European Securities and Markets Authority

European Banking Authority

Investor warning
Date: 28 February 2013

Contracts for difference (CFDs)

Key messages

- *CFDs are complex products and are not suitable for all investors.*
- *Don't use money you can't afford to lose. You could lose much more than your initial payment.*
- *You should only consider trading in CFDs if:*
    - *you have extensive experience of trading in volatile markets,*
    - *you fully understand how they operate, including all the risks and costs involved,*
    - *you are aware that the greater the leverage, the greater the risk,*
    - *you understand that your position can be closed whether or not you agree with the provider's decision to close your position,*
    - *you have sufficient time to manage your investment on an active basis.*

Why are we issuing this warning?

An on-going effect of the financial crisis is that even moderate returns on money are difficult to achieve. When looking to enhance their returns, many investors consider investing in complex products that offer the opportunity to trade on 'leverage', such as 'contracts for difference' (CFDs).

Despite being suitable only for professional clients, or highly experienced retail investors who understand the product, CFDs are also advertised to inexperienced retail clients. Potential gains may be advertised in a way that does not fully explain, or give sufficient prominence to, the risks involved.

CFD providers may offer "free start-up money", gifts, discounted fees, or trading tutorials in order to attract you as a new client. This is often just a marketing ploy to get you to speculate in CFDs. Remember also that CFDs are sometimes advertised by unauthorised and unregulated entities.

Generally, the buying and selling of CFDs, especially when done online, is not accompanied by investment advice. This means that you, the retail investor, are responsible for your own decisions to trade. Nevertheless, an authorised and regulated CFD provider must first check that dealing in CFDs is appropriate for you and that you are aware of the risks involved. Not all CFD providers do this.

CFDs are complex products, generally used for speculative purposes. They can be particularly difficult to understand.

What is a CFD?

A CFD is an agreement between a 'buyer' and a 'seller' to exchange the difference between the current price of an underlying asset (shares, currencies, commodities, indices, etc.) and its price when the contract is closed.

CFDs are leveraged products. They offer exposure to the markets while requiring you to only put down a small margin ('deposit') of the total value of the trade. They allow investors to take advantage of prices moving up (by taking 'long positions') or prices moving down (by taking 'short positions') on underlying assets.

When the contract is closed you will receive or pay the difference between the closing value and the opening value of the CFD and/or the underlying asset(s). If the difference is positive, the CFD provider pays you. If the difference is negative, you must pay the CFD provider.

CFDs might seem similar to mainstream investments such as shares, but they are very different as you never actually buy or own the asset underlying the CFD.

Example of how a CFD works

You believe a listed share (Share A) is undervalued and that its price will rise. You decide to buy 4000 CFDs in Share A at the price of 10€ per CFD. Your 'position' is therefore 40000€ (4000 x 10€). You do not actually pay 40000€: the amount you pay depends on the margin required by the CFD provider. If the CFD provider asks you for a margin of 5%, for example, that means your minimum initial payment is 2000€ (40000€ x 5%). The return you get on this initial payment depends on the price at which Share A is traded when you decide to close your position (that is, when you sell the CFD).

Share A price	Share A return	Profit/loss for investor	Return for investor
7.5€	-25%	-10000€	-500%
9.0€	-10%	-4000€	-200%
9.5€	-5%	-2000€	-100%
9.9€	-1%	-400€	-20%
10.0€	0%	0€	0%
10.1€	1%	400€	20%
10.5€	5%	2000€	100%

If the price of Share A decreases by 5% (from 10€ to 9.5€), and the leverage is 20, you lose the total amount (-100%) of your initial margin payment, i.e. you lose 2000€. If the price of Share A decreases by 10% (from 10€ to 9€), and the leverage is 20, you lose your initial payment of 2000€, and your CFD provider will ask you for another 2000€ (margin call) if you want to keep your contract open.

This means that your losses may be more than your initial margin payment.

Costs

In addition to any profits or losses, there are different types of costs linked to transactions in CFDs. Costs will impact the effective return. Examples of costs include commissions charged by CFD providers. Be aware that while some CFD providers charge a general commission, others charge a commission on each trade (i.e. on opening and closing a contract).

Costs related to CFD trading may also include bid-offer spreads, daily and overnight financing costs, account management fees, and taxes (depending on the jurisdiction in which you and the CFD provider operate). These costs can be complex to calculate and may outweigh the gross profits from a trade.

What are the main risks of investing in CFDs?

CFDs, especially when highly leveraged (the higher the leverage of the CFD, the more risky it becomes), carry a very high level of risk. They are not standardised products. Different CFD providers have their own terms, conditions and costs. Therefore, generally, they are not suitable for most retail investors.

You should only consider trading in CFDs if you wish to speculate, especially on a very short-term basis, or if you wish to hedge against an exposure in your existing portfolio, and if you have extensive experience in trading, in particular during volatile markets, and can afford any losses.

Time is not on your side

CFDs are not suitable for 'buy and hold' trading. They can require constant monitoring over a short period of time (minutes/hours/days). Even maintaining your investment overnight exposes you to greater risk and additional cost.

The volatility of the stock market and other financial markets, together with the extra leverage on your investment, can result in rapid changes to your overall investment position. Immediate action may be required to manage your risk exposure, or to post additional margin.

Therefore, if you do not have enough time to monitor your investment on a regular basis, you should not trade in CFDs.

Liquidity risk

Liquidity risk affects your ability to trade. It is the risk that your CFD or asset cannot be traded at the time you want to trade (to prevent a loss, or to make a profit).

In addition, the margin you need to maintain as a deposit with the CFD provider is recalculated daily in accordance with changes in the value of the underlying assets of the CFDs you hold. If this recalculation (revaluation) produces a reduction in value compared with the valuation on the previous day, you will be required to pay cash to the CFD provider immediately in order to restore the margin position and to cover the loss. If you cannot make the payment, then the CFD provider may close your position whether or not you agree with this action. You will have to meet the loss, even if the price of the underlying asset subsequently recovers. There are CFD providers that liquidate all your CFD positions if you do not have the required margin, even if one of those positions is showing a profit for you at that stage.

To keep your position open, you may have to agree to allow the CFD provider to take additional payments (usually from your credit card), at their discretion, when required to meet relevant margin calls. In a fast moving, volatile market you can easily run up a large credit card bill in this way.

Leverage risk

Leveraged trading means that potential profits are magnified; it also means that losses are magnified.

The lower the margin requirement, the higher the risk of potential losses if the market moves against you. Sometimes the margins required can be as little as 0.5%. Be aware that when trading using margin, your losses can exceed your initial payment and it is possible to lose much more money than you initially invested.

'Stop loss' limits

To limit losses many CFD providers offer you the opportunity to choose 'stop loss' limits. This automatically closes your position when it reaches a price limit of your choice. There are some circumstances in which a 'stop loss' limit is ineffective - for example, where there are rapid price movements, or market closure. Stop loss limits cannot always protect you from losses.

Execution risk

Execution risk is associated with the fact that trades may not take place immediately. For example, there might be a time lag between the moment you place your order and the moment it is executed. In this period, the market might have moved against you. That is, your order is not executed at the price you expected.

Some CFD providers allow you to trade even when the market is closed. Be aware that the prices for these trades can differ widely from the closing price of the underlying asset. In many cases, the spread can be wider than it is when the market is open.

Counterparty risk

Counterparty risk is the risk that the provider issuing the CFD (i.e. your counterparty) defaults and is unable to meet its financial obligations. If your funds are not properly segregated from the CFD provider's funds, and the CFD provider faces financial difficulties, then there is a risk that you may not receive back any monies due to you.

What can you do to protect yourself?

You should carefully read your agreement or contract with the CFD provider before making a trading decision.

You should make sure that you at least understand the following:

- the costs of trading CFDs with the CFD provider,
- whether the CFD provider will disclose the margins it makes on your trades,
- how the prices of the CFDs are determined by the CFD provider,
- what happens if you hold your position open overnight,
- whether the CFD provider can change or re-quote the price once you place an order,
- whether the CFD provider will execute your orders even if the underlying market is closed,
- whether there is an investor or deposit protection scheme in place in the event of counterparty or client asset issues.

If you do not understand what's on offer, do not trade.

Further information

Always check if the CFD provider is authorised to do investment business in your country. You can check this on the website of the CFD provider's national regulator.

A list of all the national regulatory authorities, and their websites, is also available on the:

- ESMA website at http://www.esma.europa.eu/investor-corner
- EBA website at http://www.eba.europa.eu/Publications/Consumer-Protection-Issues.aspx