

Limiting Investor Harm: Is more needed in the case of CFDs?

ASIC is currently considering the long term extension (till 2031) of its restrictions on the features of Contracts for Difference (CFDs) provided by financial institutions to retail clients. It announced those restrictions in October 2020, with effect from 29 March 2021, under its Product Improvement Powers (PIPs) which were legislated in response to a recommendation of the Australian Financial System (Murray) Inquiry.

ASIC's Consultation Paper ([CP348](#)), issued in October 2021, highlighted a number of claimed effects of the PIP restrictions, most notably a reduction in the losses suffered by retail investors in CFDs. Previously losses far exceeded gains for investors, but the two are now more evenly balanced. But the data in CP348 also raises questions regarding whether the PIP restrictions go far enough.

What are CFDs?

First, a brief description of CFDs is needed to explain why ASIC has imposed restrictions. A CFD is a highly leveraged investment in some underlying financial instrument, such as a share or an exchange rate.

The client places a sum of money (say \$10,000) in a margin account with the CFD provider and obtains exposure to gains or losses on a much larger (say \$100,000) amount of the underlying instrument (say 4,000 shares in XYZ currently trading at \$25 each). If it is a "long" CFD position (and "short" positions can also be taken), an increase in the XYZ price to \$30 would mean a gain of \$20,000 (\$5 on each of the 4,000 shares). The gain is credited to the investor's margin account which would now be worth \$30,000. The 20 per cent increase in XYZ share price translates into a 200 per cent increase in the investor's position via the leverage of 10 to 1 in the CFD.

But, should the share price move in the opposite direction, the investor suffers similarly magnified losses. In this example, a decline to \$22.50 would mean a loss of \$10,000, wiping out the amount in the margin account. If the position is not closed out and the share price declines further the investor loses more than the original investment.

There are other complicating features of CFDs such as interest charged to the investor (or, in principle, paid to a short investor) reflecting the implicit loan in the CFD. And note that while gains or losses to the investor could be at the ultimate expense of the CFD provider, they generally won't be, because the provider will have hedged the position in the underlying market (or by other means such as over the

counter deals with other institutions). The CFD provider makes profits through the interest rate involved, spreads on CFD prices quoted, and fees and charges.

Some History

CFDs first emerged in the UK in the 1990s to exploit a differential in stamp duty on share trading applying to brokers and others. Brokers paid no duty, so that by purchasing physical stock on own account and providing the matching CFD to institutional investors they gave the latter a synthetic stock position (with no market risk to themselves) which avoided stamp duty.

CFDs emerged somewhat later in Australia targeted at retail investors. Since large scale wholesale/institutional investors can replicate a CFD position via a bespoke equity swap with an investment bank, the absence of tax arbitrage possibilities means they have little need for the complex structuring of CFDs.

Even the ASX got into the act. It introduced exchange traded CFD contracts in 2007, giving retail investors the opportunity to take highly geared investment positions. But their contract was even more complicated than the OTC CFDs provided by institutions such as CMC and IG Markets, and a lack of investor interest saw the contracts terminated in 2014. Had they survived, they would probably have fallen foul of the ASIC PIP restrictions on leverage.

The PIP restrictions

The PIP restrictions imposed by ASIC primarily involve restrictions on the amount of leverage, and mandatory close out to prevent margin accounts going into the red. The mandatory close out effectively prevents a situation where the client's margin account has been reduced to zero, but they still owe additional money to the CFD provider. But note that margin calls will typically be made by the CFD provider as losses occur, requiring the investor to provide more funds to keep the account in credit, such that losses on a position could have exceeded the original amount invested (even with the mandatory close out).

The leverage restrictions limit how large an exposure position an investor can take given the funds they deposit into their margin account. Prior to the PIP restrictions CFDs on major currency pairs (such as the value of the AUD/USD exchange rate) a retail investor could take a leverage position of 500 to 1. After, the maximum allowed is 30 to 1. In the case of major stock indices, it declined from 200 to 1 to a maximum of 20 to 1.

The Retail /Wholesale Investor “Distinction”

The PIP restrictions only apply to retail investors and, not surprisingly, since the PIP announcement there has been a significant switch in CFD business to wholesale clients – some of whom were previously designated as retail.

This highlights a major weakness in the PIP restrictions, but which reflects the more general problem of inadequate legislative distinction between retail and wholesale investors. It is far too easy for an unsophisticated investor (including SMSFs) to be classified as wholesale/sophisticated and exposed to risks they do not fully understand. As well as the market risk involved in CFD positions, another risk is that of a failure of the CFD provider (of which there are around 60) and losses of the investor’s money – although, hopefully, rigorous adherence to segregation of client money accounts would limit that risk).

Limitations of ASIC’s Analysis

ASIC’s analysis of the effect of the PIP restrictions is a useful start, but could go much further.

First, it does not consider whether the leverage (or other) restrictions imposed are optimal. And allowed leverage remains high: 30 to 1 for CFDs on major currency pairs; 5 to 1 for CFDs on shares. By way of comparison, major banks will provide margin loans for shares but with leverage ratios of around 4 to 1 (a loan/valuation ratio) for a diversified portfolio of blue chip shares, or less for more volatile stocks.

Second, have the regulations simply shifted the problem elsewhere? An expected consequence of regulation of a financial product is that activity may switch to alternative, similar, substitute products. In the case of CFDs there are quite a few. Margin loans from banks are one, but there is no apparent evidence of a boom in this product. (Changes to the collection of official statistics in 2019 make it hard to identify trends). Similarly, the ASX statistics on activity in the warrants market (where, for example, “Minis” provide a highly leveraged position with some downside loss protection) also show no signs of increased activity.

Third, the relative proportion of gains and losses to investors’ accounts in different periods will depend on both the behavior of various market prices and the positions held by investors in the various financial instruments. If, for example, all investors only had long CFD positions in an equity index and in one period the index declined while in the second period it increased, there would be losses for all in the first period and gains for all in the second period. Controlling for those factors is needed to give more robustness to the conclusions.

Finally, ASIC’s focus on gains and losses in CFD accounts could be misleading if investors were using CFD positions to hedge physical positions in the underlying instrument. But, realistically, this is likely to be an

extremely small proportion of CFD usage. Rather CFDs are another example of our financial markets being used for speculative/gambling activities by retail investors without private information or enough knowledge to warrant taking such risks.

Kevin Davis

Emeritus Professor of Finance

The University of Melbourne

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