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Life's a beach for CFD issuers

Following positive comments made by Justice Beach, ASIC has issued a product intervention order imposing conditions on the issue and distribution of contracts for difference (CFDs) to retail clients. The instrument imposes four main conditions directed at reducing retail clients' CFS losses.

14 months after releasing its initial consultation paper, it took just one week for ASIC to act on its second ever use of their product intervention powers after receiving kudos from Justice Beach of the Federal Court, discussed below.

On Friday 23 October 2020 ASIC published the *ASIC Corporations (Product Intervention Order – Contracts for Difference) Instrument 2020/986* (**Instrument**), effecting modified restrictions on over-the-counter contracts for difference (**OTC CFDs**) to implement the restrictions proposed in Consultation Paper 322 Product intervention: OTC binary options and CFDs (**CP 322**).

The changes, which will come into effect from 29 March 2021, quickly followed the positive comments about CP 322 from Justice Beach on 16 October 2020. Justice Beach delivered a judgment ordering that AGM Markets Pty Ltd, OT Markets Pty Ltd and Ozfin Tech Pty Ltd pay a total of $75 million in pecuniary penalties for systemic unconscionable conduct in relation to providing OTC derivative products to retail investors.

In the judgement, Justice Beach noted the 'considerable merit in ASIC's proposal' and that 'if such measures had been in place, most of the egregious conduct and its consequences that was exposed in the present case would in all likelihood not have occurred'.[1] His Honour also noted the pecuniary penalties would not be paid as all the defendants are in liquidations and those penalties cannot provide in an insolvency.

What's going to happen?

Following stakeholder consultation consisting of over 400 submissions and further discussions between ASIC and a number of CFD issuers, the Instrument imposes four main conditions on retail CFD issuers. These are each discussed below.

Leverage ratio limits

The Instrument imposes minimum initial margin requirements on CFDs issued to retail clients so that leverage ratios at the time of issue do not exceed:

1. 30:1 for CFDs over an exchange rate for a major currency pair[2]
2. 20:1 for CFDs over an exchange rate for a minor currency pair,[3] gold or a major stock market index[4]
3. 10:1 for CFDs over commodities (excluding gold) or a minor stock market index[5]
4. 2:1 for CFDs over crypto-assets, and
5. 5:1 for CFDs over shares or other underlying assets.

The leverage ratios take into account any leverage inherent in an underlying reference asset, such as a CFD on a futures contract or an option contract, and represents a dramatic lowering of current leverage limits permitted for CFDs issues to retail clients of up to 500:1.

These limits are expected to reduce the size and speed of retail clients' CFD losses by reducing CFD exposure and the sensitivity of CFDs to market volatility.[6]

Margin Close-Out Protection

The Instrument requires that the terms of a CFD offered to a retail client must provide that, if at any time the net equity of the client's CFD trading account is less than 50% of the total initial margin or total margin required for all of their open CFD positions on that account (**aggregate close-out protection amount**), the CFD issuer must (as soon as market conditions allow) close out one or more open CFD positions held until the net equity of the trading account is equal to or greater than the aggregate close-out protection amount for the remaining open CFD positions or all of the CFD positions permitted to be terminated are terminated.

In effect, this limits the number and amount of positions which clients can open and trade, and seeks to limit potential loss the client is exposed to as a result.

Negative Balance Protection

The Instrument also requires the terms of a CFD offered to a retail client to limit the client's losses on CFD positions to the funds in that client's CFD trading account, such that a client's account will not be able to move into negative balance.

Prohibitions on Inducement

The Instrument prohibits a person from giving or offering a gift, discount, rebate, trading credit or reward to a retail client or prospective retail client as inducement to open a fund or CFD trading account or trade CFDs.

These prohibitions do not cover:

1. information services or educational or research tools, or
2. discounts of fees and costs that are offered to all retail clients and prospective retail clients, including volume-based discounts.

It is unclear whether a "dummy" trading environment using "play money" would qualify as an educational or research tool at this time.

Notification requirements

The Instrument imposes notification requirements on CFD issuers that have issued a CFD to a retail client in the 12 months before 23 November 2020 in circumstances that would otherwise have been covered by the Instrument must take reasonable steps to notify each client of the terms of the Instrument as soon as practicable, within 10 business days after 23 November 2020.

So, where to from here?

The order will remain in force for 18 months, after which it may be extended or made permanent.

Having provided issuers just over 4 months to comply, ASIC will expect issuers to thoroughly review and amend their systems, terms and conditions and marketing practices to meet the requirements of the Instrument. If your business requires help navigating the terms of the new product intervention order and how to apply it to your business, Piper Alderman's Financial Services Team is here to help.

ASIC's consideration of the other half of CP 322, concerning the issue and distribution of binary options to retail clients, is ongoing and an update might be expected before the end of the year.

[1] *Australian Securities and Investments Commission v AGM Markets Pty Ltd (in liquidation) (No 4)* [2020] FCA 1499 [27].

[2] An exchange rate for a pair of currencies consisting of any two of the following: AUD, GBP, CAD, EUR, JPY, CHF and USD.

[3] Being any currency pair other than a major currency pair.

[4] A major stock market index means either CAC 40, DAX, Dow Jones Industrial Average, EURO STOXX 50 Index, FTSE 100, NASDAQ-100 Index, NASDAQ Composite Index, Nikkei Stock Average, S&P 500 and S&P/ASX 200.

[5] Being any stock market index other than a major stock market index.

[6] Public notice – product intervention order in relation to contracts for difference (October 2020).