Keywords: retail derivatives, retail investors, ASIC, regulation, CFDs, ETFs, capital guaranteed, capital protected, structured products, gatekeepers.

RETAIL DERIVATIVES: WHAT WE KNOW, WHAT WE DON’T KNOW, AND REGULATORY CHALLENGES

This paper reviews what is known about retail investor participation in derivative products, including capital guaranteed/protected investments, CFDs and ETFs as well as futures, options and warrants. It highlights trends, information gaps, regulatory issues raised and the role of gatekeepers in promoting confident and informed retail investors. The paper suggests that there will be new or exacerbated challenges ahead with retail derivatives.¹

In recent decades, the range and complexity or sophistication of financial products accessible to ordinary Australians has increased. The number of direct retail investors has grown, with a small (and in some cases growing) number embracing derivatives (either directly or embodied in other products), including via self-managed super funds (SMSFs).

This paper examines a broad range of the main derivative products available to retail investors, including structured products, contracts for difference (CFDs), options, futures, warrants and exchange-traded funds (ETFs),² focusing more on the products where retail participation is or has been most rapidly rising.²

Significant gaps in data about retail investors’ use of derivatives make it difficult to monitor trends, but available information suggests that:

▷ the range of derivatives available (and marketed) to retail investors has grown;
▷ the number of retail investors investing in some derivatives has grown (e.g. CFDs); and
▷ new derivatives (or products that incorporate substantial use of derivatives) are developing rapidly (e.g. some ETFs).

Factors driving a broadening retail demand include:

▷ increasing personal wealth inside and outside superannuation that is exposed to market risk;
▷ continued messaging from government and industry for investors to raise, diversify and risk-manage their wealth;
▷ the increasing number of ‘Baby Boomers’ approaching retirement;
▷ technological innovations that make investments more attractive and/or convenient to access; and
▷ the marketing strategies used by product issuers and intermediaries.

This raises a number of questions for industry and regulators. ASIC, for example, has begun to raise concerns about the ability of retail investors to appropriately assess the features and risks of retail derivatives — to distinguish the differences between the products, determine the suitability of the investments for their needs and preferences, and manage them appropriately.

The central tenet of Australia’s regulatory approach in this area has been that investors take responsibility for their investment decisions. However, research about Australians’ financial literacy levels and the difficulties many investors have in understanding and assessing investment risks suggests that the potential for detriment with retail

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derivatives warrants ongoing attention from regulators. Consequently, ASIC plans to continue to guide and educate investors to be ‘money smart’, set standards and provide regulatory guidance, check for compliance through monitoring and surveillance, and enforce the law and take appropriate action for non-compliance so that:

- investors can make informed decisions;
- participants in financial markets meet required standards; and
- misconduct is dealt with and deterred.

In addition, the risks and issues raised in this paper support actions by product issuers, gatekeepers and other licensees, and those responsible for preparing advertising, to look at what they can do to meet their responsibilities. Such efforts would likely include improvements to standard requirements such as effective disclosure, but might also extend to improvements in industry ethics and standards, including the development of sound product approval processes.

The financialisation of Australian households

Between 1990 and 2010, households’ financial assets grew fivefold in nominal terms and, as at June 2010, financial assets accounted for approximately one-third of all household assets.¹

Superannuation is households’ primary financial asset (see Figure 1), rising from approximately 35 per cent to almost 50 per cent of total households’ financial assets between 1990 and 2010. Figure 1 also shows the sobering impact of the GFC on households (reflecting falls in the value of market-related assets and moves away from risk assets to deposits).

The central tenet of Australia’s regulatory approach in this area has been that investors take responsibility for their investment decisions. However, research about Australians’ financial literacy levels and the difficulties many investors have in understanding and assessing investment risks suggests that the potential for detriment with retail derivatives warrants ongoing attention from regulators.

Despite increased holdings of financial assets, the overall direct and indirect exposure (and usage) of households in aggregate to derivatives is still very low. Demand-side data (i.e. surveys) confirm that few Australians directly invest in derivatives:

- Only 5 per cent of the 2400 adult Australians surveyed in the Australian Securities Exchange’s (ASX) 2010 Australian Share Ownership Study held ‘other listed investments’ (i.e. direct investments other than shares) (see Figure 2).
- Only 1 per cent of the 16.6 million adult Australians represented in Roy Morgan Research’s Single Source survey in the year ending December 2009 held warrants, futures or options (i.e. approximately 140,000 adult Australians).²

**FIGURE 1: Australian household financial assets — end December**

![Graph showing Australian household financial assets from 1990 to 2010](image_url)

*Source: ABS, Cat No. 5232.0 — Australian National Accounts: Financial Accounts, December Quarter 2010, Table 10.*
> Only 5 per cent of the adult Australians, and 11 per cent of the retail investors, who participated in a study commissioned by ASIC (2008) prior to the global financial crisis (GFC), held ‘other direct investments’. Derivatives comprised a negligible proportion within the other direct investments category.6 However, there has been some growth in retail use of derivatives and the fastest growing categories appear to be structured products, CFDs and ETFs.7 Investment Trends data show that the number of Australians investing in listed or over-the-counter (OTC) derivatives, or products incorporating derivatives, has increased in recent years (see Table 1). It seems reasonable to expect that these trends will continue, and will heighten questions over financial literacy and investors’ capacity to make well-informed decisions.

Profile of retail investors investing in derivatives

The relatively little information available about those in Australia who do invest in retail derivatives suggests differentiation by type of derivative. Note, though, that investor surveys, like all data sources, have limitations (e.g. self-selection bias — the people who respond to a survey may not be representative of the underlying population).

Structured product investors9

The median age of the structured product investors surveyed by Investment Trends (2011) in 2010 was 56.9 Their median income ($110,000) and portfolio size ($1.2 million) were both high, but the survey targeted high net worth investors so these results may overstate the wealth and characteristics of the typical structured
product investor. Business owners and the self-employed were over-represented (i.e. 23 per cent of the investors were business owners or self-employed) and while most (60 per cent) of those with structured products were investing in their own name, almost a third (32 per cent) were investing through a self-managed super fund (SMSF).

Half of the investors planned to hold their investments for five years or more (down from 58 per cent in 2009) but only 3 per cent planned to hold the investment for more than 10 years (down from 4 per cent in 2009). When asked what had triggered their initial investment, the key factors were diversification (43 per cent of investors, up from 25 per cent in 2009) and capital guarantee (43 per cent, up from 17 per cent in 2009). Investment Trends analysis revealed that gearing was a reasonably frequently used strategy, with 15 per cent of investors geared internally by the product, 17 per cent geared by the product provider and 6 per cent geared by the investor (note that 8 per cent were unsure if they were geared or not).

Use of financial planners has recently increased from 39 per cent in 2009 to 43 per cent in 2010, with self-directed clients dropping from 30 per cent to 27 per cent.

**CFD investors**

A considerable number (43 per cent) of the CFD traders surveyed by Investment Trends (2010d) in 2010 had more than 10 per cent of their investable assets in CFDs, and 12 per cent had more than half of their investable assets in CFDs. Their average age was 43, their average annual income was $98,000 (median $82,000), many were tertiary educated and the vast majority were men. Most were employed and those who were employed were distributed across a range of occupations, although finance professionals, information technology (IT) specialists, and business owners appeared to be overrepresented. Separate Investment Trends (2010c) research suggests that few SMSFs invest in CFDs, and intended future use among SMSF trustees is declining.

In a smaller depth study commissioned by ASIC (2010b) many CFD investors reported that the majority of their investment portfolio was in shares and that they were using CFDs to diversify their portfolio. Many saw CFDs as a way to easily generate additional returns in a shorter timeframe. ASIC’s research found that many did not understand how CFDs worked and the significant risks involved in trading them. Some considered CFDs to be analogous to equities. On the other hand, many appeared to be overconfident about their understanding of CFDs and their ability to successfully trade them. They tended not to seek professional advice about CFDs before investing in them and relied disproportionately on material provided by CFD issuers.

**ETF investors**

An Investment Trends (2010a) 2009 ETF survey found that ETF investors had relatively small investment portfolios compared with investors in other alternative investments and tended to be younger (though older than CFD investors). They tended to cluster into two key groups: those aged 25 to 55 with an annual income above $75,000 (45 per cent of investors) and those aged over 55 with an income of less than $150,000 (26 per cent). More recent Investment Trends research (cited in Munro 2011) suggests that diversification was a key motivation for those investing in ETFs in 2010, and that most investors were self-directed and not influenced by an adviser (only 10 per cent of those surveyed said they were being advised by a financial planner and a further 7 per cent by a stockbroker).

Research reported by Tria Investment Partners (2011) suggests that SMSFs have been early adopters of ETFs, and that, ‘it’s common for local ETFs to have SMSFs representing 30 per cent to 40 per cent of their unitholders’. Investment Trends (cited in Hartge-Hazelman 2011) have also reported that the number of SMSFs holding ETFs has grown dramatically (almost doubling to 23,000 between May 2009 and April 2010) as interest in (unlisted) managed funds has fallen (since 2007).

**Option, future and warrant investors**

According to a large survey of adult Australians conducted by Roy Morgan Research (2009) only 0.4 per cent of the represented population held work share options; 0.3 per cent held other share options; 0.1 per cent held warrants; and 0.1 per cent held futures. Only the options sample is robust enough to inform demographic analysis.

Compared to the adult Australian population, option investors were more likely to be male, full-time employed, tertiary educated and among the highest (i.e. most affluent) socioeconomic quintile. Unsurprisingly, they were more likely to agree with attitudinal statements that indicated a preference for taking risks and/or a strong sense of personal responsibility. They were also more likely to have recently used the internet for financial reasons.

An Investment Trends (2010c) survey of 840 SMSF trustees found that 7 per cent were using geared products for investment and, of these, 13 per cent identified warrants as the product they primarily used to gain leverage. Separate Investment Trends (2011) data reported a considerable fall in the number of retail investors using instalment warrants between November 2008 (21,000) and December 2010 (9,000) and those using put/call warrants during the same period (from 17,500 to 6,000 investors).

**Summary of risks with derivatives for retail investors: what is ASIC’s response?**

**Key risks and issues**

The key risks an investor must consider before investing in retail derivative products include: market risk;
Regarding gatekeepers, ASIC needs to ensure that intermediaries who provide or assist in providing investors with the information they use to make decisions are competent, act with integrity and are held to account.

counterparty risks, including risks with collateral, short selling and securities lending; agency risks including conflicts of interest; and risks from leverage and margin calls. The extent of these risks depends on the underlying asset and derivative instruments used by each product and varies with market conditions and activity. High leverage is particularly risky as it can easily and dramatically magnify losses.

So are retail investors being sufficiently informed of these risks and do they understand the risks?

Marketing, distribution and suitability
The rapid growth of new complex products means that many retail investors are relatively unfamiliar with their features and risks. Compounding this, some marketing or distribution practices may confuse retail investors about the risks involved and/or attract unsuitable investors.

ASIC has raised concerns about the mass marketing approach adopted by some CFD issuers (including primetime television advertising), which may give retail investors (who are often judging these products themselves without reference to advisers) the impression that CFDs are easy to use.

ASIC has also identified instances of poor disclosure during its reviews of selected PDSs (2010a, 2010b), and has found that retail investors are highly sensitive to terminology and the way information is presented (ASIC 2011a).

Since their introduction, the complexity of ETFs has changed quickly and materially. Retail investors may misunderstand the differences in the various ETFs and their underlying risks.

Availability of market data
There is little public information about retail investment in derivatives and significant gaps in the available commercial data, which inhibits ASIC’s ability to understand and quantify the number, characteristics, preferences and behaviour of those who invest in these products. Pending a more comprehensive set of reliable data, ASIC may continue to commission targeted market research to better understand retail investors and the risks they face.

ASIC’s response
ASIC has responded to these risks and issues in a number of ways, including:

> taking a lead role in raising the financial literacy levels of all Australians;¹⁴

> providing targeted investor guides¹⁵ and plain language material on its investor and financial consumer website, MoneySmart,¹⁶ which explain the features and risks of specific investments such as CFDs and capital guaranteed/protected investments, as well as providing more general investing and financial tips;

> conducting research to better understand the way investors make decisions and using that knowledge to effectively communicate with them through a range of channels, and inform policy and industry guidance;

> conducting assessments of particular sectors or products;²⁷

> monitoring and addressing compliance issues in advertisements, disclosure and conduct;

> monitoring investor complaints;

> releasing regulatory guides for industry;²⁸

> releasing consultation papers to explore further measures (e.g. enhanced disclosure benchmarks and changes to financial requirements for issuers);²⁹ and

> encouraging issuers to develop robust client suitability policies and product approval processes.

ASIC may pursue additional regulatory mechanisms if it feels they are required (e.g. shadow shopping and/or proposing law reform).

Regarding gatekeepers, ASIC needs to ensure that intermediaries who provide or assist in providing investors with the information they use to make decisions are competent, act with integrity and are held to account. ASIC takes a wide view of gatekeepers (i.e. they include accountants, directors, advisers, custodians, product manufacturers, market operators and participants).

Advisers (including financial planners and stockbrokers) need to consider whether they have sufficient understanding of any products about which they provide advice to retail clients, and ensure that any products they recommend are suitable for their clients.

Research houses and others offering opinions on the investment merit of these products need to consider all the factors that might significantly affect their value, the complexity of the interactions of the factors and, ultimately, whether it is possible to provide a reliable and useful assessment of the products’ suitability for retail investors in light of these considerations.

Product manufacturers need to consider whether products intended for the retail market are suitable for
retail investors and are capable of being understood by them. This requires robust product approval processes and improvements to disclosure, such as:

> designing more ‘investor-focused’ documents (clear, concise and effective);
> differentiating between generic risks and significant/product-specific risks; and
> considering disclosure on who the product is intended for in order to assist with suitability assessments.

Finally, ASIC believes industry bodies have an important role to play to improve industry standards and ethics.

Future developments and challenges

There will be new or exacerbated challenges ahead with retail derivatives. These will simultaneously necessitate, and yet put strains on, regulators’ capacity to help retail investors to take confident, well-informed decisions. It is easy to note that improved data and analysis will be required to assess and respond to the risks that arise, but financial innovations always outstrip extensions of regulatory coverage.

The global proliferation of retail derivatives is likely to continue and those that are currently only available overseas such as property price derivatives and the more exotic ETFs may become more accessible to Australian investors. In addition, new products may emerge with an appeal to Australians seeking to increase net worth or protect existing net worth, including volatility derivatives, fixed income derivative products, more capital protected products, and more covered warrants and features such as knockout barriers.

Such products are likely to continue to attract the attention of regulators concerned that the speed of their development and innate and/or added complexity is exceeding the ability of issuers to effectively explain them and/or retail investors’ capacity to understand them.

In addition, the local annuity market may develop to meet the needs of Baby Boomers, driving more indirect household exposure to derivatives via the assets into which annuity providers invest their clients’ monies. Some with SMSFs may also to seek to replicate such institutionally created retirement income products. While the Australian annuities market is currently very small due to factors such as product inflexibility, low returns, tax considerations and the ‘safety net’ of the age pension, new product marketing campaigns are already beginning to develop.

Technological advances will continue to influence product design, access and take-up. The introduction of mobile and other digital technology will no doubt alter the way retail investors trade in financial products (including derivatives), and may also alter the way information is disclosed to them. Mobile developments are already underway internationally and domestically.

Finally, retail investors’ access to investment opportunities in foreign jurisdictions is likely to increase. ASIC will therefore need to continue to manage retail investors’ expectations about the limits of its regulatory reach — including warning that consumer protection levels and approaches vary across different jurisdictions and that people who invest money in foreign jurisdictions often do so at their own risk.

Notes

1. The paper presents the personal views of the author and is a shorter version of the original conference paper available at www.austaliancentre.com.au/acfs-events/events-2011/melbourne-money-and-finance-conference-2011/ While they have benefited from contributions from his colleagues in Research — Office of the Chief Economist and within ASIC, the views are not necessarily shared by the Australian Securities and Investments Commission. Particular thanks are due to Clare Marlin.

2. While most ETFs currently listed in Australia are not classified as derivative products because they hold the underlying assets that they track, there are a large number of synthetic ETFs listed overseas that rely substantially on the use of derivatives to replicate the performance of the underlying asset.

3. Australia has a more open environment for retail investor access to derivatives than many other countries. In addition to access to all listed derivatives, prohibitions on retail participation in over-the-counter derivatives markets were relaxed after the recommendation of the 1997 Inquiry into the Australian Financial System (Wallis inquiry) (see Recommendation 20). Product disclosure and regulation of the sales and advice process remain the key forms of consumer protection for these transactions.

4. At June 2010, household financial assets were $2,387 billion (ABS 2010).

5. The options category included work and other options. Base sample: 49,371 Australians aged 18 and over.

6. Retail investors were defined as investors with shares, investment property, managed investments, SMSFs and other direct investments (including investments such as debentures and bonds). A capped number of investors with lower-level investments such as term deposits, voluntary superannuation contributions and high interest savings accounts were also included in the research. The base sample for the Australian population was 53,307 and
the base sample for the investor population was 1,217. The data was collected in 2006/07. The most commonly owned other direct investment was debentures (35%), followed by bonds (21%), short-term securities (9%) and options (9%).

7. We list ETFs as ‘derivatives’ because of the more exotic versions available overseas. However, note that these exotic products are not present in the cited local statistics.

8. Defined here (i.e. by Investment Trends) as capital guaranteed funds with a fixed duration. In a recent review of selected product disclosure statements (PDSs) for capital protected products and other structured or derivative products marketed to retail investors, ASIC considered foreign exchange (FX), futures, commodities, warrants, deferred purchase agreements (DPAs) and non-traditional managed funds with structured product-type exposure (such as those with inbuilt alternative asset class exposure, leverage or dynamic management) (ASIC 2010a).

9. This was older than the median age of 54 in 2009 (Investment Trends 2010b).

10. Based on a number of sources, including a series of 30 in-depth interviews with a mix of current, former and future traders of CFDS commissioned by ASIC. The interviews were conducted by Colmar Brunton Social Research (CBSR) over the phone and face to face between 15 December 2009 and 29 January 2010. The sample also included a representation of retail investors who had considered trading CFDS but decided not to do so (deliberate non-traders).

11. It must be noted that, even if investors allocate only a small proportion of their investment portfolio to CFDS, the very high leverage involved means they are taking on a considerable amount of risk.

12. Base sample: 49,371 Australians aged 18 and over. Respondents were interviewed between January and December 2009. They were asked which investment types they currently had money directly invested in, either alone or jointly.

13. The sample included a mix of respondents sourced from a broad-based survey of the Australian population as well as members of an opt-in research panel who had taken part in previous investment-related research and indicated that they had a SMSF.


15. For example, Thinking of trading contracts for difference (CFDs)? (ASIC 2010f) and Get the facts: Capital guaranteed or protected investments (2010d).


17. For example, Report 205: Contracts for difference and retail investors (ASIC 2010b).

18. For example, Regulatory Guide 212: Client money relating to dealing in OTC derivatives (ASIC 2010c).

19. For example, Consultation Paper 156: Retail OTC derivatives: Financial requirements (ASIC 2011b) and Consultation Paper 146: Over-the-counter contracts for difference: Improving disclosure for retail investors (ASIC 2010a).

20. Annuity providers generally use derivatives for risk management (e.g. derivatives such as futures, options, swaps, and more recently synthetic ETFs are used to hedge against variables such as equity market, interest rate and currency volatilities).

21. One of the largest annuity providers (Challenger), doubled their sales to $740 million in the March 2011 quarter alone after embarking on a $5 million advertising campaign in February to boost their retail life annuity sales (The Australian 2011).

22. IG, a major UK CFD provider, reported that its iPhone app had been downloaded 12,000 times in its first month of release and that it processes over 100,000 mobile trades a month, which is about 10 per cent of total trades (Gibson 2011).

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The Australian: see Unauthorised.


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