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The Concept and Implementation of Contract for Difference in Derivatives Market

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Abstract

Contract for Difference (CFD) is a leverage product that offers exposure to the market by only placing a small margin (deposit) of the total value of the transaction. CFDs provide traders with an advantage when the price of an underlying asset goes up (by taking a long position) or when it goes down (by taking a short position). When a CFD contract is closed, traders will receive or pay a certain amount of value that arises due to the difference between the purchase price and the selling price of an underlying asset. This shows that CFDs are almost similar to a futures contract in terms of their value derived from various underlying assets and both provide an advantage by providing leverage benefits. Hence, this study aims to examine the concept and course of CFD transactions implemented in Malaysia. This qualitative study applied the content analysis method. Findings show that most traders use CFDs to achieve leverage positions offered by brokers as well as to make short sales and as a hedging tool (hedging mechanism).

Keywords: Contract for Difference, Implementation, Derivative, Contract.

Introduction

Contract for Difference (CFD) is one of the investment instruments in derivative contracts executed between buyers and sellers, where they agree to pay the difference between the purchase price and selling price of a number of financial instruments, such as currencies, commodities, stocks and indices offered through OTC. CFDs are leverage products that offer exposure to the market by only placing a small margin (deposit) of the total value of the transaction (European Securities and Market Authority, 2013). Although CFDs look similar to regular investments, such as stocks, however, there is a difference because traders actually never buying or owning the CFD's underlying asset, but only settling a sale and purchase transaction solely based on the price difference (Philip Futures, 2021). CFDs in Malaysia were introduced in 2018 but specifically aimed only at traders who are financially secure and not traded at the retail level (Securities Commission Malaysia 2018). This article aims to elaborate on the characteristics and implementation of CFD transactions in Malaysia.

Introduction to CFD

CFDs began to be traded around the 1990s in the United Kingdom (UK) so that traders can enjoy all the benefits of owning stocks without having to actually own them. CFD transactions

were also developed as a way to make short sales for individual shareholdings (Shetty & Scott 2006). In addition, the use of CFDs also allows traders to evade paying stamp duty, which was a regulation established by the UK government because fundamentally there is no ownership in shareholding (Foster et al., 2017).

CFD is a derivative instrument offered *Over-the-Counter* (OTC), which means it does not require supervision by the exchange to be traded to traders (Widiyanti 2008). CFDs were first offered to retail traders in the UK through offerings in 2000 (Shetty & Scott, 2006). According to the Financial Service Authority of the United Kingdom (2007) the OTC CFD market in the United Kingdom (UK) has grown rapidly since 2003. The number of transactions is estimated to have increased from approximately 10% of the total value of London's capital market equity transactions in 2001 to approximately 35% in 2007

In November 2007, the Australian Securities Exchange (ASX) became the first exchange to plan and list CFDs for trading on the exchange. The Australian OTC market has also grown rapidly with most investors being individual investors (Foster et al. 2017). According to Financial Standard (2008), there were approximately 20 OTC CFD service providers in Australia in 2008 and approximately 30,000 active investors. Presently, CFD transactions have received very encouraging reception from retail investors and have been introduced to numerous countries, such as Australia, United Kingdom, Cyprus and others (Neill, 2017). CFDs are innovations for futures markets and its ensuing contracts that are designed so that its prices are equal to the prices of financial instruments, such as stocks, commodities, indices and currencies, that become underlying CFD investments (Brown et al., 2010).

Characteristics of CFD

There are some specific features of CFDs such as the relationship between CFDs and underlying assets, leverage execution practices and also the risks faced by the parties involved.

1. Underlying Asset

Derivative prices are a reflection of the current price offer of an underlying asset, such as a stock, index, commodity or currency (Temple, 2009). Similarly, the price movement for a CFD instrument is based on the movement of the underlying asset; usually the CFD's price movement will follow that of the underlying asset without any difference. The underlying asset's market price will be quoted directly to the CFD trader without any amendment so that the selling and buying prices will be similar to the underlying asset's price. At the end of a CFD transaction, the price difference at the opening and closing hours of the underlying asset will determine the profit or loss accruing from the CFD transaction (Norman, 2009).

2. Contract

Basically, transactions involving the CFD instrument is a transaction that trades the sale and purchase of a contract as opposed to the sale and purchase of assets. This is because when a trader enters into an agreement or contract, he then indirectly has rights and obligations that need to be fulfilled. In other words, if a trader buys or sells a derivative, the trader actually enters into a lasting agreement until the trader closes the trade. This shows that the trader is

only trading a promise to do something and not an agreement related to the underlying asset, which is the basis of the trade (Temple, 2009).

In essence, CFD traders do not actually own any underlying asset, but enter into an agreement with the CFD provider to exchange the cash difference between the price at opening and closing of the transaction (Norman, 2009). CFDs can be categorized as contracts that occur only on paper because they only represent agreements as opposed to ownership (Temple, 2009).

3. Leverage and Margin

The opportunity for traders to trade using leverage and margin has led to a revolution in the financial industry. The use of leverage and margin is increasing due to the increasing popularity of CFD instruments as an alternative to trading in cash. Leverage allows CFD traders to choose which trading technique they want, either the long or short one, so that the rise or fall of each transaction has an effect on their profits or losses based on the position when the price is opened in a CFD contract (Norman, 2009).

Margin is the advance payment paid by traders to the broker as a guarantee that the traders will comply with the contract that has been agreed upon. Traders will be asked to pay an *initial margin* if it is the first contract involved in selling or buying in a CFD. Thus, if the movement of the underlying asset is contrary to what has been planned, the trader has to add money according to the difference in margin stipulated earlier (Temple, 2009).

Traders who want to trade in CFDs will have to pay an *initial margin* based on the percentage established by the broker according to the total value of the CFD they wish to buy. For example, if a trader wants to buy 1000 units of ABC shares worth RM10 each in the cash equity market, the trader has to pay the full value of RM10000. However, if the trader buys ABC shares using CFDs and the CFD broker offers a 10% margin that has to be paid, then the trader only needs to deposit RM1000 for the ABC shares worth RM10,000 (Shetty & Scott, 2006).

Normally, traders can only profit from rising market movements, but the emergence of new leverage products, such as CFDs, allows traders to make profits when the market is bullish or bearish (Thorpe, D. 2011). CFD traders wish to use leverage products because all CFD buying and selling transactions require only a relatively small margin payment against the actual price of the underlying instrument. In addition, using CFD instruments will generate high profits for traders with only a small margin capital but they need to be prepared to face large losses if the price movement of the underlying asset moves contrary to what is expected (Financial Standard, 2008).

4. CFD RISKS

Traders who wish to trade using CFDs need to be aware of the various risks involved. This is because CFDs are traded as OTC, i.e., there is no regulator that will protect the rights and interests of traders. CFD traders have to deal with the CFD provider themselves without having to go through the regulatory authorities as it is usually done as investments in the exchange (Norman, 2009). Among the risks that the CFD traders should be aware of are:

- a) Broker Risk

Among the risks that CFD traders will face is the risk associated with the CFD provider neglecting its responsibilities as a CFD contract provider and not being able to meet the financial obligations that had been agreed upon. It would be worse if the CFD trader's funds are not treated separately from the existing funds by the provider. And if the CFD broker has financial problems, then there is a risk that the CFD trader will not get the money that has been promised and mentioned in the contract if the CFD trader makes a profit (European Securities and Markets Authority, 2013). CFD traders need to firstly ensure that the broker keeps all the deposits paid by the traders in the client's account and not to be used as part of the broker's general operational expenses (Norman, 2009)

b) Leverage Risk

Leverage in CFDs means that a CFD trader only mentions part of the total market value of an underlying asset but the trader will obtain the same profits or losses as the trader who pays the full amount for an underlying asset (Phillip Futures, 2021). Although leverage is an advantage for CFDs, it also has a very definitive disadvantage, which is its contribution to higher risk (Ghebrehiwet, 2009).

Trading that uses leverage means that the potential for profit is very high, and at the same time, the potential for losses is also very high. The lower the margin amount, the higher the potential for loss if the market price moves against the trader's expectations. Traders should be aware that if they trade using the margin, the losses they will incur could exceed the *initial margin* amount (European Securities and Markets Authority, 2013)

c) Liquidity Risks

Since CFDs are traded on OTC basis; hence, it has no secondary market, and CFD trading is subject only to the availability of selling and buying prices as well as volume. Some CFDs have very low levels of liquidity making it difficult to trade at the market price. Thus, if traders try to sell their CFDs, traders may not be able to find a buyer, or the selling price might have to be much lower than the amount they invested in (Phillip Futures, 2021).

In addition, the amount of margin paid by traders to the CFD broker must be presumed to be a deposit paid by the CFD broker when the recalculation of the underlying assets' values held by the trader is performed on a daily basis. Hence, if this recalculation (revaluation) results in a decrease in value compared to the previous day's valuation, the trader will be asked to immediately pay cash to the CFD broker in order to restore the margin position and to cover the loss. However, if the trader is unable to make the payment, then the CFD broker can close the trader's position, regardless of whether the trader agrees or not with this action. Traders have to bear losses, even if the price of the underlying asset eventually recovers (European Securities and Markets Authority, 2013).

Implementing CFD Transactions in Malaysia

Confusion regarding CFDs that frequently emerge is about how the CFD transaction is traded, this is because CFDs are traded as OTC, which means the contract takes place between two parties without being traded in an exchange (Corbet & Twomey, 2014). This means that traders who want to initiate a CFD only need to deal with the broker without having to involve the exchange.

In 2018, Securities Commission (SC) Malaysia had introduced the first framework for derivative products at the OTC counter, namely in the form of CFDs. CFDs allow traders to

participate in the underlying instrument's price movement by using leverage. Although CFDs are not traded on the exchange, Securities Commission Malaysia (SC) had developed guidelines for CFD that explains the parameters of the CFD product and the responsibilities of brokers who wish to offer CFD products in Malaysia.

CFD's Underlying Assets

There are many financial instruments that play the role of a CFD's underlying asset, however, there are only two types of financial instruments in Malaysia that have been approved by the SC to be offered to traders, namely:

a) Shares

CFD brokers can offer CFD traders the underlying assets of stocks available on Bursa Malaysia as well as stocks available on foreign exchanges. However, the shares' underlying assets need to meet certain criteria set by the SC, such as: -

i. Malaysian Stocks

Malaysian stocks, which act as the CFD's underlying instruments, must be listed on the main board of Bursa Malaysia. In addition, the company that owns the underlying shares must have an average daily market capitalization, excluding treasury shares, of at least RM1 Billion for the last 3 months or for newly listed companies that do not meet the daily capitalization record for 3 months, the amount is RM3 Billion. Finally, the underlying company must meet the public stock spread requirements on the specified offer date.

ii. Foreign Stocks

As for foreign stocks, which act as the CFD's underlying instrument, it must be listed on an exchange where the exchange regulator is the signatory to the International Organization of Securities Commission's memorandum of understanding on negotiations and cooperation as well as exchange of information between securities regulators. In addition, the company related to the underlying stock must have an average daily market capitalization of at least RM3 Billion for the last 3 months or for a newly listed company that does not meet the daily capitalization record for 3 months, the amount is RM5 Billion. In addition, the underlying company related to the CFD stock must comply with the listing rules and requirements of the exchange. Finally, the company must provide investors with statements related to the stock price, number of stocks, financial information and sensitive information related to the movement of the company's stock price.

b) Index

As for the CFD index's underlying assets, brokers can offer traders who wish to initiate CFDs on indices listed on Bursa Malaysia or foreign exchanges that meet the following criteria: -

- i. The index must include the movements of a group of stocks or the entire market
- ii. Has a transparent composition
- iii. The index is a recognised benchmark
- iv. Information related to the composition and performance of the index must be easily accessible to investors

Margin

Traders who want to trade using CFD instruments have to pay a deposit known as the *initial margin*, *original margin* or *deposit margin*, to the broker (Azizi, 2004). The amount of margin

payable is based on a percentage of the total value of the underlying asset to be purchased. For example, if the margin to be paid is 10%, then the trader who wants to buy CFD involving 10000 units of stocks belonging to Company XYZ worth RM2.00 per unit, must pay a margin of RM 2000 to the broker.

The Commission has set the margin amount for each type of CFD depending on the underlying instrument as follows.

TYPE OF CFD	MINIMUM MARGIN
CFD Shares	<ul style="list-style-type: none"> • 10% for the index share • 20% for the non-index share
CFD Index	<ul style="list-style-type: none"> • 5%

Table 1 : Minimum Margin of CFD (Securities Commission 2018)

CFD traders should be prepared to pay a *margin call* if the movement of the underlying asset they bought is not as expected. The amount of *margin call* to be paid depends on the difference in the amount between the *initial margin* and the value of the underlying asset at the end of the transaction. Hence, if the trader does not pay the *margin call* amount requested by the broker, then the broker has the authority to close all transactions and remove the account from the *margin call* (Phillip Futures, 2021)

CFD Broker

There are generally two types of CFD supervisors that offer CFD, namely:

- *Market Maker*

Market maker refers to a broker who provides CFDs that act as the principal which sets the *bid* (buy) and *ask* (sell) values based on the market price of the underlying asset. Then the *market maker* will send the order to the underlying asset market to hedge the risk value for the trader. This means that the trader will trade directly with the CFD broker. See Diagram 1.1 below.

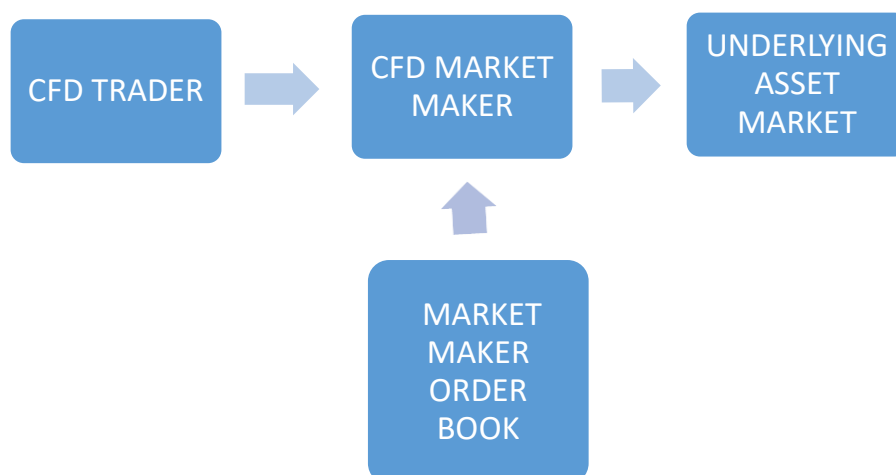


Diagram 1.1: CFD traded as the market maker (Norman, 2009)

- Direct Market Access (DMA)

The DMA allows traders to directly access the market. When a customer places an order through a broker, the order will be sent directly to the exchange, and it will be fulfilled in the actual exchange (Widiyanti, 2008). See Diagram 1.2



Diagram 1.2: CFD is traded as DMA (Norman 2009)

For example, brokers like Philip Future offer DMAs for Malaysian CFD stocks, however, the CFD price is based on the actual price of the underlying shares that have been listed on the exchange. This shows that traders also participate in the orders available on the exchange and in cases of market liquidity. Similarly, for foreign CFD shares, the CFD price is based on the actual price of the shares available on the country's exchange.

CFD Transaction

Although CFD transactions are traded based on OTC, there is still a relationship between stock market transactions in cash and the stock market according to CFDs. This is because brokers will deliver orders for a number of stocks that have been ordered by CFD traders into the cash market. Diagram 2 below shows an OTC CFD transaction.

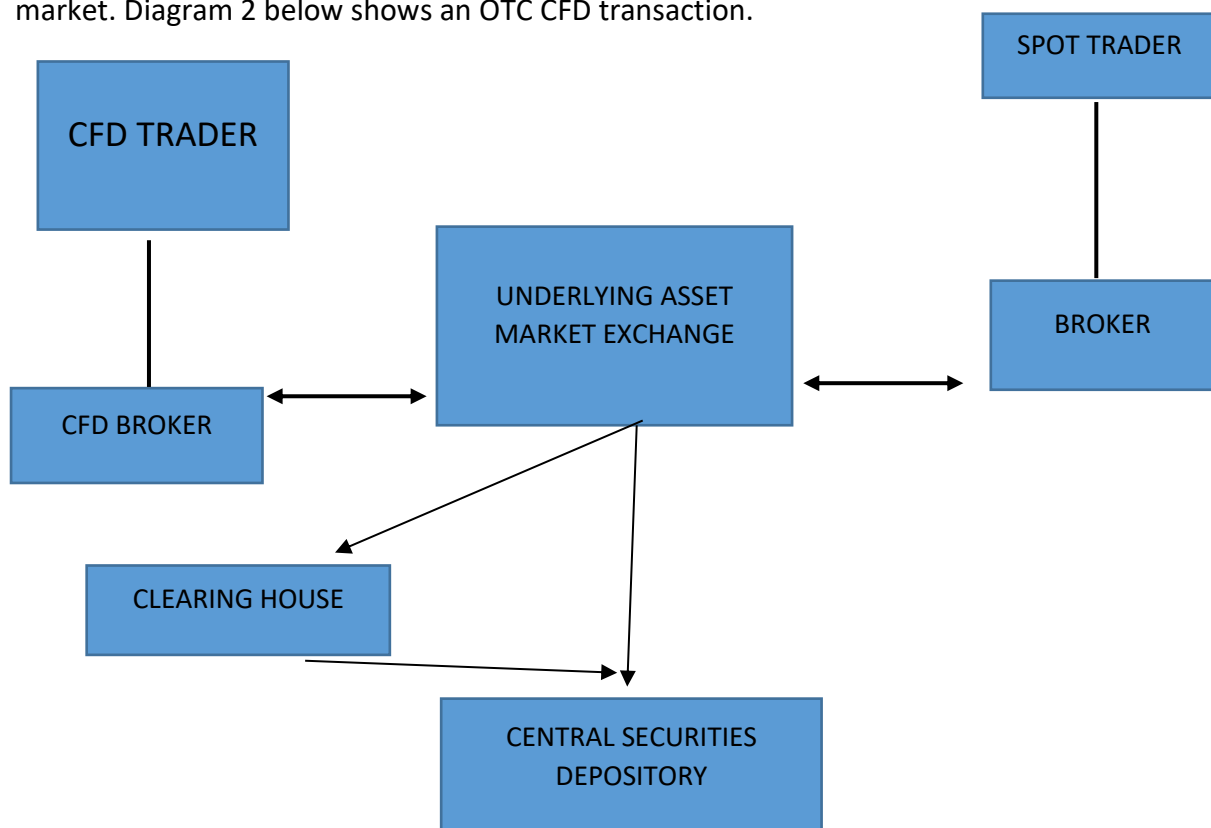


Diagram 2 : OTC CFD Transaction (Shetty & Scott, 2006)

Diagram 2 shows that a CFD broker must be a broker approved by the Exchange to conduct CFD transactions. CFD traders who wish to trade in CFD can place orders with CFD brokers. In OTC CFD trading, the price for the value of the shares to be purchased is based on the price of the shares traded in the spot market and hedged in cash in the exchange.

Conclusion

Hence, it can be concluded that CFD transactions that are executed based on OTC only involve brokers and traders without being regulated by the SC. The SC only issues guidelines on products that can be traded according to CFDs and documents that need to be provided by brokers to traders for the purpose of creating awareness about CFD risks. Although CFDs are purely the trading of prices, brokers will still send orders made by CFD traders to the real stock market. This shows that the CFD broker actually owns the shares requested by the CFD trader. This study gives an important significance to the body of knowledge about financial contract as this contract is new and increased popularity in the past decade.

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