BUSINESS
WITH THE WALL STREET JOURNAL

Watchdog takes a swipe at derivatives

John Durie and Rebecca Urban | The Australian | June 10, 2010 12:00AM

CONCERNS that derivatives could be used to mask insider trading have prompted the corporate watchdog to announce a crackdown on the controversial trading tools.

Senior operatives from the Australian Securities & Investments Commission yesterday warned that more attention would be focused on derivatives, such as contracts for difference (CFDs), when it assumed the role of supervising the financial markets later this year.

ASIC is also expected to issue a discussion paper warning of the potential dangers of trading in CFDs, which have been criticised because of their complexity and serious financial risks to investors.

The move, which was announced by ASIC deputy commissioner Belinda Gibson following her speech to a stockbroking industry conference in Melbourne yesterday, could also be seen as a stab at the commercial interests of the Australian Securities Exchange, which is a major promoter of exchange-traded CFDs.

It also further highlights the conflict that has existed as a result of ASX's dual role as supervisor and operator of the markets.

ASIC is set to take over the supervisory function as early as August.

Ms Gibson said the commission would shortly issue a discussion paper warning of the potential dangers of CFDs.

These include a lack of transparency, the increased leverage involved and a lack of knowledge as to exactly who is the counterparty in any transaction.

She also noted that two insider trading cases currently before ASIC involved CFDs and that some people falsely believed that they could avoid scrutiny by hiding behind their use of derivatives.

Ms Gibson's comments were echoed by those of ASIC's market supervision chief, Greg Yanco, who warned that the commission planned to look more closely at derivatives and CFDs when it investigated potential cases of insider trading.

CFDs are an agreement between two parties to exchange the difference between the entry price and exit price of an asset, such as a share. They give the investor the benefits of owning a stock, without the need to invest in the physical share. The appeal is the potential for great profits. The risk, however, is unlimited losses.

Historically, the CFD market was largely the domain of technical traders. But intense volatility during the financial crisis has driven client numbers up.

CFDs were exclusively traded over the counter until 2007 when the ASX introduced listed exchange-traded CFDs on the top 50 Australian equities, key global indices and some commodities.

While the size of the CFD market is unknown, some estimates claim the products turn over more than $10 billion per month. However, exchange-traded CFDs represented only 7 per cent of all cash market trading on the securities exchange last month. Any suggestions that ASIC's plan was a move against the ASX were dismissed by a spokesman, who said the bulk of the CFD market was outside the exchange. "ASX already provides the types of checks and balances that ASIC wants to see provided across the whole market. The listed CFD market on ASX is the only CFD market that's fully regulated and transparent, already," said the ASX's Matthew Gibbs.

"ASIC's plans appear consistent with a broader movement by regulators around the world, since the GFC, to bring exchange-traded features -- transparency, counterparty risk management, regulatory oversight -- to the over-the-counter market, especially . . . derivatives markets."

The move has been broadly welcomed by the industry, including by the managing director of the Stockbrokers Association of Australia, David Horsfield, who noted that CFDs were a high-risk product for retail investors.

Barry Odes, the local head of major provider CMC Markets, conceded CFDs were "not for everyone".

"CMC Markets has a strong working relationship with ASIC, and has made a significant investment in compliance," he said.

"We strongly recommend that clients should have a good understanding of how the product operates and the risks associated with using it." The crackdown comes as a former equities dealer from Orion Asset Management is due to be sentenced on 25 insider trading charges relating to dealings with CFDs.

In a separate case, a former employee of Moody's Investor Services and an associate were recently charged with purchasing shares, warrants and CFDs using inside information.

ASIC is to get greater powers to investigate insider trading.