CFDs and Liquidity Risk Providers: A Comprehensive Analysis on Hedging Risk

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This capstone project will examine Contracts for Difference (CFDs) and their relationship to liquidity risk providers in Europe. As CFDs are relatively new instruments, there is a significant increase in implementation of new regulatory policy throughout the world to limit potential losses to individual investors.

This project will attempt to fill in some of the gaps in regards to CFD liquidity providers by detailing and outlining the few that operate in Europe. It will first describe CFDs, how they work, and mention a couple CFD providers in Europe. Proceeding this, liquidity providers for CFDs will be analyzed, generating a list of six moderately large liquidity providers that operate within Europe.

Special thanks to the Fintech startup Brokerchooser, at the CEU Incubator, without which I would not have had the opportunity to research CFD Liquidity Risk providers.

CFD Basics:

CFDs have been used since the 1990s, as a new type of financial instrument, where an investor can bet on the price movements of a certain financial instrument. Investors have the ability to bet on variations in pricing in stocks, indices, currencies, treasury bonds, and commodities.

CFDs can be extremely volatile, where an incremental change in the underlying price can lead to wild swings of profit or loss for an investor. Typically traded over-the-counter (OTC), CFDs can be subject to liquidity, counterparty, and market risks among others. Potential investors should also note that CFD trading is banned in the United States and Belgium.

Leverage Example:

If, for example, the margin rate is 10%, you want to invest in an instrument (stock Y) currently trading at $200, and you want to buy 500 shares:
Normally, you would have to spend 500Y x $200 = $100,000 if you bought the shares.
With CFDs, you only need to put in the amount required by the margin rate:

$$(10\%*\$200) * 500Y= \$10,000$$

If the price increases by 5%, your gains would be the same as if you had invested the full $100,000 (i.e. $5,000). Except that now, your returns become 50% of your total investment, because you only invested $10,000, and you made $5,000.

This is cautionary, as the exact opposite could occur. If stock Y moves against you, you lose 50% of your margin, and need to either close out your position at a loss or put more money into the margin account to keep the position open. It is also dependent on how risk averse your CFD brokerage is, as they might close your position for you.

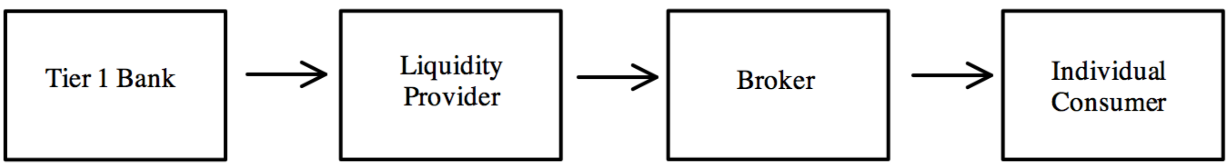
Regulation:

At this point, it needs to be noted that even with the number of regulations currently in place, it is not enough to prevent substantial losses for investors as the UK Financial Conduct Authority (FCA) found that numerous CFD providers have not conducted proper due diligence when acquiring investors. Some CFD providers have inadequately assessed consumers for knowledge and preparedness of CFD trading, and have not properly laid out the intricacies of the financial instrument. Therefore, it is important to fully understand how to trade CFDs and balance your total portfolio with other types of investments and/or set stop loss orders to mitigate losses.

CFD Providers in Europe:

I included information on 8 brokerages that provide trading services for CFDs throughout Europe. The majority have headquarters in the UK or the Nordic countries, but two of them are Israeli, and one is from the US. Markets.com, Plus500, and eToro only trade CFDs, but IG, Saxo Bank, Interactive Brokers, DEGIRO, and CMC Markets offer financial instruments for their clients. Leverage differs between company, and while some provide their own liquidity, the majority of the brokerages have independent liquidity providers.

CFD Liquidity Provider Basics:



Liquidity providers connect smaller brokerages to tier 1 banks, that otherwise would not be able to access liquidity. Liquidity providers are used because a lot of banks typically don't work with smaller brokerages, only providing liquidity for larger, more established brokers. Banks also may not carry or have the ability to deal with all financial instruments, and therefore a liquidity provider is a more useful route to use. You can think of the bank as being a larger liquidity provider to the liquidity provider.

When a broker receives an order from their customer to go long on a CFD with an underlying stock, then the broker can choose to hedge with a liquidity provider or keep the position themselves. Liquidity providers can also advise the broker if hedging is strongly suggested. If they choose to send it to the liquidity provider, then the CFD itself is transferred, and can hop around through the system as a CFD, not as the underlying stock or cash value.

Liquidity providers will typically have their own small trading department that will hedge their position(s) if required. These providers work with 10-12 other liquidity providers, put the offered prices in an aggregated pool, and then the best bid/best offer will win. This way, there is zero risk, and they usually take markup and commission.

In a substantial number of cases, the brokers don't hedge, taking on the customer's position themselves, hoping that the customer will lose. If the broker wants extra security on a CFD, for example, he can send the CFD to the liquidity provider as a hedge.

Relevant Terms:

A **Prime Broker** is a central clearing point made up of 4-5 different banks. Positions are centralized here, and can be neutralized through this method. If you have 100 long and 100 short positions open with different brokers, then you would be paying the spreads individually, whereas if it's all put into a prime broker, then your position is essentially neutralized, making it much more cost-effective. This is done at the tier 1 bank level.

Another important term is "**prime of prime**" but this is essentially a liquidity provider, which is the tier under a prime broker. These are generally non-bank, similar to the structure of liquidity providers.

API: an application programming interface that interacts with remote servers and relays information back to the website. This is a more efficient way to collect data from a remote server, as it does not have to go through your server first before connecting with the remote server.

MetaTrader 4 (MT4): an online trading platform, mostly for trading FX, but also offers technical analysis. Created in 2005, it is widely used now because it allows for the use of technology to automate trades and for users to write trading scripts. MT5 is an updated version of MT4.

CFD Liquidity Providers:

	Operations	**Financial instruments**	**Clientele**	**Regulatory Body**
CFH Clearing	HQ in London, operates worldwide	CFDs, FX, commodities	Institutional	FCA
Tradetech Alpha	London, UK	CFDs, FX, spread bets	Institutional	FCA
GBE Prime	HQ in Cyprus and Germany, operates worldwide	CFDs, FX, indices, commodities, treasuries	Retail and institutional	CySec and BaFin (Germany)
Gain Capital	HQ in New Jersey, US, operates in US, EMEA, & Asia Pacific	CFDs, FX, bonds, equities, indices, commodities	Retail and Institutional	Regulated by 9 worldwide; dependent on broker's location
Leverate	HQ in Cyprus, operates worldwide	CFD, FX, shares, cryptos, indices, commodities	Retail and institutional	CySec
X Open Hub	London, UK & Poland	CFD, FX, cryptos, indices, commodities, shares/ETF	Institutional	FCA

Conclusions:

CFDs are notorious for causing a great deal of loss for individual investors, and regardless of experience level, if you are trading a CFD, you need to consider that you may lose quite a large sum of money, like up to 80% of other investors do. Unfortunately, the CFD market is largely under-researched, with few academic articles or studies on the topic. There needs to be transparency at all levels of the liquidity chain (bank, liquidity provider, broker, investor) so that losses can be mitigated and individual clients understand the risk warnings and are properly prepared.

CFD liquidity providers are situated between tier 1 banks, such as BNP Paribas, JPMC, and UBS; and brokerages like Markets.com, IG, and Plus500. They are used when small brokerages cannot go directly to banks for liquidity purposes in the financial trading market. Brokerages hedge their positions with clients by directly sending the financial instrument, i.e. CFD, to a liquidity provider. The liquidity provider then hedges by either trading itself, or with approximately 10-12 other liquidity providers. They can also use prime brokers, which amalgamate all positions into one large pool, neutralizing, centralizing, and cost-effectively minimizing the amount of spreads that a single liquidity provider must pay.

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*please see full document for corresponding in-text references.

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