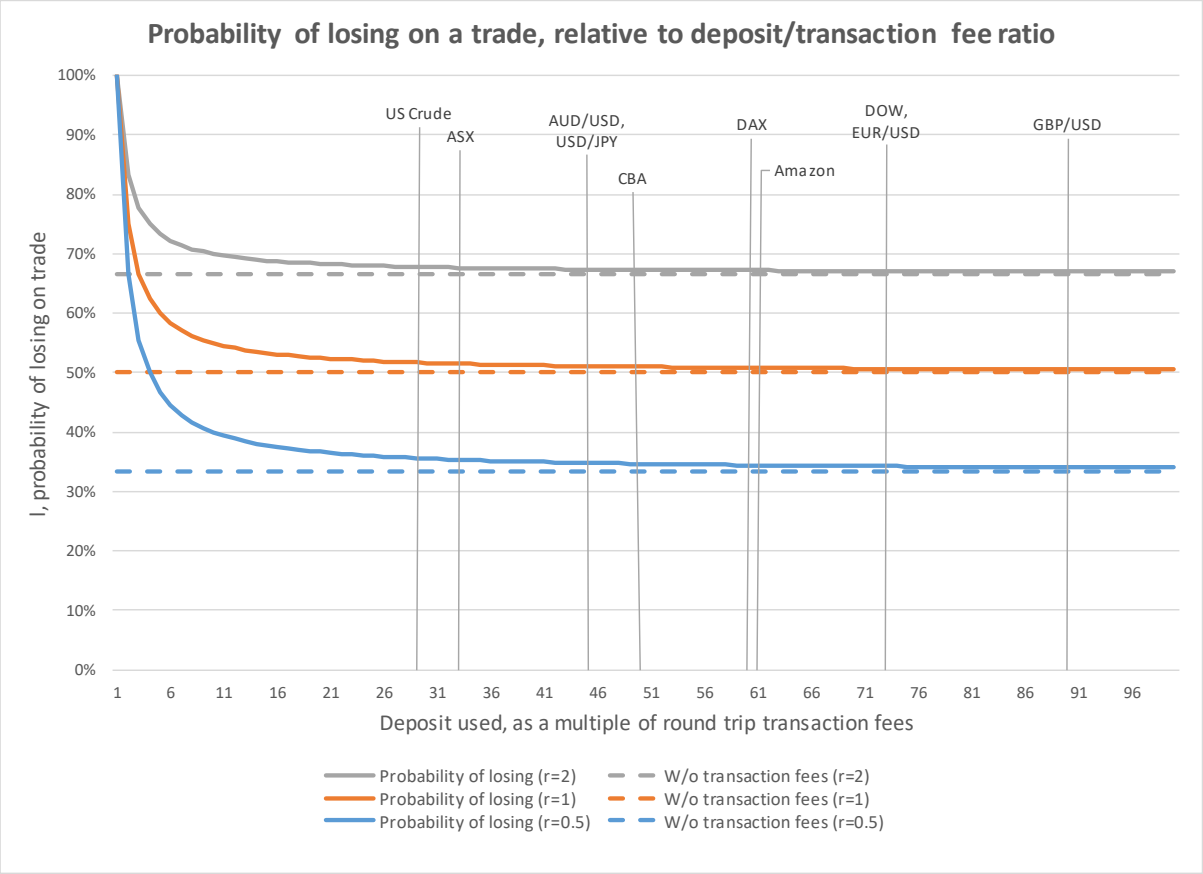

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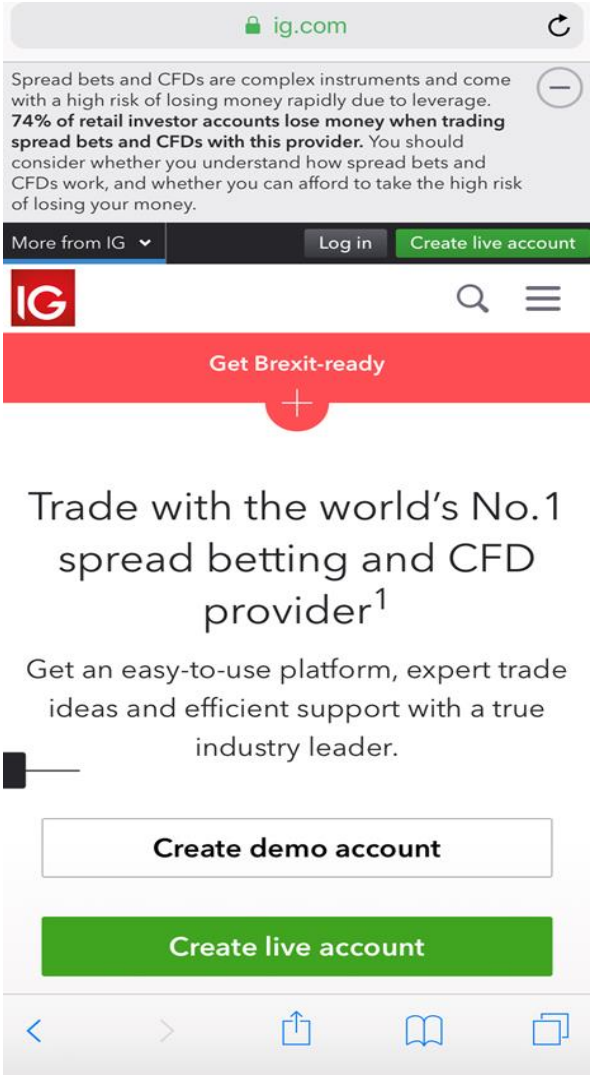
APPENDIX 2: Risk warnings for mobile devices

The following risk warning is used by IG's FCA regulated business, which a client can partially dismiss at their leisure:



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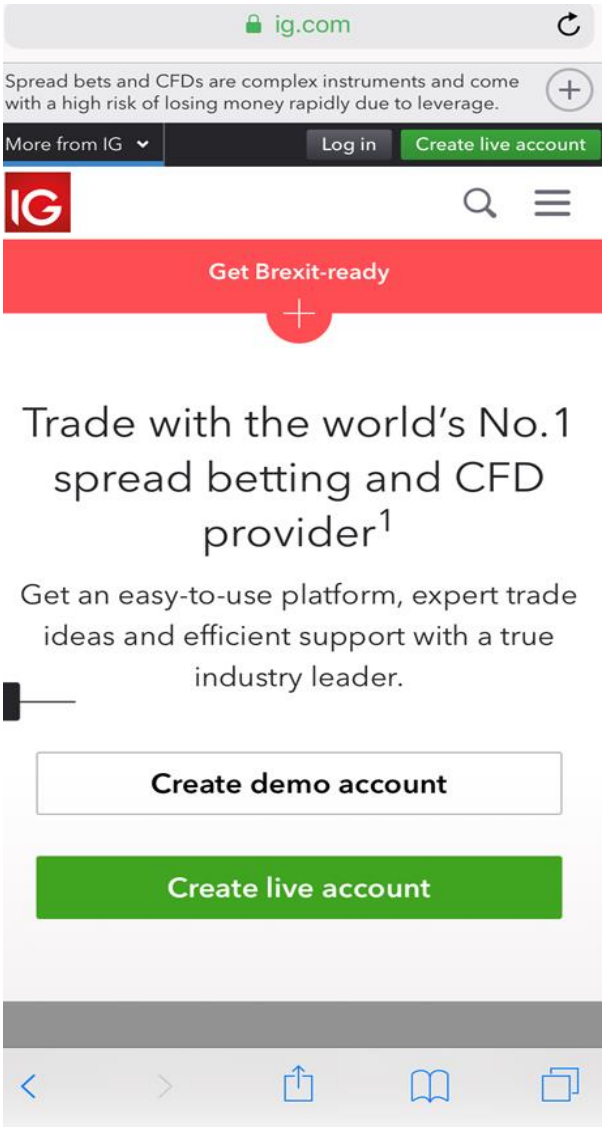

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Proposed intervention for binary options

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

Given the surprising size of the binary options industry in Australia and the history of aggressive and misleading marketing practices that target less sophisticated clients, we agree with ASIC's proposal prohibiting the issue and distribution of binary options to retail clients.

We do not agree with ASIC's view as set out in CP322, that binaries provide no economic utility - in our view binary options are a niche, but useful financial product that have been sold, and more often mis-sold, to too wide an audience. We agree with ASIC that the scale of this problem warrants intervention. However, we still feel there are some points in the consultation paper that should be addressed. Our main concern is that ASIC's definition of a binary, which is broad, appears wider than its perception of a binary when analysing client detriment. The design and merits of the most common variants of binary options are outlined below.

Fifty/Fifty Binaries

While there is nothing inherently wrong with a binary option as a product in our view, the features of this kind of binary option - "Fifty/fifties" - appeal to a particular kind of firm that aggressively targets an unsophisticated audience, often with misleading or false claims on profitability ("This Young Mum Makes $10,000 per Month Without Leaving Home").

These contracts are extremely simple: the strike price "floats", being set when a client trades, at the level of the underlying market at that precise moment. Because of this they are always 50/50 propositions – the trader is predicting only the direction of the market over the tenor of the contract. It is the simplicity - not the complexity - of these products that appeals to unscrupulous brokers. This makes the contracts easy to price, therefore cheap to offer, and (as ASIC notes) their resemblance to traditional gambling is used to appeal to an unsophisticated audience.

In its definition of a binary option in CP322, ASIC captures all types of binaries, but refers almost exclusively to fifty/fifties when illustrating client detriment from the product. In truth, for fifty/fifties, the inability to choose a strike price or close the position, the absence of volatility in determining pricing, and the price defined as a return on a fixed stake mean it is difficult to describe this product as an "option" in the traditional sense. We believe there's a place for this product, but it should not be marketed or sold as investment. We do not have access to the industry-wide data that ASIC collected on product revenue in 2019, though we would speculate that well over 90% of binary industry revenue, and nearly all problems from dishonest operators involve these products.

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Volatility Binaries

There is another kind of binary option which is offered by a very small number of firms in Australia and makes up most of our binaries business, which we'll call a "Volatility Binary".

These have not been mis-sold, are not particularly susceptible to mis-selling and meet a clear investment need for clients who want to hedge, or speculate, on market volatility in a controlled, limited risk manner. They are widely available to retail audiences in other well-regulated markets, such as the US and Japan (two historically conservative jurisdictions with respect to retail trading), and are available on various exchanges, such as the CBOE and NYSE. These products are different to the products described previously to the point that a separate regulatory approach would not be unreasonable.

These contracts differ from fifty/fifties in that:

- Their strike price is fixed and known in advance.
- They are priced in the conventional way of all financial instruments: as a 2-way, bid/ask spread.
- Their price evolves and can be continuously traded over the life of the contract, before settling at 100 (if the outcome described in the binary's name occurs) or 0 (if the outcome does not occur).

Clients trading these binaries are almost always trading on whether a market moves a set distance in a certain timeframe – they're trading on future market volatility. The sophistication required to price these contracts, along with their limited appeal to inexpert clients means they're rarely offered by dishonest firms. That said, the contracts are still simple to comprehend – the price represents a percentage chance of an event occurring.

ASIC's modelling on the '*distribution of aggregate returns from selected numbers of repeated binary options trades*', and their assertion of negative expected returns on the product does not necessarily apply to this form of binary option. A client who places a trade on this style of option is taking the view that market volatility in the future will be higher or lower than the market maker's perception. For this reason, volatility binaries have historically been one of the markets our global client base outperforms on – a client trading these products only needs a more informed view than the market maker, rather than the market. Of course, as with all speculative trading, clients tend to roughly lose transaction costs in aggregate, but this is not the near mathematical certainty that ASIC presents in the consultation paper.

In summary, in the absence of bad actors in the industry, we view binary options as a legitimate trading tool for a suitable audience of traders. While we are disappointed an alternate solution was not found to the mis-selling problem that plagues the industry, we agree with ASIC that product intervention is warranted in this case in the interest of consumers.

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

We agree with this proposal.

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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?

We agree that the proposed delayed commencement of the order is appropriate, having regard to the time it will take to implement the order.

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

Yes, we agree.