ASIC

Australian Securities & Investments Commission

REGULATION IMPACT STATEMENT

Over-the-counter contracts for difference: Improving disclosure for retail investors

August 2011

About this Regulation Impact Statement

This Regulation Impact Statement (RIS) addresses ASIC's proposed policy on disclosure benchmarks for over-the-counter contracts for difference (OTC CFDs). The policy intends to improve the quality of disclosure available to retail investors, while not unduly interfering with the marketing and sale of these financial products.

What this Regulation Impact Statement is about

1 This Regulation Impact Statement (RIS) addresses ASIC's proposed policy on disclosure for over-the-counter contracts for difference (OTC CFDs). This follows a consultation paper published in November 2010, setting out our proposals and supporting rationale for changing the way disclosure documents for OTC CFDs are prepared: see Consultation Paper 146 *Over-the-counter contracts for difference: Improving disclosure for retail investors* (CP 146). A summary of the submissions made in response to CP 146 and our consideration of those responses can be found in *Response to submissions on CP 146 OTC CFDs: Improving disclosure for retail investors* (REP 246), as well as Section D of this RIS.

2 We initiated this work because we have concerns about the quality of disclosure available to retail investors on OTC CFDs. We have reached this view based on the results of qualitative research we commissioned in 2009–2010, an examination of quantitative research relating to this sector of the market,[1] a review of Product Disclosure Statements (PDSs) and a review of complaints referred to ASIC and the Financial Ombudsman Service (FOS). The conclusions that we have drawn from these sources is that many PDSs currently in use for these products do not adequately explain the way OTC CFDs work, and the risks associated with trading in them, and this has resulted in retail investors beginning to trade without an adequate understanding of these risks.

3 The regulatory framework in the *Corporations Act 2001* (Corporations Act) (outlined in paragraphs 23–27) is intended to provide adequate disclosure about financial products, including OTC CFDs. In meeting this regulatory framework, a product issuer must provide a great deal of information to prospective investors. However, the issuer is largely free to structure and present this information as it chooses. We are concerned that current disclosure practices are not resulting in documents that clearly and adequately discuss the risks involved in trading in OTC CFDs.

4 If investors are better informed about the risks involved in the investments they are about to make, they are better equipped to make an investment decision that suits their needs and future circumstances. Better investment decisions can be made when investors receive clear, consistent and comparable disclosure about the key risks of trading and issuers' business models.

5 Therefore, the overall aim of our work is to improve the quality of disclosure available to retail investors on OTC CFDs—to assist them to evaluate whether such products are appropriate for them. This aligns with ASIC's strategic priorities, including promoting:

[1] Investment Trends, *2010 Australia CFD report*, May 2010.

- confident and informed investors and financial consumers; and
- fair and efficient financial markets.

6 In developing our final position, we have considered the regulatory and financial impact of our proposals. We are aiming to strike an appropriate balance between:

- disclosure that assists investors to make better-informed decisions about trading in OTC CFDs; and
- not unduly interfering with the marketing and sale of these financial products.

7 This RIS sets out our assessment of the regulatory and financial impacts of our proposed policy and our achievement of this balance. It deals with:

- compliance costs;
- the potential effect on competition; and
- other impacts, costs and benefits.

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A Introduction

Background

What are OTC CFDs?

8 Contracts for difference (CFDs) are leveraged derivative products that allow investors trading in them to take a position on the change in the market price of an underlying asset, such as a share or commodity, or the value of an index or a currency exchange rate. With a long CFD, investors are looking to profit from increases in the market price of a particular asset. With a short CFD, they are seeking to profit from falls in the market price of the asset.

9 While the term 'derivative' has the meaning given by s761D of the Corporations Act, the term 'contract for difference' is not defined in legislation. We are concerned about instruments known as, or which have a similar economic intent and effect as, CFDs or margin forex, whether they are marketed as CFDs, margin forex or otherwise.

10 In Australia, most CFDs are issued as over-the-counter (OTC) products. For the last few years, the ASX Group has also offered listed exchange-traded CFDs; however, the market share for these products is still relatively small in comparison to the OTC CFD market.[2]

Investors

11 There are currently almost 40,000 active CFD investors in Australia.[3] While this represents a smaller share of the market for financial investments than another popular leveraged investment, margin loans,[4] we believe that more Australians invest in CFDs than many other major OTC derivative products.[5] The CFD market has seen growth of over 300% in the five years to 2010,[6] and it is reasonable to infer that this growth will continue. Therefore, we think this sector is sufficiently significant to warrant regulatory attention.

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[2] A best estimate of the ASX market share is 5%, based on the dataset used in the Investment Trends, *2010 Australia CFD Report*, May 2010.

[3] Investment Trends, *2010 Australia CFD report*, May 2010.

[4] There were over 170,000 Australians investing through a margin lending facility in 2009: Investment Trends, *December 2009 margin lending report: Investors*, December 2009.

[5] Investment Trends, *December 2009 structured products report*, December 2009, found that there were 13,500 people investing in futures and 12,000 in instalment warrants.

[6] By comparison with the figure of 9000 CFD traders in Australia reported in Investment Trends, 2005 *Contracts for difference report: Understanding current and next wave CFD traders*, September 2005.

12 From our industry consultation, we know that OTC CFDs are predominantly marketed to, and traded by, retail investors, rather than wholesale investors.

> Note: This RIS uses the term 'retail investor' to refer to people who trade in CFDs, with the same meaning as 'retail client' as defined in s761G and 761GA of the Corporations Act.

Issuers

13 According to industry consultation undertaken by ASIC in early 2009, CFD issuers manage approximately $350 million of client money. The market for CFDs has traditionally been dominated by two issuers who collectively held about half of the market in 2010, although the trend is for increasing diversification of the market.[7]

14 The industry can be roughly separated into three models: market maker, direct market access (DMA) and ASX-listed CFDs.

(a) Under the market maker pricing model, the issuer quotes its own prices for each instrument over which it writes CFDs. Investors are expected to be price takers. As a market maker, client orders create a corresponding position, which the issuer may retain or hedge. A market maker can write CFDs against synthetic assets such as indices or real assets, even if there is little or no liquidity in the underlying market. As a result they tend to offer a wider range of CFDs than other issuers.

(b) Under the DMA pricing model, an issuer automatically places each client order into underlying markets and therefore does not carry any market risk from the trade. As a result, a DMA issuer relies on there being volume in the underlying market in order for it to issue CFDs. Using programs that capture exchange data feeds, investors can actually see the matching orders placed by their DMA issuer into the underlying market.

(c) ASX-listed CFDs are listed instruments. ASX 24 (the market formerly known as the Sydney Futures Exchange), which is part of the ASX Group, is responsible for the registration, clearing and processing of all ASX CFD trades. Trades in ASX CFDs over an ASX-listed equity do not result in trades in the underlying ASX market. ASX Clear (Futures) acts as counterparty to all ASX CFD transactions, so even though buy and sell orders must be matched for a trade to occur, both buyer and seller contract with ASX Clear (Futures) and not directly with each other.

15 The issuer's pricing model obviously affects the prices that investors are offered for CFDs (i.e. whether the CFD is priced by direct relation to the price of the underlying asset, or according to the issuer's own choice). More

[7] Investment Trends, *2010 Australia CFD report*, May 2010.

broadly, the issuer's business model affects the counterparty risk associated with trading (i.e. the risk that the issuer will fail to meet its obligations under its contracts with clients, due to its own exposure to the market). Therefore, it is important that prospective investors understand the different models, and the implications of choosing one over another.

Risks in trading CFDs

16 Risk areas in trading CFDs include margin calls, investment loss, gapping, opaque pricing structures and counterparty risk. Many of these risks are difficult to explain to investors. Table 1 sets out the key risk areas according to the issuer's business model. The combination of risks is not present in simpler financial products commonly traded by retail investors, where disclosure is more straightforward.

Margin calls and investment loss

17 When investors take out a CFD position, they are only required to commit a small percentage of the underlying value of the assets in question; however, they are required to maintain a certain percentage of the value of the position in their account (margin). A margin call can occur if the market moves against an investor so that the margin falls below the required amount. If this occurs, the investor will need to post additional cash or sell a portion of their position to restore the margin—that is, the investor must pay the issuer the difference between the current price of the underlying asset and the price when the investor took out the contract. With a high degree of leverage, this could be many times more than the original amount invested.

18 Margin calls are often a feature of leveraged products, and investment risk is inherent to investing in financial products, in general. However, the potential for margin calls and large losses are much greater in CFDs than for many other leveraged products. CFD issuers generally offer investors a much higher degree of leverage than do issuers of other products like margin loans.

Gapping

19 'Gapping' is a situation where the market price of the CFD moves between the time the order is placed, and when it is executed by the issuer, which can result in the trade being executed at a worse price than the investor expected. This risk is a fundamental aspect of trading in CFDs, and is generally not present in other financial products.

Opaque pricing structures

20 Various fees and charges apply to financial products, and these can sometimes be difficult for some retail investors to understand. However, in a market maker business model, the CFD issuer sets its own price for the

underlying asset on which the CFDs are traded, and there is not necessarily a direct correlation between the price for the CFD and the market value of the underlying asset. This means it can be particularly difficult for investors to make an objective decision about the prices they are quoted.

Counterparty risk

21 Counterparty risk is the risk that the issuer will default on its obligations to investors. This risk could result in payments due to investors not being made, orders not being filled or executed, or proceeds of successful trades not being returned to investors.

22 Trading in CFDs involves contracting directly with an issuer, and hence exposes investors to counterparty risk. This is much higher than for other financial products typically invested in by retail investors (e.g. managed investment schemes), where responsible entities manage investors' assets but do not take on direct liabilities to investors.

Table 1: Risk in trading CFDs by business model

Risk area	Business model	Level of risk that should be disclosed
Margin calls	OTC market maker OTC direct market access Exchange-traded CFDs	A high risk of margin calls for all three business models if the value of the underlying asset moves sufficiently against the investor.
Investment loss	OTC market maker OTC direct market access Exchange-traded CFDs	A moderate–high risk of loss for all three business models that equals or exceeds the investor's initial investment if the value of the underlying asset moves sufficiently against the investor.
Gapping	OTC market maker OTC direct market access Exchange-traded CFDs	A moderate–high risk for all three business models of gapping or market illiquidity, if there is significant market volatility or a lack of investors in the market.
Opaque pricing structures	OTC market maker	The risk of unfavourable or opaque pricing is relatively high, as traders are price takers. CFD prices are determined by the issuer and may diverge from the market price of the underlying asset.
	OTC direct market access Exchange-traded CFDs	N/A—traded prices reflect the underlying security.
Counterparty risk	OTC market maker OTC direct market access	A high counterparty risk—this is a significant risk, and it may be difficult for investors to assess when choosing an issuer.

Risk area	Business model	Level of risk that should be disclosed
	Exchange-traded CFDs	A low counterparty risk—there is significantly lower counterparty risk exposure for exchange-traded CFDs, due to centralised clearing and settlement processes. The exchange clearing house acts as a counterparty to each trade, minimising risk.

Current regulation of CFDs

23 As noted in paragraph 9, the term 'contract for difference' is not defined in the Corporations Act. However, as a type of derivative, a CFD is a financial product, and the offer of CFDs is regulated under the Corporations Act. The obligations for the offer of financial products in Pt 7.9 apply, including the requirement to prepare a Product Disclosure Statement (PDS), ongoing disclosure obligations and requirements relating to the advertising of the offer.

Note: All sections (s), chapters (Chs) and parts (Pts) referred to in this RIS are from the Corporations Act unless otherwise stated.

PDS disclosure

24 The Corporations Act requires disclosure in the form of a PDS for an offer of CFDs to retail investors. The PDS must:

(a) be worded and presented in a clear, concise and effective manner (s1013C(3));

(b) make specific disclosures, including about the significant risks associated with holding the product (s1013D); and

(c) include all other information that might reasonably be expected to have a material influence on the decision of a reasonable person (when investing as a retail investor) about whether or not to invest in CFDs (s1013E).

Ongoing disclosure

25 An issuer of CFDs has obligations to provide ongoing disclosure to investors under the Corporations Act, including:

(a) issuing a supplementary PDS if there are certain material changes to information in a current PDS; and

(b) disclosure of material changes and significant events (s1017B).

Restrictions on advertising

26 The Corporations Act provides restrictions on advertising and publicity for offers of financial products before and after interests are available for acquisition by retail clients: s1018A.

27 There are also general consumer protection provisions in the *Australian Securities and Investments Commission Act 2001* (ASIC Act), including prohibitions against misleading and deceptive conduct, as well as prohibitions against false or misleading representations.

Regulation by ASIC

28 We administer the law relating to financial products, within the powers granted by the Corporations Act. This includes conducting surveillance and undertaking enforcement action in cases of any breach of the Corporations Act (as well as the ASIC Act).

29 While PDSs are generally not required to be lodged with ASIC and we do not approve PDSs, we have powers to make a stop order on a PDS if we are satisfied that:

(a) information in a PDS is not worded and presented in a clear, concise and effective manner; or

(b) an offer under a PDS contains a misleading or deceptive statement, or omits information from the disclosure statement that is required under the Corporations Act (s1020E).

30 In the case of exchange-traded CFDs, an issuer offering these products is subject to an additional layer of regulation in that, as a market participant they must also comply with the market integrity rules for the relevant market (i.e. the ASIC Market Integrity Rules (ASX 24 Market) 2010)). This includes additional obligations not imposed on OTC issuers, including:

(a) more stringent controls on the permitted uses of client money; and

(b) rules dealing with specific circumstances where the participant's interests might conflict with those of its clients (e.g. the market integrity rules require a participant to give preference to client orders over the participant's own orders when entering them).

Identifying and assessing the problem

Our investigation of the problem

31 In 2009, we conducted a 'health check' of the Australian CFD market. We used the following sources of information:

(a) information gathered during meetings with members of the industry;

(b) a specially commissioned qualitative investor research project, which involved a representative group of retail investors who were current,

former and future traders of CFDs, or who had investigated CFD trading but had decided not to proceed;[8]

(c) primary analysis of CFD issuer advertisements and PDSs;

(d) primary analysis of complaints referred to ASIC and FOS about CFDs;

(e) surveillance of CFD seminars; and

(f) an examination of quantitative and qualitative research undertaken by Investment Trends into the Australian CFD market in 2009 and 2010.[9]

32 From the research we undertook, we made the findings outlined below.

Sources of information available to prospective investors

33 The majority of investors do not seek or receive personal financial advice before investing in OTC CFDs. Very few participants in our qualitative study spoke to any kind of independent financial expert (e.g. accountant, broker or lawyer) before beginning to trade.

34 Most participants in our qualitative study relied on sources of information provided by the product issuer itself (e.g. marketing, information on the issuer's website, and issuer-run seminars). This finding is borne out by Investment Trends research into the most frequently used sources of information that investors used to gain additional information about OTC CFDs.[10]

35 Participants in our qualitative study expressed a desire to receive more information about OTC CFDs, particularly independent information.

36 We think that many investors begin to trade without necessarily understanding all of the risks involved with the product. Many OTC CFD providers use mainstream media sources to market their products directly to investors, and we believe that investors have increasingly come to regard CFDs as an accessible and attractive investment, in which they can start trading almost immediately. For this reason, they do not seek out personal advice before beginning to trade. Our qualitative research found that, while some investors read information about the product before beginning to trade, this was generally information provided by the issuer itself, and was neither independent nor a good source of information about the risks of trading.[11]

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[8] The qualitative research commissioned by ASIC consisted of a series of 30 in-depth interviews with a mix of current, former and future traders of CFDs. It also included a representation of retail investors who had considered trading CFDs but decided not to do so (deliberate non-traders). The in-depth interviews were conducted by Colmar Brunton Social Research over the phone and face to face between 15 December 2009 and 29 January 2010.

[9] Investment Trends, *2009 Australia CFD report*, July 2009; Investment Trends, *2010 Australia CFD report*, May 2010.

[10] Investment Trends, *2010 Australia CFD report*, May 2010.

[11] Colmar Brunton Social Research, *Retail investor understanding, expectations and experience of trading CFDs*, March 2010, p. 5.

37 Against this context, the PDS is likely to be the main source of information that investors receive with a degree of independence (i.e. in that issuers must include certain information by law). In carrying out our research we reviewed 15 PDSs. This represents a significant sample of the total PDSs in use for this product—for example, only 37 and 35 CFD PDSs were issued in 2009 and 2010, respectively, and many of these were replacement PDSs for existing products. The PDSs we reviewed were generally not effective as communication documents. Most were poorly and illogically structured, and the presentation of information was dense and difficult to read. Warnings about the risks associated with the product were often buried in other information, rather than being highlighted.

38 In general, the PDSs we reviewed did not meet our expectations of a 'clear, concise and effective' document, within the meaning of s1013C(3). We do not have any evidence to suggest, however, that issuers are not attempting to comply with their legal obligations; indeed, the length of many documents we reviewed suggests that issuers are attempting to include as much relevant information about the product as possible, and this is having the effect that PDSs become too long and complicated for investors to understand. Rather, we think that, as the PDS content requirements (described in paragraph 24) are principles-based and very broad, this is not assisting issuers to ensure that the information that they provide in PDSs is appropriately targeted to the needs of investors.

Gaps in retail investors' understanding about the product

39 In addition to concerns about the availability and quality of information about OTC CFDs, we also found evidence of gaps in investors' understanding of the features of the product, key risks and issuers' business models. We found that participants in our qualitative study generally did not clearly understand the difference between the market maker business model and the DMA business model, and could not articulate which model their current issuer was using. We also found that participants did not have a deep understanding of key features of the product, such as margin calls, and many initially went into the product believing it was similar to online share trading.

40 As noted above, we do not think that current PDSs are serving as an adequate tool to provide explanation to prospective investors about the full range of risks associated with this product.

Difficulty among retail investors

41 We have also found evidence that this lack of understanding of the product is leading to difficulty among investors. Generally, in its annual review of complaints, FOS does not distinguish between complaints relating to CFDs and those relating to other derivative products. However, in its 2009–10

annual review, FOS highlighted the fact that half of all disputes it accepted on derivatives concerned OTC CFDs, with 30% of the disputes relating to service issues (e.g. the issuer incorrectly processing instructions, or a delay in processing instructions) and 20% to the quality of disclosure. This suggests the problem has become more noticeable in recent times. FOS states:

> FOS is concerned that the typical retail investor does not adequately understand the risks inherent in over-the-counter (OTC) trading in CFDs. CFDs are very complex, highly leveraged products, and some retail investors who have not understood how they work have lost large sums of money trading in them. Some of these investors have brought disputes to FOS.[12]

42 While some retail investors make money trading in OTC CFDs, this is often balanced out by those who make losses. The average current CFD trader surveyed by Investment Trends self-assessed their number of losing trades at 41% of all trades in the 12 months to May 2010, compared with 44% winning trades, and 16% of trades breaking even.[13] In our experience of consumer research, survey participants often tend to under-represent investment losses due to embarrassment, so actual losses may have been even higher. These data also relate to current traders only—had they included those who have ceased trading, reported losses may have been higher.

43 This research did not examine the quanta of these losses; however, our qualitative research suggests that losses can often be stark, in that large losses can often be made quickly—even on a single trade. Participants in our qualitative research study had made losses of up to $10,000 on single trades.[14] A review of complaints relating to CFDs upheld by FOS, from January 2009 to the present, also indicates that complainants lost between $5000–$13,000 in a single trade or series of trades.

44 While a risk of loss is inherent to any market-based investment, we think that there is a connection between the quality of information that retail investors currently access on OTC CFDs and the difficulties many experience in trading. For example, our qualitative research found some investors seemed to have no clear understanding about trading in OTC CFDs, or were magnifying their risks—for example, by drawing on their mortgages or superannuation funds for capital to invest, or trading CFDs as a part of their self-managed super fund. Because many investors begin trading quickly after hearing about the product, rather than seeking out professional financial advice, we think a crucial part of addressing this problem is improving the information available to investors before they trade. Our

[12] Financial Ombudsman Service, *2009–2010 annual review*, 2010.
[13] Investment Trends, *2010 Australia CFD report*, May 2010.
[14] Colmar Brunton Social Research, *Retail investor understanding, expectations and experience of trading CFDs*, March 2010, p. 50.

conclusion on the nature of the problem we have identified is discussed further in the next section.

Our conclusion on the nature of the problem

45 Our conclusion is that:

(a) The complex structure of OTC CFDs and the risks associated with them mean that they may not meet the investment needs and objectives and the risk profile of many retail investors.

(b) In our experience, the great majority of retail investors seek financial products that are likely to give them a reasonable investment return without exposing them to undue risk. This group may broadly understand that investment returns may go up and down, but does not have a tolerance for products involving the risk of large losses, including the risk of losing all of the investor's initial outlay. OTC CFDs can give rise to such a risk and it is important that investors understand this.

(c) There is also a smaller group of retail investors that is interested in seeking out new investments, has a higher tolerance for risk, can cope better with making investment losses, and is prepared to spend time researching and learning about financial products. While it will depend on each investor's personal circumstances, this group is more likely to be suited to trading in OTC CFDs. Whichever group they fall into, retail investors need to understand the factors that will determine whether OTC CFDs are suitable for them before making a decision to begin trading.

(d) Because most retail investors do not consult a financial adviser or other independent expert before beginning to trade, it is important that they have access to high-quality information about the product. An important source of information about the products is the PDS; however, we have concerns about the general quality of PDSs relating to OTC CFDs. There is also a general lack of independent information available about CFD trading.

(e) This problem can be characterised firstly as one of market failure through asymmetric availability of information—investors do not have access to sufficiently clear information about OTC CFDs, because the current product disclosure information available to them does not describe the risks of the product clearly enough. The problem is also one of legislative failure—the PDS content requirements (described in paragraph 24) are principles-based and apply to all financial products, and do not specifically address the risks of OTC CFDs. As discussed in paragraph 38, we think issuers are attempting to comply with the law, but the law is not sufficiently clear on how to produce a good PDS for this product.

(f) OTC CFDs have been available in Australia for a number of years; however, we have not seen any comprehensive, industry-led solution to the need for improved disclosure. Industry bodies have previously attempted to provide guidance to their members about good disclosure; however, this has largely replicated our general disclosure guidance (e.g. Regulatory Guide 168 *Disclosure: Product Disclosure Statements (and other disclosure obligations)* (RG 168)), rather than addressing issues specific to OTC CFDs. Therefore, we think that we need to take action to improve the quality of information available on CFD trading to prospective investors.

46 We have already taken action on this issue by developing and releasing an investor guide, *Thinking of trading contracts for difference (CFDs)?*, which provides clear, independent information about how CFDs work, and also explains the significant risks that can be involved in CFD trading. However, this kind of guidance relates to this type of investing more broadly, rather than to specific products. Prospective investors also need good quality disclosure about particular issuers and their products before choosing to trade with them; however, our analysis of the problem suggests that this is not currently occurring.

47 Because we think the problem is partly one of legislative failure, and not a lack of compliance among issuers, we do not think that an approach targeting individual issuers is an efficient solution to the problem we have identified; rather, a holistic solution to improve disclosure is required: see paragraphs 74–79.

48 The majority of retail investors who trade in CFDs use OTC, rather than exchange-traded products. As discussed above, some of the risks associated with OTC CFDs do not apply to exchange-traded products: see paragraphs 16–22. A review of our complaints data did not reveal any significant body of complaints relating to exchange-traded CFDs. We think the profile of investors trading via exchange-traded CFDs is likely to be different from those trading via OTC products—the former group are likely to receive an additional element of support and advice by trading through brokers, and are also able to access a great deal of product information provided by ASX Group itself. We have concluded that the problem identified relates primarily to the OTC market; however, we are aware of the need to monitor this issue, in case any specific problems arise in relation to exchange-traded CFDs.

49 Although we have not extended our work to exchange-traded CFDs, we do not think that this is likely to lead to any particular positive or negative perceptions of exchange-traded CFDs relative to OTC products, as the two types of products are not viewed as being directly in competition with one another. OTC CFDs are often directly marketed to retail investors through television and other advertising, and are growing in popularity. On the other hand, the market for exchange-traded CFDs is still very small, and are not

marketed to the same extent.[15] As already described, these products operate in a significantly different manner to OTC CFDs: see paragraph 14(c). We do not think that these products form a direct substitute for one another.

Our objectives

50 In doing this work, we are aiming to improve the quality of disclosure available to retail investors about OTC CFDs, in order to maximise the chance that they will make an investment decision relating to this product that is appropriate for them.

51 Our proposals relate to OTC CFDs traded by retail investors. We have concentrated on the retail sector because OTC CFDs are predominantly marketed to, and traded by retail investors, despite the fact that the complex structure of these products and the risks associated with them mean that they are unlikely to meet the investment needs and objectives and the risk profile of many retail investors.

52 As explained in paragraph 48, we are concerned with products offered 'over the counter', rather than exchange-traded CFDs, due to the fact that the latter products are not traded widely by retail investors, and are subject to additional regulation under the rules of the relevant market and the market integrity rules administered by ASIC.

53 We are aiming to strike an appropriate balance between:

(a) promoting disclosure that assists investors to make better-informed decisions about trading in OTC CFDs; and

(b) not unduly interfering with the marketing and sale of these financial products.

54 The need to strike an appropriate balance between protecting investors' interests and allowing markets to operate freely is part of ASIC's mandate under the ASIC Act.

[15] A best estimate of the ASX market share is 5%, based on the dataset used in the Investment Trends *2010 Australia CFD report*, May 2010.

B Options

55 We think that the options to meet our objectives include:

Option 1: No additional guidance to industry about disclosure obligations under the law, with reliance on investor guidance and compliance and enforcement activity to solve the problem (status quo).

Option 2: Provide additional guidance about what the law requires in a PDS for an OTC CFD and update investor guide to explain this additional disclosure (preferred option).

Option 1: No additional guidance to industry about disclosure obligations under the law, with reliance on investor guidance and compliance and enforcement activity (status quo)

56 Option 1 is that the existing disclosure requirements under the Corporations Act continue to apply without any specific guidance for OTC CFDs. ASIC's existing powers to take action on a case-by-case basis against defective PDSs and advertisements would also continue.

57 Under this option, we would continue to administer the law under our current policy settings. For example, PDSs would continue to be required as and when they currently are.

58 In order to solve the problem we have identified (i.e. that there is insufficient information of adequate quality available to retail investors about trading in OTC CFDs) we would rely on regulatory tools already available to us at present, that is, we would:

(a) disseminate our investor guide *Thinking of trading in contracts for difference (CFDs)?* to promote better understanding about the nature of the product; and

(b) work with issuers on a case-by-case basis, both by encouraging them to improve deficits in their PDSs, and by increasing our current level of surveillance activities on all OTC CFD issuers, including requiring issuers to lodge PDSs with ASIC.

Option 2: Provide additional guidance about what the law requires in a PDS for an OTC CFD and update our investor guide to explain this additional disclosure (preferred option)

59 Under this option, we would give guidance to CFD issuers on how to comply with the law, with the goal of improving risk assessment by retail investors

60 We think the best and most efficient means of achieving this is through the benchmark model of disclosure, which would include:

(a) setting out the benchmarks we believe should be disclosed at law to help retail investors identify the key areas of risk associated with trading in OTC CFDs;

(b) requiring issuers of OTC CFDs to address the benchmarks on an 'if not, why not?' basis (see paragraph 64), so that retail investors can assess whether particular issuers have strategies in place to mitigate key areas of risk, where possible; and

(c) providing additional guidance on good practices in the disclosure and advertising of OTC CFDs.

61 An alternative means of requiring additional disclosure would be for ASIC to develop and release general guidance about the kinds of matters that should be disclosed for OTC CFDs (i.e. building on the good disclosure principles set out in RG 168, but with more specific application to CFD trading).

62 However, we do not think this is a realistic option to address the problem identified in Section A. This option might result in some improvement in the quality of disclosure documents, where issuers follow suggestions in our guidance about structuring and presenting disclosure information. However, there is a risk that general guidance may be applied inconsistently among issuers, and may not result in disclosure documents that are readily comparable, or to highlight key risk areas in a sufficiently structured way to deal with the identified problem.

The benchmark model of disclosure

63 The benchmark model of disclosure:

(a) identifies, for a particular financial product, the key risk areas potential investors should understand before making a decision to invest;

(b) sets a benchmark for how a product issuer should address these risks in establishing its business model and compliance procedures; and

(c) sets out our expectation that an issuer will state in the PDS and other disclosures whether it meets the benchmark, and if not, why not.

This model of disclosure provides concrete standards by which retail investors can assess financial products for which there are typically few such external benchmarks.

64 Disclosing on an 'if not, why not' basis means, for each benchmark, stating that the issuer either:

(a) meets the benchmark; or

(b) does not meet the benchmark, and explaining why not.

65 'Why not' means explaining how an issuer deals with the business factor or concern underlying the benchmark (including the alternative systems and controls the issuer has in place to deal with the concern). Failing to meet one or more of these benchmarks does not mean that a product provided by a particular issuer necessarily represents a poor investment. However, the issuer will need to explain what alternative measures it has in place to mitigate the concern underlying the benchmark.

Disclosure benchmarks for OTC CFDSs

66 We propose to introduce the seven benchmarks listed in Table 2, which reflect key areas of risk associated with OTC CFDs. These are disclosure benchmarks. ASIC's view is that disclosure about whether an issuer meets the benchmark is required under the law. No issuer is under an obligation to adopt the benchmark. However, we consider issuers are under an obligation to disclose whether or not the benchmark is met.

Table 2: Proposed disclosure benchmarks for OTC CFDs

<table>
<tr><th>Disclosure benchmark</th><th>Disclosure required</th></tr>
<tr><td>1 Client qualification
An issuer should maintain and apply a written client qualification policy that:
• sets out the minimum qualification criteria that prospective investors will need to demonstrate they meet before the issuer will agree to open a new account on their behalf;
• outlines the processes the issuer has in place to ensure that prospective investors who do not meet the qualification criteria are not able to open an account and trade in CFDs; and
• requires the issuer to keep written records of client assessments.
We suggest that an adequate client qualification policy would assess the following matters:
• previous experience in investing in financial products, including securities and derivatives;
• understanding of the concepts of leverage, margins and volatility;
• understanding of the nature of CFD trading, including that CFDs do not provide investors with interests or rights in the underlying asset over which a position is taken;
• understanding of the processes and technologies used in trading; and
• preparedness to monitor and manage the risks of trading.</td><td>If an issuer meets this benchmark, the PDS should clearly explain:
• that trading in CFDs is not suitable for all investors because of the significant risks involved; and
• how the issuer's client qualification policy operates in practice.
If an issuer does not have such a policy in place, or one that does not incorporate all of the elements in out guidance, it should disclose this in the PDS and explain why this is so.</td></tr>
<tr><td>2 Opening collateral
An issuer should generally only accept cash or cash equivalents from investors as opening collateral when establishing an account to trade in CFDs. Where credit cards are used to open accounts, an issuer should accept no more than $1000 via credit card to fund the account.</td><td>If an issuer meets this benchmark, the PDS should explain the types of assets the issuer will accept as opening collateral.
If an issuer accepts non-cash assets as opening collateral (other than credit cards to a limit of $1000), the PDS should explain why the issuer does so and the additional risks that using other types of assets (e.g. securities and real property) as opening collateral may pose for the investor. This includes, for example, the risks of 'double leverage' if leveraged assets are accepted as opening collateral.</td></tr>
</table>

<table>
<tr><th>Disclosure benchmark</th><th>Disclosure required</th></tr>
<tr><td>3 Counterparty risk—Hedging
An issuer should maintain and apply a written policy to manage its exposure to market risk from client positions, which includes its policies on:
• the factors it takes into account when determining if hedging counterparties are of sufficient financial standing; and
• the identities of those hedging counterparties (as they stand from time to time).
Policies should be displayed in an up-to-date form on the issuer’s website.</td><td>If an issuer meets this benchmark, the PDS should provide the following explanations:
• a broad overview of the nature of hedging activity the issuer undertakes to mitigate its market risk, and the factors the issuer takes into account when selecting hedging counterparties; and
• details about where investors can find the issuer’s more detailed policy on the activities it undertakes to mitigate its counterparty and market risk.
If an issuer does not meet this benchmark, it should disclose this in the PDS and explain why this is so.
The PDS must include information about the significant risks associated with the product: s1013D(1)(c). The PDS should also provide a clear explanation of the counterparty risk associated with OTC CFDs. The PDS should explain that, if the issuer defaults on its obligations, investors may become unsecured creditors in an administration or liquidation and will not have recourse to any underlying assets in the event of the issuer’s insolvency.</td></tr>
<tr><td>4 Counterparty risk—Financial resources
An issuer should maintain and apply a written policy to maintain adequate financial resources, which details how the issuer:
• monitors its compliance with its Australian financial services (AFS) licence financial requirements; and
• conducts stress testing to ensure it holds sufficient liquid funds to withstand significant adverse market movements.</td><td>If an issuer meets this benchmark, the PDS should explain how the issuer’s policy operates in practice.
If an issuer does not meet the requirement on stress testing, it should explain why and what alternative strategies it has in place to ensure that, in the event of significant adverse market movements, the issuer would have sufficient liquid resources to meet its obligations to investors without needing to have recourse to client money to do so.
An issuer should also make available to prospective investors a copy of its latest audited annual financial statement, either online or as an attachment to the PDS.</td></tr>
</table>

Disclosure benchmark	Disclosure required
5 Client money An issuer should maintain and apply a clear policy on its use of client money, including whether it uses money deposited by one investor to meet the margin or settlement requirements of another.	If an issuer meets this benchmark, the PDS should clearly: • describe the issuer's client money policy, including how the issuer deals with client money and when, and on what basis, it makes withdrawals from client money; and • explain the counterparty risk associated with the use of client money for derivatives. If an issuer does not have such a policy in place, or one that does not incorporate all of the elements described in our guidance, it should disclose this in the PDS. If an issuer's policy allows it to use money deposited by one client to meet the margin or settlement requirements of another client, it should very clearly and prominently explain this and the additional risks to client money entailed by this practice. An issuer's client money policy should be explained in the PDS in a way that allows potential investors to properly evaluate and quantify the nature of the risk, if any, to client money.
6 Suspended or halted underlying assets An issuer should not allow new CFD positions to be opened when there is a trading halt over the underlying asset, or trading in the underlying asset has otherwise been suspended, in accordance with the rules of the relevant market.	If an issuer meets this benchmark, the PDS should explain the issuer's approach to trading when underlying assets are suspended or halted. If an issuer does not meet this benchmark, it should disclose this in the PDS and explain why this is so, as well as the additional risks that trading when underlying assets are suspended may pose for investors. To provide a full explanation of this aspect of the product, an issuer should explain any discretions it retains as to how it manages positions over halted or suspended assets, and how it determines when and how it uses these discretions. This should include disclosure of any discretions the issuer retains to: • change the margin requirement on a position; • re-price a position; or • close out a position.

Disclosure benchmark	Disclosure required
7 Margin calls An issuer should maintain and apply a written policy about its margining practices, which details: • how the issuer will monitor client accounts, to ensure that it receives early notice of accounts likely to enter into margin call; • what rights the issuer may exercise in relation to client accounts, including the right to make a margin call or close out positions; and • when the issuer will exercise these rights, and what factors it will take into account in deciding whether to do so.	If an issuer meets this benchmark, the PDS should explain the issuer's policy and margin call practices. If an issuer does not have such a policy in place, or one that does not incorporate all of the elements in our guidance, it should disclose this in the PDS and explain why this is so. To provide full and accurate information about this aspect of CFD trading, the PDS should clearly state that trading in CFDs involves the risk of losing substantially more than the initial investment. This will ensure the issuer meets its obligation to include in the PDS information about the significant risks associated with the product: s1013D(1)(c).

67 We first introduced benchmark disclosure requirements for unlisted, unrated debentures in October 2007: see Regulatory Guide 69 *Debentures and unsecured notes: Improving disclosure for retail investors* (RG 69). Since then, we have introduced similar requirements for mortgage schemes (see Regulatory Guide 45 *Mortgage schemes: Improving disclosure for retail investors* (RG 45)), and for unlisted property schemes (see Regulatory Guide 46 *Unlisted property schemes: Improving disclosure for retail investors* (RG 46)).

68 The benchmarks we have published in these guides relate to matters that must be disclosed under s1013D–1013E of the Corporations Act. Issues addressed by the benchmarks are all matters that might reasonably be expected to have a material influence on the decision of a reasonable person whether to invest in this type of product, when investing as a retail investor.

69 It is not a requirement of the law for issuers to meet the benchmarks, but we consider it is a legal requirement to disclose whether or not they meet the benchmark.

70 We released a consultation paper (CP 146) in November 2010 setting out our proposals on benchmark disclosure for OTC CFDs. The results of this consultation are summarised in more detail in Section E of this RIS.

Other guidance on good disclosure and advertising

71 To provide further context to the benchmarks, and to assist issuers to improve their disclosure practices, we would also provide additional guidance on good disclosure and advertising practices, including that:

(a) advertising of CFDs should not target an unreasonably broad audience, or provide the impression that CFD trading is likely to be suitable for an unlimited range of investors;

(b) issuers should make financial statements available to prospective investors;

(c) a prominent warning should be included in advertising material, explaining that trading in CFDs involves the risk of losing substantially more than the initial investment, and that CFD investors do not own or have any rights to underlying assets (e.g. the right to receive dividend payments).

Investor guide

72 As discussed in paragraph 46, we have already released an investor guide, providing broad and clear information about how CFDs work, and the significant risks that can be involved in CFD trading. To complement the presentation of benchmarks in PDSs, we would release an amended investor

guide that provides a deeper explanation about each of the risk areas, and how to evaluate the issuer's responses. This measure would assist investors to understand and use the benchmarks, together with the issuer's 'if not, why not' responses, in their investment decision making.

C Impact analysis

Affected parties

73 Parties affected by the proposed policy would be:

(a) issuers of OTC CFDs (we estimate around 15 issuers hold 98% of the market share in Australia[16]);

(b) current retail investors who trade in OTC CFDs;

(c) prospective retail investors in OTC CFDs; and

(d) ASIC.

Costs and benefits of each option

Option 1: No additional guidance to industry about disclosure obligations under the law, with reliance on investor guidance and compliance and enforcement activity (status quo)

Benefits

74 In the short term, providing no guidance would avoid imposing direct new costs on industry because there would be no changes to how issuers of OTC CFDs are regulated.

75 Investor protection would continue at least at its current level because we would continue to monitor potential issues in this area, and could take action on a case-by-case basis against issuers if PDSs or advertisements were defective.

Costs

76 We think this option will impose costs on investors because it will not effectively address the problem identified in Section A of this RIS. That is, under this option, investors are likely to continue to receive poor quality disclosure.

77 Under this option, we would still take action against defective PDSs and advertisements on a case-by-case basis. However, at our current level of resources, we are unlikely to be able to take action in relation to all PDSs

[16] Investment Trends, *2010 Australia CFD report*, May 2010.

that are currently defective. In order to address the problem effectively, we would require additional resources (e.g. to undertake PDS reviews more often, and to spend time working with issuers to improve processes). In 2009 and 2010, 37 and 35 CFD PDSs were issued, respectively. To carry out reviews of all of these PDSs, including follow up surveillance work at the desired level to produce effective change, we would incur additional costs in staff, estimated at 1.5 full-time equivalents.

78 Even if we had adequate resources to undertake this work, we do not think that this would be an appropriate solution to the problem we have identified. As noted in Section A, there is no evidence to suggest that issuers are not attempting to comply with their disclosure obligations, but we do think they need further guidance in order to comply. Therefore, an option relying on our existing compliance and enforcement regulatory tools would not be as effective as a more holistic, guidance-based solution because:

(a) given that the problem extends across the industry, targeting particular issuers would not be efficient;

(b) issuers would still have less certainty about the standard of disclosure that was expected of them;

(c) the process for identifying these standards would be less transparent and only emerge as issues arise on a case-by-case basis; and

(d) although some issuers may elect to provide better disclosure to investors of their own accord, such an ad hoc approach is not likely to provide investors with comparability across products.

79 Maintaining the status quo may also involve some further costs to industry in the longer term. In the past few years, there has been media attention about the risks of trading in CFDs.[17] Therefore, doing nothing (i.e. no changes to the regulatory settings) may mean that, in future, some potential investors may avoid this sector, and pursue other investments.

Option 2: Provide additional guidance about what the law requires in a PDS for an OTC CFD and update our investor guide to explain this additional disclosure (preferred option)

Benefits

80 We think this approach would effectively address the problem identified in Section A of this paper, by promoting disclosure documents that better address:

(a) the risks associated with OTC CFDs; and

[17] See, for example. Patrick Durkin, 'Regulator taking a close look at CFDs', *Australian Financial Review*, 2 March 2011.

(b) whether the issuer has strategies in place to mitigate these risks, where possible.

We think that this will have a direct positive impact on the ability of retail investors to make informed decisions about whether to trade in OTC CFDs.

Benefits of requiring benchmarks

81 Our rationale for developing each of the benchmarks was outlined in CP 146. While some amendments have been made to the proposed benchmarks to address concerns raised during consultation, the rationale behind the proposed benchmarks remains the same.

82 Guidance about the disclosure of relevant risk areas for these products would have significant benefits for prospective investors by enabling them to more easily and effectively compare different issuers' business models, and the products they offer. Comparable disclosure of key risk information should assist prospective investors to better assess whether to trade with particular issuers.

83 Additional disclosure would not directly address the fact that trading in OTC CFDs is a risky investment compared to a number of other financial products. However, as well as improving prospective investors' understanding of the product, additional disclosure is likely to improve the practices OTC CFD issuers put in place to mitigate risks, by requiring them to make specific disclosure about these practices and possibly modify them where necessary.

84 An additional benefit of this particular approach is flexibility. The 'if not, why not' approach means that if an issuer does not meet a particular benchmark for good reason, it can explain that this is because it has alternative methods of mitigating the relevant risk area. The benchmark disclosure model requires disclosure of key areas of potential risk for investors and would apply, where appropriate, to ensure that investors obtain adequate information.

85 The potential benefits of each benchmark are discussed in Table 3.

Benefits of investor education

86 The proposal to complement the additional disclosure with investor education materials would help investors to understand the benchmark information and explanations given by issuers. This would help investors better understand the products offered to them, and thus enable them to make better choices that suit their own risk tolerance.

87 We consider that ASIC would benefit from the implementation of the benchmarks and investor education through fewer complaints resulting from

investors better understanding these products, meaning that our resources can be focused on other areas.

Costs

88 This section considers potential costs of implementing this approach from two aspects:

(a) first, costs associated with providing a different style of disclosure; and

(b) second, costs associated with the benchmarks themselves.

Costs associated with disclosure

89 Our guidance on disclosure benchmarks represents our view on the best way for issuers to provide disclosure about the risks of investing in OTC CFDs. However, there is no formal legal requirement to follow our guidance. If an issuer believes it can meet its obligations to provide clear, concise and effective disclosure (s1013C(3)) and make disclosures about the significant risks associated with holding the product (s1013D) in some other way, it may do so.

90 Nevertheless, by issuing guidance about our view of the law, and, given that we are likely to take this into account when enforcing the law, our experience is that many issuers are likely to follow the disclosure benchmark approach. However, we do not think that making these additional will impose any significant additional costs on issuers, above the normal costs incurred in relation to disclosure. To prepare a new PDS following the disclosure benchmark framework, issuers will not need to collect any new information, or implement any new business practices. Under the current legislative requirements, a PDS must be up-to-date at the time it is given: s1012J. This means that, in practice, an issuer will need to produce new PDS documents on a regular basis. As we propose to give issuers until 31 March 2012 before we will begin to review PDSs in this sector, issuers should have sufficient time to develop new documents in accordance with their normal PDS updating procedures.

91 In CP 146, we asked specific questions about the likely costs of implementing our proposals. Respondents to the consultation paper generally stated that it would be too difficult to quantify the costs at this stage, but, as updating disclosure documents is a cost already borne by industry, the quantum of direct costs resulting from our proposals would vary greatly depending on the amount of lead-in time provided to industry. Based on this feedback, we think the proposed transitional period of up until 31 March 2012 should assist industry to implement our proposals without undue costs.

92 If issuers decide to change their business practices to meet a disclosure benchmark, this may have the effect of imposing indirect costs. However, our guidance makes it clear that issuers are not required to ‘pass’ each of the

benchmarks, and may meet the area of concern underlying each benchmark using some alternative business practice. It is difficult to quantify this cost, as it will depend on the practices and decisions of individual issuers.

93 We also propose that disclosure against the benchmarks should be included in ongoing disclosure to existing investors under s1017B (the requirement to provide ongoing disclosure of material changes and significant events). This proposal may result in some initial compliance costs in understanding how to apply our guidance in the context of ongoing disclosure; however, as we think that all of the benchmarks deal with significant characteristics of the product, issuers should already be providing information about material changes and significant events in relation to these matters. Therefore, the direct costs of this proposal are likely to be low, and restricted to the implementation stage.

Costs associated with the benchmarks

94 Table 3 sets out the potential costs associated with each of the benchmarks, along with a discussion of potential benefits, where relevant.

Table 3: Impacts of each disclosure benchmark

Benchmark	Impacts
1 Client qualification	**Issuers** Where issuers choose to develop and apply a client qualification policy, this may result in costs to them, in losing potential investors. Investors that do not qualify may turn to other issuers that do not have a client qualification policy. From informal discussions with a leading OTC CFD provider, we believe a client qualification assessment of the type described in the benchmark would result in around 10% of prospective clients being refused an account at the initial stage. This would not necessarily mean that issuers applying such a policy would need to terminate their relationship with prospective clients entirely—they might recommend that clients seek professional financial advice, or further information and training. However, we consider that, even if adopting such a client qualification policy means that issuers lose some prospective clients, this cost to issuers is outweighed by the benefit of ensuring that clients that do not have sufficient knowledge and understanding of the product do not begin to trade and enter into difficulties. On the other hand, if issuers only accept the types of investors who would meet the criteria set out in Table 2, this may actually benefit issuers. By dealing only with investors who already have a good understanding of the product, issuers are likely to require less time providing investor education, and investors are less likely to enter into difficulties in trading and make fewer complaints about issuers. Issuers that do not develop a client qualification policy may benefit from increased business from investors who do not meet another issuer's client qualification policy. On the other hand, such issuers may develop a reputation for being less committed to investor welfare than issuers that do have a client qualification policy. More risk-averse investors may choose not to trade with such issuers. **Investors**

Benchmark	Impacts
	The process of undergoing a client qualification assessment may benefit investors, including in some cases by stopping them from trading, until, for example, they have undertaken further training. We think that this will particularly benefit the type of retail investor described in paragraph 45(b), who does not necessarily understand all of the risks involved in trading in OTC CFDs before beginning to trade, and who may not appreciate that this type of investment is significantly more complex than, for example, trading directly in share markets. This disclosure benchmark will have a neutral effect on those investors who do not meet the client qualification policy of one issuer, and who are able instead to trade with an issuer that does not set a client qualification assessment.
2 Opening collateral	**Issuers** Changing practices to meet this benchmark would involve very limited initial costs in amending written policies where necessary. Issuers that do not accept non-cash assets from potential investors as opening collateral to open accounts and begin trading (other than credit cards to a limit of $1000) may also face costs in losing potential investors. This may benefit issuers that do not have a similar requirement, in gaining investors who wish to use non-cash assets to open accounts. However, investors who provide non-cash assets to open accounts are more likely to enter into financial difficulty should they experience trading losses than if they simply provided cash, particularly if they use leveraged assets. Avoiding trading with these kinds of investors may benefit issuers, for example, by dealing with fewer complaints. **Investors** A practice of only accepting cash assets (other than credit cards to a limit of $1000) is likely to benefit investors. Investors who are unable to provide cash when opening accounts are also less likely to be able to obtain sufficient funds to maintain margins on an ongoing basis, and are exposed to additional risks such as the risk of ‘double leverage’ if leveraged assets are accepted as opening collateral. This benchmark will have a neutral effect on those investors who wish to use non-cash assets to open accounts, and who are able instead to trade with an issuer that will accept such assets as opening collateral to open accounts and begin trading.
3 Counterparty risk—Hedging	**Issuers** This benchmark requires an issuer to describe its hedging practices and name its counterparties. In general, meeting this benchmark should not result in any significant costs for issuers. Assessing that a hedging counterparty is of sufficient financial standing (i.e. that it will be able to meet its contractual obligations to the issuer, and that it is the kind of counterparty that is likely to have good financial resources, such as an authorised deposit-taking institution) is part of normal prudent business practice. The purpose of this benchmark is to ensure information about counterparty risk is provided in as clear, concise and effective a manner as possible, rather than to mandate a particular type of business practice. Where issuers prefer to keep this information confidential for commercial reasons, as was stated by some respondents to CP 146 (see Table 4 for further details), they may not be able to meet this benchmark. This may give the impression that the issuer’s hedging practices are deficient in some respect, which may or may not be the case in reality. Where this deters potential investors from choosing a particular issuer, this may represent a cost for that issuer. **Investors**

Benchmark	Impacts
	Providing investors with this information will assist them to understand and assess how the issuer manages counterparty risk through hedging. This will be of benefit to investors, as they will be able to make a more informed choice about whether to trade with a particular issuer.
4 Counterparty risk—Financial resources	**Issuers** This benchmark requires an issuer to describe how it ensures it meets the financial resource requirements that are a condition of its AFS licence. In general, meeting this benchmark should not of itself require issuers to incur any particular costs, in that it simply requires them to describe their current practices. The purpose of this benchmark is to mandate a formal way of disclosing to prospective investors about how an issuer goes about meeting its financial resource requirements, to ensure this information is provided in as clear, concise and effective a manner as possible. Meeting this benchmark may result in either a cost or a benefit to issuers, depending on how investors assess their explanation, and the extent that this influences their decision whether or not to trade with a particular issuer. **Investors** Providing investors with this information will assist them to understand and assess how the issuer manages counterparty risk through its financial resources. This will be of benefit to investors, as they will be able to make a more informed choice about whether to trade with a particular issuer.
5 Client money	**Issuers** This benchmark requires an issuer to describe how it deals with client money, including whether it uses money deposited by one investor to meet the margin or settlement requirements of another. It does not of itself require issuers to adopt or change any business practices. Where issuers do not meet this benchmark, this may result in costs to them if this results in investors having a negative perception of those issuers because of their practices in relation to client money, and deciding not to trade with them. Conversely, this may benefit those issuers that do meet this benchmark, if investors choose them for this reason. If an issuer were motivated by this to change its practices in relation to client money, and use an alternative source of funds for its own margin transactions, this might result in some initial and ongoing costs. How each issuer would do this would depend on its individual circumstances. The United Kingdom has recently implemented legislation to prohibit the use of retail client money for margining purposes by CFD issuers.[18] In preparing a cost benefit analysis, the Financial Services Authority (FSA) conducted a survey of affected firms and found that they were likely to incur one-off and ongoing costs. One-off costs were found to be the costs of raising additional working capital, and systems changes.[19] Ongoing costs related to servicing the refinancing (e.g. loan interest payments).[20] However, the FSA found that these potential costs were outweighed by the likely benefit for retail investors and financial markets, in not bearing issuers' credit risk. In our experience, larger issuers are generally more likely to rely on their own funds for

[18] *Client Assets Sourcebook (Title Transfer) (Amendment) Instrument 2010* (FSA 2010/59).
[19] These were estimated at an average of £130,000 per firm.
[20] This will depend on the extent required to be borrowed, but was estimated by the FSA be an average of £720,000 per firm per annum.

Benchmark	Impacts
	margining purposes, while smaller issuers are less likely to do so, including new entrants into the market. We estimate that small issuers currently make up less than 2% of the market. Implementing this benchmark may result in such entities having fewer incentives to enter or remain in the market. Nevertheless, smaller issuers with less capital may pose greater risks for investors. To the extent that this benchmark does result in smaller entities having fewer incentives to enter or remain in the market, we think this is outweighed by the likely benefits for retail investors, as described below. **Investors** Providing investors with this information will assist them to understand the issue of issuer use of client money and assess how the issuer manages counterparty risk through its financial resources. This will be of benefit to investors, as they will be able to make a more informed choice about whether to trade with a particular issuer. To the extent that this benchmark encourages issuers to change their practices in relation to client money, and rely on alternative funds for margining purposes, we think this is likely to result in benefits for investors. While the law currently permits the use of client money for this purpose, it does expose retail investors to counterparty risk.
6 Suspended or halted underlying assets	**Issuers** Implementing this benchmark would result in limited initial costs to an issuer, in changing its internal policies where necessary. Ongoing compliance with the benchmark would mean requiring clients not to open new positions over underlying assets in which trading has been suspended or halted within the rules of the relevant market. In practice this would not result in any costs to issuers—even meeting this benchmark, there is not likely to be any shortage of alternative assets over which clients may open positions, and this is not likely to result in any reduced business. Where issuers do not meet this benchmark, this may result in costs to them if this results in investors having a negative perception of those issuers, and decide not to trade with them. Conversely, this may result in a benefit for those issuers that do meet this benchmark, if investors choose them for this reason. **Investors** Avoiding opening positions in CFDs while there is a trading halt over the underlying asset, or trading in the underlying asset has otherwise been suspended, increases both the risk of investors trading without all the requisite information.
7 Margin calls	**Issuers** This benchmark requires an issuer to describe its practices in the case of client accounts going into margin call. In general, meeting this benchmark should not of itself require issuers to incur any particular costs, in that it simply requires them to describe their current practices. The purpose of this benchmark is to mandate a formal way of disclosing to prospective investors about what will happen should their account enter into margin call, to ensure this information is provided in as clear, concise and effective a manner as possible. Where issuers do not meet this benchmark, this may result in costs to them if this results in investors having a negative perception of those issuers, and the way that they will handle margin calls, and deciding not to trade with them. Conversely, this may result in a benefit for those issuers that do meet this benchmark, if investors choose them for this reason. **Investors**

Benchmark	Impacts
	Providing investors with this information will assist them to understand how an issuer will act if an investor’s account goes into margin call. This will be of benefit to investors, as they will be able to make a more informed choice about whether to trade with a particular issuer, and, if they do decide to trade with a particular issuer, they will be forewarned about what will happen in the case of a margin call.

D Consultation

95 We released CP 146 in November 2010, proposing to introduce disclosure benchmarks for OTC CFDs. We proposed that an issuer following the benchmark disclosure model should explain in its PDSs whether or not it meets the benchmark, and, if it does not, whether it deals with the concern underlying the benchmark in some other way.

96 We received 10 submissions in total—from current issuers, representative bodies, and individuals. Submissions were fairly consistent in their views, and we propose to make a number of changes to the benchmarks as a result of our consultation. The proposed final form of the benchmarks is set out in Table 2. Table 4 summarises the original proposed benchmarks, the feedback we received on each, and our response to this feedback.

Table 4: Benchmarks proposed in CP 146, the feedback and our response to the feedback

Proposed disclosure benchmark	Area of risk addressed by benchmark	Feedback on benchmark	How we propose to revise benchmark
1 Client suitability An issuer should maintain a policy on investors' suitability for CFD trading, including criteria by which to assess suitability of prospective investors before they can open an account to trade.	This addresses the risk that OTC CFDs will be traded by retail investors for whom this is not a suitable investment. As CFDs are a complex investment, we think they should only be traded by investors who have a good understanding of the way that the product works, are prepared to monitor their accounts and are prepared for the fact that they may sustain losses. An issuer will not be able to ensure this in every case, but can assist by assessing investors against suitability criteria before they begin to trade.	The suggested suitability assessment criteria included looking at investors' income and assets. A number of respondents were concerned that assessing an investor as suitable to trade in CFDs according to these criteria would amount to providing personal advice that they should trade in CFDs.	The revised benchmark (Benchmark 1: Client qualification) states that an issuer should make an assessment about the prospective investor's readiness to trade, but the focus should be on the prospective investor's understanding of the product, and their experience with trading, rather than on their financial situation. Our view is that this avoids the giving of personal financial product advice.
2 Opening collateral An issuer should maintain a policy on the types of assets accepted from investors as collateral to open an account and begin trading, including whether only cash or cash equivalents are accepted, or whether the issuer will also accept leveraged assets (e.g. credit cards).	This addresses the risk of 'double leverage'. Given that OTC CFDs are a leveraged investment, if investors use borrowed funds to open accounts, this risks the possibility that losses will be magnified.	Many respondents stated that the use of credit cards to open accounts is normal business practice, is not correlated with defaults and enables accounts to be opened in an efficient manner.	The revised benchmark (Benchmark 2: Opening collateral) relaxes the requirement around credit cards, stating that they may be used to provide opening collateral, but an issuer should place a limit of $1000 on the amount it will accept from credit cards for this purpose.

Proposed disclosure benchmark	Area of risk addressed by benchmark	Feedback on benchmark	How we propose to revise benchmark
3 Counterparty risk—Hedging An issuer should maintain a written policy to manage its exposure to market risk from client positions, which includes a practice of engaging multiple hedging counterparties of sufficient financial standing.	This addresses counterparty risk to investors. Investors need to rely on an issuer taking appropriate measures to reduce the risk that the issuer will not be able to meet liabilities (e.g. due to market movements)—in this case by hedging their exposure to investor positions.	There was concern among respondents about the requirement to engage multiple hedging counterparties, with some respondents stating that the most important factor is each counterparty's financial standing, not how many counterparties are used. There was also concern about revealing the identity of hedging counterparties (for commercial reasons).	The revised benchmark (Benchmark 3: Counterparty risk—Hedging) avoids some of the elements respondents found problematic (e.g. estimating the probability of hedges not meeting the issuer's exposure to client positions), but still requires an issuer to give an explanation of counterparty risk and the hedging strategy it undertakes to minimise this risk. We have decided to retain the requirement to name hedging counterparties to meet the benchmark, due to the importance of this information for prospective investors in assessing how the issuer manages counterparty risk.
4 Counterparty risk—Capital An issuer should hold sufficient capital to address its exposure to risk.	This addresses counterparty risk to investors. Investors need to rely on an issuer taking appropriate measures to reduce counterparty risk—in this case by holding a portion of capital aside as a financial buffer to withstand unexpected adverse events.	There was concern among respondents that this benchmark might have the effect of going beyond the current financial resource requirements imposed on AFS licensees (as set out in Regulatory Guide 166 *Licensing: Financial requirements* (RG 166)). Respondents also felt this benchmark overlapped too much with the succeeding benchmark (liquidity).	We have decided to combine the benchmarks on capital and liquidity into a single benchmark (Benchmark 4: Counterparty risk—Financial resources), which does not extend requirements beyond those in RG 166, but which focuses on whether the issuer has adequate systems in place to comply with its RG 166 requirements.
5 Counterparty risk—Liquidity An issuer should engage in strategic planning to ensure it has the financial resources to meet its liabilities when necessary.	This addresses counterparty risk to investors. Investors need to rely on an issuer taking appropriate measures to reduce counterparty risk—in this case by forecasting anticipated revenue and liabilities on a rolling 12-month basis, and ensuring it has sufficient liquid funds available to meet liabilities over that period.	As above.	As above.

Proposed disclosure benchmark	Area of risk addressed by benchmark	Feedback on benchmark	How we propose to revise benchmark
6 Client money An issuer should maintain a policy on its use of client money, including whether it relies on funds deposited by one investor to meet the margin or settlement requirements of another.	This addresses the risk that if an issuer uses money received from one investor to meet its liabilities to another, in the event of the failure of the issuer an investor will not receive all of their money back	Respondents were generally comfortable with this benchmark.	No change to this benchmark (Benchmark 5: Client money).
7 Halted or suspended underlying assets An issuer should not allow new CFD positions to be opened, or existing positions to be varied or closed out, when trading on the underlying asset has been halted or suspended.	Trading in OTC CFDs while underlying assets have been suspended increases both the risk of investors trading without all the requisite information and the potential for insider trading.	Respondents asked for some clarification about what 'halted or suspended' means in practice, and whether this benchmark is intended to apply during the ordinary close of trading (e.g. when markets are closed overnight).	The revised benchmark (Benchmark 6: Suspended or halted underlying assets) clarifies that this benchmark does not apply to the ordinary close of trading.
8 Margin calls An issuer should maintain a written policy about its margining practices, which details how the issuer will monitor client accounts, to ensure that it receives early notice of accounts likely to enter into margin call, and notify investors before closing out positions.	This addresses the risk of margin calls. The potential for OTC CFD investors to enter into margin call is reasonably high because small movements in the price of the underlying asset may lead to large changes in the value of the CFD position. Investors need to understand when the issuer is likely to make a margin call, and the action the issuer is likely to take should it do so.	Respondents were concerned that, to meet this benchmark, they would need to ensure they gained contact with investors and obtained their explicit consent before closing out positions, which might jeopardise their ability to take quick action to forestall losses in a falling market.	The revised benchmark (Benchmark 7: Margin calls) clarifies that an issuer only needs to make 'reasonable attempts' to get into contact with investors, according to a pre-arranged communication method. It is important that investors know when a margin call has been made, but we recognise that issuers will need to take prompt action to prevent further losses in some cases.
9 Fees and costs An issuer should provide transparent disclosure of fees and costs.	This addresses the risk that prospective investors will not understand the issuer's pricing model.	Respondents generally stated that this benchmark only reiterated existing law, and that fees and costs are not a key area of risk suitable for benchmark disclosure.	We propose to remove this benchmark. As the key issue on fees and costs is the transparency of pricing, and the relationship between pricing structures and the issuer's business model, we propose to provide some general guidance about providing clear disclosure on fees and costs.

E Conclusion and recommended option

97 We recommend Option 2.

98 We think that implementing the benchmark disclosure model will result in improved disclosure documents, which better address (compared to current disclosure documents):

(a) the risks associated with OTC CFDs; and

(b) whether the issuer has strategies in place to mitigate these risks, where possible.

99 We think that this option will have a direct, positive impact on the ability of retail investors to make informed decisions about whether to trade in OTC CFDs, thereby addressing the problem identified in Section A of this RIS.

100 This option may result in issuers incurring additional costs, in spending time understanding the new approach and updating documents. These costs are likely to vary between issuers, depending on their current systems, and are difficult to quantify. None of the submissions we received provided an indication of the costs of implementing the benchmark disclosure model. However, these costs will be limited, in that:

(a) this option does not require issuers to make any changes to their business practices (although some may choose to change so that they meet the benchmarks in order to appear more attractive);

(b) where there were concerns expressed by respondents to CP 146 about the content of individual benchmarks, we have considered these comments, and have made changes that we think reflect reasonable industry practices;

(c) as issuers already need to update their PDSs and provide ongoing disclosure on a regular basis to meet the current requirements of the law, this option does not require a great deal of additional work, and the costs associated with this option are not dissimilar to those that would be incurred by maintaining the status quo; and

(d) while we will monitor the uptake of the benchmark disclosure approach among issuers, and assess the quality of disclosure documents using our guidance as a starting point, we propose to provide a long lead-in time to issuers before we would start doing this (i.e. until 31 March 2012).

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F Implementation and review

Implementing our proposals

101 While it is not a formal legal requirement to implement the disclosure benchmarks, our previous experience with implementing this kind of approach is that most issuers are likely to follow our guidance. We expect that issuers will implement the benchmarks in both their PDSs and ongoing disclosure documents.

102 Our proposed transition period is as follows:

(a) issuers should address the benchmarks on an 'if not, why not' basis and bring them directly to the attention of existing investors by 31 March 2012; and

(b) all new PDSs issued on or after 1 January 2012 should disclose against the benchmarks on an 'if not, why not' basis.

103 We will review PDSs and other disclosures to monitor whether and how the disclosure benchmarks are being applied from 31 March 2012 onwards. This review will check that the benchmarking information is being adequately disclosed to investors, and the new approach is resulting in improved documents.

104 We will also:

(a) work with issuers and their industry representative organisations to ensure that the benchmarks and our disclosure expectations are understood;

(b) discuss with issuers any concerns we have about their disclosure and, where necessary, require additional disclosure from them (e.g. about the practical impact of not following a particular benchmark and the associated risks for investors); and

(c) conduct surveillance visits, as needed, to reinforce our disclosure expectations.

105 As outlined in paragraph 29, we can use our stop-order powers if we consider that a PDS does not comply with the PDS content requirements. At the end of the transition period, we will continue to review disclosure documents on an ongoing basis. We will have recourse to the stop order powers if the documents do not disclose against the benchmarks on an 'if not, why not' basis, and do not meet the requirements of the law in some alternative manner (i.e. by providing clear, concise and effective disclosure using some alternative format).

Our guidance

106 Our proposed policy will be implemented by publishing two documents:

(a) a new regulatory guide explaining the benchmarks and the 'if not, why not' approach, and our expectations of issuers; and

(b) a revised investor guide on CFDs, which explains the benchmarks to prospective investors in more detail.

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