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CFD Requirements Consultation
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CFD Requirements Consultation

Dear Sir,

Please find attached the submission on the CFD Requirements Consultation from Goodbody.

Yours sincerely

Neil Collins
Head of Compliance

CFD Consultation Draft

Although the Central Bank's consultation paper covers contracts for difference ("CFDs"), spread beds and rolling spot forex contracts, this submission focuses primarily on CFDs on individual equities. Other providers who are active in the wider CFD market are best placed to comment on areas of the market in which we have no presence.

Market Overview
In the Irish market investors gain exposure to individual equities via either conventional cash accounts or leveraged CFD accounts. Investors can make such investments via Execution-Only, Advisory or Discretionary accounts. In general Execution-Only accounts tend to be held by unsophisticated investors who typically invest in relatively small amounts. Many of such Execution-Only accounts are transacted on online platforms.

In our view the CFD market is comprised of two distinct elements i.e. the unsophisticated Execution-Only sector and the sophisticated Advisory sector. The introductory paragraph of the Central Bank's consultation paper refers to "*Investment firms offering CFDs to retail clients typically do so through online trading platforms on an execution-only basis...*". Accordingly the paper focuses primarily on the Execution-Only sector and the issues associated with the marketing of CFDs to such investors.

The Advisory CFD sector tends to be characterised by sophisticated investors who invest larger amounts than Execution-Only investors. Advisory CFD investors frequently use CFDs as a portfolio management tool to balance their other investments in direct equities, pension funds, property etc.

The Central Bank's consultation paper made reference to survey data which indicated that a high percentage of retail CFD investors experience capital losses. It may well be the case that the retail investors within such surveys were predominantly Execution-Only investors. It would be of interest to carry out similar surveys of active Execution-Only investors who invest via conventional cash accounts. It appears likely that such surveys would also show a high percentage of capital losses. However the percentage of investor's capital lost may be higher in leveraged accounts.

Goodbody's Role in the CFD Market
Goodbody are positioned in the Advisory and Discretionary CFD market and do not offer Execution-Only CFDs. Our CFD clients predominantly hold Advisory accounts and we only provide CFDs to investors with a tolerance for high risk. Typically we leverage CFD accounts in the range 1.25:1 to 2:1 times. Our level of CFD client turnover is low with over 80% of CFD accounts opened since 2012 still with us. In 2016 the majority of our CFD accounts that had positions were profitable.

We view CFDs as high-risk instruments that should only be offered to suitable clients. Clients must understand and be fully aware of the leverage nature of CFDs. Clients likely to be accepted as CFD account holders will be High Net Worth ("HNW") individuals with a speculative attitude to risk. In addition to being HNW, clients must also have the necessary liquidity to meet margin calls. CFD applicants must also complete the required client on-boarding documentation.

On-boarding documentation includes completion of CFD Client Suitability Form and Knowledge/Experience template. Upon completion these documents are submitted to Senior Management for sign off. A client's suitability for CFDs is formally reviewed on an annual basis and such Annual Suitability Forms require Senior Management sign off.

The daily bargain reports for CFDs, margin call reports and annual suitability templates are reviewed by Wealth Management Senior Management, which includes the Head of

Trading and Execution, the Head of Investment Management and the Head of Wealth Management, who is a member of the firm's Compliance Committee.

Questions for Consideration

1 Which of the options outlined in this paper do you consider will most effectively and proportionately address the investor protection risks associated with the sale or distribution of CFDs to retail clients?

We do not feel that Option 1, the prohibition of the sale or distribution of CFDs to retail clients, is appropriate as it would deny advisory clients the opportunity of investing via CFDs for portfolio management purposes. This would be inequitable and would discriminate against retail investors in favour of other classes of investors.

Leverage is a bona fide investment tool that is utilised in a number of asset classes including equities, property etc. Although leveraged investment has associated risks, CFDs should be available to sophisticated investors that have a high tolerance for risk.

CFDs are also used by sophisticated retail investors for shorting purposes. This is a legitimate form of investment which should be available to such investors.

Investing in direct equities via CFDs rather than conventional cash accounts has the benefit of limiting foreign exchange exposure to the profit or loss on an individual transaction rather than being exposed for the full capital value of the position. Option 1 would deny investors access to this attractive feature of CFDs.

Option 2 is more appropriate as it provides investor protection mechanisms that can be targeted towards the sub sector of the retail CFD market that warrants further protection. This option does not restrict access to CFDs by sophisticated clients who use these instruments for portfolio management purposes.

2 In relation to Option 2:

a) Do you agree with the proposal to restrict leverage to 25:1 for retail clients trading CFDs. Please give reasons for your answer.

We have no difficulty with a proposal to restrict leverage. If the intention is to protect unsophisticated Execution-Only investors then an overall restriction of 25:1 is perhaps too high. We would suggest a limit of 10:1 for individual equities. We understand that there is a valid case to be made for leverage above 25:1 for other asset classes and indices. Again this lies outside of our area of expertise and hence we will leave it to other providers to provide comment in this respect.

b) Do you agree with the proposal that retail clients trading CFDs should not be at risk of potentially limitless losses and that firms offering CFDs should be required to put in place negative balance protection on a per position basis? Please give reasons for your answer.

We agree that CFD providers should offer retail investors a choice between two forms of account i.e. with or without negative balance protection. Accounts that provide such protection are appropriate for unsophisticated Execution-Only investors who have no further capital to invest beyond their initial margin. Sophisticated Advisory investors recognise that margin paid at the outset is merely an initial payment which may need to be supplemented in volatile markets. Typically such investors would not want negative balance protection because of the associated costs.

c) **Do you agree with the proposal to prohibit all bonus promotions and trading incentives in relation to CFD client accounts? Please give reasons for your answer.**

We agree with this proposal as it serves to protect inexperienced retail clients from investing in products for which they are not suited.

d) **Do you agree with the proposal to require firms offering CFDs to retail consumers to provide a standardised risk warning to clients disclosing the percentage of active retail CFD clients who suffered a loss of equity during the previous quarter and over the previous 12-month period? Please give reasons for your answer.**

We have no difficulty with the concept underlying this proposal. However it should be pointed out that the proposal would require investment firms to make a higher level of disclosure for CFDs than for other investment products. In relation to the specifics of the proposal, we would suggest that quarterly performance is too short for a product that can experience volatility over short time periods. We feel that disclosure of 1, 2 and 3 year performance would be more appropriate.

3 Are there further measures which the Central Bank should consider as part of its analysis? Please give reasons for your answer.

It appears that the Central Bank is seeking to protect unsophisticated Execution-Only investors who regard CFDs as similar to placing a bet without realising that there is a high likelihood of them losing their "stake" and potentially more. We feel that the proposals to restrict aggressive marketing and to offer negative balance protection to Execution-Only investors would go a long way towards addressing the Bank's concerns.

The methodology for computing the percentage of a firm's loss making CFD clients would need to be prescribed in sufficient detail so as to ensure that all firms perform the calculation using exactly the same input criteria.

4 In relation to the options outlined in this paper, are there any detrimental effects on investors or the markets or unintended consequences that you consider should be taken into account by the Central Bank? Please give reasons for your answer.

If Option 1 were to be implemented it would have the following potential unintended consequences:

- Sophisticated clients would be precluded from investing in CFDs for portfolio management purposes and from availing of the investment benefits of leverage, shorting and reduced Fx exposure. In addition such investors would be discriminated against as they would not be able to avail of CFD related tax efficiencies that are available to other classes of investors.

- A prohibition on the sale or distribution of CFDs could result in Irish Advisory clients being left with no alternative other than investing with an overseas provider on an Execution-Only basis. Such providers could be located in jurisdictions with weak regulatory structures.

- Prior to the advent of CFDs in the Irish market, investors used conventional bank borrowings to leverage their equity portfolios. This was a cumbersome arrangement whereby the bank placed a lien over the client's account. The mechanisms used for risk management where much less sophisticated that those currently in place for CFDs. A ban on CFDs could result in a reversion to such cumbersome forms of leverage.

- A prohibition on the sale or distribution of CFDs could lead to retail investors converting to professional classification. Whereas many of such clients would qualify for professional status, it would result in potentially large numbers of investors, who marginally meet the professional requirements, forfeiting retail protections.

We do not foresee a difficulty with the prohibition of trading bonuses. However if such a restriction took the form of a complete ban on CFD advertising it could have unintended consequences e.g. it could prevent a firm writing to a client and recommending CFDs in response to the client's request for a high risk leveraged investment.

5 What do you consider will be the likely effect of the options outlined in this paper on investors and market participants who may hold, use or benefit from CFDs? Please give reasons for your answer.

We have largely addressed this question at 4 above.