Contracts for Difference Product Review

Findings and recommendations

The Netherlands Authority for the Financial Markets

The AFM promotes fairness and transparency within financial markets. We are the independent supervisory authority for the savings, lending, investment and insurance markets. We promote the fair and conscientious provision of financial services to consumers and retail investors, as well as professional and semi-professional parties. We supervise the fair and efficient operation of the capital markets. Our aim is to improve consumers' and companies' confidence in the financial markets, both in the Netherlands and abroad. In performing this task, the AFM contributes to the stability of the financial system, the economy and the reputation and prosperity of the Netherlands.

Table of Contents

Summary

Contracts for Difference

This report present the findings of the review of Contracts for Difference (CfDs)[1] that was performed by the AFM in the period starting from the autumn of 2013 until the end of 2014. CfDs are used for investment purposes. A CfD is a contract between a provider (a financial institution) and an investor, in which it is agreed that the price difference of certain underlying value(s) (when compared with the initial price) is to be settled between the two parties. The underlying value of the contract is known, and there is a broad range of underlying values available in the market. In order to conclude such a contract, the investor is required to deposit an initial amount. The amount of this deposit is a percentage of the value of the underlying value, and is referred to as the margin.

The main characteristic of a CfD is that, by using the leverage principle, an investor makes an indirect investment in an underlying value. The potential loss sustained by investors is often not limited to the initial deposit, and that means that investors may lose more than their deposit.

Summary of the findings

The findings of the AFM's review confirm the view that CfDs are high-risk and complicated products that are only suitable for investors with sufficient knowledge, experience, risk tolerance and capital. Risk tolerance is a particularly important condition; this is confirmed by a review by the French supervisor.[2] This review shows that the large majority of investors in CfDs sustains a loss. Complex aspects, such as the leverage effect and the spread, are difficult to understand and are not always clearly explained in advance. Where necessary, the AFM confronted some of the providers of CfDs related to these observations, and they have improved their provision of information.

Furthermore, many providers do not offer the possibility to implement protection against residual debt in relation to a selected CfD position, while the AFM does consider this desirable. The aforementioned characteristics of CfDs mean that it is even more important for providers to make a major effort to address and accept in a more targeted manner those investors who have sufficient knowledge and experience and who are willing to take risks. This is contrary to the finding of the review that CfDs are often marketed in an aggressive manner, focusing on a broad target market. The AFM

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[1] A CfD qualifies as a financial contract for settling differences as included in Section 1.1 financial instrument under i as part of the definition of a financial product in the Financial Supervision Act (Wft).

[2] The Autorité des Marches Financiers (AMF) published an review report on 13 October 2014 entitled 'Study of investment performance of individuals trading in CFDs and forex in France'. This review showed that an average of 89% of investors sustains a loss on a CfD investment and that average loss amounts to €10,887 (median - €1,843). Considering that the product in France does not differ from the product that is offered in the Netherlands, there is no reason to assume that the findings of this review would not be applicable to the Dutch market.

considers that this is undesirable, because CfDs are only suitable for a very small target market.

The AFM shared these findings on an individual basis with the providers involved in the review. Most providers indicate that they agree that CfDs are not suitable for every type of investment or for every type of investment objective. The AFM encourages providers to structure the provision of information and client on-boarding policy accordingly. So far, only one provider has indicated that it would do so. The fact that the other providers do not fall under AFM supervision and the statutory powers are consequently limited, means that the AFM has not been able to enforce improvements in client on-boarding policy at these parties. The AFM concludes that several providers do not comply with the applicable European rules to a sufficient extent. The AFM considers this situation to be a cause for concern, and it intends to address this matter at a European level.

Structure of the report

This report follows the review and is structured as follows. Chapter 1 explains what CfDs are and how these products work. Chapter 2 deals with the main risks of CfDs. Chapter 3 subsequently provides further information concerning the AFM review, and Chapter 4 subsequently discusses the findings of the review. And finally, Chapter 5 describes the action that has been taken as well as the recommendations that have been formulated pursuant to the review.

1 How CfDs operate

1.1 How the product operates

Contract

A CfD is a contract for settling differences between two parties: the investor and the provider. This contract contains agreements about when which party pays an amount to the other party. The amount that must be paid as part of each contract depends on the price development of an underlying value (for example an exchange rate such as the EUR/USD or an index such as the AEX). An example of a CfD (long[3]) in an index has been included for clarification:

> The underlying value of *index ABC* is currently at 400. The investor concludes a contract (long) for 100 items.
>
> (i) Index ABC then drops to 390. The difference with the original price is -10 (390-400). As an investor you are obliged to pay the other party 1000 (100*10).
>
> (ii) Index ABC then increases to 410. The difference with the original price is +10 (410-400). As an investor you receive 1000 (100*10) from the other party.

In order to be able to conclude the contract, the investor has to pay part of the underlying value immediately into an investment account. The provider of the contract has a claim against this account. The provider is allowed to appropriate the necessary amount from this account if the price of the underlying value develops unfavourably.

Margin

The amount of money maintained in this specific account is also referred to as the margin. The margin is always a percentage of the price of the underlying value. This is a low percentage in most cases. The provider determines the minimum percentage for each underlying value that must be maintained in the account (margin requirement).

Leverage

A leverage effect is created as the investor invests only a small amount but is exposed to a higher value. Applied to the example:

[3] *A long position speculates on a price increase of the underlying value when compared with the original price.*

At a certain moment index ABC has a price of 400. The investor concludes a contract (long) for 100 items. In the event of a direct purchase, this would cost €40,000 (€400*100). In the case of a CfD with a margin requirement of 10%, the investor only has to deposit €4,000 (10% of 40,000) into an investment account.

(i) In the event that index ABC drops to 390, the investor pays €1,000 to the provider (see above). That is a loss of 25% on the investment (1,000/4,000).

(ii) In the event that index ABC increases to 410, the investor receives €1,000. That is a profit of 25% on the initial deposit (margin).

In the case of a direct investment in index ABC, the profit and/or loss would only be 2.5% (1,000/40,000). The difference between these percentages is caused by the CfD's leverage effect.

As demonstrated by the example above, the leverage effect can cause a quick increase in the profit – but also the losses. If the price develops unfavourably, the investor will no longer comply with the margin requirement. The investor is then required to deposit additional money into the investment account. If the provider demands that additional money be deposited into the investment, this is referred to as a margin call. If the margin requirements are not satisfied, the provider has the right to decide to close the investor's positions. It is not mandatory to close out the position. It may therefore be the case that the investor loses more than the deposit (margin) in the case of a very unfavourable price development, for example if the value of the underlying investment changes quickly. In such cases, the investor will be obliged to comply with the contract, and must therefore pay the difference between the value of its deposit and the obligations contained in the contract. The investor will sustain a residual debt if these obligations exceed the margin that is maintained.

Margin call

Index ABC currently has a price of 400. The investor concludes a contract (long) for 100 items. The margin requirement is 5%, which means that the investor has to maintain at least €2,000 (5% of 100*400) as margin. The value of index ABC drops to 390, which is a decrease of 10 or 2.5%. In the event the contract is closed, the investor would become obliged to pay 1,000 (100*10) to the financial institution. The margin amounted to €2,000, which is a sufficient buffer to pay for this.
The only problem is that in this situation the margin dropped below the required 5%. This means that the investor will have to supplement the margin or close the position.

This leverage effect caused by the margin is typical of CfDs. The margin requirements differ per provider and also per underlying value. If the margin requirements are low and the underlying value is volatile, there is a significant chance that, in the case of major changes in the prices, your margin will not be sufficient to deal with the losses. That means that, in the case of low margin requirements and volatile investments, there is a higher chance losing the entire deposit, or more. The increased chance of sustaining a loss is caused by the margin requirement[4]. Having a margin requirement impacts the probability distribution. It could be compared to placing a knock-out level. The impact thereof on the distribution of probability of returns has been demonstrated by the AFM in the report on leveraged products. The difference between CfDs and turbo is that the settlement of the residual value is performed in a more transparent manner.

[4] *Incidentally, the same applies to placing a stop-loss order or a guaranteed stop-loss order.*

2 Main characteristics of a CfD

This chapter discusses the main characteristics of a CfD. These are:

- the leverage effect
- the financing costs
- the spread
- the type of orders that can be placed

These characteristics are discussed below.

2.1 Leverage effect

As explained in the first chapter, the leverage effect is a typical characteristic of a CfD. This leverage effect is created because the investor is required to maintain only part of the invested amount in a separate investment account (margin). A price increase or decrease of the underlying value leads in terms of percentage to more or less profit when compared to a direct investment in the underlying value (see Chapter 1 for examples).

One of the areas in which providers distinguish themselves is the minimum margin that must be maintained in order to be able to conclude a CfD. This results in the following: the lower the margin, the higher the potential leverage effect.[5]

2.2 Financing costs

Adopting a position by means of CfDs is comparable to financing a larger position (a direct investment)) using borrowed money. Similarly, the provider of CfDs charges financing costs for maintaining a CfD position. These financing costs are often a percentage on top of the applicable market value (for example Euribor), whereby the surcharge is between 2%- and 3%-point on average. In the case of a CfD short position[6], the investor actually receives an interest payment (provided the market value is high enough) that is equal to the market value less a percentage. This interest is calculated on a daily basis for positions that remain open "overnight". No financing costs have to be paid for positions that are only maintained during the day and that are closed before the market closes. Financing costs constitute one of the sources of income in the business model for offering CfDs next to the income from spreads (see below).

2.3 Spread

CfDs have a quote with both a bid and ask price. The difference between the bid and ask price is referred to as the spread. It is important to be aware that the spread is always calculated on the total position (including the leverage effect). This means that the spread as a percentage is relatively high in case of a lower margin.

[5] *The margin is inversely proportionate to the leverage effect. The leverage effect is 20 (1/0.05) in the case of a margin of 5%.*

[6] *A short position speculates on a price decrease of the underlying value when compared with the original price.*

The costs of the spread can be significant. The average spread for a provider of certain index CfDs was, for example, equal to 0.05%. This provider offers index CfDs with a minimum margin of 0.5% or, in other words, a maximum leverage of 200. In that case, the costs as a percentage of the margin that has been deposited are equal to 0.05 times the leverage effect, not taking into account any additional costs. This is shown in the table below. The costs increase to 10% of the margin that was deposited in the case of a leverage effect of 200. This means that a total of 10% of the deposit is spent on costs for opening and later closing the position.

Margin	10%	2%	1%	0.5%
leverage	10	50	100	200
Cost underlying	costs (spread) as % of the margin			
0.05%	0.5%	2.5%	5%	10%

The spreads are wider for CfDs with respect to individual shares. In certain transactions a fee is charged as well. The minimum margin for CfDs in respect of shares is also higher and the maximum leverage is lower than in the case of index CfDs. Assuming a spread of 0.25% and a fee of 0.1%, the total costs for opening and closing the position are 0.25% + (2 x 0.1%) = 0.45%. In the case of a maximum leverage of 33, the costs as a percentage of the spread may increase to 15% of the margin that was deposited.

Margin	20%	10%	5%	3%
leverage	5	10	20	33
Cost underlying	costs (spread + fee) as % of the margin			
0.45%	2.3%	4.5%	9.0%	14.9%

Costs (spread + fee) concerning individual shares

2.4 Order types

Several different order types can be placed in the providers' electronic trading environment. The main order types offered are:

- *Market order*: buy/sell against the next bid/ask price;
- *Limit order*: buy/sell against the next bid/ask price until the price has reached a certain limit. These orders may have a definite or indefinite term ('Good-till-cancelled').
- *Stop-loss* or *Take-profit order*: a market order whereby a position is closed (by means of a market order) if the loss on that position reaches a certain level (stop-loss level) or if the profit reaches a certain level (take-profit) defined on the basis of the price at which the order was placed;

- *Trailing Stop-loss order*: a stop-loss order whereby the level at which the position is closed increases as the position becomes more profitable[7]; and
- *Guaranteed stop*: a stop-loss order whereby it is guaranteed that the position is closed at the level of the order so that there can be no slippage (in the case of a normal stop-loss order the position is closed by means of a market order, but the next price may be worse than the stop-loss level).

Order types that occur less frequently include *Market-if-Touched*, *One-Cancels-the-Other* and *If-done*.[8]

Some order types result in a gap risk: the risk that the price of an underlying asset surpasses the level of an order that has been placed. This implies that the order is carried out at a less advantageous level. This loss sustained by the investor is referred to as 'slippage'. A guaranteed stop-order provides protection against the above. Only one provider at the time of the review offered this type of order. Currently there are more providers that offer guaranteed stop-loss orders. These types of orders require additional payment because the gap risk continues to exist, but it is now for the risk of the provider.

2.5 An account

Maintaining an account with a CfD provider is free of charge, because the provider profits from the transactions by means of the spread, the financing costs and any fees. Inactive accounts (no open positions and no transactions) are sometimes subject to penalties. A condition that is often applied is that a certain amount, for instance an amount of $5 a month, is deducted from the account following 3 months of inactivity. Additional costs are sometimes charged for access to certain markets or additional facilities for technical analysis or fundamental analyses.

2.6 Underlying values

The AFM encountered roughly five types of underlying values during its review. These types are:

- Indices;
- Shares;
- Commodities;
- Forex (currency); and

[7] *A trailing stop-loss order applies, for example, if a long position is opened at price 10 with a trailing stop loss of 1 so that the initial stop-loss level is 9. If the price now increases to 12, the trailing stop-loss level will increase along with it, to 11, in order to protect part of the profit that has been realised.*

[8] *Market-if-touched: a conditional order that changes into a market order as soon as the price reaches a certain level determined in advance;*

One-Cancels-the-Other: an additional order on top of two other orders that indicates that if one of the two is carried out, the other order is cancelled;

If-done: a generic order type whereby an order determined in advance is placed as soon as a specific condition is met (for example, placing a limit order to purchase a CfD in respect of underlying A for price X if the price of share B has increased to level Y);

- Bonds.

There are also CfDs for more 'exotic' underlying values, such as ETF's, forwards, interest and inflation indicators and the VIX, which is a volatility indicator.

3 Review of the CfD market

3.1 Reason for the review

The European Securities Markets Authority (ESMA) warned retail investors at the end of 2011 for the large risks involved in CfDs and other currency derivatives. The AFM placed this warning on its website.[9] According to ESMA, CfDs are not suitable for retail investors, because the losses may exceed the deposit. Moreover, it concerns investments in markets that are very volatile and originally intended for professional investors. ESMA also expressly warned investors in 2011 not to install software offered on digital platforms. This software could cause investors to lose control of the transactions performed by them, because they transferred responsibility for transactions to the software.

In February 2013, ESMA – this time in cooperation with EBA (European Banking Authority) – again issued a warning against CfDs.[10] ESMA observed that the financial crisis was resulting in historically low returns on traditional investments and savings accounts. ESMA and EBA concluded in this context that advertisements of CfD providers were focusing on inexperienced retail investors. Potential profits are not placed in their proper perspective as a result of the fact that the considerable risks are not mentioned. This means that retail investors looking for high returns are choosing CfDs more quickly than before. This is undesirable, because the product is only suitable for professional investors or retail investors with a great deal of experience.

The AFM published the 'report on leveraged products'[11] (a report on the review into turbos, speeders and sprinters) in September 2013. Providers of turbos decided, in consultation with the AFM, inter alia to limit the product offer and to no longer offer products with a very large leverage effect. The report that was issued following the review states:

> *The AFM also takes the view that providers of other investment products such as CfDs, options and futures that add little or no value for investors should also reassess their product offerings. The considerations mentioned in this report could contribute to a good analysis of these products as well. The AFM will certainly encourage the providers of these products to conduct this type of analysis as well.*

One reason why the report on leveraged products refers explicitly to CfDs is the overlap in characteristics between the two products. Within the context of a level playing field, it was decided to further assess the CfD product . The leverage effects for CfDs with shares as underlying value are generally lower than the average leverage effect of turbos. However, the leverage effect of CfDs with forex as underlying value are generally many times higher than the average leverage effect of turbos.

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[9] *http://www.afm.nl/nl/nieuws/2011/dec/esma-waarschuwing-beleggers.aspx*

[10] *http://www.esma.europa.eu/news/ESMA-and-EBA-warn-investors-about-contracts-difference*

[11] *The report on leveraged products, AFM, July 2010, http://www.afm.nl/~/media/Files/rapport/2013/hefboomproducten.ashx'*

A further reason for this review was that the AFM observed an increase in the number of providers of CfDs, and that the marketing of these providers was also increasing in scale.

The AFM will continue to monitor the extent to which the market for leveraged products is fair and transparent. Institutions will be held accountable when actively offering undesirable products or when actively marketing products to a wrong target market.

3.2 Description of the market

The AFM review shows that there are many players active in the CfD market. In addition to investors (there were some 18,000 active clients in the Netherlands by the middle of 2014), there are also providers and brokers. Providers and brokers can also act as market makers and in that case offer investors the opportunity to trade in CfDs. There are also several providers that offer a white label programme. Such a programme allows other companies to offer CfDs, while using the infrastructure of the underlying broker. In that case the investor runs the counterparty risk towards the intermediary broker, who may be less creditworthy than the more professional and financially-strong underlying broker.

All providers of CfDs offer their products via the internet. CfD brokers use electronic trading platforms for trading CfDs. Investors can place orders (in other words, they can trade) on these platforms. There are brokers who have their own platform, but there are also platforms that can be used by several brokers. These separate platforms often have functionalities for both desktop software, web applications and a mobile site or application.

There are only a few large players active in the Dutch market of CfD providers; there are several medium-sized players and a large number of players who have a relatively small market share. Most large and medium-sized providers of CfDs are active in several countries (on the basis of a European passport). In some cases, the provision of information of these providers is adjusted to the country where the offer is made. This means that there are several Dutch websites operated by foreign providers. Several smaller players are only active in the country of origin. When the review commenced, there were three Dutch players active in the market. These three players were under direct supervision of the AFM. During the review, two of the providers indicated that it cease its operations in the Netherlands, and these have ceased in the meantime. Therefore, the majority of providers in the Netherlands comes from abroad; these providers are active here on the basis of a European passport.

Investors are informed about the operation of the product via the providers' websites. In order to familiarise investors with the CfD product, nearly all providers offer a demo account that can be used by investors to practice trading in CfDs. The information about the platform and its operation is very limited, however. There are also providers of CfDs who offer investors the opportunity to obtain more information by attending seminars or webinars.

Finally, there are providers who offer investors the opportunity to link an automatic transaction to the trading platform on which CfDs are traded. This allows investors to copy transactions of other investors or trade on the basis of signals, and these transactions can then be performed automatically. This type of automatic trading conflicts with the need on the part of investors to continuously monitor their positions.

3.3 Statutory framework

A CfD qualifies as a financial instrument.[12] Offering CfDs is therefore subject to rules.

A provider requires an AFM licence or a European passport from a foreign supervisor in order to be allowed to offer CfDs in the Netherlands[13]. Although Dutch providers of CfDs are required to comply with the rules of conduct concerning, for example, the provision of information[14], not all rules of conduct apply to them. For example, the product development standard[15], on the basis of which a provider is obliged to take the interests of consumers into account when developing its product, does not apply to these providers.

Most of the providers that are active in the Netherlands operate here on the basis of a European passport. They come under the supervision of the home supervisor. If they do not have a branch office in the Netherlands, they are not required to comply with the rules that apply with respect to the provision of information in the Netherlands[16]. The product development standard does not apply to them either. European passport holders are supervised by the supervisor that issued their passport, and the AFM has regular contact with these supervisors.
As a result of the matters set out above, the AFM's supervisory powers with regard to the providers of CfDs that currently operate on the Dutch market are therefore limited.

3.4 Structure of the review

The AFM commenced the review into the CfD product, its characteristics and the market, at the end of 2013. Before the start of the review meetings with product experts and providers took place. In addition, the websites of twenty providers were assessed as regards the product offer and the provision of information concerning the products (including the contractual conditions). The review also focused on the marketing materials of the providers, to the extent that these were available. This review did not make a distinction between the providers that operate from the Netherlands or providers that are active here on the basis of a European passport. The random sample contains three providers that operate from a branch office in the Netherlands. One of these parties indicated that it would stop offering CfDs before the

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[12] As included in Section 1.1 under the definition of a financial instrument under i, (financial contract to settle differences) in the Financial Supervision Act (Wft).

[13] Sections 2:96 – 2:98 Wft.

[14] Sections 4:19, 4:20 Wft

[15] Section 32 Decree on Conduct of Business Supervision of Financial Undertakings under the Wft (Bgfo)

[16] Section 4:1(2) Wft.

exploratory phase of the review had been completed. Another party later indicated that it would cease its CfD-related activities in the Netherlands, inter alia as a result of little demand. The other parties operate in the Netherlands on the basis of a European passport.

During the second phase of the review, the providers were notified, where possible, and the specific findings were shared with these parties. However, it seemed not possible to notify all foreign providers. The providers that were not notified can be characterized by their multiple trade names and that they provide limited information on the product and their recruitment communications have a strongly promotional character. A couple of parties in the sample did not qualify as CfD provider or broker. These parties referred potential clients on to another CfD provider. These parties that refer clients to other providers are also called affiliates (see also below). The client on-boarding process was, after all, being performed by the ultimate CfD provider. This ultimate provider was notified during the second phase of the review. provide.

All notified providers during the second phase responded in writing and indicated the areas in which they would be implementing changes. These changes mainly concern the provision of information, and in several cases it concerned the provider's on-boarding policy.

4 Risks of the product

4.1 The contractual exclusion of the possibility of a residual debt is a best practice

The AFM considers the main danger of CfDs to be the fact that investors run the risk of losing more than the initial deposit in an unforeseen manner. Most providers have included a 'best efforts' principle in the conditions, in which they indicate that they will close outstanding positions if a certain limit is reached. At the start of the review there was only one provider in the market who guaranteed that it would close the position so that the investor would not be left with a residual debt. This provider has ceased its CfD-related activities in the Netherlands.

In the terms and conditions of twelve of the twenty investigated providers indicate that it is possible that the investor may be obliged to pay more than the initial deposit (the margin requirements). This implies that it is possible that investors will be left with a residual debt. Fourteen of the twenty providers indicate that they have a close-out procedure. This means that the positions of the investor are liquidated if the margin requirement drops below a certain minimum percentage. Two providers have indicated that they have this option, but that they are not obliged to actually close an investor's position. Because of such non-committal formulation, or in cases of slippage, it is possible that positions will not be closed in a timely manner, that the losses for the investor will continue to increase, and that the investor will be ultimately left with a residual debt to the provider. Several other providers have indicated, at their own initiative, in the meantime that they would ensure that the investor cannot be left with a residual debt.

Investors can also limit the possibility of a residual debt by placing stop-loss orders. There are four providers who even offer guaranteed stop-loss orders (see below). These orders cost more than regular stop-loss orders. The difference lies in the fact that an investor is protected against slippage in the case of a guaranteed stop-loss order.

4.2 The product risk is increased by the extent of the leverage effect

The leverage effect increases the risk (volatility) of the underlying value. This implies that in the event of changes in the price of the underlying value, not only the potential profits but also the potential losses are increased.

The volatility of an underlying value combined with the leverage effect means that the value of the CfD can change very quickly and very significantly. It is therefore important that an investor continuously monitors its position. It may be necessary that an investor is required to take immediate action, for example by depositing additional margin or closing the position.

As was demonstrated by the AFM in the review into turbos[17], the distribution of probability of the potential return of leveraged products changes as a result of adding a stop, guaranteed stop or a trailing stop order, for example.[18]

Providers of contracts with a comparable underlying value (such as the USD/EUR) often do impose different minimum margin requirements. This means that the maximum leverage effect may differ per provider. On average one could conclude that the higher the leverage the higher the chance of a loss.

4.3 Slippage is a risk when closing a position

It is possible that the price of the underlying value 'moves' so quickly at the moment an investor places an order to close the position that it is impossible to perform the order against the desired price. The order will then be carried out against the next available price. This process is also referred to as 'slippage'. This can lead to losses that are larger than desired, for example in the case of stop-loss orders. The risk is larger if a position is maintained overnight: the provider will not close the position if the underlying stock exchange is closed at night, while developments during the night can lead to very unfavourable price leaps when the stock exchange opens the next day.

In the case of a guaranteed stop-loss order, the order is carried out against a price agreed in advance. There is therefore no slippage. These orders are more expensive, however, because in such cases the risk of slippage is for the account of the provider. At the time the review was performed, this type of order was offered by only one provider. There are now several parties that, at their own initiative, are offering guaranteed stop-loss orders.

4.4 CfDs always involve a counterparty risk

If you invest in CfDs as an investor, you conclude a contract with another party for each CfD. This contract obliges both parties to pay the difference in the price development at the moment it develops unfavourably for this party. As with any contract, the investor then runs the counterparty risk or, in other words, the risk that the other party is unable to comply with its obligations. The other party is often a provider of the CfDs because the investor is usually only able to trade with the provider directly and not with other investors on the same platform.
Investors should therefore establish carefully who their counterparty is, and providers should also clearly inform investors that CfDs involve a counterparty risk. This implies that if the other party is unable to comply with its obligations (for example in the case of bankruptcy), it is possible that the investor will lose all of its investment.

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[17] *http://www.afm.nl/~/media/Files/rapport/2013/hefboomproducten.ashx*

[18] *There are also limit orders (taking profit). We do not consider this to be a risk, but for the sake of completeness, we are pointing out the fact that this possibility exists.*

4.5 The costs of the product by means of spreads are difficult to compare

CfDs are traded on the platforms owned by the various providers. The fact that the prices against which contracts are concluded are not registered centrally makes it difficult for investors to compare which provider offers the best spread. The costs of CfDs are often not stated on the providers' general websites. It is therefore not easy for potential investors to compare the costs of the various providers during the orientation phase.

5 Findings

This chapter sets out the main findings of the review into CfDs. The findings are divided by:

- the provision of information;
- the providers' on-boarding policy;
- marketing.

5.1 Provision of information

Providers provide insufficient information concerning the operation of the product
The information about CfDs is provided in all cases via the provider's website. The information about the operation of the product that can be found here is generally insufficient. The majority of the providers had provided no clear information, or in some cases no information *at all,* concerning the operation of CfDs. There were also two providers that described only the positive scenarios. These providers did not explain the impact of a negative movement of the underlying value on the product. Only four providers provided a sufficiently clear explanation about the product.

The risks of the product are not described adequately
The providers' description of the risk factors is insufficient in most cases. This description is often contained in a separate document. This document must be signed by the investor when applying for an account or the investor must declare that it had read this document. Most risk descriptions explain that the investor may lose more than the deposit. Three investors did not include this risk, while this was a possible risk. Many providers do not inform potential investors that CfDs are not suitable for certain investment purposes such as pension or income. Other important risks that are not described include the fact that the investor does not become the owner of the underlying value, and the investor runs the counterparty risk in relation to the contract. The risk factors are not described sufficiently clear, with the exception of one party.

Information concerning costs is difficult to compare between providers
All providers provide information concerning the costs. However, this information is not complete in some cases and clients are referred to the platform for further information. For example, information about the costs of the spread (and the fact that this spread is calculated on the entire position) is not provided by most providers. This implies that this information cannot be compared by the investors in a simple manner. The providers refer to the information provided on the platform for a full overview of the costs.

The target market is not specified
Only three providers had included clear information on their website concerning the intended target market. The AFM considers this to be disappointing, because the high-risk characteristics of the product mean that providers must be very clear in this context. The other providers limit themselves to reporting the risks or by communicating that it involves a high-risk product and therefore not suitable for all

types of investors. As indicated, it is often not stated that the product is not suitable for all investment purposes.

5.2 The providers' client on-boarding policy leaves a lot of room

The providers' websites do not show the on-boarding criteria that apply for new investors prominently. There is a limited number of providers that indicate explicitly that they are targeting experienced investors with a very high risk profile.

The client on-boarding policy of the providers is inconsistent. It may consist of completing a questionnaire or signing the conditions. It is not known whether all providers perform checks on whether the characteristics and experience of the investor correspond to the target market for which the product could have added value. There is no evidence that providers do not fulfil the requirements of testing the knowledge and experience of potential investors.

As explained above, it is very important that the CfD target market has sufficient knowledge, experience, risk tolerance and capital. It is therefore undesirable that providers accept investors with very limited knowledge, experience and income. Almost all brokers do not exclude the possibility that they are accepting investors even when they do not satisfy the criteria. One broker indicated during a meeting with the AFM that the mandatory risk warning did change depending on the investor's score in the knowledge and experience test. In case of doubt, for example after failing the knowledge and experience test, the AFM considers that the provider should possibly personally contact the potential investor, but should also decide not to accept investors. It was not laid down in any policy that potential investors are not accepted if they do not satisfy the prescribed criteria.

5.3 Marketing

The market review clearly showed that providers use aggressive marketing to recruit new clients.

Bonus systems for introducing new clients are undesirable
Some providers use bonus systems. These systems offer investors an amount if they open an account with the relevant provider. These bonus systems occur in the form of a starting fee, an acquisition bonus or volume bonuses. The starting fee that is promised to an investor when opening an account often cannot be withdrawn from the account until a certain transaction value threshold has been exceeded. A starting fee is a bonus whereby an investor receives money in its own account if a new client is introduced who has exceeded a certain transaction value threshold.
Brokers also offer fees to affiliates for sending new investors to their brokerage. These affiliates are often websites operated by bloggers and "gurus" who write about CfDs. Following an enthusiastic story about the advantages about trading in CfDs, the reader is led to the broker's website, which pays the affiliate a fee if an account is opened and a minimum number of transactions are performed.

And finally there are the volume bonuses, which are offered less often and which are used to encourage the investor to perform many transactions. By performing many transactions the investor earns additional income for its own account, but this income cannot be withdrawn, however, until another large number of transactions has been performed.

Advertisements focus on the ease with which CfDs can be traded

CfD providers use advertisements on search engines and social media sites, such as Facebook, to create interest among clients regarding the ease with which CfDs can be traded. In addition, advertisements mainly emphasize the possible returns that could potentially be realised by means of a high leverage. In one case the possible returns on CfDs were even compared with the low returns on savings accounts without mentioning the difference in risk.

6 Actions taken and recommendations

The operation of the product CfD, its characteristics and the findings of the AFM's review were described in the previous chapters. This chapter explains, on the basis thereof, what action has been taken by the AFM pursuant to the findings and recommendations are made.

6.1 Actions taken

The generic findings described in the previous chapter were shared with seven providers. In addition, relevant specific findings were communicated separately to providers. These specific findings mainly concerned certain statements in the provision of information on the provider's website. Furthermore, a request for information was send with regard to their client on-boarding procedures.

There are several reasons why not all parties involved in the review were notified. Most of the parties involved in the review are supervised by foreign supervisors, and the AFM has not been able, in all cases, to notify these providers or to influence them. Characteristic of these providers is that they often have several trade names and the provision of information is mainly limited to aggressively promotional recruitment communications. There were also parties that were not providers of the product but acted as affiliates. In these cases we notified the ultimate provider.

All seven providers who were notified responded in writing. Six of the seven providers indicated the structure of their client on-boarding process in their responses. Four providers implemented changes in their provision of information pursuant to this feedback. The providers who did not do so subsequently provided the AFM with a clear and acceptable explanation regarding the reasons why the current communication is not misleading for (potential) investors. Many providers indicated that they agreed that the product is not suitable for every investor or for every investment purpose. However, the ultimate decision to invest in CfDs is the client's own. The client on-boarding process is structured in line with the above. This implies that a warning is often issued when a client does not satisfy the on-boarding criteria, but that the providers do not deny it access. One provider had already indicated during the first phase of the review that it would be stopping and another provider indicated that it would stop offering CfDs. These parties are no longer active in the field of offering CfDs.

6.2 Recommendations

CfDs are not suitable for *all investors*

CfDs are highly volatile investment products as a result of the leverage effect. Volatility increases as the margin requirements become lower. Similarly to the review into leveraged products, the chance of losses increases as the leverage of CfDs increases. There is a chance that the investor will be left with a residual debt. The characteristics of the product mean that the product is only suitable for very experienced investors who fully understand the risks. Investors must also be willing to run a significant risk and be able to bear the losses. This also implies that the investor does not need the money that has been invested for future financial obligations. The AFM considers that CfDs are high-risk products and therefore unsuitable for most investors. Providers should warn vulnerable investors thereof more explicitly.

A recent review performed by French supervisor AMF shows that more than 89% of the active CfD investors sustained a loss in the period from 2009 to 2013; this was a period in which financial markets showed a generally positive development.[19] This strengthens the image that CfDs are an unsuitable investment for the majority of the investors.

Providers should pursue responsible client on-boarding policy
The AFM sees similarities and differences between CfDs and other leveraged products, such as turbos, speeders and sprinters. An importance difference is that CfDs are traded on a separate platform and that the product concerns an individualised contract between the provider and the investor. The CfD provider determines which investors do or do not have access to their platform. In that sense, the provider also has the option to decide, with respect to each investor, whether the investor is part of the target market for which the product is intended. The AFM expects that providers will handle this responsibility in the appropriate manner. Providers could and should adjust their client on-boarding policy more in line with the matters set out above. A provider is not obliged to accept a client. It would appear that the chances of miscommunication and consequently foreseeable disappointments decrease by making the product only available to those investors that are part of the target market. The AFM therefore encourages providers to structure their client on-boarding policy in such a manner that the product only becomes available for investors who are part of the intended target market.

Marketing and the provision of information must focus on the target market
Investors also have a personal responsibility to establish whether CfDs should have a place in their investment portfolio. The AFM nevertheless wishes to emphasise in particular the major responsibility on the part of the provider of the product. Providers must take a very critical look at the applied distribution strategy with respect to CfDs. As stated, the product is only suitable for experienced investors who are aware of the risks inherent in the product and who are able to bear the (significant) losses. This should also be the starting point of the distribution strategy of CfD providers. They should draw more careful conclusions if a potential client does not pass a suitability test. Merely issuing a (mandatory) warning does not appear sufficient in this context. It is important that providers determine a clear target market for their product. Determining a target market is not only important for the client on-boarding policy described above, but it is also relevant for marketing. The provider of the product is responsible for aligning distribution strategy with the intended target market. It must be clear, from the marketing communications, for which target market the product is

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[19] *"Study of investment performance of individuals trading in CFDs and forex in France", see http://www.amf-france.org/technique/multimedia?docId=workspace%3A%2F%2FSpacesStore%2F9bf2caa8-1ce4-4832-85f4-4dffcace8644&famille=PIECE_JOINTE*

intended. Broadly deployed marketing (such as TV advertisements and banners via social media) is therefore not a suitable method. In addition, a prominent, warning that the product is not suitable for all investors is ‘a must’ for all advertisements.

In many cases, the provider's websites contained insufficient information concerning the operation of the product, the risks and the costs related to the product. A clear description is an essential condition for investors to be able to understand the product. If examples are used, it is also important to point out the negative scenarios instead of merely the positive ones.

The possibility of a residual debt is undesirable

The AFM considers the possibility of a residual debt to be an important risk of the product. There are several providers active in the market who protect investors against a possible residual debt. It is advisable to offer investors the opportunity to protect themselves against residual debt. This can be done by introducing for example the opportunity to place a guaranteed stop order or to amend the terms and conditions of the CfDs to ensure that the investor's will not be left with residual debt.

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