Are CFDs ever a good idea for insurers (or investors)?

The short answer to both questions is no – most of the time.

Read on for the longer answer

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What are CFDs?

Contracts for difference (CFDs) are a way of speculating on the change in value of a foreign exchange rate, share price or market index. CFDs are a type of derivative that, under Australian law, can be made available to retail investors by Australian Financial Service Licensees (AFSLs) who have the appropriate authorisation to deal with derivatives.

A derivative is an advanced investing option in which the security being traded derives its price from an underlying asset. What makes CFDs unique is, unlike other derivatives where there is an obligation or option to buy or sell the underlying asset at a future date, purchasers of CFDs never own the underlying asset.

In its Consultation Paper No 322 titled "*Product intervention: OTC binary options and CFDs*" (ASIC Consultation Paper) published in August 2019, ASIC recorded 64 CFD issuers in Australia.[1]

The largest issuers tend to be entities that specialise in offering CFDs, which are often subsidiaries of international companies offering derivatives overseas. For example, IG Markets is a subsidiary of a UK company, Saxo Capital Markets is a subsidiary of a Danish company, and Pepperstone is a subsidiary of a Cypriot company.

CFDs have a leverage ratio that is the value of capital committed against the amount that could be gained or lost (similar to betting odds). CFDs are often offered at high leverage rates, for example 500:1. This means that for every $1 invested, the investor has borrowed $500. This creates a significant risk.

For example – consider the scenario where Microsoft shares are trading at $288 and an investor buys Microsoft CFDs (so not the shares) at that price. The investor pays $1,000 at a leverage ratio of 500:1, which means they are actually investing $500,000 (which allows them to purchase 1,736 CFDs). Unfortunately for the investor, in our scenario Microsoft shares fall by $1 to $287. That 0.3% movement means the CFD investor has now lost $1,736 – more than the amount they initially invested.

[1] ASIC, Consultation Paper No 322 titled "*Product intervention: OTC binary options and CFDs*" published in August 2019

Impact of CFDs on retail investors

Perhaps Beach J of the Federal Court provided the most insightful commentary on CFDs when he referred to CFDs as “little more than gambling” and commented that they provide retail investors with “financial heroin hits”.[2]

ASIC reviews of CFDs over the past two decades have consistently found that most retail investors lose money trading CFDs.[3] In 2019, the ASIC Consultation Paper revealed:

- 72% of retail clients who trade CFDs lose money
- high leverage ratios carry amplified losses and costs
- fees and costs lack transparency and can quickly deplete the investment, and
- confusing information about risks and pricing are leading to the sale to retail clients of CFDs that are misaligned with their needs or expectations.

In 2021, ASIC further reported the average loss to investors between 2016 and 2021 was $9,000 a year and 70% of those investors earned an annual income of $80,000 or less.

Regulation of CFDs

US

CFDs are banned in the US on regulated exchanges due to their high risk. Offshore online trading platforms are used by some US residents to get around this restriction, but that creates even greater risk since they are not regulated.

Europe / UK

In 2016, the European Securities and Markets Authority (ESMA) issued a warning on the sale of speculative products to retail investors that included the sale of CFDs. In response in 2019, the UK (where CFDs originated and which remains one of the main markets in Europe for CFDs) introduced maximum leverage restrictions for CFDs of 30:1.

Australia

In November 2020 and March 2021, ASIC issued a product intervention order restricting CFD leverage ratios offered to retail clients.[4] Currently, these range from 30:1 for CFDs referencing to the exchange rate of major currencies down to 5:1 for CFDs referencing share prices. These restrictions are in place until May 2027. In April 2022, ASIC determined that this had resulted in a 91% reduction in retail client losses from $372m to $33m aggregate net loss per quarter.[5] CFDs are also subject to the Design and Distribution Obligation (DDO) regime, which requires retail issuers to provide Target Market Determinations (TMDs) in their disclosure material. In essence, this sets out who the target client is for each financial product. Dealing with clients outside the TMDs can require notification to ASIC, which may then result in regulatory action.

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

[3] Report 205: Contracts for difference and retail investors July 2010; Report 626 Consumer harm from OTC binary options and CFDs August 2019

[4] ASIC *Corporations (Product Intervention Order—Contracts for Difference) Instrument 2020/986*

[5] Report 724 Response to submissions on CP 348 Extension of the CFD product intervention order 6 April 2022

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Regulatory risk

Given the number of reports ASIC has written on the topic, it's reasonable to expect the regulator is closely scrutinising the conduct of CFD issuers and those who recommend these products to their clients.

ASIC attention has resulted in investigations and intervention orders, as well as prosecutions and interventions including:

- In December 2020, ASIC filed proceedings against Union Standard alleging that it contravened Australian legislation by encouraging Chinese investors to obtain forex products, which is in breach of Chinese law.
- In 2020, before the restrictions on retail investors were introduced, Beach J issued pecuniary penalties of $75 million in connection with a contravention concerning the inappropriate marketing of CFDs to retail investors.[6]
- In May 2021, ASIC obtained a $20m judgment against Forex CT for implementing a trading floor culture that prioritised the maximisation of trading volumes and deposits rather than compliance, and using incentives for clients to deposit funds while having disincentives for withdrawal.
- In May 2023, ASIC used its product intervention powers under the DDO regime to make eight interim stop orders preventing Saxo Capital Markets from issuing some CFDs to retail clients because of deficiencies in their TMDs. Saxo Capital has since amended the TMDs resulting in the revocation of the stop orders.[7]

Litigation risk

More recently, class action lawyers and funders have taken an interest in this area. Developments in this space include:

- In 2022, Johnson Winter & Slattery (funded by Harbour Fund V, L.P.) commenced a class action against CMC[8] – the allegations are that CMC's platform simulated a gaming experience that created an addiction to trading and facilitated poor decision-making.[9]
- Mayweather Lawyers (funded by Omni Bridgeway) are investigating a potential class action regarding the CMC Markets' Crude Oil West Texas Intermediate (WTI) Cash product, which is a CFD that speculates on the price of oil.[10]
- In May 2023, Piper Alderman (funded by Omni Bridgeway) commenced a class action against IG Markets alleging losses by investors of up to $800 million[11] on the basis that the CFDs ought not have been sold to retail investors.[12]

[6] *Australian Securities and Investments Commission v AGM Markets Pty Ltd (in liquidation) (No 4)* [2020] FCA 1499
[7] https://asic.gov.au/about-asic/news-centre/find-a-media-release/2023-releases/23-127mr-saxo-capital-markets-amends-tmds-following-asic-stop-orders
[8] https://www.cmcmarketsclassaction.com.au/#section-overview
[9] Lawyerly "Online traders win discovery in class action over risky CFDs" 24 May 2023
[10] https://portal.omnibridgeway.com/cases/register/cmc-markets
[11] Sydney Morning Herald "$800 million in losses: Trading house hit with class action on behalf of 20,000 Australians" 11 May 2023
[12] https://portal.omnibridgeway.com/cases/register/ig-markets-class-action-overview

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- William Roberts is investigating a class action against IG Markets on a similar basis to the proceeding filed by Piper Alderman, namely that IG Markets allegedly held out that CFDs were a suitable product for retail investors.[13]

- Banton Group has also indicated that it is considering class actions against the following CFD trading platforms:
  - eToro
  - Pepperstone
  - International Capital Markets
  - Plus500 AU
  - IG Markets
  - Vantage
  - City Index
  - CMC Markets Asia Pacific Pty Ltd
  - BlueBerry Markets
  - Mitrade Global Pty Ltd, and
  - Saxo Capital Markets.[14]

- Banton Group is also investigating a class action against HighLow for binary options. A binary option is an all or nothing bet on the outcome of an event and considered a similar product to the CFD and also subject to restrictions by ASIC.[15]

CFDs – Not all bad news?

Beach J noted that CFDs may serve legitimate hedging purposes. This view has been endorsed by CFD providers, such as Adam Smith, CEO of Saxo Capital Markets Australia, who told the *Australian Financial Review* that CFDs "democratises access to investment opportunities that have long been the domain of institutional investors."[16]

There have been some innovative uses of CFDs to achieve positive policy outcomes.

For example – the UK Government introduced CFDs in October 2014 to support the move to renewable energy.[17] In that case, the CFD is based on a difference between the market price of renewable energy and an agreed 'strike price'.

If the 'strike price' is higher than a market price, a government-owned company (the Low Carbon Contracts Company) must pay the renewable generator the difference between the 'strike price' and the market price. If the market price is higher than the agreed 'strike price', the renewable generator must pay back the difference between the market price and the 'strike price'. This initiative provides protection from volatile wholesale prices for developers of renewables projects that have high upfront costs and long lifetimes. The costs of that CFD scheme are funded by a statutory levy on all UK-based licensed electricity suppliers, which is passed on to consumers.

[13] https://www.williamroberts.com.au/class-actions/ig-class-action
[14] https://bantongroup.com/class-actions
[15] Ibid.
[16] Australian Financial Review "Investors ignore CFD warnings as ASIC cracks down" 7 April 2021
[17] https://www.gov.uk/government/publications/contracts-for-difference/contract-for-difference

Key takeaways for insurers

While CFDs are rarely a good idea for investors, they can also be a risky proposition for insurers of financial institutions and advisors.

There's no question that both the regulators and litigation funders have CFD trading platforms in their sights. What's more, recent changes to legislation governing CFDs adds another layer of risk for insurers as insured financial institutions and professional advisors may not have stayed up-to-date with the requirements.

For insurers considering underwriting financial institutions or advisors, it is worth asking if the prospective insured promotes CFDs. If they do, consider clarifying if they sell CFDs to retail investors and whether their AFSL has the appropriate authorisations to deal in derivatives.

It is also worth knowing whether they have robust processes in place to identify retail investors. In June 2023, ASIC issued a stop order to Mitrade Global for failing to take reasonable steps to ensure its clients were the appropriate target market for its CFD products. ASIC said that Mitrade Global's retail investor questionnaire had significant flaws. Unfortunately, some institutions and advisors may attempt to get around the retail restriction by asking their clients to state that they are not retail investors (when in reality they are).

Another significant risk that needs illuminating is whether the insured has 'conflicted' remuneration. This practice was banned in June 2012 as part of the Future of Financial Advice reforms. In 2021, Forex CT was penalised $20 million for "engaging in systemic unconscionable conduct, paying conflicted remuneration to its team leaders and account managers and failing to act in the best interests of its clients".[18] Forex CT's sole director, Shlomo Yoshai, also received a $400,000 penalty and was disqualified from managing corporations for eight years.

[18] https://asic.gov.au/about-asic/news-centre/find-a-media-release/2021-releases/21-120mr-forex-ct-ordered-to-pay-20-million-penalty-and-sole-director-disqualified-fined-400-000

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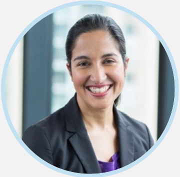
Need to know more?

If you would like further information about, or guidance on, any of the issues discussed in this article, get in touch with our authors.



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