Executive Summary

Contracts For Differences (CFDs)

An investigation of counterparty risk and investor compensation

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Introduction

This research project has sought to understand and document two central aspects within the area of CFD trading, namely 1) the counterparty risks involved from a client's perspective and 2) what are the current rules in place in terms of financial compensation if a CFD broker becomes insolvent or otherwise unable to honor its financial obligations towards a client.

What are CFDs?

It should be evident that contracts for differences (CFDs) are complex derivative instruments, which can be used for either hedging another position (i.e. a long/short position in the stock market) or for pure speculative purposes. Contrary to for example trading stocks, bonds or commodities, neither the client or the CFD broker who have entered into the specific CFD contract actually owns the underlying asset – they are in effect "only" betting on the price movement of the underlying asset or financial instrument. One of the main features of CFDs is the ability to operate on leverage, which could range anywhere from 2:1 to 400:1, meaning an investor would only have to deposit a fraction of his/her actual exposure towards the underlying asset. As an example, and to put it into perspective, an individual with a margin deposit of $5,000 and a leverage ratio of 100 would then be able to initiate a trading position of up to $500,000. Clearly, for many investors, the prospect of achieving a significant return and only having to put up a small percentage of the exposure can be very tempting, but more often than not, these highly leveraged positions have proven to be a disastrous financial investment decision. In other words, it appears that average retail investors have difficulties understanding the complexity of these derivative instruments, the fees and charges involved and the overall financial risks they are exposing themselves to.

New measures on the provision of contract for differences

In an attempt to help retail investors avoid exposing themselves to risks that they are unable to either understand or financially in a position to honor, the European Securities and Markets Authority (ESMA) has from 1st of August 2018 put several measures in place as a step towards creating greater investor protection in the EU. The main features of the new regulations are: 1) restriction on leverage of a position by a retail investor; 2) margin close out; 3) negative balance protection; 4) restriction on incentives offered; and 5) standardized risk warnings.

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General risks

Besides the general risks involved with trading CFDs such as market risk (the price/value of the underlying asset moves in the opposite direction of the client's position), too much leverage (the client gets a margin call), negative account balance possibility (the client can be held liable for losses in excess of the funds in their CFD account, however not applicable from 1st August 2018) and systemic risks (the market as a whole will move due to unforeseen events), another important aspect of trading CFDs is the counterparty risk an investor face.

Counterparty risk

Simply stated, counterparty risk is the possibility that a counterparty (in this case a CFD broker) will default, become insolvent or otherwise unable to meet its financial obligations in accordance with agreed terms. From a clients' perspective, counterparty risks such as the broker not being able to execute the trade(s) on time and at best price, the broker experiencing internal deficiencies or software issues are also present, but these risks will typically be described in the terms and conditions as events that the broker cannot be held liable for. A majority of CFD brokers will naturally take measures towards avoiding a scenario where a client would lose his/her funds in the event of the broker becoming insolvent such as segregating a clients' funds from the CFD providers' funds and also being regulated by the appropriate financial authorities. The first measure of segregating a brokers' funds from a clients' and thereby creating transparency and a distance between the broker and the investor seems like a valid and reasonable measure to take. However, could that (despite being a perfectly sensible measure) open up for another possible risk – third-party risks?

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Third-party risk

The fact that CFDs are "merely" contracts between two parties and no underlying financial instruments or assets are owned by either party fundamentally means that a simple bet is placed by an investor, money is transferred by the investor to a counterparty (the broker), which then transfer those funds to a third-party – typically a custodian bank. However, in worst case scenario, if a third-party is unable to honor its financial obligations towards a broker, which indirectly could affect a client, what are the rules and regulations, since the client does not have a contract with the third-party, but only with the broker and no assets, besides the funds deposited, are held anywhere?

Investor Compensation Schemes

As a measure towards compensating investors in case of default or insolvency by a counterparty, The Investor Compensation Schemes Directive (ICSD) was adopted in 1997. The purpose of the directive is aimed towards providing clients, who have received investment services from investment firms, to be financially compensated if the firm or broker is unable to return either money or financial instruments that it holds on behalf of a client. As stipulated in the directive, a client is entitled to receive compensation up to a limit of €20,000 per account, but individual countries within the EU have the ability to raise that amount, should they wish to do so (as in the case with brokers and investment firms authorized by the Financial Conduct Authority (FCA) or the Prudential Regulation Authority (PRA) in the UK, which have set the upper compensation limit to £50,000). However, it appears that most other countries within the EU have set the limit to €20,000 as provided in the guidelines by the directive.

Proposed update

In order to introduce a new and more comprehensive set of rules, the European Commission proposed in 2010 to update the rules. Amongst the main features in the proposed update were to 1) raise the compensation limit to €50,000; 2) introduce a borrowing mechanism across national compensation schemes; 3) reduce delays in the payout of claims to investors; 4) set a common regulatory framework related to the funding of the schemes and lastly, but not least; 5) the right for an investor to be compensated by the scheme in case of the investment firm not being able to return the assets or funds to the client due to failure by a third-party custodian. However, since the proposal was not endorsed at EU level, the Commission decided to withdraw it in March 2015.

Since CFDs are highly complex investments and a vast majority (74% – 89%) of retail investors lose money when engaging in these trades, it seems appropriate that ESMA (finally) has taken the initiative and are introducing the new measures from 1st August 2018 to help protect CFD retail investors (mainly from themselves), due to the lack of understanding and complexity of the financial derivate instrument.

The current situation

Currently investors within the EU are in a situation where there seem to be a lack of cross-border funding rules of the national investor compensation schemes. In other words, each Member State appears to have drawn up internal rules, where, if a compensation scheme should face financial difficulties, they can then either seek funding within its own borders or alternatively (perhaps) borrow on the open market. Also, if compensation had to be paid to a client of a CFD broker, the existing rules dictates that compensation should happen *'as quickly as possible'*, which basically means that there is no specific time frame in place for when compensation have to have been paid out. Furthermore, there seem to be a lack of a common regulatory framework relating to the funding of the various schemes (besides that it should come from *'market participants'*), which in turn means that each Member State has to decide for themselves how and to what level the schemes should be funded. Lastly, the absence of clarity relating to the potential failure of third-party custodians also needs to be noted as a potential area of concern. Clearly, this area is especially of great importance when dealing with CFDs due to the segregation of client funds and the fact that CFDs are "merely" contracts between two parties, where one of them have placed funds with a third-party, whom the investor does not have a contractual arrangement.

What measures can individual retail investors take?

Firstly, the importance of understanding the risks involved when dealing with leveraged, financial instruments cannot be emphasized enough. Countless examples exist, but to give an indication of the risk involved by leveraging up a position, a 20:1 leverage with an initial margin of 5% would mean that a decrease of 1% of the underlying asset would result in a 20% loss and a 5% decrease would be a loss of 100% of the initial margin payment. Secondly, in order to minimize potential losses in the case of a CFD broker becoming insolvent, some traders spread their trading capital over different brokers to avoid being too heavily exposed to the counterparty risk of any one provider. Lastly, the importance of dealing solely with highly regulated CFD brokers has to be paramount, since no protection or compensation towards the client can or will happen if the broker is not fully regulated and authorized by the appropriate financial authorities.

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Conclusion

The matter of fact is that presently investors dealing with CFD brokers and investment firms within the EU are financially protected by a relatively outdated directive, which have been tested to the limit during both the dotcom bubble and the financial crisis. It can seem somewhat perplex that in the age of technological and financial innovation, where highly leveraged trading by retail clients can be done by a single click at home and complex financial instruments are available to almost anyone above the age of 18 regardless of trading experience, clarity and an up-to-date ruleset is absent. In order for financial systems to function efficiently and in a transparent way, the ability to stay up-to-date with the regulatory evolution should result in consumer confidence and ultimately better protection and compensation for the individual investor within the European Union.

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