# Tutorial 4 Qn 3

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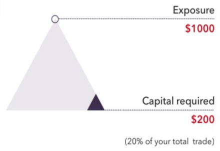
## Introduction of CFD

- A contract for differences (CFD) — a form of financial derivative
- It's an agreement between an investor and a CFD broker to exchange the difference in the value of a financial product between the time the contract opens and closes

| Advantages | Disadvantages |
|---|---|
| • Make the capital go further with leverage<br>• Trade a huge range of markets<br>• The ability to go long or short without actually holding the underlier. | • Immediate decrease of the investor's initial position<br>• CFD risks:<br>  ○ Weak industry regulation<br>  ○ Potential lack of liquidity<br>  ○ Need to maintain an adequate margin |




If margin factor is 20%, then a position worth $1000 will only require a deposit of $200.

## Introduction of Central Clearing System

- A central clearing counterparty (CCP) is a financial institution that takes on counterparty credit risk between parties to a transaction and provides clearing and settlement services for trades in foreign exchange, securities, options, and derivative contracts.
- CCPs are highly regulated institutions that specialize in managing counterparty credit risk.

| Key Benefits of Central Clearing |
|---|
| • Standardizes Counterparty Credit Risk<br>• Reduces Operational and Trading Costs<br>• Capital Efficiency<br>• Consistent Valuation and Mark-to-Market |

## Overview of MF Global

MF Global

- MF Global, formerly known as Man Financial, was a major global financial derivatives broker, or commodities brokerage firm that went bankrupt in 2011.
- **How it collapsed?**
  - MF Global made a $6.3 billion investment in bonds of Europe's most indebted nations
  - Improper transfers of over $891 million from customer accounts to a MF broker-dealer account to cover trading losses
  - European Debt Crisis + Scandal ⟶ Massive liquidity crisis at the firm ⟶ Collapsed
- **Effects:**
  - Several brokerages in Singapore used MF Global as a counterparty for CFD trades
  - Cannot access overseas exchanges to close CFD positions
  - Customers funds are frozen due to unsegregated from the company's operation account

# (a) Why do you think the current CFD market in Singapore does not have a central clearing system?

## Risks of CFD trading

**<u>High Counterparty Risk</u>**

Counterparty risk: Risk of a party defaulting → The counterparty fails to fulfil its financial obligations

- If a party defaults, CFDs have **no value** as there is <u>no ownership</u> over the underlying asset
- The investors have no rights to the underlying assets as they have not actually bought them

## Risks of CFD trading

**<u>High Liquidity Risk</u>**

Liquidity risk: Risk of incurring losses resulting from the inability to meet payment obligations in a timely manner when they become due

- Due to the fast-moving nature of financial markets, the price of a CFD can fall before your trade can be executed at a previously agreed price
    - The holder of an existing contract would have to take less than optimal profits or cover any losses incurred by the CFD provider

## Exchange Limitations for CFDs

| Regulation | Non-Standardisation |
| --- | --- |
| CFDs trade over-the-counter (OTC) through a network of brokers and not on the exchange | CFDs are not standardised contracts and every CFD provider has their own terms and conditions |
| The CFD industry is <u>not highly regulated</u>, the broker's credibility is based on its reputation and financial viability. | Standardisation, which is required by central clearing system, is <u>unfavourable</u> for CFDs |

# (b) How will SGX <u>safeguard the interest of investors</u> if it manages the clearing of CFDs?




# Current Regulatory Guidelines to CFD trading

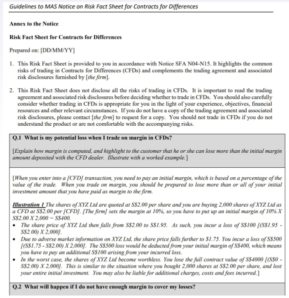
**Singapore Regulatory Environment**

- Allow CFD brokers to offer <u>high-leverage trading</u> across different instruments to clients

- Prevent some <u>offshore clients</u> from opening an account with some Singapore-based brokers

- Require brokers to be <u>adequately capitalized</u> to protect customers from monetary losses

- Brokers are required to show potential investors the CFD <u>risk fact sheet</u>



*Guidelines to MAS Notice on Risk Fact Sheet for Contracts for Differences*

**Annex to the Notice**

**Risk Fact Sheet for Contracts for Differences**

Prepared on: [DD/MM/YY]

1. This Risk Fact Sheet is provided to you in accordance with Notice SFA N04-N15. It highlights the common risks of trading in Contracts for Differences (CFDs) and complements the trading agreement and associated risk disclosures furnished by [*the firm*].

2. This Risk Fact Sheet does not disclose all the risks of trading in CFDs. It is important to read the trading agreement and associated risk disclosures before deciding whether to trade in CFDs. You should also carefully consider whether trading in CFDs is appropriate for you in the light of your experience, objectives, financial resources and other relevant circumstances. If you do not have a copy of the trading agreement and associated risk disclosures, please contact [*the firm*] to request for a copy. You should not trade in CFDs if you do not understand the product or are not comfortable with the accompanying risks.

**Q.1 What is my potential loss when I trade on margin in CFDs?**

[*Explain how margin is computed, and highlight to the customer that he or she can lose more than the initial margin amount deposited with the CFD dealer. Illustrate with a worked example.*]

[*When you enter into a [CFD] transaction, you need to pay an initial margin, which is based on a percentage of the value of the trade. When you trade on margin, you should be prepared to lose more than or all of your initial investment amount that you have paid as margin to the firm.*

***<u>Illustration 1</u>*** *The shares of XYZ Ltd are quoted at S$2.00 per share and you are buying 2,000 shares of XYZ Ltd as a CFD at S$2.00 per [CFD]. [The firm] sets the margin at 10%, so you have to put up an initial margin of 10% X S$2.00 X 2,000 = S$400.*

- *The share price of XYZ Ltd then falls from S$2.00 to S$1.95. As such, you incur a loss of S$100 [(S$1.95 - S$2.00) X 2,000].*
- *Due to adverse market information on XYZ Ltd, the share price falls further to $1.75. You incur a loss of S$500 [(S$1.75 - S$2.00) X 2,000]. The S$500 loss would be deducted from your initial margin of S$400, which means you have to pay an additional S$100 arising from your incurred loss.*
- *In the worst case, the shares of XYZ Ltd become worthless. You lose the full contract value of S$4000 [(S$0 - S$2.00) X 2,000]. This is similar to the situation where you bought 2,000 shares at S$2.00 per share, and lost your entire initial investment. You may also be liable for additional charges, costs and fees incurred.*]

**Q.2 What will happen if I do not have enough margin to cover my losses?**

**SFA 04-N15**: MAS Notice on Risk Fact Sheet for CFDs



# Safeguard the interest of investors

**Increased Transparency**

**More Stringent Regulatory Environment**

**Absorbs Counterparty Risk**



# More Transparency & Stringent Regulations

<u>**Pre-Trade**</u>

- **Price Discovery** - CFDs will be <u>closely monitored</u> across brokers to ensure the underlying securities involved and market-based pricing information are provided publicly
- **Restrictions on CFD marketing and incentive tools** - Regulate brokers who portray CFD as a <u>"Get-rich-quick" investment</u> and mandate Customer Knowledge Assessment (CKA)

<u>**Trade**</u>

- **Limiting Leverage** - <u>Set maximum possible leverages</u> according to the underlying asset's volatility
- **Order creation** - Ensure trade details are <u>accurate</u> during ticket creation by brokers; To be settled through confirmation matching

## SGX Absorbs Counterparty Risk

**Post-Trade**

- **Standardise CFD contracts** - SGX will determine the terms of the contract, including the settlement process, expiration dates, etc.
- **Enforce Delivery Versus Payment (DVP) Instructions** - Delivery of securities will occur only if payment is made (Instructions through standard SWIFT Message Types to reduce settlement risks and allow for automatic processing)

**Post-Settlement**

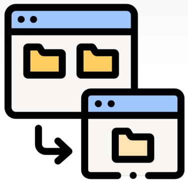
- **Monitor creditworthiness of CFD brokers** - Reduce default risk of brokers
- **Require guarantee fund for CFD brokers** - Cover losses that exceed a defaulting brokers' collateral deposits

## c) Assuming SGX takes up the role of clearing CFDs. Describe some of the technological and non-technological challenges SGX will face in designing the clearing mechanism

# Technological

## Problems with Data Synchronisation

- Different brokers capture different data-types for their customers, there is a need to be able to process the unstructured data to meet SGX's T+2 clearing and settlement standard
- Risk of data being incorrect due to difference in data storage system when transferring data
- During the process of data migration, trading and fulfillment of contracts could be affected



## Latency Risk

- The increase in number of steps in the process gives rise to latency risk i.e time delay

SGX needs to:

1) Ensure that the speed of clearing and settlement remains efficient and as sped up as possible
2) Minimise time difference between order submission and execution

## Gapping and Execution Risk

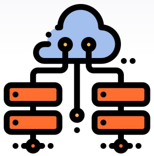
The fast moving nature of the market, along with the latency risk could give rise to gapping and execution risk

- Losses will be amplified due to the leveraged nature of CFDs

| Gapping Risk | Execution Risk |
|---|---|
| • Risk of stock prices falling dramatically from one trade to the next<br>• Resulting in losses for buy side/sell side | • Risk of a transaction not being executed within the range of recent market prices or within the step order limits set by an investor<br>• Resulting in losses for buy side/sell side |

## Solution: Purchase More Cloud Servers

- To prevent latency issues due to the increase in server requests
- Purchase more cloud server space that allows SGX to handle the increase in request volume
- Cloud servers increase efficiency and achieves low latency



# Non -Technological

## Market Inefficiency

1) Commission fees for sellers and buyers need to be kept low to encourage them to trade with SGX rather through OTC trades.
   a) Limits the potential revenue SGX can earn from the exchange
   b) No guarantee that sellers and buyers will use the SGX platform even if commission is low.

## Regulatory and Compliance

1) Buyers and seller of CFD may not desire the additional internal controls by SGX to manage regulatory risks

Sellers:

- Current CFD providers operate with lower transparency hence higher margin levels. (MF Global)
- SGX acting as a counterparty leads to standardisation of CFDs and force sellers to be transparent.
- Very difficult to make high margins and might charge more fees
- Have to display their best available prices for transparency purposes
- NOT all CFDs offered can be traded through an exchange

**CFD providers will suffer reduce in profits. Less incentive for CFD providers.**

## Regulatory and Compliance

1) Buyers and seller of CFD may not desire the additional internal controls by SGX to manage regulatory risks

Buyers:

- Smaller selection of CFD types (not all stocks/forex will be listed)
- Inflexible leverage levels as CFD providers who operate with less transparency can offer more leverage.
- To mitigate default risk, clearing house will impose margin requirements
  - Even less CFD providers willing to join the enter the exchange (higher barrier of entry)

**Not compelling for both buy side and retail investors. They might choose OTC trades where fees and selection might be better.**

## Regulatory and Compliance

Stakeholder pushback:

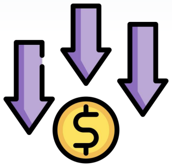
- OTC brokers will not be motivated to change as increases market transparency erodes competitiveness

Adoption rate:

- Needs high adoption rate to for exchange to be financially solvent. Low adoption rate leads to a death spiral.

Exposure risk:

- Due to different CFD sellers offering different leverage rates, SGX will need to maintain huge excess for their exchange fund. Especially if sell side becomes insolvent.



## Possible mitigation

- Enhanced and exclusive services
- Offer enhanced market insights and expert opinions using predictive analytics and market wide analysis to improve insights derived from the trading of CFDs
- More data points and better market insight vs individual CFD sellers
- Offer special courses or services for businesses and individuals when it comes to CFD buying and selling.
- E.g. MooMoo enhanced package that gives lower commission rates and more market information