Contracts for Difference (CFDs)

The Australian Securities and Investments Commission (ASIC) has released quite a bit of information about CFDs. ASIC has also issued some warnings about their unsuitability for inexperienced speculators.

CFDs were initially developed in the UK for use by professional speculators. They have been available in Australia for a while now and have unfortunately been advertised to inexperienced speculators. CFDs are totally banned in the US.

ASIC's guide to help investors understand CFDs, and to assess the risks in using CFDs as a vehicle for speculation, may be downloaded at www.fido.gov.au

CFDs are a derivative product. "Derivative" means that when buying a CFD, we are not buying the stock or other financial security on which the price of the CFD is based. Instead we are making a bet with the CFD provider – if long, that the price will go up; if short, that the price will go down.

CFDs are not like an ordinary bet at the races. There, we can only lose what we wager, but may win many times the wager. With CFDs, we can also win many times the margin we put up, but the losses are also not limited. If our bet goes against us we could very quickly lose all of the margin we put up and much more. This is because the margin is only a surety we post, it is not the limit of our risk.

There are three key types of risk involved in CFDs:

1. **Leverage** – even a slight price movement can result in the amount lost being greater than the margin posted. In this case the speculator must deposit more margin with the CFD provider. If there is undue delay in doing so, the position may be closed by the CFD provider and the speculator must cover the losses incurred to that point.
2. **Counterparty risk** – this is industry jargon for saying that a CFD is only as good as the company that sold the CFD. If the provider goes belly up, the speculator may lose everything gained on CFD positions.
3. **Client Money risk** – Money deposited with a CFD provider is not covered by the National Guarantee Fund as may be the case with speculating in stocks on the ASX through a stockbroker (even when a stockbroking firm provides the CFD). If something goes wrong with the CFD provider, clients may lose some or all of their deposited funds.

ASIC strongly believes that CFDs are only suitable for experienced speculators. This experience should have four attributes:

1. **Experience** – successful day-trading of stocks and/or successful short term speculation in options, futures or other derivative securities. This experience should include periods of high volatility in prices.
2. **Knowledge** – about how CFDs work and how the trading platform to be used operates. There can be some quite tricky aspects and in a high pressure environment, the CFD speculator may have very little room for hesitation. Mistakes can be very costly.
3. **Risk control** – proven trading methods backed up by strong money management and use of stop-loss orders.
4. **Financial capacity** – sufficient reserves to cover losses that are unavoidable from time to time in any trading method.

Note: CFDs would not normally be used by investors because of the costs. However, experienced investors might use them for short-term hedging of a portfolio by shorting a CFD on stocks held in the investment portfolio. This is because shorting the stocks themselves is not easy in Australia for retail investors. Also *because naked shorting is banned and any shorting allowed must be covered by borrowing the stocks from lending services at a fee.*

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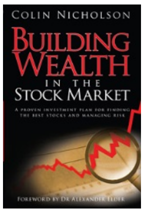

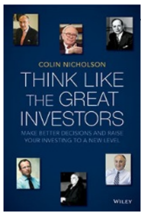

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