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## **EMERGING INVESTMENT PRODUCTS AND THEIR REGULATORY CHALLENGES**

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INVESTMENT DEALERS  
ASSOCIATION OF CANADA

ASSOCIATION CANADIENNE DES  
COURTIERS EN VALEURS MOBILIÈRES

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# Emerging Products

## Contracts for Difference (CFD)

*“OTC Swap Market  
Goes Retail”*

FAS September 29, 2007



# Contracts for Difference (CFD)

- ◆ CFD is a derivative
- ◆ Trades over-the-counter (OTC) and tracks the economic performance of the underlying security based on its price movement. Holder of the long contract will benefit from upward price movement of the underlying security and receive payment for the profit earned from the issuer of the contract and vice versa.
- ◆ Highly leveraged product with no fixed expiry date or contract size
- ◆ Allow investors to speculate (or hedge) on the underlying security movements without ownership and physical settlement of the underlying security.
- ◆ Attractive to day traders



## CFD - Salient Characteristics

- ◆ Profit from rising and falling prices
- ◆ Lower margin rates
- ◆ Flexible contract sizes allow for partial closing of positions
- ◆ Low execution costs (opening and closing the position)
- ◆ No physical settlement of the underlying (no clearing, settlement and custody charges)
- ◆ Interest charged only on positions rolled over
- ◆ No stock borrowing costs for short CFD positions
- ◆ Participate in dividends and stock splits – but no voting rights (unless convertible)

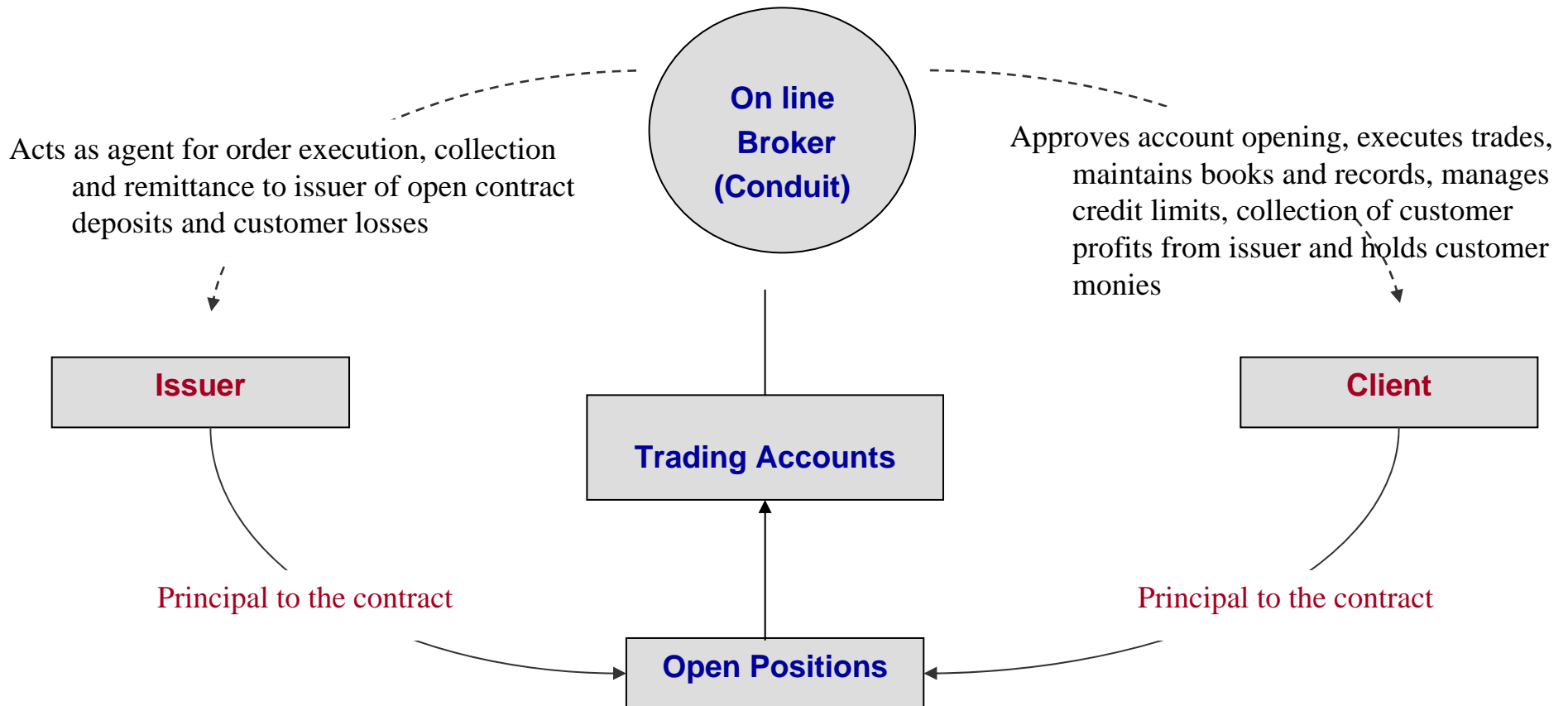
# It's all about "leverage and transaction cost"

Buy / Sell	CFD	CFD	Listed Security
	(Issuer)	(Issuer)	(Discount Broker)
<b>Day 1 Buy 750 ABC @ \$12 = \$9,000</b>			
<b>Margin rate</b>	<b>5%</b>	<b>20%</b>	<b>30% (LSERM)</b>
Margin deposit	\$450	\$1,800	\$2,700
Commission	\$9.00 (0.10%)	\$9.00 (0.10%)	\$9.99
Cost Comparison – Initial Outlay required to make trade	\$459	\$1,809	\$2,709.99
<b>Day 3 Sell 750 ABC @ \$13 = \$9,750</b>			
Financing (6.75% Annually)	\$4.74	\$3.99	\$3.50
Commission	\$9.75 (0.10%)	\$9.75 (0.10%)	\$9.99
Gross Profit	\$750	\$750	\$750
Total Cost of Transactions	\$23.49	\$22.74	\$23.48
Net Profit	\$726.51	\$727.26	\$726.52
<b>% Potential Return on initial investment</b>	<b>158.3%</b>	<b>40.2%</b>	<b>26.8%</b>

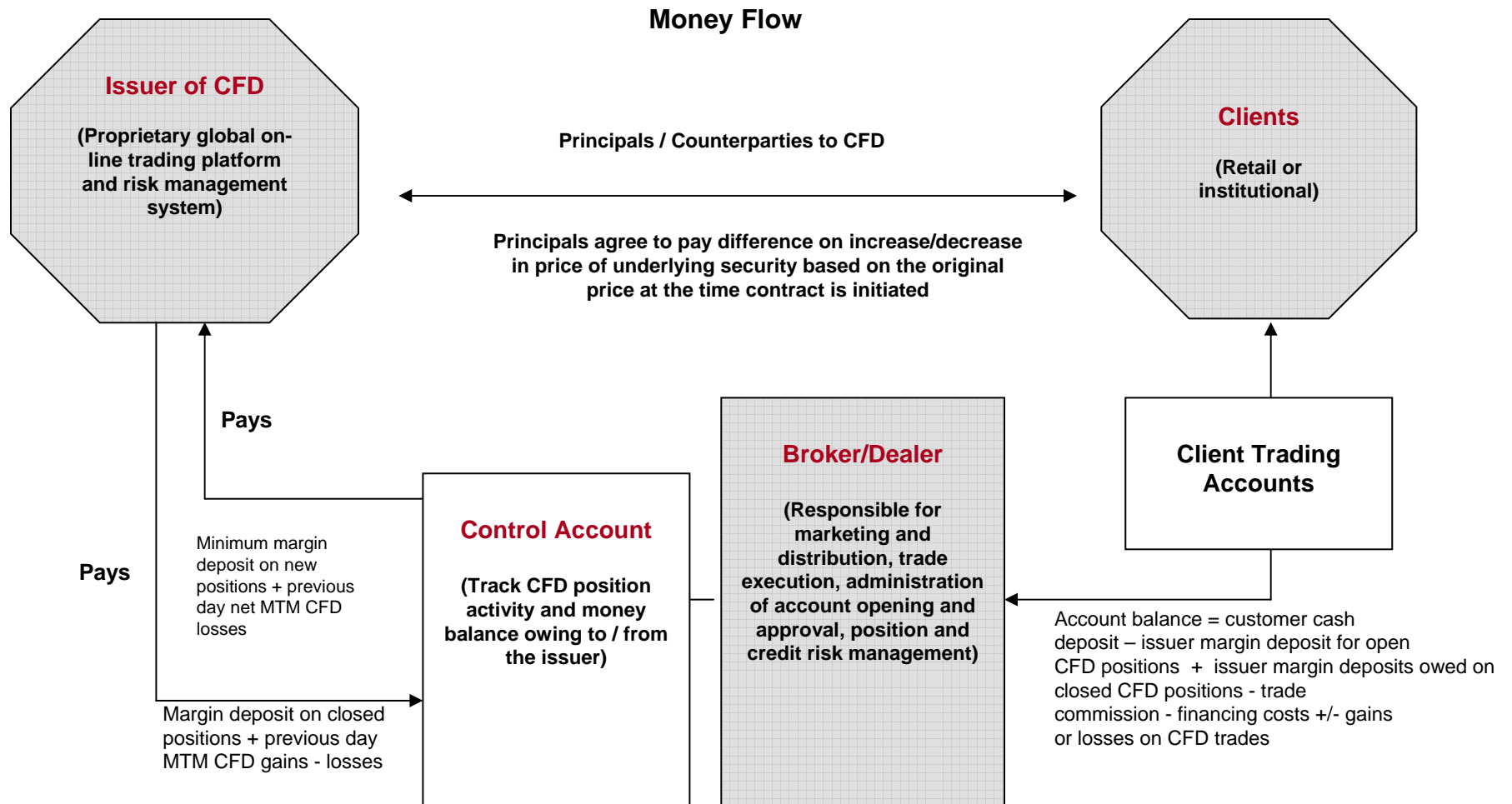
Note: Cumulative CFD profit and loss based on rollover of the contract over 3 business days.



# CFD Issuer – Broker – Client Interrelationship



# “White Label” Business Model





## IDA Margin Rule for CFDs

- ◆ Margin requirement for any swap transaction is to apply the IDA margin rate applicable to the underlying security position
- ◆ For TSX (and US major exchanges) listed equities – IDA adopted the Bourse margin rules for single equity futures contracts
  - floating margin rates
  - floor minimum rate of 15%



## CFD Risks

- ◆ Issuer payment default
- ◆ Price gapping - May not be possible to get out at the stop loss price if the market has gapped (unless it the stop loss is “guaranteed” by the issuer)
- ◆ Liquidity or price volatility of the underlying may increase loss by making it difficult to close out existing CFD positions.



# CFD Regulatory Business Case Requirements

- ◆ Trading system must have the following
  - Generate minimum regulatory books and records
  - Real time trading environment
  - Credit and position risk management controls
  - Computer environment controls
- ◆ IDA prescribed minimum margin rates apply for client open CFD positions
- ◆ Clients must meet and maintain regulatory margin at all times
- ◆ Issuer of CFD must qualify as an AI or RE or dealer will incur capital charge for open contract CFD client margin deposited with the issuer
- ◆ Excess client margin held with the issuer is subject to capital charge unless transferred back to the dealer by the next day.



## CFD Regulatory Business Case Requirements

- ◆ Risk disclosure statements and client suitability waivers must be in a form acceptable to the IDA
- ◆ Policies and procedures to set credit limits and monitor individual cumulative loss
- ◆ Prohibit CFD trading by clients that are “insiders”
- ◆ Limit open CFD position for any client or related group of clients to no more than 1/2% of the float of the underlying listed equity security
- ◆ Prevent money laundering acts by ensuring appropriate account opening procedures and account trading supervision



## Will OTC CFD Market Go Listed?

- ◆ Bourse introduced single stock futures contracts in 2001
- ◆ Nortel first contract traded until November 2004 when it was suspended and removed from active list of products on the Bourse
- ◆ Bourse abandoned introducing new single equity futures contracts
- ◆ Bourse may re-introduce single equity futures contracts
- ◆ Will the TSX introduce listed CFDs as part of their drive to develop derivative products?
- ◆ What are the benefits of a listed CFD – let's look to the ASX current initiative

## Topic 1: The ASX CFD Market

### Trading ASX CFDs

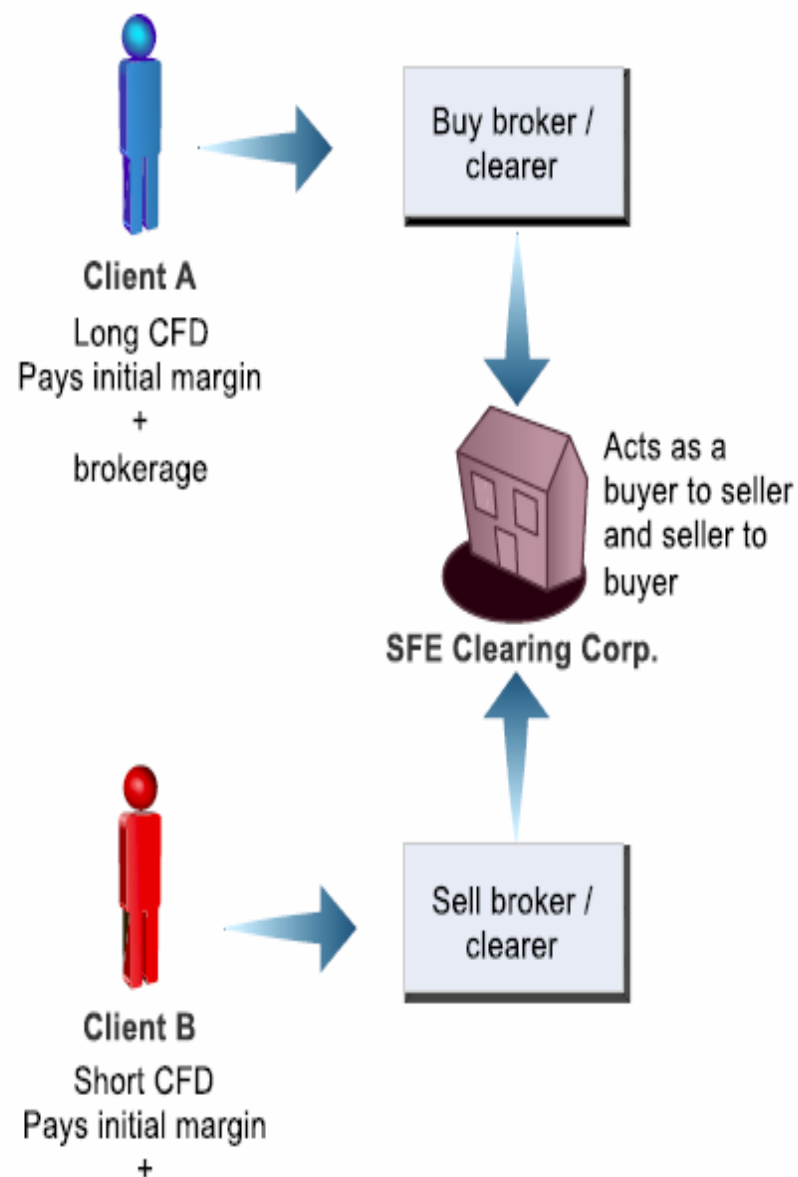
Traders of ASX CFDs can either:

- **Buy** - undertake a long transaction; or
- **Sell** - undertake a short transaction.

When you first buy (or sell) an ASX CFD it is called an *opening transaction*. If you then sell (or buy) an ASX CFD to cancel an existing bought (or sold) open positions, it is called a *closing transaction*. The market automatically recognises if a trade is an opening or closing trade.

Trading on SYCOM is **anonymous**, this means the identity of the buyer or seller is unknown to the market.

After the trade occurs the nexus between the two original contracting parties is broken through the process of **novation**. Novating contracts is where SFE Clearing Corporation (the Clearing House) becomes the buyer to the seller, and the seller to the buyer. SFE Clearing Corp. effectively becoming the counterparty for both buyer and seller.





# Advantages of Listed ASX CFDs

## Price Transparency

- ◆ All prices and market depth are fully transparent in the ASX CFD order book and ensures ASX's statutory obligation to conduct fair, orderly and transparent markets. OTC markets do not have this obligation.
- ◆ Designated market makers bring liquidity to the ASX contracts.

## Exchange Independence

- ◆ ASX, as issuer of the CFDs, does not take a position in the trade. The ASX is not in conflict with the client
- ◆ ASX ensures all trades are executed on a strict price/time priority. Price/time priority means the first person to enter the best price is traded against first.



# Advantages of ASX CFDs

## **Greater Investor Protection**

- ◆ CFD advisers must complete an ASX CFD accreditation program. This ensures they have achieved acceptable standards of knowledge of ASX CFDs.
- ◆ Counterparty risk is transferred to the clearing house (SFE Clearing Corporation) and the performance of the trade is guaranteed by SFE Clearing Corporation.
- ◆ All margin requirements are calculated by SPAN.
- ◆ SFE Clearing Corporation's clearing & settlement facilities are recognized and supervised by applicable regulatory bodies in Australia.