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## **Submissions regarding the Design and Distribution Obligations and Product Intervention Power – revised draft legislation**

### **1. Preamble**

The CFD & FX Forum is pleased to provide submissions regarding the exposure draft of the Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2018.

The CFD & FX Forum and each of its members ("Members") are committed to enhancing the efficient operation, transparency and overall investor understanding and confidence in CFDs and FX within Australia, and in the Australian CFD and FX industry as a whole.

Representing 64%<sup>1</sup> of Australian CFD & FX providers by market share, the CFD & FX Forum has established Best Practice Standards ("Standards") for the purpose of continuously improving existing CFD and FX industry standards and addressing specific CFD and FX industry issues and investor concerns, building upon existing legislation to deliver additional benefits to investors and elevating investor perception and understanding in dealing in CFD and FX products.

The CFD & FX Forum considers its submissions regarding the draft legislation as an opportunity to work with ASIC in implementing best practice across the wider industry.

### **2. Introduction**

The CFD & FX Forum appreciates that Treasury has carefully considered submissions in response to the previous exposure draft released in December 2017, and has made a number of amendments, some of which have addressed the majority of our concerns, in the revised draft of the Bill.

The CFD & FX Forum has the following general comments to make regarding the draft legislation. Specific submissions are considered further below with reference to the relevant sections of the draft legislation:

- We welcome the amendment to clarify that a financial product must 'likely be consistent with the likely objectives, financial situation and needs of the people in the target market'. This has addressed our previous concern that a financial product must meet 'all' of the objectives, financial situation and needs of the target market and issuers to know individual customers.

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<sup>1</sup> June 2016 Investment Trends Report

- We welcome the amendment to clarify that a distributor does not breach requirements to take reasonable steps to distribute in a manner consistent with a target market determination for a product merely because a consumer who is not in the target market acquires the product.
- We welcome the amendment to confirm that not all consumers who visit an issuer's website and acquire products need to fall within the target market. However, it remains unclear whether we need to ensure that the contents on our websites is suitable for all consumers who visit the website. If that is required, further detailed clarification should be provided in the regulatory guidance by ASIC.
- We welcome the new provisions which require issuers to specify the information that must be kept, who must keep it and, if kept by a third party distributor, how often that information must be provided to the issuer. We expect that it will reduce the regulatory burden associated with record keeping.
- We welcome the amendment to clarify that distribution must stop as soon as practicable or within 10 business days upon a review of target market determination is triggered.
- Greatest focus should be given to the suitability assessment that firms are required to apply to potential clients. By raising the bar to accessing particular products through additional guidance, in particular requiring firms to reject inappropriate clients, firms will be naturally incentivised to market more responsibly and to a narrower target market. This in turn should greatly reduce incidents of significant harm.
- The risk profiles of consumers affected will need to be taken into account by ASIC in determining whether a loss is significant. The scale of detriment should be measured against the threshold of "significant harm" on a market wide basis and this should be explicitly reflected in the legislation.
- It is important that the industry is given ample opportunity to voluntarily change behaviours without ASIC formally exercising product intervention powers. Furthermore, transparency in ASIC's assessment of 'significant harm' is essential in order for the industry to have a common and clear understanding of the circumstances in which ASIC may exercise its product intervention powers. Regulators across Europe remain unable to articulate acceptable client loss rates for CFDs - this lack of clear guidance has been counterproductive to the effort of addressing concerns and has led to disproportionate leverage restrictions being imposed. As a consequence, more and more consumers are moving their accounts offshore.
- In considering whether detriment resulting from a financial product constitutes 'significant harm', ASIC should be required to take into account whether the detriment was caused by AFS licensees or by unlicensed. The latter are typically offshore brokers who will continue to inflict detriment on Australian consumers irrespective of whether the product intervention rules are in place. We are concerned of the consequences of a one-size-fits-all approach in which responsible firms are adversely impacted due to the actions of a small number of bad actors. In particular, we are concerned that a disproportionate approach will inevitably lead to Australian consumers moving their business to product distributors and issuers in offshore, unregulated jurisdictions, thereby losing the protections afforded by Australian financial services regulation.
- The consultation must be a private matter with no pre-exercise of the product intervention power and must give the affected entity reasonable opportunities to respond and to resolve the problems identified by ASIC. Failure by ASIC to follow such a process should void the intervention and possibly become liable for damages to the entity if the intervention caused significant disruption to the entity's business and loss of profit.

### 3. Submissions

#### **Amendments relating to Design and Distribution Obligations**

##### ***Section 994E(4) Reasonable steps to ensure consistency with target market determinations***

We note that the section 994E(4) has been added to clarify that a distributor does not breach requirements to take reasonable steps to distribute in a manner consistent with a target market determination for a product, merely because a consumer who is not in a target market acquires the product. We welcome this amendment as it confirms that not all consumers who visit an issuer's website and acquire products need to fall within the target market. However, it remains unclear whether we need to ensure that the contents on our websites is suitable for all consumers who visit the website. If that is required further detailed clarification should be provided in the regulatory guidance by ASIC.

#### **Amendments relating to Product Intervention Orders**

##### ***Section 1023E Significant detriment to retail clients***

We note that the meaning of "significant" is not defined in the revised draft of the Bill and intentionally so according to the Explanatory Memorandum ("EM"). The paragraph 2.31 of the EM states that 'significant' is not defined for the purposes of the new power and that the meaning of significant is intended to take its ordinary meaning in the context of the new provision. The paragraph 2.33 of the EM further states that ASIC can take into account a range of objective and subjective factors in determining whether a loss is significant. For example, objective factors could include the number of consumers affected and the total amount of the detriment. Subjective factors could include the impact of the detriment on the consumers affected by it.

Whilst we agree that the extent of consumer detriment can partially be determined by reference to the objective and subjective factors stated in the EM, we believe that the risk profile of consumers affected should also form the basis for determining the extent of consumer detriment. The risk profiles of consumers vary across different product types. Leverage can magnify both profits and losses, therefore undoubtedly consumers who invest in leveraged trading products have different risk appetites compared to consumers who invest in non-leveraged products such as conventional shares. We believe that if an issuer complies with the disclosure requirements and the obligations of design and distribution (as proposed in the Bill), as long as consumers understand the risks of leveraged trading, it should not be subject to an arbitrary and unpredictable hindrance on the continuation of a product.

Given the significant commercial impact that a product intervention could cause, we consider the scale of detriment should be measured against the threshold of "significant harm" on a market wide basis and this should be explicitly reflected in the legislation. It would also be beneficial to have regulatory guidance by ASIC detailing what quantitative tests will be used to determine the size of potential losses, and consideration of the likelihood of any relevant assumptions used. Clear guidance on what factors are being applied and the steps involved in an investigation should be made available to the industry with disclosure of actual cases in practice to demonstrate how ASIC are applying these powers. Transparency in ASIC's assessment of "significant harm" is essential as it ensures that any intervention is based on accurate information. It further helps the industry to have a common and clear understanding of the circumstances of when ASIC may exercise the product intervention power, and consequently presents the industry an opportunity to voluntarily change their behaviour without ASIC formally exercising product intervention power.

CFDs are typically used to take short term speculative views on market movements, rather than to make long term investments. In contrast to the case where assets are bought and held as investments for months or years, there is no meaningful interest income or dividend yield from a CFD position held for a number of hours or days. In other words, short term trading (using CFDs, or any other analogous product, such as futures or options) is a zero sum game – in the absence of transaction fees, the net P&L of all short term speculative traders is zero, with profits of successful traders balanced by the losses of unsuccessful traders. However, the fact that trading is not free of costs leads to the typical results seen for all short term speculative products – including CFDs – where the average trader P&L is a loss equal to the sum of transaction fees paid, and where the majority of traders lose. For CFD traders, results vary across firms (and preferred underlying asset classes) but typically 75-80% of traders tend to lose, and 20-25% of traders tend to win (over an annual time horizon). However, provided that this population of CFD traders is made up exclusively of individuals who (a) have an appropriate level of knowledge and understanding and financial standing; and (b) have a risk profile consistent with trading a short-term speculative leveraged product, these loss rates needn't necessarily be indicative of poor consumer outcomes<sup>2</sup>. In particular, if consumers are realistic about the likelihood of being profitable<sup>3</sup>.

While we welcome many of the design and distribution obligations, in particular the measures aimed at defining appropriate target markets and ensuring that issuers and distributors appropriately market and distribute financial products, we believe that occurrence of significant harm would be greatly reduced by new detailed measures in the area of suitability testing. That is, measures that ensure that only clients of sufficient knowledge, understanding and financial means are able to access particular complex products. In our view, greater rules and guidance in this area would naturally incentive firms to market to a sensible target market since they would be required to reject applications falling outside. This would greatly improve firm conduct whilst simultaneously protecting a large number of consumers for whom the product is clearly inappropriate.

Finally, in determining whether the detriment resulting from a financial product is significant, ASIC should be required to also take into account whether the detriment is caused by an AFS licensee, or, by unlicensed offshore broker(s). The latter will continue to inflict detriment on Australian consumers, irrespective of the product intervention rules in place. Having regard to the industry we operate in, the regulatory and conduct issues which have arisen are the result of small firms, operating in a non-compliant manner with poor conduct risk cultures, leading to poor outcomes for the clients who contract with these firms. A market-wide ban on a particular product to address the unregulated and/or offshore provider will likely lead to unintended consequences – e.g., accelerating the numbers of consumers taking their business to offshore, unregulated product issuers, thereby losing the investor protections afforded to them by ASIC and the access to external dispute resolution bodies, such as FOS (soon to be replaced with AFCA) in the process. Early indications in Europe are suggestive of the fact that ESMA's product intervention is having precisely this effect, with EU clients taking their business offshore.

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<sup>2</sup> In Europe, ESMA's CFD product intervention identifies 'significant harm' as being a high proportion of clients trades being automatically closed out due to having insufficient margin. Their leverage restrictions that are therefore intended to limit the chance of an automated margin close-out on CFD positions to less than 5%, given historic price moves in each underlying asset class and an assumed typical holding period for positions in CFDs on each underlying asset class. Limiting the chances of automated close out to less than 5% is, we think, perfectly reasonable. Unfortunately, ESMA have imposed leverage restrictions above and beyond those needed to achieve its aims. We will look to engage with ASIC on this important topic in the coming weeks and months ahead.

<sup>3</sup> Client survey data gathered during the ESMA consultation process strongly supports the view that clients are fully aware of the risks of losses and are realistic about their prospects of being profitable. That they make an informed decision to participate however, is of key importance.

***Section 1023F ASIC to consult before making product intervention orders***

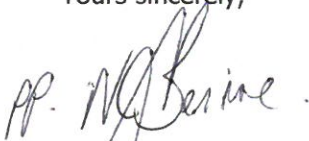
We note that under subsection (1) ASIC must not make a product intervention order unless ASIC has consulted persons who are reasonably likely to be affected by the proposed order. However under subsection (3) ASIC is taken to comply with subsection(1) if ASIC on its website make the proposed order available and invites the public to comment on the proposed order, and a failure under subsection (1) does not invalidate a product intervention order.

We believe that the consultation must be a private matter with no pre-exercise of the product intervention power and must give the affected entity reasonable opportunities to respond and to resolve the problems identified by ASIC. As such, we are concerned that ASIC's failure to comply with the consultation requirements does not invalidate a product intervention power. Failure by ASIC to follow such a process should void the intervention and possibly become liable for damages to the entity if the intervention caused significant disruption to the entity's business and loss of profit.

**Conclusion**

Thank you for the opportunity to participate in this consultation process. We are happy to engage in further discussion and please do not hesitate to contact us for any further assistance.

Yours sincerely,



Kevin Algeo  
Chair, Australian CFD & FX Forum