

12 January 2022

The Officer in Charge
Retail Complex Products and Investor Protection
Market Supervision
Australian Securities and Investment Commission
GPO Box 9827
Brisbane QLD 4001

by email to Market.Supervision.OTC@asic.gov.au

Dear Sir/ Madam,

Re: Consultation Paper 348 on Extension of the CFD Product Intervention Order

While this Submission is out of time, we wish to confirm our belief that the sale by licensed financial services intermediaries of CFDs to Retail Clients should be prohibited.

On 20 November 2019 at the request of ASIC we wrote to the Treasury, a copy of which is attached, and which included the following at the foot of page 2,

"We would prefer to see ASIC move to adopt the IOSCO option of prohibiting the sale by intermediaries of CFDs to Retail Clients, but as ASIC has opted for a lesser degree of intervention with the objective of curtailing the exposure of Retail Clients to CFDs we have little option but to support the proposal."

While the evidence presented in the Consultation Paper suggests that ASIC's CFD Order may have been effective in reducing the risk of significant detriment to Retail Clients, the key shortcomings of the Australian CFD Market remain, namely;

- the Australian CFD Market is neither centrally regulated nor cleared by licensed operators;
- with the CFD provider being the CFD Users Counterparty the Conflict of Interest within the Australian CFD Market is unparalleled.
- Retail Users of the Australian CFD Market are apparently not the recipients of Personal Advice and consequently cannot benefit from the Corporations Act personal advice protections.
- with the current CFD Market structure the limited segregation of funds obligations increases the risk of provider default.
- the international regulation within, or close to, the Australian time zone is more relevant than that of the UK and Europe.

However, the fact that ASIC uncovered that before the ASIC OTC Order came into force that the Retail Clients of a sample of 13, of the 60, CFD providers made net losses of more than \$774 million during only a 5 week period in March and April 2020 speaks for itself and the need for a complete ban on the provision of CFD Contracts to Retail Clients, notwithstanding that ASIC has observed a reduction in Retail Client aggregate net losses from a quarterly average of \$372 million in the year prior to the ASIC CFD Order to \$22 million post the ASIC CFD order.



Lewis Bell
Director

20 November 2019

Mr [REDACTED]
Senior Adviser to the Federal Treasurer
Treasurer's Office
Canberra, ACT

by email [REDACTED]

Dear [REDACTED]

Re: Binary Options and Contracts for Difference

We are writing to you in support of ASIC's proposal to ban OTC Binary Options and restrict OTC CFD's offered to Retail Clients.

To introduce ourselves we are Stockbrokers being Market, Clearing and Settlement Participants of the ASX. Back in 1970 we were non-exchange listed Equity Option Brokers and then Futures Brokers (becoming a member of the Sydney Futures Exchange) and in 1988 we joined the Australian Stock Exchange and now have 13 interstate offices and 4 international offices. In conjunction with our Stockbroking business we have operated a Margin Lending business through Bell Potter Capital Limited since 2006.

To disclose our potential biases at the outset, we do not deal in either Binary Options or CFDs, although we did participate in the unsuccessful launch of a CFD product by The Sydney Futures in 2007. In the absence of a regulated market and central clearing we resolved not to deal in any OTC CFD product.

Binary Options:

We support ASIC's proposed prohibition on the issue of Binary Options to Retail Clients for ASIC's reasons, namely, because:

- they provide no meaningful investment or economic utility,
- they do not offer participation in the growth in the value of the underlying asset,
- they are completely unsuitable for risk management arrangements,
- the negative expected return embedded within their payoff structure,
- their lack of pricing transparency,
- they are not available from a regulated market,
- they are not the subject of central counterparty clearing,
- ASIC reports that 80% of Binary Options clients lose, and
- ASIC also reports that 83% of Binary Options (and CFD) issuers' clients are overseas clients without any national benefit for Australia, despite the notional gains from the aforementioned loss ratio,
- all of the foregoing are, according to ASIC, leading to the exponential growth of Binary Options.

There can be no argument about prohibiting Binary Options as a financial product on the basis that it is completely undisguised betting. You just need to Google Binary Options and you will see

representatives of the principal Binary Option issuers freely acknowledge they are into spread betting and binary bets with On-Line addresses of Binarybet.com and that a binary bet is a cross between a spread bet and a fixed odds trade and make no attempt to hide the betting nature of the Binary Option. Accordingly, the offering of Binary Options as a financial product should be completely prohibited.

Contracts for Difference (CFDs)

With regard to OTC CFDs, ASIC proposes to exercise its product intervention powers to impose leverage ratio limits, a standardised approach to automatic closeout, protection against negative balances, prohibiting the offer of certain inducements which are in line with overseas developments and requiring enhancing transparency of pricing, execution, costs and risks.

Significance of the CFD Market in Australia:

While leverage ratio limits alone with a standardised approach to automatic closeout, protection against negative balances and the prohibition of the offer of inducements may be in line with what has already been imposed in overseas CFD markets, we are unsure of the relative significance of the CFD market in these overseas jurisdictions, however, the essentially unregulated OTC CFD market in Australia is of substantial significance alongside the highly regulated market in exchange listed securities. In Australia there are 30 Market, Clearing and Settlement Participants of the ASX while ASIC's CP 322 reports that it has identified 65 AFS licensees who issue Binary Options and CFDs in or from Australia to Retail Clients. We believe that not one of the aforementioned 30 Participants of the ASX would be issuing Binary Options or CFDs. The number of firms offering CFDs is multiplied by the practice of licensees renting out their license authorisation to what is known as Authorised Representatives, a practice we abhor and do not utilise.

Australia's CFD Market needs to be compared with that of Cyprus on one hand and the US on the other hand. Cyprus appears to be a haven for CPD providers with in the order of 181 providers lured by the favourable tax regime, EU membership and light touch regulation, like Australia; whereas the US has only 3 firms offering CFD after the US National Futures Association crackdown on the CFD industry, largely as a result of its US\$20m capital requirement, although the aforementioned 3 may be augmented by introducing brokers, which look similar to Australia's Authorised Representatives.

Possible Restrictions on the CFD Market:

While IOSCO's toolkit for dealing with OTC leveraged products offered and sold to retail investors contains a range of policy measures varying from leverage limits and pricing methodologies to restrictions on marketing and prohibition on the sale by intermediaries of CFDs to Retail Clients, IOSCO's other tool kits for investor education to inform retail investors of the nature and risks of CFDs and to deal with unlicensed entities offering CFDs are not felt to be relevant to Australia as the former will only result in more retail participation and it is expected ASIC is already fully across the latter.

We would prefer to see ASIC move to adopt the IOSCO option of prohibiting the sale by Intermediaries of CFDs to Retail Clients, but as ASIC has opted for a lesser degree of intervention with the objective of curtailing the exposure of retail clients to CFDs we have little option but to support the proposal.

Financial markets are fast becoming globalised as, is their regulation, with the result that advantage can quickly be taken of lighter touch regulation in one jurisdiction particularly within the same time zone, for example, the Southeast Asian time zone. Accordingly, it is important to understand the degree of regulation of CFDs in Japan, South Korea, China, Hong Kong, Singapore and Australia and it will be seen that Australia is the “odd man out” with virtually zero restrictions on CFD trading by Retail Clients. On the other hand Japan has restricted leverage, Korea prohibits CFDs (except for FX which is allowed with restricted leverage), China effectively prohibits CFDs altogether, Hong Kong is similar to Korea, and Singapore has restricted leverage. However, the key indicator of the regulatory imbalance is the finding of ASIC’s 2019 review that as at 31 March 2019 Australian clients accounted for only 17% of Binary Option and CFD clients dealing with Australian licensed financial service providers, with Asia accounting for 62% of the clients. These statistics speak for themselves in regard for the need for restrictive regulation on these financial products. With 83% of Binary Option and CFD users are now overseas clients. Australia must follow the other developed financial markets and intervene to regulate the retail component of the Australian CFD market; so ASIC must be allowed to exercise its product intervention powers.

Key Shortcomings of the Australian CFD Market:

The key shortcoming of the Australian CFD Market is that it is neither a fully regulated market nor a centrally cleared market, and, in our view, without both full market regulation and central clearing it shouldn’t be available to Retail Clients in Australia. Without operating through a fully regulated and centrally cleared market where brokers are matching transactions between a buyer and a seller the CFD issuer is the market maker (i.e. the price maker) as there is no matching transaction at the point of execution and consequently the CFD issuer is operating as principal, rather than broker, and is effectively dealing against its clients. Separately the CFD issuer will decide whether to hedge its exposure, and what part of that exposure to hedge, and will, no doubt, take account of its client win/loss record in making that decision. ASIC reports that 62% of clients lost money trading Margin FX and 72% of clients lost money trading other CFDs.

In reviewing this shortcoming account needs to be taken of the Australian regulation of client money relating to dealing in OTC derivatives and the fact that, although there is segregation of the issuer’s money from client money, these regulations do not provide full protection for Retail Clients as the OTC issuer can make withdrawals from a client money account for the purpose of meeting obligations it incurs in connection with the margining, guaranteeing, securing, transferring, adjusting or settling dealings in CFDs. Significantly, in the UK the FCA does not allow client funds to be used for hedging purposes.

We deal in exchange traded and centrally cleared Futures and Options contracts some of which have leverage equal to or approaching that of CFDs. Because of their orderliness, stability, standardisation, liquidity and transparency along with the accompanying management pursuant to the Corporations Act, Market Operating Rules and Market Integrity Rules, Retail Client default, mandatory close-out and complaint is negligible. Compare the volume of Complaints received by AFCA from users of the fully regulated and centrally cleared markets to those received from users of the CFD markets.

There is a place for OTC Markets but they are not for servicing Retail Clients. OTC markets might be suitable for institutional investors, who have the “muscle” to work with issuers; however, they are not suitable for Retail Investors who should be using fully regulated and centrally cleared derivatives markets. According to ASIC well over 90% of users of the Australian CFD market are Retail Clients. Even institutional users of OTC interest rate markets utilise the ASX’s central clearing service for some of these OTC products.

We also believe that confining retail Investors to fully regulated and centrally cleared derivatives markets would help to avoid the complete collapse of brokers like Sonray, Tricom and BBY, which we believe can be attributed to a significant degree to their OTC CFD businesses. This risk of default must be exacerbated by the extent to which the Australian non-regulated and non-centrally cleared CFD market is being utilised by overseas investors (83% of the clients of Binary Options and CFD issuers as at 31.3.19, according to ASIC). The requirement, with effect from 31 Jan. 2014, for CFD issuers to hold Net Tangible Assets of the greater of \$1m or 10% of average revenue will have mitigated the risk of issuer collapse, although this new capital adequacy requirement is not linked to transactional flow.

Best Interests of the CFD Client:

However, something must be grossly amiss in the financial service regulatory framework when we, as a Stockbroker, being an ASX Market, Clearing and Settlement Participant, operating in a fully regulated and centrally cleared market, believe that our securities advisory service entails the provision of Personal Advice to all the Company's Retail Equities Clients and therefore brings into play the various protections embodied in the Corporations Act for such Retail Clients (Statements and Records of Advice and the Best Interests Duty and its associated obligations), while the CFD issuers dealing virtually entirely with Retail Clients blithely avoid the provision of Personal Advice and as a result deny their Retail Clients the protections embodied in the Corporations Act.

In addition to the CFD issuers expressly excluding the provision of personal advice, and as a result, the statutory best interest duty (and its associated obligations), the on-line dealing facility provided by the CFD issuer to its clients reinforces the lack of client dependency on, or influence by, the CFD issuers' expertise such that the relationship between CFD issuer and client does not give rise to a fiduciary duty. It is only when personal advice is provided or a fiduciary duty exists that the financial product provider is not allowed to put its interests ahead of its clients. The CFD issuer by taking the other side of every client's CFD transaction is always placing its interests ahead of its clients' interests.

Purpose of the CFD Market:

Financial Product Derivatives should be able to be used for both hedging exposure and to speculate by a wide range of users. However, the virtual total use of the OTC CFD market by Retail Clients suggests the CFD market is being used, virtually totally, to speculate.

Marketing of CFDs in Australia:

Bell Potter Securities' expenditure on Marketing in 2018 was zero and it is anticipated that the 30 Stockbrokers combined would have minimal Marketing expenditure, in very sharp contrast to the \$131 million spent by Australia's Binary Option and CFD issuers in 2018 (as reported by ASIC).

The relatively heavy CFD market expenditure, in comparison to the Stockbroking sector of the Financial Services Industry, underlines the market making role of the CFD issuer and the orientation of the current Australian CFD business to the best interests of the CFD issuers rather than the best interests of the CFD client.

Settlement Defaults, Mandatory Close-outs and Complaints:

Client Settlement Defaults, Mandatory Close-outs and Complaints are a good measure of client suitability to a particular financial product and the quality of advice provided. We use Complaints (both the volume, and the nature, of Complaints) to AFCA by our clients, as well as by clients of all Stockbrokers, as an indicator of the quality of advice being provided by our Company and the Stockbroking sector of the financial services industry. You will be able to ascertain via ASIC the number of Complaints received in relation to Stockbrokers to compare with the just under 4,000 Complaints received by either ASIC or AFCA in the first 7 months of 2019. We believe there will be an enormous difference, which we believe can be attributed to the fact that Stockbrokers are dealing in a fully regulated and centrally cleared market pursuant to Market Operating Rules and Market Integrity Rules.

ASIC's Proposed Intervention:

Restricting CFD leverage alone will not achieve very much by way of protection of the Retail Client. ASIC reports that it commonly sees CFD leverage ratios of between 200:1 and 500:1, in other words, to secure a \$1m exposure the CFD client is required to put up between .02% and .04% of the value of the contract, i.e. between \$2,000 and \$5,000. These rates of CFD leverage while a lot less than ASX SPI 200 Index Futures leverage of 4.35%, [basis a current (but variable) Initial Margin of \$7,665 on a Total Contract Value of \$175,750 (basis \$25 per 6870 Index points)]; ASX's 30-day Interbank Cash Rate and 90-day Bank Accepted Bill Futures leverage is not dissimilar to the aforementioned CFD leverage. Accordingly substantial leverage ratio limits are required, but along with the other proposed protections of margin close-out protection, negative balance protection, prohibition on inducements, risk warnings, real time disclosure to the Retail Client of total position size and overnight funding costs and transparent CFD pricing methodology and CFD execution policy.

As ASIC's proposed prohibitions/restrictions, relate to Retail Clients it is inevitable that Binary Option and CFD issuers will reclassify their Clients as Sophisticated Investor, or even Professional Investor, Clients. In Stockbroking there can be some advantage in being classified as a wholesale client (on the basis of the production of either a Sophisticated Investor Certificate or evidence of qualifying as a Professional Investor) in that Wholesale investors can participate in capital raisings without disclosure pursuant to the Corporations Act and this is probably the principle basis for the classification of non-institutional clients as Wholesale. Nevertheless, all of our Sophisticated Investor Certificates are footnoted with the statutory retail protections that are lost as well as confirmation that it is Bell Potter Securities policy to have a reasonable basis of advice for all advice based on a knowledge of the client and the financial product and that at Common Law we have an obligation to act in the best interests of the client, use reasonable skill and care, exercise that degree of competence that a reasonable financial adviser would exercise and avoid conflicts of interest and where they cannot be avoided manage any potential conflicts of interest by disclosure or avoidance of the potential conflict altogether. As we see it there would be no benefit to clients of issuers of CFDs to be reclassified as Wholesale.

Conclusion:

If OTC CFDs are to be allowed to be issued to Retail Clients the basis on which that is done has to be put on a completely different, and substantially higher, plane in line with the other countries in our time zone. Hopefully this will completely eliminate the overseas Retail Client participation in Australia's OTC CFD market. It cannot be in the national interest that overseas retail speculators

BELL POTTER

(with the encouragement of the local CFD issuers) should be taking advantage of the current Australian light touch regulation of CFDs. This is likely to reduce the number of CFD issuers in Australia and very likely the number of Australian Retail Clients trading CFD's, a bit like what we believed occurred in the US.

Yours sincerely



Lewis Bell
Director

Cc: Greg Yanco, Executive Director Markets, Australian Securities and Investment Commission, Sydney