

ASIC CONSULTATION PAPER 146

This submission is made in response to ASIC's *Consultation Paper 146: Over-the-Counter Contracts For Difference: Improving disclosure for retail investors* ("CP146").

The submission has been prepared by the Investments, Life Insurance and Superannuation ("ILIS") division of FOS and does not necessarily represent the views of the Board of FOS.

The submission draws on the experience of FOS and its predecessors in the resolution of disputes relating to financial services.

Information about FOS and ILIS

FOS commenced operations on 1 July 2008. It is an independent dispute resolution scheme that was formed through the consolidation of three schemes:

- the Banking and Financial Services Ombudsman ("BFSO");
- the Financial Industry Complaints Service ("FICS"); and
- the Insurance Ombudsman Service ("IOS").

Upon consolidation of the three schemes under the FOS name, FICS internally became known as ILIS.

On 1 January 2009, two other schemes joined FOS, namely:

- the Credit Union Dispute Resolution Centre ("CUDRC"); and
- Insurance Brokers Disputes Ltd ("IBD").

FOS is an external dispute resolution ("EDR") scheme approved by ASIC. Membership of FOS is open to any financial services provider carrying on business in Australia including providers not required to join a dispute resolution scheme approved by ASIC. Replacing the schemes previously operated by BFSO, FICS, IOS, CUDRC and IBD, FOS provides free, fair and accessible dispute resolution for consumers unable to resolve disputes with financial services providers that are members of FOS.

Members of BFSO, FICS, IOS, CUDRC and IBD are now members of FOS. The members of those schemes included:

- BFSO – credit providers, mortgage brokers, payment system operators, Australian banks and their related corporations, Australian subsidiaries of foreign banks and foreign banks with Australian operations;
- FICS – life insurance companies, fund managers, friendly societies, stockbrokers, financial planners, pooled superannuation trusts, timeshare operators and other Australian financial services providers;
- IOS – general insurance companies, re-insurers, underwriting agents and related entities of member companies;

- CUDRC – credit unions and building societies;
- IBD – insurance brokers, underwriting agents and other insurance intermediaries.

FOS has over 20 years' experience in providing dispute resolution services in the financial services sector and it is estimated that FOS covers up to 80% of banking, insurance and investment disputes in Australia.

FOS provides services to resolve disputes between member financial services providers and consumers, including certain small businesses, about financial services such as:

- banking;
- credit;
- loans;
- general insurance;
- life insurance;
- financial planning;
- investments;
- stock broking;
- managed funds; and
- pooled superannuation trusts.

As well as its functions in relation to dispute resolution, FOS has responsibilities to identify and resolve systemic issues and obligations to make certain reports to ASIC. FOS is a not for profit organisation governed by an independent board with consumer representatives and financial services industry representatives.

Introductory comments

FOS agrees with the criticism of existing practices contained in "*Report 205: Contracts for difference and retail investors*" ("Report 205"). In particular FOS considers that Report 205 demonstrates that retail investors are poorly served by, and exposed to unacceptable levels of risk by the current practices of, OTC CFD issuers.

For the reasons set out in its various responses to the questions posed by ASIC, FOS has reservations as to whether the proposals explained in CP 146 will prove effective in substantially reducing the probability of unsophisticated investors engaging in trading OTC CFDs to their detriment.

However, FOS acknowledges that ASIC has signalled that it will continue to monitor the market in order to ascertain the effectiveness of the measures it puts in place at the conclusion of the current consultation process and that legislative action may be necessary if the proposals fail to achieve significant improvements in investor experience.

FOS's responses

B1Q1 *Do you agree with our proposed scope for the benchmarks? Please give reasons.*

FOS is of the view that specifying minimum standards of conduct would be more effective than the “if not, why not” benchmark model for the reasons set out in the response to **B2Q2** below.

In particular, FOS believes the use of the “if not, why not” benchmark model in relation to the investor suitability benchmark is not appropriate.

FOS asks ASIC to consider setting, and providing clear guidance on a minimum standard of enquiry that issuers of OTC CFDs must meet. Details of FOS’s suggested approach are set out below in the response to **B1Q4**.

B1Q3 Do you expect that our proposed guidance will affect investor behaviour, including the decision whether to invest in OTC CFDs?

FOS has reservations as to whether the proposals explained in CP146 will prove effective in substantially reducing the probability of unsophisticated investors engaging in trading OTC CFDs to their detriment.

The main concern held by FOS is whether the “if not, why not” benchmark approach will be effective. The reservations held by FOS in this regard are set out in the response to **B2Q2** below.

In any event, while FOS recognises the modification of investor behaviour is an important objective, it also considers the modification of the conduct of issuers of OTC CFDs as being equally important.

In this regard, FOS applauds the content of benchmark 1 (investor suitability), but questions whether it is appropriate for the benchmark to be met by the issuers of OTC CFDs on an “if not, why not” basis.

FOS considers it important for ASIC to impose an obligation on OTC CFD issuers to meet a minimum standard in assessing investor suitability through the amendment of issuers’ licence conditions. Please refer to FOS’s response to **B1Q4** below for further particulars of FOS’s position on this issue.

B1Q4 Do you think the objectives of the benchmarks should be achieved through other means (e.g. by imposing licensing conditions)?

FOS acknowledges ASIC’s position that:

- (as stated in the draft Regulatory Guide at RG000.13) disclosure is not designed to stop retail investors from taking investment risks, but to help them in understanding the risks involved; and,
- (as stated at RG000.24) there is a need to strike a balance between protecting investors’ interests and allowing markets to operate freely.

However, because OTC CFDs are inherently high risk and complex, it is essential, in FOS’s view, that issuers of OTC CFDs are obliged to adhere to a minimum standard of enquiry into client suitability.

The minimum standard must mandate the extent and method of enquiry the issuer must make into the suitability of each client.

FOS also believes questions asked by issuers about previous investment experience, understanding of concepts of leverage, margins and volatility, understanding of the nature of CFD trading, the issuer's procedures and the need to monitor positions, must be capable of eliciting substantive and considered responses from the investor.

This is because FOS considers that OTC CFD issuers must not allow retail clients to trade OTC CFDs unless the investors have (and can demonstrate) substantial experience in trading in highly leveraged derivatives and/or in derivatives where they were exposed to losses exceeding the initial stake invested (such as uncovered put option trading).

While FOS accepts all of the matters set out at RG000.39 of the proposed Regulatory Guide to be relevant in the assessment of client suitability, it is FOS's view that issuers must also ask questions about the source of funds the investor intends to use to invest in CFDs. If the investor states he / she will be using borrowed funds, the level of enquiry must be scalable in light of the increased risk of the investor experiencing financial difficulty in what is essentially a "double gearing" situation.

FOS recognises that issuers of OTC CFDs may be concerned that enquiries into client suitability may lead to an inference that the issuers have considered one or more of the client's relevant personal circumstances (therefore leading to a conclusion that they have provided personal advice) and activate the requirement to comply with subsection 945A(1) of the *Corporations Act 2001*.

This concern can be removed by ASIC either:

- providing issuers of OTC CFDs with relief under a class order; or
- preventing OTC CFD issuers from dealing with retail investors unless the investor has obtained personal financial advice from a third party licensee that addresses the issue of suitability.

FOS notes that the approach referred to in the second bullet point above is one commonly used by Managed Discretionary Account providers and is described in RG179.

B1Q5 *Is there any further guidance we should give? Please provide as much specific information as possible, as this will assist us to provide guidance that is of greater use to you.*

Please refer to FOS's responses to **B1Q1** and **B1Q4** above.

FOS also notes Report 205 dealt with the conduct of issuers of OTC CFDs (or their agents) at seminars and noted a number of behaviours that required remedial action.

It is therefore surprising to FOS that ASIC's draft Regulatory Guide did not attempt to directly address the behaviours ASIC identified during its surveillance of seminars conducted by (or on behalf of) issuers of OTC CFDs.

Of particular concern to FOS are misrepresentations made in seminars that lead retail investors to believe that:

- CFDs offer a simple way for retail investors to achieve substantial gains with modest outlays; and
- OTC CFD issuers provide effective risk management strategies (via stop loss orders etc) where – in reality – the risk management strategies that are offered are expensive and are largely ineffective because they do not automatically result in the investor’s position being closed out at the price selected by the investor but rather merely triggers the placement of the stop loss order without any guarantee that the investor’s position will be closed out at the selected price

To address the above concerns, FOS asks ASIC to consider:

- providing clear guidance to the industry and consumers about the standard of conduct that ASIC expects of issuers of OTC CFDs (and their agents) at seminars; and
- imposing a licence condition on issuers of OTC CFDs to keep a record of:
 - the date, time and location of each seminar;
 - representations (including a video record) made at each seminar; and
 - the names and addresses of the persons who attended each seminarfor a period of seven (7) years.

FOS is of the view that the above approach will go some way to addressing the concerns raised in Report 205. At the least, the above approach will directly tackle the issue of retail clients receiving representations at seminars that create a false impression of the risks and benefits associated with OTC CFDs that induce them to deal with the issuer.

Requiring issuers to maintain a record will provide ASIC with an opportunity to conduct audits against an acceptable standard of conduct and will provide evidence of representations made at seminars.

B2Q1 *Have we identified the relevant benchmarks? Are there any other benchmarks that are missing? Have we included anything that is not relevant?*

As identified above in its response to **B1Q5**, FOS is of the view that ASIC should provide clear guidance on the conduct of seminars and create an obligation for issuers to keep records of representations made at seminars.

B2Q2 *Are there more effective ways of dealing with the risks faced by retail investors other than by benchmarks? Please give details.*

In FOS’s view, it would be more effective if ASIC were to provide clear guidance on the minimum standard of conduct it expects from the issuers of OTC CFDs and oblige the issuers meet the minimum standards.

FOS is concerned that the benchmark approach will not assist retail clients in circumstances where the issuer does not meet the benchmark and provides information about how it addresses the concern behind the benchmark. This approach requires retail clients (many of them unsophisticated) to:

- understand the concerns the benchmark is designed to address; and,
- consider whether or not the issuer's alternative proposal to meet a benchmark addresses those concerns.

Such an approach assumes a level of knowledge that most retail investors simply do not have.

B6Q1 *Do you agree with the proposed timetable for implementation of the benchmark approach for OTC CFDs?*

FOS agrees with the proposed timetable for implementation.

B7Q1 *Do you agree with the proposed timetable for implementation of the benchmark approach for OTC CFDs?*

FOS agrees with the proposed timetable for implementation.

B8Q1 *Are there any other statements that should be included in advertisements for CFDs?*

FOS notes that ASIC intends to take a broad approach to the concept of "advertising". FOS understands that this broad approach may even extend to information provided at seminars.

Report 205 suggests that retail investors are systematically misled through advertising and in seminars where they receive representations that:

- CFDs offer a simple way for ordinary investors to achieve substantial gains with modest outlays; and
- OTC CFD issuers provide effective risk management strategies (via stop loss orders etc).

FOS submits that it would be appropriate for these representations to be proscribed in advertising unless the representations are qualified by clear and equally prominent statements to the effect that:

- there is a real risk of sustaining substantial losses despite the modest outlay; and
- the risk management strategies offered are expensive and largely ineffective because they do not automatically result in the investor's position being closed at the price selected by the investor.

ASIC should also require OTC CFD issuers to state that trading in CFDs represents an unacceptable risk for retail clients unless the investors have (and can demonstrate) substantial experience in trading in highly leveraged derivatives and / or in derivatives where they were exposed to losses exceeding the initial stake invested (such as uncovered put option trading).

Such are the risks inherent with OTC CFDs, and the dangers these risks pose to unsophisticated retail investors, that it would be appropriate for legislation to be enacted requiring all advertising and points of sale (including websites, seminars and PDSs) to contain prominent and appropriate warnings of the significant risks associated with the product in much the same manner as cigarette packets are required to prominently display the health risks associated with smoking.

B8Q3 *Can you suggest more effective ways of dealing with advertising issues?*

Please refer to FOS's response to **B8Q1** above.