Difference in Contracts-for-Difference: A Comparative Study of OTC Leveraged Derivatives in Selected Jurisdictions

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Abstract

This article outlines and compares the treatment of leveraged derivative products in four jurisdictions: Australia, Cyprus, United Kingdom and the United States of America. The article specifically looks at rules relating to the handling of client money; fair market pricing; leverage limits and capital requirements. The article will provide recommendations to regulators including ASIC on the regulation of OTC leveraged derivative products.

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Table summarising the factors compared between jurisdictions

	Cyprus	Australia	United Kingdom	United States
Number of providers	181	65	104	3
Number of local users	~	37,000	135,000	~
Client money buffer	No	No	No	Yes
Fair market pricing	Yes	No	Yes	Yes
Capital requirements*	€730,000	AUD1,000,000 / 10% of average revenue	€730,000	USD20,000,000 + adjustments for liabilities
Leverage	Lower limit of 1:50	N/A	N/A	1:50 or 1:20 based on currency

***May differ for STP brokers in some jurisdictions**

Introduction

This article outlines and compares the treatment of an over-the-counter ("OTC") leveraged derivative product known as Contracts-for-Difference ("CFDs") in four jurisdictions: Australia, Cyprus, United Kingdom and the United States of America. A CFD is an OTC derivative product that enables traders to leverage a small margin deposit for a much greater market effect in relation to an underlying reference asset including, amongst others, a currency, financial security, an index or a commodity. A CFD is an agreement under which you may make a profit or incur a loss arising from fluctuations in the price of the contract.[2]

The article evaluates rules relating to the treatment of client money; fair market pricing; leverage limits and capital requirements. The article will provide recommendations to regulators including ASIC on the regulation of OTC leveraged derivative products. The author acknowledges that there are many other areas of significant importance in the proper regulation of CFDs including product disclosure, regulation of advertising to ensure it is not misleading or deceptive; risk management; anti-money laundering procedures such as know-your-client; product appropriateness tests/client qualifications; and privacy considerations. These issues will not be examined by this article.

A summary table of the different factors compared between jurisdictions is provided at the end of this article.

[2] ILQ Australia Pty Ltd 'Product Disclosure Statement' (27 May 2016) < http://files.ilq.com/ILQ_AUS_PDS.pdf>.

Contracts-for-Difference

As outlined above, a CFD is an agreement under which you may make a profit or incur a loss from fluctuations in the price of the contract.[3] CFD providers will generally quote bid and offer prices at which the provider is willing to enter into long or short contracts with clients over an online platform.[4] Clients are generally required to fund their trading account (known as posting initial margin) which allows them to trade. Trades are made on a margined basis; this means that the amount which is required to place a trade does not match the notional value of the underlying asset and is typically in the range of 1%-50% of the notional value.[5] Industry practice dictates that this margin amount is quoted as a ratio, for example a 2% margin is quoted as 50:1.

The CFD is said to have been originally developed in the early 1990s by Messrs Brian Keelan and Jon Wood, while they were employed on the Smith New Court derivatives desk. However, transactions similar in nature to CFDs can be found as early as the 19th Century. For example, *Grizewood v Blane*[6] concerned an agreement where parties contemplated no delivery of equity securities but only settlement of difference in price. At Smith New Court, CFDs initially represented a cost-effective way for hedge fund clients to short the London stock market, as they were able to take advantage of leverage and benefit from stamp duty exemptions.

Size of the Market

CFDs and specifically Margin FX comprise one of the largest segments of the world's financial markets; foreign exchange markets transact 5.4 trillion US dollars every day. Due to the high degree of leverage within the specifications of these products, it is not uncommon for small to medium size firms offering CFDs to trade USD 1 billion (known as a "yard") per day, with bigger operations trading multiples of this figure.

The International Organization of Securities Commissions ("IOSCO") in its report into retail OTC leveraged products notes "[t]he regulation in reporting jurisdictions is quite heterogenous" .[7]

Australia

The CFD industry in Australia is in its infancy by comparison to the well-developed market in the UK. CFDs first appeared in Australia in March 2002 when CMC Markets entered the Australian market. IG Markets closely followed, entering Australia in July 2002. As of June 2016, there were 65 OTC derivative issuers.[8] According to research firm Investment Trends there were approximately 37,000 active CFD traders in Australia in 2016, down from 49,000 active traders in 2015.[9] The Australian market is dominated by two providers, IG Markets and

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[3] Ibid.
[4] Sally Palmer 'Contracts-for-difference, spread bets and over the counter derivatives: Through a lawyer's looking glass' (2007) *25 C&SLJ* 246.
[5] Ibid.
[6] (1851) 11 CB 526.
[7] The Board of the International Organization of Securities Commissions 'Report on the IOSCO Survey on Retail OTC Leveraged Products' (December 2016).
[8] ASIC 'Compliance review of the retail OTC derivative sector' (June 2016) *Report 482* < http://download.asic.gov.au/media/3899926/rep482-published-20-june-2016.pdf>.
[9] Investment Trends 'FX and CFDs 2016'(2016)

CMC Markets who combined, make up 56% of the market.[10] The Australian component of FX volume is sizeable and growing with total average daily volumes across over-the-counter (OTC) markets amounting to $134.8 billion in April 2016.[11]

Companies wishing to offer CFDs must hold an Australian Financial Services ("AFS") Licence, authorising them to advise, deal by issuing and make a market in derivatives (and foreign exchange contracts if the broker wishes to offer CFDs over currency pairs, known as Margin FX).

Cyprus

Cyprus is one of the most popular jurisdictions for CFD providers with 181 licensed CFD providers as of March 2017.[12] Online CFD Forum *The FX View* speculates that the primary reasons for CFD providers to set up in Cyprus are the favourable tax regime; European Union membership and light touch regulation, going so far as to comment:

> [t]he regulatory requirements in many countries far exceeds the minimums as required by MiFID, however Cyprus has taken a relatively light touch approach to financial regulation. This makes it much cheaper for brokerages to be regulated by CySec, than other European regulators such as Britain's FCA or Germany's BaFIN.[13]

United Kingdom

The United Kingdom is seen as a mature CFD market.[14] As at December 2016 there were 104 firms authorised by the Financial Conduct Authority ("FCA") to provide CFDs,[15] with an estimated 135,000 active users of CFDs.[16]

United States of America

Regulation of CFDs in the United States is governed by the *Commodity Exchange Act*. Firms offering CFDs must be registered with the US Commodities and Futures Trading Commission ("CFTC"), as either a retail foreign exchange dealer ("RFED") or a Futures Commission Merchant ("FCM").[17] These firms must also be forex dealer members of the National Futures Association ("NFA"). According to IOSCO, there were 6 FCM/RFED firms.[18] However, as at the date of writing there remain three firms who are RFEDs which offer CFDs, being GAIN Capital Group LLC; Interactive Brokers LLC and OANDA Corporation.[19] This is a significant

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[10] Maria Nikolova 'Investment Trends report- IG and CMC Markets dominate Australian CFD market' *Leaprate* (21 October 2015) < https://www.leaprate.com/news/investment-trends-report-ig-and-cmc-markets-dominate-australian-cfd-market/>.

[11] Victor Golovtchenko 'FX Turnover in Australia Signals Plateau as AUD Decline is Arrested' *Finance Magnates* (29 August 2016) < http://www.financemagnates.com/institutional-forex/execution/fx-turnover-australia-signals-plateau-aud-decline-arrested/>.

[12] Cyprus Securities and Exchange Commission <http://www.cysec.gov.cy/en-GB/home/>.

[13] The FX View 'CySec Forex Brokers' <http://thefxview.com/cysec-forex-brokers/?>.

[14] Above n 7.

[15] Ibid.

[16] Ibid, 10.

[17] Above n 7, 15.

[18] Ibid.

[19] National Futures Association <https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=4779>.

decrease from 52 firms who acted as counterparties to retail forex clients in 2007 (together holding USD 1.3 billion in client funds).[20] A further 181 firms existed acting as introducing brokers. The United States' NFA crackdown on the industry has contributed to this reduction with large listed CFD provider FXCM the latest to relinquish its licence in early 2017.[21]

Client Money

When it comes to regulating CFDs, one of the more critical aspects for the protection of investors is how client money is dealt with. Each jurisdiction has different rules for the treatment of client money, that is, how it needs to be held and accounted for, the manner in which client money may be used and importantly, when client money may not be used. The importance of this was apparent in the case of *In re MF Global Australia Ltd (in liq)*[22]. In that case, MF Global Australia used their ability to use client money to hedge to its parent company which on 31 October 2011 declared bankruptcy with an estimated US$1.6 billion of client funds being lost.[23] From the clients' perspective, laws surrounding whether money deposited is held on trust or not are important. In order for money to be held on trust, it must be segregated from company funds and therefore, is protected in the event of the CFD issuer's insolvency.

Australia

In Australia, the treatment of client money is dealt with by Part 7.8 of the *Corporations Act 2001* (Cth). Detailed analysis of the application of this to OTC derivative issuers is provided by ASIC in 'Regulatory Guide 212: Client money relating to dealing in OTC derivatives' ("RG 212"), which defines what client money is. RG 212 stipulates that client money is money paid to an AFS licensee:

(a) In connection with either a financial service that has been provided (or that will or may be provided to a client or a financial product held by a clients, and
(b) Either:
    (i) By a client or a person acting on behalf of a client; or
    (ii) to the licensee in the licensee's capacity as a person acting on behalf of the client.

The client money provisions do not apply to:

(a) Money paid as remuneration to a licensee;
(b) Money paid to reimburse (or discharge a liability incurred by) the licensee for payment made to acquire a financial product;
(c) Money paid to acquire a financial product from the licensee;
(d) Loan money; or
(e) Money paid to be credited to a deposit product.[24]

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[20] Above n, 15.
[21] Victor Golovtchenko 'Complant against FXDD, Raising Allegations on Five Counts' (5 September 2014) *Finance Magnates* <http://www.financemagnates.com/forex/brokers/exclusive-nfas-issues-a-complaint-against-fxdd-raising-allegations-on-five-counts/>.
[22] *In re MF Global (in liq) No 2* [2012] NSWSC 1426.
[23] Nathan Lynch 'Five-year fix: Australia finally overhauls flawed client money rules' (28 March 2017) Thomson Reuters' Regulatory Intelligence.
[24] ASIC 'Regulatory Guide 212: Client money relating to dealing in OTC derivatives' (July 2010) < http://download.asic.gov.au/media/1241354/rg212-9july2010.pdf>, 4.

Handling client money is governed by s 981 of the *Corporations Act 2001* (Cth). Specifically, s 981B of the *Corporations Act 2001* (Cth) requires that client money must be deposited into a designated client money account which is operated as a trust account. This account must be segregated from company funds.

> A licensee may make payments out of a client money account in the following circumstances:
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> (a) Making a payment to, or in accordance with the written direction of, a person entitled to the money;
> (b) Defraying brokerage and other proper charges;
> (c) Paying to the licensee money to which the licensee is entitled; and making a payment that is otherwise authorised by law or pursuant to the operating rules of a licensed market.[25]

Currently, section 981D applies in respect of dealing in derivatives. It provides the following:

> Despite anything in regulations made for the purposes of 981C, if:
>
> (a) The financial service referred to in subparagraph 981A(1)(a)(i) is or relates to a dealing in a derivative; or
> (b) The financial product referred to in subparagraph 981A(1)(a)(ii) is a derivative;
>
> The money concerned any also be used for the purpose of meeting obligations incurred by the licensee in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings on behalf of people other than the client.

In simple terms, this provision allows CFD issuers to use client money for the purposes of hedging with another broker. This increases counterparty risk significantly. Client money which remains in the designated trust account will not be subject to creditors of the CFD issuer in the event that the CFD issuer becomes insolvent. Under s981D, the CFD issuer may place client money with a third party for the purpose of hedging. Warren Buffett's famous (and crude) writings said it as plainly as one can, "*[d]erivatives are like sex. It's not who we're sleeping with, it's who they're sleeping with that's the problem".*[26]

To endeavour to remedy this issue, the Australian Government in October 2015 announced that it would develop legislation to better protect its root and branch examination of Australia's financial system. On 1 December 2016 the *Treasury Laws Amendment (2016 Measures No. 1) Bill 2016* was introduced into Federal Parliament, with the intention of, amongst other things, *"removing the exemption in the client money regime that allows Australian financial service licensees to withdraw client money provided in relation to retail OTC derivatives from client money trust accounts, and use it for a wide range of purposes including working capital".*[27] The Bill passed both Houses on 27 March 2017 and received Royal Assent on 4 April 2017. In commenting on the changes to the client money rules, ASIC Commissioner Cathie Armour stated:

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[25] Ibid, 5.

[26] Warren Buffett 'Derivatives are like Sex' <http://www.goodreads.com/quotes/871616-derivatives-are-like-sex-it-s-not-who-we-re-sleeping-with>.

[27] ASIC '17-083MR ASIC welcomes passage of client money reforms by Parliament' (28 March 2017) < http://www.asic.gov.au/about-asic/media-centre/find-a-media-release/2017-releases/17-083mr-asic-welcomes-passage-of-client-money-reforms-by-parliament/>.

> The amendments to the client money regime made in the Bill have strengthened the protection of client money that is provided to retail derivative clients. Doing so will help to increase investor confidence in the Australian financial system.[28]

Market participants are less confident these amendments will provide the intended benefits and protections for investors. Financial services expert and solicitor, Sophie Gerber made the following observation in relation to the changes to client money rules:

> This has been a very divisive issue in the industry. What may have been a more beneficial approach to this issue would be to have disallowed the use of the Corporations Act provisions for using client money for margining/hedging etc. with related parties and also prohibiting the payment of any forms of conflicted remuneration in these relationships. Time will show us whether these reforms have or have not benefitted the industry, I think unfortunately in this case the retail client will not see any benefits, and over the next few years the outcomes will be reduced competition and increased costs.[29]

While these changes are an excellent step towards ensuring that client money is protected from credit risk from the issuer who may have significant exposure to the vagaries of the market, the changes do not provide full protection for retail clients. Their money is pooled with other clients' money. As a result, retail clients are still exposed to counterparty risk. This may occur where the OTC derivative issuer makes a withdrawal from a client money account of money that is entitled to be used under s981D. This could result in total client liabilities exceeding the amount in the client trust account. With insufficient funds remaining in the client trust account if the OTC derivative issuer becomes insolvent, the clients would receive less money than they are strictly entitled to.

Additionally, ASIC prohibits segregated trust accounts from including a buffer of house funds.[30] In contrast, other jurisdictions require that there is excess money in the client trust account to ensure there is never a client shortfall.

Cyprus

The treatment of client money is specified in both the Investment Services and Activities and Regulated Markets Law of 2007 ("Regulated Markets Law") and Part VI of CySec Directive DI144-2007-01 of 2012 ("Directive"). Section 18(2)(j) of the Regulated Markets Law states:

> a Cyprus Investment Firm ("CIF") must, when holding funds belonging to clients, make adequate arrangements to safeguard the clients' rights and, except in the case of credit institutions, prevent the use of client funds for its own account.

Under section 18(1)(e) of the Directive, CIFs must ensure that clients' funds are held in accounts identified separately from company accounts. CIFs must conduct regular reconciliations of client accounts and company funds.[31] CIFs are required to report information on clients' funds to CySec on a quarterly basis with an annual audit submitted to CySec verifying these quarterly reports.

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[28] Ibid.
[29] Sophie Gerber 'Interview with J O'Neill on 24 April 2017'.
[30] Above n 20.
[31] S 18(1)(c) Directive DI144-2007-01.

United Kingdom

The treatment of client money by derivative issuers is dictated by the Client Asset Sourcebook ("CASS") which is published by the FCA. CASS 7.13 stipulates that "The segregation of client money from a firm's own money is an important safeguard for its protection".[32] CASS restricts CFD issuers from depositing money which is not client money into the client trust account.[33] Furthermore, the FCA requires that all client money is directly deposited into the segregated client money account rather than to the CFD provider's account and then further deposited into a segregated client trust account.[34] An individual client's money may be pooled with other clients' money.[35] The FCA does not allow client funds to be used for hedging purposes.

United States of America

The *Commodity Exchange Act* and CFTC Regulation 1.20 require that all client funds be segregated from the CFD issuer's funds.[36] Client funds must be deposited in an account that is clearly identified and titled as a client segregated account.[37] A CFD issuer is prohibited from using one client's funds to meet the obligations of another client.[38] A CFD issuer is permitted to deposit its own funds in the client segregated account to meet any shortfall. Furthermore, in contrast to Australia which prohibits the use of a buffer – money in excess of the client funds to be placed in the segregated trust account using the CFD issuer's funds – the NFA requires CFD issuers to maintain written policies and procedures that identify a target amount (either a percentage or dollar amount) that it will seek to maintain as its residual interest in client segregated accounts.[39] Where a disbursement of greater than 25% of the client segregated trust account is required, this must be pre-approved by the CEO or CFO and a confirmation must be sent to the NFA of this disbursement.[40]

Analysis

All jurisdictions appear to conform and agree that the segregation of company funds and client funds is vital for the protection of investors. The different approaches by the relevant regulators appears to centre on the questions:

1. Whether the regulator allows client money to be used for hedging and margining purposes? and
2. Whether the regulator allows a buffer in the client segregated account?

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[32] CASS 7.13 CASS <https://www.handbook.fca.org.uk/handbook/CASS/7/13.html>
[33] CASS 7.12.4.
[34] CASS 7.13.6.
[35] Ibid, CASS 7.13.17.
[36] National Futures Association 'NFA Requirements For FCMs, IBs, CPOs and CTAs' (February 2016) <https://www.nfa.futures.org/nfa-compliance/publication-library/regulatory-requirements-guide.pdf> 28.
[37] Ibid.
[38] Ibid.
[39] Ibid.
[40] Ibid.

Hedging Allowances

Allowing brokers to use client funds to hedge their trades effectively acknowledges and endorses that not all brokers are market makers who take the other side of a client's trade. For some brokers, for example, the straight-through-processing ("STP") model where the broker effectively clips the ticket and passes the risk to a third party, it is a necessity due to capital restraints. Critics lament that allowing hedging using client money is a slippery slope, for example, a hedging policy may not match trades, instead it may use the approach where aggregate positions are presented to a trading desk who are tasked with hedging out the risk while maximising profits. Where this occurs, the line between proprietary trading and hedging may be trivial. Proponents of the current model in Australia include Duncan Fairweather, Executive Director of the Australian Financial Markets Association (AFMA), he commented:

> One of the advantages of this approach [allowing client money to be used for hedging] was that it allowed providers to make more efficient use of their capital. Rather than needing separate capital for the hedging transaction, they were able to use money that they held on account for clients.[41]

Buffer in Client Account

A significant difference in client money rules between the US and other countries is the requirement for a buffer in the trust account. Arguments against allowing brokers to place a buffer of corporate funds into client accounts are threefold:

1. Depositing corporate funds into client money accounts may change the firm's attitude to the funds, they may begin to treat those funds as their own;
2. The firm may not undertake diligence to ensure that client funds do not drop below client trading account balances, due to lack of diligence required by periodic reconciliations; and
3. Non-client deposited funds may blur the trust designation required for a trust and could result in prolonged litigation from creditors seeking to have surplus funds in the client trust account distributed for the purpose of the insolvency.

In the author's view, none of these arguments seem persuasive. Point one, is a hypothetical about how some participants in the market may interact contrary to the law. Point two, could easily be remedied through legislation requiring regular reconciliation. In the US example, brokers were still required to reconcile their accounts daily as the buffer was a specific amount. Finally, the last point may be overcome with legislation that states that any money which is used as a buffer in client trust accounts cannot be used for the benefit of creditors until all clients have had their money returned.

Segregated Individual Trust Accounts

A further area, which is acknowledged by ASIC but which is not addressed by the NFA, CySec or the FCA is the pooling of client funds into the trust account. This structure creates credit risk

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41 Reuter 'MF Global collapse exposes local loopholes' (3 November 2011) *Sydney Morning Herald* <http://www.smh.com.au/business/mf-global-collapse-exposes-local-loopholes-20111103-1mxg1.html>.

between each individual client. One more unique feature of the CFD is its ability for investors to lose in excess of their initial deposit. As a consequence, the aggregate of client money accounts may result in a liability to the CFD issuer where a significant market event occurs and causes losses in excess of total funds. These losses may be as a result of transactions relating to only a minority of clients within the pooled trust account. One approach to remedying this issue would be to mandate that all designated segregated trust accounts are account specific. That is, each client is provided with its own bank account holding the exact funds as in its trading account. The benefit of this approach is that no counterparty risk between the broker and the client; and client and client exist. The disadvantages of this proposal are that the costs could be significant, there would be additional administrative costs to set up each account, compliance costs to manage adherence to the additional rules and additional bank fees. Defending the pooling of client money, Duncan Fairweather notes:

> There can be practical benefits in the operations of pooled funds that create operational efficiencies in the provision of brokering services.[42]

Having segregated individual trust accounts means that there is no requirement for a buffer within trust accounts.

Fair Market Pricing

As CFDs are derivatives traded over-the-counter, one issue that is prevalent within the market and should be a concern for all regulators is fair market pricing. Fair market pricing refers to ensuring that the price on transaction is in-line with general market expectations. One issue that complicates this is a phenomenon known as slippage. According to Tradimo (a finance education platform):

> Slippage refers to the difference a trader expects to pay for a trade and the actual price at which the trade is executed. Slippage occurs because there is a slight time delay between the trader entering the trade and the time the broker receives the order. During this time delay, the price may have changed. Slippage can be much higher in fast-moving, volatile markets. It can either work in favour of or against the trader. Liquidity and frictional costs may also have an impact on the slippage percentage.[43]

Fair market pricing is fundamental to a fair, honest and transparent financial services industry and allows participants to have confidence in the relevant financial market. Regrettably, the nature of trading means that slippage is unavoidable. However, best practice dictates that on the law of averages slippage should be symmetrical. Slippage in the client's favour indicates predatory trading and/or arbitrage on behalf of the client and if prevalent and repeated in perpetuity will lead to broker insolvency. Pricing in the broker's favour indicates unethical trading practices on behalf of the broker.

Australia

Australia does not have any specific legislation mandating pricing of CFDs and slippage. The Australian financial services regulatory system does, however, provide a general obligation on

[42] Ibid.
[43] Tradimo 'What is slippage?' < http://en.tradimo.com/tradipedia/slippage/>.

all AFS licence holders to act efficiently, honestly and fairly.[44] Justice Young in *Story's Case*[45] refers to the duty to act honestly as being upright, righteous, truthful and a person who is ethically sound. There is yet to be any jurisprudence as to whether a AFS licensee's general obligations would extend to ensuring that slippage is symmetrical. Caselaw confirms the meaning of efficiently, honestly and fairly, which:

> must be read as a compendious indication meaning a person goes about their duties efficiently having regard to the dictates of honesty and fairness, honestly having regard to the dictates of efficiency and fairness, and fairly having regard to the dictates of efficiency and honesty.[46]

Additionally, Enderby J's comments in *Nisic's Case*[47] that ASIC "*is entitled to rely upon and consider those part* [industry conventions related to stockbroking] *of the business of the plaintiffs in licensing matters"*[48] suggests that courts may be willing to read fair market pricing into the ambit of s 912A(1)(a) of the *Corporations Act 2001* (Cth). Justice Young provided obiter that s 912A(1)(a) "is obviously designed to protect the public".[49]

Other examples within the *Corporations Act 2001* (Cth) provide examples of prohibitions to mispricing such as Pt 7.10 Div. 2 which contains market manipulation, false trading, market rigging and false or misleading statements relating to financial products and services. These themes are echoed by Mason J in *North v Marra Developments Ltd:*

> … to ensure that the market reflects the forces of genuine supply and demand. By "genuine supply and demand" I exclude buyers and sellers whose transactions are undertaken for the sole or primary purpose of setting or maintaining the market price. It is in the interests of the community that the market for securities should be real and genuine, free from manipulation.[50]

In the author's view, it would be unlikely that a CFD issuer who engages in asymmetrical slippage will infringe on false trading, market manipulation, market rigging or false or misleading statements relating to financial service products. This is because of the definition of making a market in s 766D(1) of the *Corporations Act 2001* (Cth):

> A person makes a market for a financial product if:
>
> (a) Either through a facility, at a place or otherwise, the person regularly states the prices at which they propose to acquire or dispose of financial products on their own behalf;
> (b) Other persons have a reasonable expectation that they will be able to regularly effect transactions at the stated prices; and
> (c) The actions of the person do not, or would not if they happened through a facility or at a place, constitute a financial market.[51]

As the financial product is issued by the CFD provider, the CFD provider must state prices at which other persons have reasonable expectations that they will be able to regularly affect prices. Persistent positive slippage (that is, slippage in favour of the client) may result in fewer orders being filled and the CFD provider either increasing spreads or only partially filling orders. While there is a strong possibility that asymmetric slippage would infringe on s

[44] S 912A(1)(a) *Corporations Act 2001*(Cth)
[45] (1988) 13 NSWLR 661.
[46] Ibid.
[47] (1990) 8 ACLC 514 at 528.
[48] Ibid.
[49] Above 42, 671.
[50] *North v Marra Developments Ltd* (1981) 148 CLR 42 at 59 per Mason J.
[51] S 766D(1) *Corporations Act 2001* (Cth).

912A(1)(a), the likelihood of the issue being tested by a court is remote. For this reason it is the author's view that legislative reform may be required to ensure fair market pricing.

Financial Services expert, Sophie Gerber contributed her perspective on this matter:

> Unlike the OTC derivative industry, market participants (e.g. on the ASX) in Australia have a best execution obligation (RG223) and for a retail client, a market participant must take reasonable steps when handling and executing an order to obtain the best outcome for the client. It is possible that ASIC may impose similar obligations on the OTC derivative industry down the line, however this has not been mentioned as far as I'm aware. I believe this is primarily because ASIC doesn't have sufficient expertise or resources for enforcing this type of provision. ASIC may also impose relevant disclosure obligations on licensees regarding their execution practices to allow retail clients to make more informed decisions on whether to invest and who to invest with.[52]

Cyprus

Cyprus laws relating to fair market pricing come under the *Investment Services and Activities and Regulated Markets Law of 2007*. It provides that CFD issuers must:

1. Act honestly, fairly and professionally in accordance with the best interests of their clients and provide adequate information to clients about the financial instruments offered (Article 36).[53]
2. Take all reasonable steps to obtain, when executing orders, the best possible result for its clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order (Article 39).[54]
3. Implement procedures and arrangements for the execution of orders that provide for the prompt, fair and expeditious execution of client orders (Article 38).[55]

Readers will note that Article 36's initial limbs exhibit a similar flavour to those drafted in Australia's general obligations. The obligations in the Cyprus regulations go further than the Australian equivalent requiring firms to act in the best interests of their clients in addition to providing adequate information to clients about the financial instruments. The pertinent issue here is whether disclosure of symmetrical slippage would discharge the CFD provider's duty to act in accordance with the best interests of the client.

Article 38 appears to be a reasonable one, it requires firms to provide reasonable pricing when offering prices for orders looking at the general market conditions and the size and nature of the orders. For example, a client who is trying to execute a large trade, for example US$15 million, is likely to receive a larger spread than a client who is executing a small transaction. In times of market volatility, spreads are generally going to be wider than low volatility periods and Article 38 seems to take this into consideration. Of benefit to clients, CySec on 13 February

[52] Above n 44.
[53] Article 36, *Investment Services and Activities and Regulated Markets Law of 2007* (Cyprus) < http://www.cysec.gov.cy/CMSPages/GetFile.aspx?guid=60f8cf0b-08ba-4f4c-8208-1b50cda64d9f>.
[54] Article 38, Ibid.
[55] Article 39, Ibid.

2017 published some guidance into how they interpret Article 38 stating "*CIFs must execute orders on terms* most favourable to clients".[56]

United Kingdom

In the UK, fair market pricing is dealt with by the FCA within the Conduct Business section of the *FCA Handbook*. CFD issuers have the following obligations:

> **11.2 Obligation to execute orders on terms most favourable to the client**
>
> A firm must take all reasonable steps to obtain, when executing orders, the best possible result for its clients taking into account execution factors. [Where execution factors is defined as price, costs, speed, likelihood of execution and settlement, size, nature or any consideration relevant to the execution of an order].
>
> **Application of best execution obligation**
>
> The obligation to take all reasonable steps to obtain the best possible result for its clients should apply to a firm which owes contractual or agency obligations to the client.
>
> Dealing on own account with clients by a firm should be considered as the execution of client orders, and therefore subject to the requirements under MiFID, in particular, those obligations in relation to best execution.
>
> If a firm provides a quote to a client and that quote would meet the firm's obligations to take all reasonable steps to obtain the best possible result for its clients if the firm executed that quote at the time the quote was provided, the firm will meet those same obligations if it executes its quote after the client accepts it, provided that, taking into account the changing market conditions and the time elapsed between the offer and acceptance of the quote, the quote is not manifestly out of date.
>
> The obligation to deliver the best possible result when executing client orders in relation to all types of financial instruments. However, given differences in market structures or the structure of financial instruments, it may be difficult to identify and apply uniform standard of and procedure for best execution that would be valid and effective for all classes of instrument. Best execution obligations should therefore be applied in a manner that takes into account the different circumstances associated with the execution of orders related to particular types of financial instruments.
>
> **Requirement for order execution arrangements including an order execution policy**
>
> A firm must establish and implement effective arrangements for complying with the obligation to take all reasonable steps to obtain the best possible result for its clients. In particular, the firm must establish and implement an order execution policy to allow it to obtain, for its client orders, the best possible result in accordance with that obligation.[57]

The United Kingdom's approach to fair market pricing is to require firms to obtain the best possible result for the client. The FCA rules do, however, acknowledge that market forces may not always result in zero slippage or positive slippage only. The rules add flexibility to allow negative slippage, however, there is a requirement that clients consent to an order execution policy. Firms that provide clients with

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[56] CySec 'Enhancing the regulatory obligations of CIFs when providing investment services in binary options'.

[57] COBS 11.2 *FCA Handbook* <https://www.handbook.fca.org.uk/handbook/COBS/11/2.html?date=2016-12-31>.

asymmetrical pricing, not in the client's favour, will contravene the legislation. This provides clients with a reasonable amount of protection.

United States of America

In the US, the NFA has mandated the following with regards to fair market pricing:

> Trading Platforms must be designed to provide bids and offers that are reasonably related to current prices and conditions.
>
> Slippage. An electronic trading platform should be designed to ensure that any slippage is based on real market conditions. For example, slippage should be less frequent in stable currencies than in volatile ones, and prices should move in clients' favour as often as against them.[58]

Additionally, the NFA also reads fair market pricing into its general requirement that

> [n]o Forex Dealer Member or Associate of a Forex Dealer Member engaging in any forex transaction shall: (1) Cheat, defraud or deceive, or attempt to cheat, defraud or deceive any other person; or… (4) [e]ngage in manipulative acts or practices regarding the price of any foreign currency or a forex transaction.[59]

In its interpretative note on Rule 2-36, the NFA spoke about the application of the rule and cases involving infringing foreign dealer members:

> The FDM used asymmetrical slippage settings that benefited the FDM to the detriment of the client because the slippage settings made it much more likely that a client order that moved against the client (and therefore the FDM's favour) would be filled than one that moved in the client's favour. Any asymmetrical slippage settings or requoting practices or any other manipulative practices, that provide an advantage to the FDM to the detriment of the forex client would violate these rule provisions, including:
>
> - The FDM set the maximum losing slippage (i.e., slippage that was unfavorable to the client and favorable to the FDM) at a much wider range of pips than the maximum profit slippage (i.e., slippage that was favorable to the client and unfavorable to the FDM). As a result, a client was much more likely to have an order filled when the market move was unfavorable to it than when the movement was favorable to the client.
>
> - The FDM set the limit on the number of contracts in an order that could be executed that experienced losing slippage for the client at a much higher number than the limit on the number of contracts in an order that could be executed that experienced profitable slippage for the client. As a result, a larger sized order that moved against the client was much more likely to be executed than a smaller sized order that moved in the client's favor.
>
> - The FDM only passed negative slippage on to the client. If the FDM was able to offset the client's order at a better price than the price at the time the client submitted its order, the FDM did not give the client the better price. However, if the FDM offset the client's order at a price that had negative slippage and was unfavorable to the

[58] 9099 NFA Compliance Rule 2-4 *NFA Manual* <https://www.nfa.futures.org/nfamanual/NFAManual.aspx>.
[59] Rule 2-36 Requirements for Forex Transaction *NFA Rules* <https://www.nfa.futures.org/nfamanual/NFAManual.aspx?RuleID=RULE%202-36&Section=4>.

> client, the FDM would thereby benefit from the slippage and fill the client's order at the offset price.[60]

The NFA's approach makes it clear that slippage is likely to occur, and the CFD issuer is required to ensure that slippage occurs on a symmetrical basis and must not manipulate prices to ensure that pricing favours the broker.

Analysis

Pricing of derivatives is fundamental to transparency and confidence in the financial market, the financial product and the financial service provider. If the client believes that a product is skewed in the financial service provider's favour, it erodes confidence. It is therefore imperative that jurisdictions that regulate CFDs ensure their laws deal appropriately with fair market pricing. In the author's view, ASIC's regulatory omission of rules dealing with fair market pricing is left wanting. Similarly, CySec's rules on fair market pricing are also inadequate and are potentially damaging to CFD issuers if followed assiduously. CySec's rules effectively prohibit negative slippage. Over a prolonged period of time and in a market full of scalpers (clients whose trading strategy is to 'hit' brokers off-market) this could result in the bankruptcy of brokers. The author commends the NFA and FCA for their rules on fair market pricing. Though, different in their approach, both operate to ensure that brokers can operate within the general market while prohibiting nefarious behaviour when it comes to pricing of the financial instruments.

Capital Requirements

Other than market risk, perhaps the largest risk that an investor in CFDs is exposed to is counterparty risk. This risk is the credit risk that the consumer has as against the derivative issuer. One mechanism regulators have to ensure that CFD providers remain a going concern is the imposition of financial resource requirements.

Australia

On 31 July 2012, ASIC announced financial requirements for CFD providers through Class Order [CO 12/752] *Adequate financial resources for financial services licensees that issue OTC derivatives to retail clients*.[61] Under the ASIC Class Order, OTC derivative issuers must meet a net tangible asset ("NTA") threshold.[62] From 31 January 2013, this requirement was the greater of AUD $500,000 or 5% of average revenue.[63] From 31 January 2014, the NTA requirement increased to the greater of AUD $1,000,000 or 10% of average revenue.[64] Under

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[60] 9064 – NFA Compliance Rule 2-36 *NFA Manual* <https://www.nfa.futures.org/nfamanual/NFAManual.aspx>.

[61] ASIC Media Release '12-180MR New financial requirements for issuers of over-the-counter derivatives' (31 July 2012) < http://asic.gov.au/about-asic/media-centre/find-a-media-release/2012-releases/12-180mr-new-financial-requirements-for-issuers-of-over-the-counter-derivatives/>.

[62] ASIC Class Order [CO 12/752] 'Adequate financial resources for financial services licensees that issue OTC derivatives to retail clients'.

[63] Ibid.

[64] Ibid.

this instrument, OTC derivative issuers are required to hold 50% of the required NTA in cash or cash equivalent to ensure liquidity.[65]

CFD providers who hold less than 110% of the required NTA will have a 'notifiable event' and must lodge a report with ASIC that notifies them within 3 business days after becoming aware of the notifiable event.[66] OTC derivative issuers who have less than 100% of the required NTA will be in breach of their AFS licence.[67] OTC derivative issues who do not replenish their NTA within two months must notify their clients about the deficiency.[68] OTC derivative issuers who have less than 75% of the required NTA must not enter into any transactions with clients that could give rise to any further liabilities, contingent liabilities or other financial obligations.[69]

ASIC commenting about the adequacy of the NTA requirement stated:

> The NTA requirement provides a financial buffer that decreases the risk of a disorderly or non-compliant wind-up if your business fails. The required minimum amount of NTA reflects the contemporary costs of administering the type of financial services business carried on by retail OTC derivative issuers.
>
> It also aligns Australia more closely with comparable regimes for retail OTC derivative issuers in Singapore (a minimum requirement of S$1 million) and the United Kingdom (a minimum requirement of £730,000). While the US Commodity Futures Trading Commission has a much higher minimum requirement (US$20 million), we believe this amount would be overly onerous.[70]

Cyprus

CySec initially had one of the higher capital adequacy standards in Europe being €1,000,000, however, following the publication of European Directive 2013/36/EU on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, the Cyprian corporate regulator has amended the capital requirement. In 2013, CySec introduced Amending Law 193(1)/2014 with the express objective of harmonising national law with European standards. Amending Law 193(1)/2014, became effective as of 19 December 2014 and reduces the capital requirement for market makers from €1,000,000 to €730,000. STP brokers capital requirements went from €200,000 to €125,000.[71]

United Kingdom

The FCA's capital requirements are tiered based on the activities of the provider. The FCA split the capital requirements into two categories, CFD providers who deal on their own accounts or firms that are STP brokers. Firms which are STP brokers are required to hold a

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65 Ibid.
66 Ibid.
67 ASIC 'RG 166 Regulatory Guide 166: Licensing: Financial requirements' (July 2015) < http://download.asic.gov.au/media/3278616/rg166-published-1-july-2015.pdf>.
68 Ibid, 127.
69 Ibid.
70 Ibid.
71 Amending Law 193(1)/2014 <http://www.cysec.gov.cy/CMSPages/GetFile.aspx?guid=503a8026-e4a3-4b57-be8a-da1d9e5edae8>.

minimum of €125,000, while firms which deal on their own account must hold a minimum of €730,000.[72] In addition to this minimum amount, firms which deal on their own account must also hold the sum of:

(1) (a) the credit risk of capital requirement; and
    (c) The market risk capital requirement; and
(2) The fixed overheads requirement.[73]

The credit risk is 8% of the total of a firm's risk weighted exposure amount plus concentration risk and counterparty risk.[74] The fixed overheads requirement is the expected expenditure the firm will incur over the next quarter.[75]

Additionally, the FCA has the ability to impose a higher capital requirement than the minimum required at any time.[76]

United States of America

Minimum financial requirements for OTC derivative issuers are elucidated in Section 12 of the NFA Manual:

> SECTION 11. FOREX DEALER MEMBER FINANCIAL REQUIREMENTS
>
> (a) Each Forex Dealer Member must maintain "Adjusted Net Capital" equal to or in excess of the greatest of:
>   i. $20,000,000
>   ii. The amount required by subsection (a)(i) above plus:
>   (aa) 5% of all liabilities the Forex Dealer Member owes to clients and to eligible contract participant counterparties that are not an affiliate of the Forex Dealer Member and are not acting as a dealer exceeding $10,000,000; and
>   (bb) 10% of all liabilities the Forex Dealer Member owes to eligible contract participant counterparties that are an affiliate of the Forex Dealer Member not acting as a dealer; and
>   (cc) 10% of all liabilities eligible contract participant counterparties that are an affiliate of the Forex Dealer Member and acting as a dealer owe to their client (including eligible contract participants), including liabilities related to retail commodity transactions; and
>   (dd) 10% of all liabilities the Forex Dealer Member owes to eligible contract participant counterparties acting as a dealer that are not an affiliate of the Forex Dealer Member, including liabilities related to retail transactions.[77]

In other words, licensees are required to pay USD 20,000,000 plus 0.05(client liabilities - $10,000,000) and apply a 10% haircut for all hedged transactions.

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[72] IFPRU 3.1.9 *FCA Handbook* < https://www.handbook.fca.org.uk/handbook/IFPRU/3/1.html>.
[73] GENPRU 2.1.45 *FCA Handbook* < https://www.handbook.fca.org.uk/handbook/GENPRU/2/?view=chapter>.
[74] BIPRU 3.1.5 *FCA Handbook* < https://www.handbook.fca.org.uk/handbook/BIPRU/3/1.html#D416>.
[75] GENPRU 2.1.53 *FCA Handbook* < https://www.handbook.fca.org.uk/handbook/GENPRU/2/1.html#D1055>.
[76] GENPRU 2.1.12 *FCA Handbook.*
[77] Section 11 *NFA Manual* <
https://www.nfa.futures.org/nfamanual/NFAManual.aspx?RuleID=SECTION%2011&Section=7>.

Analysis

In order to ensure that CFD issuers are reputable, a not insignificant barrier to entry is required. Corporate regulators must also view capital adequacy as a mechanism against insolvency. The ASIC and CySec model does not in the author's view meet a metric that the public should consider acceptable. By design the capital requirements are static and may not incorporate the real-time exposure that the CFD issuer may require. For example, under the ASIC requirement the provider must have the greater of AUD 1 million or 10% of average revenue. It is quite possible that the provider on-boards a new client whose trades are significant from day one. In the previous 12 months, the CFD issuer may not have had transactional flow that would require it to increase its capital requirement to a level that would be appropriate when taking into account the trades with the new client. Similarly, periods of losses may result in low revenues despite noteworthy trade flow. The ASIC and CySec capital adequacy rules also do not mention volatility. The amount of capital required would need to be significant for the same notional value of transactions where volatility is high in comparison to a trading environment with low volatility.

One advantage of the CySec and ASIC model is its simplicity. It is easy to understand and therefore will be more likely to be complied with.

In the author's view the FCA model is the preferable model. The NFA's USD20 million stymies competition and will mean investors are more likely to receive increased costs so that firms can operate with such a high capital requirement. The FCA model is not static and capital requires change as the firms receive more transactional flow (and risk). Similarly, the FCA model recognises that some CFD providers do not take risk at all and they provide a lower capital requirement.

Leverage

One of the more controversial features of CFDs is the degree of leverage. Leverage allows investors to increase their exposure without the capital otherwise needed to obtain that exposure. A significant risk of leverage is the possibility investors could lose more than their initial deposit. Regulators diverge on whether regulation is required and if so, the appropriate leverage limit.

Australia

Currently, there are no limits on leverage for retail clients. The *Australian Securities and Investments Commission Act 2001* (Cth) does not give ASIC power to impose rules on leverage.

However, on 13 December 2016, the Australian government released a proposal paper titled "Design and Distribution Obligations and Product Intervention Power".[78] The paper included an intention to provide ASIC with the ability to make a product intervention if it identifies a

[78] Australian Government 'Design and Distribution Obligations and Product Intervention Power Proposal Paper' (December 2016) <
http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/Consultations/2016/Design%20and%20distribution%20obligations/Key%20Documents/PDF/Design-and-distribution-obligations.ashx>

risk of significant consumer detriment. A list of possible scenarios for intervention were included:

- Requiring additional disclosure or product warnings;
- Regulating the use of specified words or symbols in relation to a product;
- Changing the content, form or timing of up-front disclosures to ensure consumers better understand their choices or the limitation of the product;
- Requiring or changing the content, form or timing of ongoing disclosure;
- Banning the bundling of a product or certain product features with another product or certain product feature;
- Limiting distribution of a product or a product with particular features to retail clients;
- Setting minimum standards for certain products or product features (for, example, mandating basic features for a product);
- Banning the distribution of the product to a subset of retail clients that do not benefit from the product;
- Banning the distribution of the product or feature to retail clients.[79]

Leading Financial Services lawyer Paul Derham's views on the proposals are illustrative of the issues that arise:

> It appears that ASIC may not be able to directly require restricted leverage. Rather, it can restrict who can access high leverage, by saying something like "We think that offering leverage of more than 1:20 to retail clients would cause significant consumer detriment, so stop it." So ASIC could achieve the same outcome, but possibly not as directly or as easily as the FCA can (the FCA has broad product intervention powers).[80]

Global law firm Ashurst agrees that should ASIC receive its intervention power, margin FX and CFDs are not unlikely to be subject to the power:

> Given ASIC's recent heightened interest in margin FX and CFDs for retail clients one might reasonably foresee product intervention powers being used in respect of products such as these if such powers were introduced here.[81]

Commenting on whether a leverage limit is required, Sophie Gerber stated:

> I don't have a view on the appropriate leverage limit - I don't personally think there should be one as people will find a way to get what they want, probably now by going offshore to brokers in less regulated jurisdictions. It is interesting to note that individuals are not capped on the amount of time they can spend in a casino, or the portion of their funds they can gamble, or tested for their understanding of what they are about to do when playing blackjack/poker/roulette.... do you think this is political pressure and power of casino operators? If partaking in CFDs is just the same as a "day at the races" (an old quote from a politician/regulator), then why aren't they treated equally?[82]

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[79] Ibid.
[80] Paul Derham 'OTC Derivatives (CFDs, Margin FX) Clampdown? Australia Proposes New Product Intervention Powers, Following Global Trend' (23 December 2017) *The Industry Spread* < http://theindustryspread.com/otc-global-trend/>.
[81] Corey McHattan and Jonathan Gordon 'ASIC Urges The Government to Provide it With New Product Intervention Powers' (1 March 2015) *Ashurst Financial Services Update* < https://www.ashurst.com/en/news-and-insights/legal-updates/financial-services-update-product-intervention/>.
[82] Above n 29.

Cyprus

The issue of leverage has been considered in great detail by European regulators, most recently, the European Securities and Markets Authority ("ESMA") stated:

> In theory the probability of realising a loss is equal (or very close) to the probability of realising a profit. However, in practice, when firms offer products such as CFDs to retail clients, the application of leverage may increase the probability of a larger loss for the client to a greater extent than the probability of a greater gain.[83]

In response to ESMA's Q&A, CySec released circular C168 on 30 November 2016 providing its guidance on leverage, stating:

> It is unlikely that a CIF [OTC derivative issuer] offering excessive leverage to retail clients can demonstrate to CySec that this is in the best interests of retail clients [article 36(1) of the Investments Services and Activities and Regulated Markets Law].

OTC derivatives issuers according to CySec should therefore:

a. Design their trading systems in a way that offer their retail clients as a **default** the lower leverage limit determined in the leverage policy and give them the option, if they choose, to change the default to a higher leverage. It is provided that the lower leverage limit is reasonable and does not exceed the cap of 1:50 (default).
b. Limit the level of leverage available to retail clients that do not pass the appropriateness test or limit the sum that the client can invest, in any one transaction for a period of time.
c. Ensure that the maximum loss for the clients at any point in time never exceed the clients' available funds (negative balance protection).
d. Establish a leverage policy which is approved by the board of directors of the CIF and included in its internal procedures manual. Through this leverage policy, CIFs should identify how leverage ratios are established having regard to factors like:
    - The capital base and financial strength of the CIF.
    - The risk appetite and risk management of the CIF.
    - The asset class and instrument characteristics, including among others liquidity and trading volumes, volatility and standard deviation, market cap, country of issuer, hedging capacities, general economic client and geopolitical events.[84]

Following CySec's circular, the corporate regulator forced licensed firm Exness to limit its leverage from unlimited to a maximum leverage of 1:200.

United Kingdom

Currently, the United Kingdom has no limits on leverage.

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[83] European Securities and Markets Authority 'Questions and Answers Relating to the provision of CFDs and other speculative products to retail investors under MiFID (31 March 2017) < https://www.esma.europa.eu/sites/default/files/library/esma35-36-794_qa_on_cfds_and_other_speculative_products_mifid.pdf>.

[84] CySec 'Circular C168 Updated version of ESMA's Q&A document relating to the provision of CFDs and other speculative products to retail investors under MiFID' (30 November 2016) < http://www.cysec.gov.cy/CMSPages/GetFile.aspx?guid=8a41b640-9022-4986-b6d9-dff92c39888f>.

In December 2016, the FCA released a consultation paper titled "Enhancing conduct of business rules for firms providing contract for difference products to retail clients". In this consultation paper, the FCA proposed, amongst other things, leverage limits as follows:

- Lower leverage limits for inexperienced retail clients that have less than 12 months of active trading experience in CFD products or other relevant margined products (with a maximum of 25:1), and
- Higher leverage limits for experienced retails clients, which are set according to the volatility of the underlying asset, to prevent plainly excessive levels being offered by firms (with a maximum of 50:1).[85]

United States of America

The maximum amount of leverage that may be offered to retail clients is stipulated in the NFA Manual, specifically Section 12:

> **Section 12. Security Deposits for Forex Transactions with Forex Dealer Members**
>
> (a) Each Forex Dealer Member shall collect and maintain the following minimum security deposit for each forex transaction between the Forex Dealer Member and its clients and/or eligible contract participant counterparties:
>
> i. 2% of the notional value of transactions in the British pound, the Swiss franc, the Japanese yen, the Euro, the Australian dollar, the New Zealand dollar, the Swedish krona, the Norwegian krone, and the Danish krone;
>
> ii. 5% of the notional value of other transactions;
>
> iii. For short options, the above amount plus the premium received; and
>
> iv. For long options, the entire premium.
>
> (b) The Executive Committee may temporarily increase these requirements under extraordinary market conditions.[86]

More simply, the NFA limits leverage to 50:1 for currency pairs known as the 'majors' and imposes a 20:1 leverage limit on 'exotics'. The NFA has the power to change these limits depending on the prevailing market conditions or the expected prevailing market conditions. For example, on 5 December 2016, the NFA increase the required margin for derivatives transactions involving the Mexican peso, Japanese yen, and the New Zealand dollar in response to perceived uncertainty as a result of the Trump Presidency.[87] The NFA required traders to increase their initial margin to 8% (12.5:1) for Mexican peso; 4% (25:1) for Japanese yen and 3% (33.33:1) for New Zealand dollar derivative transactions.[88]

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[85] Financial Conduct Authority 'Enhancing conduct of business rules for firms providing contract for difference products to retail clients' (December 2016) < https://www.fca.org.uk/publication/consultation/cp16-40.pdf>.

[86] S 12 *NFA Manual* < https://www.nfa.futures.org/nfamanual/NFAManual.aspx?RuleID=SECTION%2012&Section=7>.

[87] Aziz Abdel-Qader 'NFA lowered the margin required for CHF trading for the first time since the SNB's Black Swan in 2015' (29 November 2016) *Finance Magnates* < http://www.financemagnates.com/forex/regulation/nfa-changes-margin-requirements-on-forex-trades/>.

[88] Ibid.

Analysis

Leverage limits are a contentious issue in the CFD industry. Regulatory technology expert Quinn Perrott argues that *"[l]owering the leverage won't save clients from losses*".[89] Furthermore, many industry professionals say limits on leverage will cause clients to move to jurisdictions with less regulation and less protection. While supporters of leverage limits such as Gold-i's Tom Higgins say it "is good for the industry as a whole as the ultimate client must always be looked after. They are not professionals and need education and controls to stop them 'blowing up' in a matter of weeks".

In the author's view, specific limits on leverage are not required. The risks of leverage are appropriately disclosed to clients and leverage is one of the features that attracts clients to these financial instruments. The author agrees imposing limits may result in clients moving their business to jurisdictions without limits. The author suggests a measure of "reasonably appropriate" leverage would be a useful benchmark in order to endeavour to reduce the use of excessive limits such as over 200:1.

Conclusion

Two noteworthy trends in global financial markets are the increasing complexity of financial products and jurisdictions competing to attract investors. One of the ways certain jurisdictions attempt to lure investors is through regulation that encourages investment. In this regard, regulators endeavour to find the appropriate balance between placing obligations on market participants so investors are protected, maintaining market confidence, and ensuring finance is not stifled or discouraged.

This article analysed four important regulatory areas for CFDs and examined the various ways which the four jurisdictions regulate these areas.

The author considers, with the exception of the United States, the selected jurisdictions have in place the appropriate capital requirements. Some criticism of CySec and ASIC was deemed appropriate due to regulators in those jurisdictions not imposing any capital adequacy linked to transactional flow. In the author's view, this additional requirement is sensible and essential for prudent risk management.

Regulation of how client money is to be treated is different in each of the jurisdictions assessed with varying degree of protection for clients. Ideally, client money would be required to be held in an individual segregated trust account, this would provide the optimum level of protection for investors. Some industry participants see that level of obligation on providers as overly burdensome. However, it would benefit clients by ensuring their funds are secure in a volatile market. The author is optimistic regarding the recent changes ASIC made to the treatment of client money. With the legislation enacted a matter of weeks prior to the publication of this article, we are yet to see the benefits for clients from these changes.

Ensuring pricing is fair and transparent is fundamental for investors to have reliance on CFDs as a stable financial instrument and confidence in brokers. In the author's view Australia and

[89] Quinn Perrott 'FCA rulings on CFDs lambasted – "Lowering the leverage won't save clients from losses" says regulatory technology expert Quinn Perrott' *Finance Feeds* <financefeeds.com/fca-rulings-cfds-lambasted-lowering-leverage-wont-save-clients-losses-says-regulatory-technology-expert-quinn-perrott/>.

Cyprus currently underperform in this area, whilst the United Kingdom and the United States have addressed the interest of investors more appropriately. The recommendation is for Australia to consider the introduction of specific fair market pricing rules to ensure that the mandate in s 912A(1)(a) of honesty, fairness and efficiency are met. In general, regulation related to fair market pricing should recognise that slippage occurs both in the client's favour and against the client, and while best execution obligations are well meaning, regulation which results in asymmetrical pricing in either party's favour can be detrimental to a functioning CFD market.

Leverage continues to be a highly controversial feature of CFDs. It is often charged as the reason for significant client losses and gives rise to significant debate. At present, there is a trend toward limiting leverage as seen in the United States. However, even the mature market of the United Kingdom has no leverage limits. It is challenging to find the appropriate balance here, leverage of 1000:1 may be unhealthy for clients and give these products and this segment of the financial market a poor image. On the other hand, the ability to leverage is one of the main reasons investors use these products, this is the pertinent issue for regulators and a large part of the reason for divergence in the regulation within the jurisdictions assessed.

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