AUSTRALIAN CFD & FX ASSOCIATION

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24 May 2022

Director – Crypto Policy Unit
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: crypto@treasury.gov.au

Dear Director – Crypto Policy Unit,

Re: Crypto asset secondary service providers: Licensing and custody requirements consultation paper ("Crypto Legislation CP")

The Australian CFD and FX Association ("**Association**" "**we**" "**us**" "**our**") is an alliance of domestic retail over-the-counter ("**OTC**") derivative providers, established to promote consumer protection and healthy industry competition and standards. Our members are margin foreign exchange and contracts for difference ("**CFD**") issuers which offer their products to retail and wholesale clients in Australia.

Many of our members already offer CFDs that reference crypto-assets as the underlying instrument and several CFD issuers in the broader industry have already expanded directly into the crypto-asset space.

We are encouraged by the Australian Government's work in this area and are fully supportive of the recommendations in the Crypto Legislation CP, including focussing the legislation on the licensing of crypto-asset secondary service providers ("**CASSPrs**") rather than the products themselves. We believe that this is an innovative way of regulating this space and ensures that the relevant benchmarking and protections are focussed where the potential for investor harm is the greatest.

As an industry with an innovative product that has recently been subject to significant regulatory reform, we feel it important to show support for positive legislative change that strikes a better comparative balance between investor protection and innovation.

We note that ASIC has been leading work on a recent IOSCO Consultation Paper ("**IOSCO Paper**") where some alarmist statements were made about the crypto-asset industry and regulatory intervention generally:[1]

- *"IOSCO members have highlighted the following retail risks in crypto-assets, among others:…Unsuitability for retail investors due to lack of underlying value and high price volatility"*[2]

[1] See Public Comment on IOSCO Retail Market Conduct Task Force Report CR03/2022: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD698.pdf ("**IOSCO Consultation Paper**").
[2] Ibid page 20.

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- *"Regulators need to consider creative tools and interventions to effect change in the absence of law reform"*[3]

The IOSCO Paper also made some statements about self-directed trading (which is fundamentally how the crypto-asset industry operates) and modern marketing practices which we consider to be unreasonable. We believe these statements illustrate a concerning lack of understanding by traditional regulators of the crypto-asset market and other innovative financial services industries, particularly their creators and users, which are predominantly retail investors.

It is also concerning that global regulators are making such aggressive policy statements. The primary goal of financial services regulators should be enforcing the law. There is an inherent conflict when the people who enforce the laws also seek to write them.

For this reason, we caution against enabling a licensing and regulatory regime that allows regulators to push through additional reforms using their own powers, which would result in number of unintended negative consequences, as was the case with our industry.

As the IOSCO Consultation Paper raises several critical issues that are relevant to discussions on crypto-asset regulation in Australia, we have included the submission we made to that consultation in Appendix A for your reference.

Please let us know if we can provide any additional information on the matters we have raised in this submission.

Yours respectfully,

Peta Stead
Director
Australian CFD and FX Association

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[3] Ibid page 46.

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23 May 2022

Alp Eroglu
International Organization of Securities Commissions ("**IOSCO**")
Calle Oquendo 12
28006 Madrid
Spain

By email: consultation-03-2022@iosco.org

Dear Alp Eroglu,

Re: Public Comment on IOSCO Retail Market Conduct Task Force Report CR03/2022 ("Paper")

The Australian CFD and FX Association ("**Association**" **"we" "us" "our"**) is an alliance of domestic retail over-the-counter ("**OTC**") derivative providers, established to promote consumer protection and healthy industry competition and standards. Our members are margin FX and contracts for difference ("**CFD**") issuers who offer their products to retail and wholesale clients in Australia.

Although we are Australian based, and many of our members were first established in Australia, most of our members hold licenses globally, allowing them to provide financial services in numerous jurisdictions.

We are concerned this Paper appears to single out our industry in multiple areas that are relevant to all financial services industry participants. In addition, CFDs are now subject to highly prescriptive regulation in multiple jurisdictions, which makes some of the suggested conduct impossible without breaching local regulation, making some of the items raised in the Paper more relevant to other sectors.

It is unfortunate that our sector has suffered from a sub-group of bad actors who have used the opportunities provided by our products being an off-exchange, online offering to facilitate their fraud and scams. While we acknowledge that regulators made legislative changes to our product offerings with the view to reduce consumer harm, evidence suggests that there has been a side effect for the legitimate businesses remaining in the industry.

Leverage restrictions have morphed CFD Products into different products, severely impacted their value and made them no longer of use to the experienced, high volume, speculative traders that have utilised them in the past. These investors were well aware of the risks associated with trading these products and many are now requesting to be classified as wholesale (and giving up their retail protections) or heading to offshore trading venues to be able to continue to trade the products the way they want to. This not only impacts the businesses of legitimate entities who

want to operate under robust regulatory systems but increases the likelihood of investors trading outside of their home country, which is one of the key issues raised in this Paper.

Meanwhile scammers and fraudsters continue to operate out of regulatory reach, taking advantage of vulnerable clients. To avoid scrutiny these criminal elements may have changed the products they are advertising, but they continue to operate using the same business strategies such as cold call centres, boiler rooms, hidden identities, and pressure selling. In that sense, much of the serious harm that led to regulatory changes remains an issue. It is important that regulators do not make the same mistake with other innovative industries.

We are concerned that if regulators remained focussed on products rather than on the actual misconduct or the specific individuals and entities facilitating these frauds, regulation will be too burdensome, products will become too restrictive and investors will abandon formal regulation in favour of easier and more cost effective alternatives.

History now shows us that investors are willing to look outside of traditional regulation and give up protections to continue to trade the way they want. In fact, many cryptocurrency products were invented because people want more control over their assets and less interference by third parties or governments.

These are critical considerations when looking at many of the questions in this Paper. It is not right to consider that all investors with less capital are automatically vulnerable. It is also not right to assume that anyone who wants to access riskier products and seek short-term gains is inexperienced or does not understand the risks they are taking, nor that if some people do lose money trading riskier products they have necessarily been harmed. Vulnerable clients do need to be protected, and risk factors clearly explained, but not at the cost of legitimate businesses being able to operate or knowledgeable investors accessing the products they want on a self-directed basis.

With that in mind, we provide the following additional information to assist IOSCO in their consideration of the questions they have raised in the Paper.

Q1: In their risk analysis, should regulators specifically consider/target specific demographic profiles/groups for additional or enhanced investor protection measures? If so, should greater attention be focused on younger age groups or older age groups? Is there a tipping point in behaviours beyond which regulators should become concerned?

1.1 Age does not equate to vulnerability

In our view it would be a mistake to make generalised risk assumptions about a demographic's capacity, knowledge and experience based on age.

There may be older investors who have a lifetime of experience and understanding that they can use to make informed investor decisions.

As mentioned in the Paper, younger investors are more interested in short-term investing and less traditional products. This matches the behaviour of younger generations generally in that they also are not wedded to traditional brands and are comfortable dealing with entities operating outside of their jurisdiction. It is highly unlikely, for instance, that members of these generations will consider working for the same company for 40 years. In fact, they are more than happy to

change careers every year or so. No one is suggesting mandating a minimum time young people should stay in their first few roles, even though that may provide them with valuable experience and be a less risky proposition from a career point of view.

There needs to be an understanding and acceptance by both regulators and traditional financial service providers that things have changed, including the financial goals and requirements of new generations that live their lives differently. Any additional restrictions will simply encourage investors to trade offshore, potentially outside of any regulatory oversight.

Younger investors should also be encouraged to develop their investing and trading skills with regulated providers, as such knowledge and experience will enable them to pursue their individual financial goals in later life and increase their financial literacy. Placing unreasonable barriers in the way of younger people acquiring exposure to trading and investing with regulated providers would be detrimental to their ability to make financial decisions independently, and negatively impact financial inclusion.

Additional investor protection measures are also not necessary in our view. Regulators already have access to many established mechanisms that assist in protecting various demographic groups. Most regulated entities are already required to ensure they take steps to protect vulnerable clients and ensure their products are distributed appropriately. All jurisdictions contain within their legislative provisions the concept of unconscionability which, as a matter of law, can consider age as a factor. These existing mechanisms already give regulators sufficient power to act should they consider a particular entity is not dealing with younger or older clients in a reasonable way.

Q2: Does the consultation report capture accurately the important retail trends and the reasons for increased retail trading? Are there any missing concerns or issues and other potential risk magnifiers? What may be the current and potential long-term implications of increased retail participation in markets in your view?

2.1 Reasons for the increase in retail trading

The Paper does not appear to adequately appreciate that there has been an evolution in many aspects of financial services that has created opportunities that retail investors want to take advantage of.

2.1.1 The divide between institutional investor and retail investor has narrowed

Access to both real-time and comprehensive information is a big driver in retail participation in the markets. It is only recently that technology has progressed to the point that allows retail investors to compete close to, and in some cases at, the same level of large institutional investors.

Retail investors now have access to:

- inexpensive or free real-time market information and company/market analysis, which in the past was typically only available via expensive data information companies and reports;
- close to real-time pricing and trading, whereas in the past retail spreads (the difference between the buy and sell price) were broad and there was often a delay to the quality of

their data and trade execution which meant that retail investors were at a significant competitive disadvantage to institutional trading desks;
- increased computing power that is efficient and affordable, allowing for more sophisticated analysis and artificial intelligence ("**AI**") opportunities on home computers, and automation of trading or investing activity; and
- reduced trading costs, allowing them to be able to speculate on market movements in a way that is now economically viable in smaller notional sizes.

In the past, retail investors may have traded more long-term buy and hold strategies rather than speculatively, because they did not have the financial capacity or access to technology to be able to compete with the deep pockets and data of institutional strategic traders, especially with the fees they were charged. A typical traditional stockbroker could charge 1.5% commission on trades for a small investor. If an investor were to invest just $1,000 on a share purchase, they would be charged a minimum of $30 for placing and closing out the trade. The share would therefore have to increase by $30 for the investor to break even when selling it, putting a short-term speculative strategy out of reach for most individuals.

Another factor that is relevant to the change in retail investor behaviour could be the additional cost of investing in traditional well-known assets. Twenty years ago, gold was trading above US$450, gold is now trading above US$1,900. Ten years ago, Amazon shares were trading around US$180, they are now trading over US$2,900. Unless there are guaranteed returns, traders should only be investing money they can afford to lose. For many investors, these type of investments are out of their reach regardless of their knowledge or experience.

2.1.2 Retail access to high leverage

Our industry is aware of regulators' concerns regarding leveraged trading, but we remain of the view that capping leverage has not reduced harm to retail investors. All it has done is take away the buying power of investors, putting them at a significant disadvantage, particularly for speculative trading purposes.

If an investor purchases a CFD contract with leverage of 100:1 and use a fractional lot size of 0.1 lots (noting that around 90% of trades are typically less than 1 lot), they can gain economic exposure to an asset that would normally cost them a minimum of $2,000 for as little as $2. Investors in CFDs do not need to pay the full value of the underlying asset, only the difference in price between when they buy and sell a product. Many CFD issuers also offer commission free trading. That means for that same $2,000 amount, a person can place numerous trades.

This is why our products, and products like them such as fractional shares, have become more popular with retail investors, even in the face of increased regulatory scrutiny and restrictions - because the cost of trading the underlying asset is often too expensive for them.

While we agree that it is concerning for a retail investor to expose themselves to losses greater than they can afford to lose, it is not accurate to assume that any investment at high leverage will lead to such an unacceptable retail loss. Negative balance protection is now common practice in industry related legislation (with most in the industry having implemented that protection even prior to it being required). If an investor understands the risk of trading, it should be up to them to determine their risk/reward appetite and act accordingly.

2.1.3 Market volatility

Markets have generally been more volatile in recent times, providing better opportunities for speculative style trading. As an industry whose products are used primarily for speculative purposes, we can confirm that there is a material increase in people wanting to trade our products in volatile times.

2.2 Concerns about retail participation

2.2.1 Mis-selling, mis-use of social media, frauds and scams

While frauds and scams have always been an issue, it is no longer necessary to have a large bricks and mortar presence in a jurisdiction to look legitimate. Stamping down on regulated entities that are providing transparent information to regulators and are subject to clear oversight is not the way to reduce this harm. If anything, all it does is make it more expensive for legitimate firms to operate and provide better business for the bad firms who can offer services at a much cheaper cost or with higher leverage.

It is important that regulators improve their monitoring abilities and take swift action against serious misconduct but we note that most regulators already have substantial existing regulatory powers to enable them to take action in the event of:

- mis-selling;
- unlicensed conduct;
- misleading and deceptive advertising practices;
- unconscionable conduct;
- market manipulation; and
- fraud.

In our view, these existing powers are more than sufficient to deal with the types of misconduct described in the Paper.

2.3 Implication of increased retail participation in markets

We believe that encouraging retail investors to actively participate in investment decisions that impact them, to challenge them to research and understand what factors impact market movements and encourage them to make thoughtful investment decisions can only be beneficial for the markets and for those investors.

All regulators suggest that investor education is a key aspect of investor protection. If investors are becoming passionate about the markets, start understanding market behaviour and drivers, particularly understanding it enough to be able to make more self-directed trading decisions, that seems like a positive outcome.

It may be that more traditional financial institutions cannot compete with newer business models, but we do not consider this a valid reason to hold back innovation.

Q3: What may be the potential implications of self-directed trading and gamification from a retail risk and conduct perspective? Should high risk aspects of these activities be regulated or prohibited, for example, certain risky gamification techniques?

3.1 Self-directed trading

Many of the reasons for the increase in self-directed trading are covered in our response to question 1 and 2.

It is critical that regulators understand and appreciate that the environment traders of today are operating within is completely different to how it was 10 or 20 years ago. Every aspect of modern life is becoming more about consumer choice, personal customisation based on history and preferences and, most importantly, individual control versus needing a third party to facilitate transactions.

The move to self-directed trading has meant many retail investors have taken steps to dramatically increase their understanding of financial services regulation and markets rather than relying on third parties. This should be seen as a positive step towards broader financial education and inclusion and should be encouraged, not curtailed.

We believe that stepping in to regulate or try to curb this evolution will simply mean people will move outside of regulatory remits, as the underlying consumer demand for self-directed trading is growing regardless. Instead, we believe that regulators should be tapping into the increased interest in financial services by younger generations and improving their educational information to better reach those audiences.

3.2 Gamification

We strongly disagree with the following comment made in the Paper:

> *"CFDs are a good example of gamification. A common feature of the CFD industry has been to offer trading benefits (monetary and non-monetary), such as bonuses to attract retail clients, including the offer of gifts, tutorials or reduced costs."*

Offering bonuses and reductions in costs to attract people to buy financial products has been around since long before CFDs were invented. Most, if not all, stockbrokers reduce commissions based on trading size and many provide gifts, organise meals or tutorials for clients. Other financial services firms who exist in a competitive marketplace, for instance car insurance or credit card providers, also have a long history of offering bonuses for switching an account over or reducing costs to new clients. Such "trading benefits" are merely indicative of healthy competition and greater client choice, and the concomitant requirement for firms to compete to attract new clients and grow their business.

We also note that all incentives to trade (both monetary and non-monetary) have now been restricted or banned in many IOSCO jurisdictions prior to this Paper being written. It seems unnecessary to single out our industry, which has taken steps to comply with these stringent restrictions, especially when most other financial services industries continue to offer similar incentives as they do not have the same limitations.

We also do not agree with the Paper's broad definition of "gamification" or the assessment of its danger to investors.

In our view, facilitating a simple, efficient, friendly, customised online experience is not "gamifying" something nor is it pressuring people to trade.

Home computers became common in the 1980s, the Internet become popular in the 1990s. People born in those time periods are now in their 30s and 40s. Those in their 20s practically learnt to communicate via online games and apps. The movement in marketing is not about copying the gambling industry, it is about an appreciation that the most efficient and effective way to communicate with younger generations is through clean online design, that provides users with a customisable experience based on their preferences and feedback. It is no different from Apple or Google suggesting a song to someone based on what is in their music library, or Twitter or Facebook showing ads about products and services matched to a person's internet searching history.

It may be that the gambling industry has adopted similar marketing tools in the past but that is simply because that industry always tends to be more innovative and cutting edge in their marketing. Other industries have only now caught up.

We believe it highly unlikely that retail investors have made complaints to regulators about improvements to their customer experience and we question whether the concerns being raised are driven by crystalised investor issues or have been brought up as risks by traditional financial institutions that are struggling to compete with the new offerings. We therefore caution IOSCO against making any assumptions on this point until it has considered the proposals in light of the preferences of new generations of investors in financial services.

Additionally, global regulators already have numerous consumer protection powers to curb misconduct in marketing, product distribution and unlicensed or inappropriate advice. In our view, this is sufficient to prevent the concerning conduct raised in the Paper.

Q4: How should regulators consider whether to monitor crypto-asset trading by retail investors? Are there ways that the apparent data gaps with regard to retail investor crypto-asset trading could be filled or other protections for retail investors or ways in which regulators could begin to monitor crypto-asset trading? Are different approaches likely to be more or less effective in jurisdictions with different regulatory, statistical and other governmental and private sector approaches to data gathering?

4.1 Crypto was started by retail investors

Some of the main benefits of blockchain technology is its immutability and its decentralised nature, allowing transactions to be transparently viewed. This provides informational advantages over other types of financial products, with investors able to see their own transactions appearing on the blockchain and being able to obtain undeniable evidence of transactions and ownership.

In our view, starting from a regulatory position of crypto-asset "[u]nsuitablity for retail investors due to lack of underlying value and high price volatility"[1] is a mistake, as it was predominantly retail investors that created crypto-assets and drove their popularity. It is only more recently, after

[1] See Paper page 20.

it has become popular, that traditional wholesale investors and providers have started to pro-actively participate in crypto-asset trading.

Rather than assuming a lack of underlying value of these products in the narrow sense of securities or bonds, we believe that regulators should consider the reasons why these products became popular in the first place and what their benefits are to users. In addition to the overall security and transparency of being on a public blockchain, much of their popularity is because of the removal of intermediaries, leading to a reduction in fees and increase in access and control for individuals.

Different crypto-assets have different features and use cases, and therefore should be treated differently. Some assets enable peer-to-peer payments without using the expensive and slow banking system, and as such clearly have a value to people looking to make and receive payments online. Some assets allow access to the resources of a computing network, or to execute smart contracts without the need of a trusted authority, and again clearly have a value for those looking to utilise them. And some assets act as the equivalent of governance or security tokens, giving holders the ability to control or profit from the activities of a decentralised organisation.

In common with any new technology or financial products, there are early periods of volatility as the market adapts to these innovations, and some projects may become very successful while others disappear. This is no different to earlier periods of innovation, from the dotcom boom in the 1990s to the spread of railways across the United States in the nineteenth century. Such new products also attract speculation, and wider investor participation, which is a result of innovation and should not be restricted simply because there is high volatility in crypto-asset prices.

In our view, any decision about increasing regulation must keep these factors in mind.

4.2 Crypto data

It is unclear what data gaps exist for crypto-asset trading given the blockchain technology. There are many options for accessing current and historic crypto-asset trading data across exchanges and market venues. For example, CryptoCompare: https://data.cryptocompare.com/. There are also many providers of AML and transaction monitoring tools that benefit from the public nature of blockchain transactions, for instance Elliptic (https://www.elliptic.co) and Merkle Science (https://www.merklescience.com).

4.3 Retail investor protection

We believe that there is room for regulators to provide education to all investors about the types of things they should look out for when investing in crypto-assets or dealing with a crypto-asset provider or intermediary. Regulators may also find a need to educate crypto-asset participants about where current regulation starts to capture some of the products or services offered.

In our view, a generalised licensing regime, such as the one currently being considered by the Australian Government would also be useful as it at provides some standardisation of practices and more easily allows for benchmarking of providers by investors.[2] It would be a middle ground

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[2] *Crypto asset secondary service providers: Licensing and custody requirement*, Australian Government, 21 March 2022.

where investors can choose whether they would sacrifice some independence from Government oversight to gain some additional regulatory protection.

However, we again caution against prescriptive restrictions which impact the fundamentals of the products and the reasons they were created in the first place.

Q5: How should regulators approach these trends (e.g., both trading for crypto-assets or brokerages using hidden revenue raising mechanisms) and when should they seek to intervene?

5.1 CFD specific statements

We strongly disagree with the following comment about the CFD industry:

> *"misleading marketing such as the use of sponsorship arrangements or affiliations with major sports teams, which may give the misleading impression that complex and speculative products such as CFDs are suitable for the retail mass market by promoting general brand name awareness"*[3]

The reference to this quote was from 2015. The CFD industry has experienced significant global regulatory change since then, including fundamental changes to CFD products for retail investors in most jurisdictions, which have completely changed the product risk profile. In addition, investors interested in CFDs complete a comprehensive onboarding process. Some of our members have said typically, only 20-30% of investors that start the onboarding process for a CFD trading account end up completing that process and trading. This means the investors that eventually trade with a CFD issuer must have a level of understanding and desire for the product that goes far beyond what simple brand awareness could deliver.

Existing in a competitive marketplace also requires CFD firms to establish their unique brand identities in the same manner as other financial firms do, and the use of such marketing merely indicates a healthy competitive environment.

5.2 When should regulators intervene

In our view, regulators should only intervene in the case of scams or fraud, unlicensed conduct, where there are clearly misleading comments or misrepresentations, or where the conduct leads to a breach of local regulation (which would include in many cases where conflicted remuneration was being provided or where there was a failure to disclose material information such as a relationship between the provider of advice and the issuer of a product).

Q6: Should regulators proactively monitor social media and online statements for retail investor protection and if so, when and how? Should social media be subject to additional regulatory obligations regarding securities trading and/or crypto-asset trading? How could such monitoring be implemented, and obligations enforced proportionate to the harm/potential harm? Are there any legal (e.g., data protection) or technical obstacles? What sort of risk assessment should regulators do to determine where to allocate their resources?

[3] See Paper p 23.

6.1 Social media and online statement monitoring

In our view, the general monitoring of social media and the internet should be one of the many intelligence tools used by regulators' to look for scams and potential breaches of local regulation. Noting however that there are hundreds of social media sites, thousands of forums and billions of users.

Another key area of intelligence should therefore be regulators' complaints area. Many regulators would benefit from improving the ease of making a complaint. For example, allowing concerned citizens to simply lodge a link to a problematic public chat or social media statement or a simple screenshot under various topics (such as cryptocurrency, scam, shares etc) could greatly assist regulators in searching for and taking swift action against scammers.

6.2 Additional regulatory obligations related to social media

We believe that intervening and implementing regulatory restrictions on the more well-known social media sites runs the risk of harmful conduct moving to less transparent forums, noting that many of the discussions around the more innovative products are not on the main social media platforms anyway. Monitoring personal and private conversations on social media for potential harmful marketing is an unacceptable level of intrusion that heavily outweighs any potential benefit.

The substantial current regulatory requirements around marketing to retail clients should be applied equally across all channels used to communicate with customers or potential customers. The fact that social media is a popular channel for marketing does not mean it needs additional obligations.

In some respects, we do need to go back to the concept of "caveat emptor" and allow investors to be responsible for their own choices.

6.3 Allocation of regulatory resources

We believe that it would be a more efficient use of regulatory resources to hire experts in innovative products and upskill regulatory staff.

Regulators should also use their resources to improve investor education and understanding and take swift action when misconduct is clear but allow people to be responsible for their own choices.

It is also important that regulators spend time educating providers of innovative financial services who may be experts in software but not have the legal and regulatory obligation understanding that more traditional financial firms have.

Q7: Are the main fraud types covered correctly (e.g., crypto-asset scams, boiler room scams, clone investment firms, and misleading information and promotional material)? What are the fraud patterns that cause/have potential to cause most retail investor harm? Are there other types of frauds or scams that regulators should consider?

7.1 Acting outside of regulatory regimes or being highly speculative is not automatically fraud

Given the evolution of crypto-assets and the fact that one key goal is to operate outside of Government interference, stating crypto-asset trading platforms "acting outside of regulatory regimes"[4] or being a "highly speculative product"[5] should not automatically render them fraudulent or scams.

This does not mean that bad actors do not take advantage of operating outside of regulatory oversight to hide their true identities, avoid using robust systems and conduct fraudulent or criminal activities, but we believe that is a separate issue that relates to the actions of the persons behind such criminal activities rather than the products or platforms themselves.

One of the failures of regulators in the past has been to blame the product and not the bad actors. This has allowed criminal elements to continue their scams by simply changing the products they market. This has also been exacerbated by highly prescriptive regulation allowing for those bad actors to be able to offer a broader range of trading options to clients that are less expensive, encouraging investors to seek them out beyond traditional regulation.

Q8: How has COVID-19 impacted retail conduct and frauds? How should regulators best respond to fraud and misconduct in the current environment, also in consideration of the impact of COVID-19 on retail market conduct?

8.1 COVID-19 impacts

COVID-19 did add volatility to the market, allowing for more short-term investment opportunities and therefore an increase in the use of speculatively traded products, but in our view this should not necessarily be considered a bad thing where investors are making confident and informed decisions.

There was an increase in cyber security incidents because of the new remote working environment. Traditional businesses needed to implement this environment in a short period of time, which left openings for cyber criminals to exploit less secure home office systems. However, most businesses have had time to embed more thorough systems and processes since then.

8.2 How should regulators respond

We believe that current regulatory responses remain the best path forward, in particular:

- investor education is still key with anti-fraud and anti-scam awareness campaigns a very important aspect of that; and

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[4] Paper p25 para 4.1.1

[5] Ibid.

- quick, decisive action by regulators when they discover misconduct will assist in reducing the effectiveness of scams and fraudulent conduct.

As an aside, CFD industry participants regularly inform their client bases about potential upcoming volatility events that may impact trading. We find this is very beneficial to our clients who may choose to close out positions or at least more actively monitor the positions they have.

Q9: Does the Consultation Report capture well the existing cross-border challenges? Are there any missing concerns or issues that are not highlighted? Are there any other novel ways of addressing cross-border challenges affecting retail investors? As an international body, what could be IOSCO's role in addressing the cross-border challenges highlighted in this consultation report?

9.1 The provision of cross-border financial services does not necessarily constitute fraud

We believe that there is a critical distinction to be made between fraudulent cross-border activities such as:

- outright scams;
- misrepresentations about the regulatory status of an individual/entity or the regulatory protections offered to an investor;
- misrepresentations about the risk or structure of a product or service;
- misleading information as to the entity offering the product or service;
- inappropriate marketing of a financial product or service; and
- false claims about the performance of an investment opportunity;

and the scenario where a retail investor has not been directly targeted and has made a fully informed decision to trade with an entity in another jurisdiction to access the trading products they want.

9.2 Ways to address cross-border challenges

Regulators' decisions to stringently restrict CFDs has fundamentally changed the product, causing investors to look to overseas options and exacerbating the cross-border jurisdictional issue.

A preferable outcome would have been to allow experienced and informed investors who understand the risks of trading to choose to trade the products they want within their regulated jurisdiction of choice. This would limit the compulsion to trade outside of a regulated environment and make it easier for regulators to focus on the truly fraudulent offshore activity.

We believe that this is a good example of where overzealous regulation can inadvertently increase other regulatory risks and should be considered when enacting similar regulations in the future.

Q10: What may be the concerns or issues that regulators should ask for disclosure of (at both firm and product level), keeping in mind the balance between quantity of disclosure and the ability of retail investors to absorb such disclosure? Should markets continue to seek to put in place special arrangements that could encourage companies during stressed market events to provide disclosures and updates that help retail investors better evaluate current and expected impacts of such events? If so, what may be the practical options to achieve this, including who should provide this information? Are there specific technological measures or non-technological measures (e.g. changing the timing presentation of the information) you would suggest to enhance the ability of retail investors to process the disclosure?

10.1 Mandatory disclosure of stressed market events

In our view it would be a mistake to mandate additional stressed market event disclosures, as investors may become over-reliant on a warning to exhibit caution and could then be at risk when a volatility event occurs without notice. On the other hand, issuing too many warnings for potential volatility events that do not eventuate may lead to investor complacency, which can also put them at risk if a genuine event were to occur.

We believe that current disclosure requirements are already sufficient to cover general information about volatility. It is in the interest of providers to continue to have people trade successfully, so many brokers are already publishing market relevant information. Regulators should also continue to educate investors about the importance of caution during volatile times, what to look out for and what to do when a volatile event occurs.

In modern times news sources have proliferated and real-time reporting of market events has become the norm, meaning that today's traders have access to a vast amount of information about current market events that would have been impossible in the past, and do not necessarily need to rely on their financial services providers to inform them.

10.2 Alternatives to disclosure

The CFD industry provides access to demo accounts, or paper trading, in addition to disclosures. Demo accounts are a great way for investors to gain experience with financial products and platforms without risk. We believe that regulators should encourage this sort of practice.

In our view, the assumption that disclosure is not effective and that investors do not understand the products they trade (even products like CFDs) is not necessarily backed up by statistical complaint information. Most complaints that regulators are receiving about complex products are to do with fraudulent practices or unlicensed and unauthorised firms.[6] The percentage of legitimate complaints demonstrating a lack of understanding about a product against a regulated

[6] *"Approximately one-half of reporting jurisdictions – the majority of EU respondents as well as Australia and the United States (CFTC and the National Futures Association or NFA) – indicate that promotional techniques and messages may be aggressive and/or misleading; in some of these jurisdictions, such behavior is prevalent primarily with unregulated firms"* – Report on IOSCO Survey on Retail OTC Leveraged Products, December 2016 page 4. *"Although unregulated firms based outside the European Union have a relatively small market share, they are very numerous (326 in October 2015) and represent the majority of customer complaints received by the French AMF."* - Report on IOSCO Survey on Retail OTC Leveraged Products, December 2016 page 18.

firm would be a fraction of a firm's overall client base, a much smaller percentage of clients than, for example, complaints about a banking product.[7]

Q11: Where product intervention powers exist, what factors should regulators consider to determine when it should be used and at what stage to ensure suitability and to mitigate investor harm? For example, should regulators monitor leverage levels in retail trading and/or seek the power to limit leverage? If so, is it possible to describe the kind of situation in which such powers could justifiably be used?

11.1 Product Intervention should be avoided except in extreme circumstances

We believe that regulators should not be making decisions that limit the freedom of investment choice except in the most extreme cases where all other avenues, including distribution obligations, have failed.

They should also avoid making decisions about well-established products as this could have unintended consequences, such as those set out in section 11.2 below in respect of the CFD industry.

We remain of the view that regulatory discussion about leverage contributing to investor harm is potentially misinformed and based on a lack of understanding about how and why investors use leveraged products.

11.2 Limiting leverage

Leverage restrictions in our industry have increased the cost of trading and changed the risk/reward balance of CFDs so fundamentally that the products are no longer fit for purpose for the experienced retail investors, particularly the high-volume, speculative day traders that they are most suitable for. Our view is based on the following factors:

- Traditionally, CFD investors trade frequently and hold their positions open for only a short time (over a period of 90 days, one member saw 94% of clients close their positions in less than 1 day).[8] The cost to facilitate multiple trades, versus the new leverage restrictions and the amount of return they will get on those trades, means that CFD products are no longer economically viable for retail investors; and

- informing our view that high-volume traders are no longer trading CFD products as retail investors, some of our members estimate since Australia introduced leverage restrictions there was:
  - a nearly **50% reduction** in the average number of trades on a retail trading account;
  - a **75% reduction** in Electronic Adviser ("**EA**" or automated trading) users;
  - a **75% reduction** in accounts undertaking over 10 trades a week; and
  - an **85% reduction** in accounts undertaking over 50 trades a week.

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[7] See Australian Financial Complaints Authority two year report – 1 November 2018 – 31 October 2020: 89,660 banking complaints received versus 8,494 complaints across the entire investment and advice sector (which includes personal advice, funds advice and OTC derivative providers).
[8] See CP322 submission Pepperstone Group Limited p3: https://download.asic.gov.au/media/5643362/cp322-submission-pepperstone.pdf

The restrictions have not significantly changed loss rates and have not materially reduced the interest in trading high leverage products. We have seen, and there have been regulatory reports that suggest, that many investors are willing to give up their retail protections or trade offshore in order to continue to trade the way they want. All that has happened is a reduction in protections for many and a reduction in transparency and reach for regulators.

While our members will continue to comply with our regulatory obligations in the jurisdictions in which we operate, we believe that the CFD industry is at a competitive disadvantage to unregulated firms due to the introduction of these reforms. We request that IOSCO consider the negative outcomes of these reforms prior to encouraging the future use of product intervention powers or any consideration around limiting leverage.

Q12: Are the developments in retail investor behaviour sufficiently significant and persistent to justify reviews by regulators of their current approaches to retail investor protection? If so, is that true globally or only in some markets? If some, what are the characteristics of the markets for which that is most true?

12.1 Developments in retail investor behaviour

As mentioned above, we believe the changes in retail investor behaviour suggest a new investor cohort who:

- want more control and choice;
- have different wants and needs;
- embrace innovation and are less interested in traditional trading or traditional financial services;
- are looking for more short-term investment opportunities;
- are supported by evolved technology that allows them to undertake short-term investment in a way that is comparable to the tools that were predominantly reserved for wholesale investors; and
- communicate (and want to be communicated to) in different ways.

12.2 Regulatory approach to retail investor protection

Regulators already have comprehensive legislation in place that provides for investor protection and powers that allow for decisive deterrent and enforcement action to be taken against firms that mislead or take advantage of investors. We believe that these existing powers are sufficient to deal with the type of misconduct and concerns raised in the Paper.

We acknowledge that some aspects of crypto-asset products may fall outside of the current regulatory remit but are encouraged to see the work that some governments, such as the Australian Government,[9] are doing to introduce a general licensing framework to provide some regulatory coverage and consistency for crypto-asset businesses without being overly burdensome.

[9] *Crypto asset secondary service providers: Licensing and custody requirement*, Australian Government, 21 March 2022.

For completeness we note an additional concerning reference to the CFD industry in the Paper which we believe lacks foundation:

> *"Outsourcing of services – Some investment firms may often use external companies, which may not be regulated or under the remit of securities regulator/regulation to carry out customer support and services or sales activities in relation to risky investment activity and product offerings e.g., CFDs, without adequate supervision, which may not always operate in the best interest of retail investors."*

We question why the Paper singles out the CFD industry in this respect. Any financial service firm that outsources aspects of its financial services without adequate supervision is not acting in the best interests of its clients or its own shareholders.

Under Australian regulation a licensee would remain responsible for financial services activities even if those activities were outsourced. There have been numerous recent high-profile cases in Australia about a lack of supervision of outsourced functions, not acting in the best interest of retail clients and inadequate compliance functions, but these have all been related to the banking industry.

Q13: Are the above regulatory tools appropriate, proportionate, and effective? Are there other regulatory tools regulators might consider? What new technologies may help regulators as they continue to address misconduct and fraud (including online/via social media)?

13.1 Appropriate regulatory tools

We agree that there is opportunity for regulators to improve their investor education and implement more effective ways of communicating their messaging to investors. Regulators should also be looking to innovative tools to improve their standard monitoring and intelligence gathering in this expanded online environment.

We do not agree with the following statements:

> *"Regulators need to consider creative tools and interventions to effect change in the absence of law reform."*[10]

This type of statement leads to serious regulatory uncertainty in our view. Changes to law should be left in the hands of Governments via formal legislative or executive processes. The primary goal of financial service regulators should be enforcing the law, not creating it. There is an inherent conflict when the people who enforce the laws also write them. Any regulator-driven interference beyond minor and technical changes or clarification of policy should therefore be rare and reserved for only the most egregious of circumstances where no other option exists.

Q14: Since the date of the IOSCO survey exercise in August 2021, have there been any other measurable changes in retail investor trends that should be taken into consideration?

We think many of the considerations and conclusions in this Paper need more thorough examination and would caution IOSCO against reliance on the August 2021 IOSCO survey as being indicative of any measurable change. The sample size was small and information was provided by predominantly traditional financial service firms and traditional regulators which may

[10] See Paper page 46 paragraph 7.6.3

not have an adequate understanding of innovative products and the changing tastes of new investor generations.

We therefore recommend interaction with innovative firms and investors in order to obtain a more complete picture, and a general approach of seeking to embrace innovation and facilitate its benefits to society rather than reflexively restricting such activity simply because it is new and less well understood.

Please let us know if we can provide any additional information on the matters we have raised in this submission.

Yours respectfully,

Peta Stead
Director
Australian CFD and FX Association