Regulatory Analysis of Contracts for Differences(CFDs)

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INVESTMENT DEALERS ASSOCIATION OF CANADA

Investment Dealers Association of Canada

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PREFACE

This regulatory study examines the salient characteristics of a new retail product referred to as Contracts-for-Difference (or CFDs). The paper was researched and prepared in response to a pending new IDA member application. This product is currently marketed and sold to accredited Canadian customers under the applicant firm's current Ontario registration as a limited market dealer and registration categories in other provinces. The applicant intends to expand its target market by product offerings to non-accredited retail customers through registration as an investment dealer and member of the IDA. The CFDs will be sold under a proposed base shelf prospectus[1] to both retail and institutional investors.

In order to provide the reader with a full understanding of CFDs and related regulatory issues, the following subject matters are covered:

- Introduction and product characteristics;
- Distribution structure and transaction money flow;
- On-line trading and risk management systems;
- Rules in foreign markets and regulatory jurisdictions;
- Application of IDA capital and margin rules;
- Books and Records and Business Conduct Requirements for IDA Members.

Louis P. Piergeti
Vice-President, Financial Compliance
June 6, 2007

[1] NI 44-102: the term "base shelf prospectus" is defined as a short form prospectus filed in respect of an aggregate dollar amount of securities, which are put on "shelf" for up to 25 months until the issuer decides to take some or all of the qualified securities "off the shelf" to distribute them. At the time of issuance a supplement is prepared with specific information about the securities being sold which is incorporated in the "base shelf prospectus".

1. INTRODUCTION AND PRODUCT CHARACTERISTICS

A **Contract-for-Difference** (**CFD**) is a derivative product that allows investors to speculate or hedge on the underlying security movements, without the need for ownership and physical settlement of the underlying security. CFDs are generally traded over-the-counter (OTC) and mirror the economic performance of the underlying security based on its price movement[2].

The underlying security is common shares listed on a stock exchange, but may also be foreign currencies, bonds and indices where there is market transparency of price and traded volumes. CFDs allow investors to take long or short positions on the underlying security, but unlike futures contracts they have no fixed expiry date or contract size. A holder of the long contract, usually intra-day, will benefit from upward price movement of the underlying security and receive payment for the profit earned from the issuer of the contract. The contract is generally closed out by the end of the trading day and the settlement of profit and loss, less related commissions, is paid in full. Contracts may be rolled overnight subject to a financing charge on the leveraged amount of the position. The price of CFDs rolled over night is re-set the next trading day.

CFDs are marketed as high leverage products that can generate large profits, but losses as well for the investor. They represent a short term trading strategy and not a long term investment. As such, for retail investors they are speculative investment products and do not usually serve any significant hedge or risk management function. As a result, the distribution to investors is based on suitability waivers and account opening documents that consist of risk disclosure statements and written acknowledgements by the investor before an account is accepted and opened.

The salient features of the CFD that make it appealing to any speculative investor as an alternative short term day trading or hedge strategy are as follows:

- Low margin requirements ranging from 1% to 10% (100:1 to 10:1);
- Flexible contract sizes allow for partial closing of positions;
- Low execution costs ranging from 0.2-0.25% (calculated on size of the position and charged on opening and closing the position);
- No physical settlement of the underlying (no clearing, settlement and custody charges);
- Participation in corporate actions such as dividends and stock splits – but no voting rights[3];
- Ability to profit from rising and falling prices;
- No stock borrowing costs for short contract positions;
- No stamp duty (applicable in the UK);
- Exposure to foreign markets.

[2] There is some uncertainty as to whether OTC derivative contracts such as CFDs are, or should be, considered to be securities for the purpose of Canadian provincial securities legislation. Provincial securities commissions have not exercised comprehensive or uniform jurisdiction over such products. However, based on existing case law and the securities legislation in most provinces, it is likely that retail CFD products which represent a speculative investment contract are securities for the purposes of the legislation.

[3] Long convertible CFDs may result in voting rights if exercised.

Factors that may not be advantageous for a CFD investor relates to restrictions on contract offerings. For example, an issuer may restrict CFD product offerings to only underlying securities where the issuer has direct market access and there exist market price discovery mechanisms and high traded volumes of the underlying security. There may also be short availability of any issued CFD contract in the event that the issuer must limit or hedge its exposure to the underlying security at any time.

The contracts are further subject to a daily financing charge if rolled overnight. The financing charge is applied based on a previously agreed rate above or below LIBOR or other interest rate benchmark. All contracts are settled daily for the cash differential between the price of the opening and closing trades, including rollovers. Dealers acting as agents earn a substantial part of their revenue on financing the leveraged CFD positions rolled overnight, in addition to the small commission charges on execution of opening and closing the position.

2. DISTRIBUTION STRUCTURE AND TRANSACTION MONEY FLOW

Contracts-for-Differences (CFDs) are typically a contract between the investor and the issuer. They have varying brand names depending on who issues them. For example, they are sometimes called Turbo Certificates or Waves. In Hong Kong, they are referred to as Callable Bull/Bear Contracts (CBBCs). They may be structured as a one-off contract based on the price movement of an underlying security or a spread between the price movements of two underlying instruments — also known as a "spread bet".

As with any derivative instrument based on the economic performance of the underlying equities, bonds, foreign currencies or indices, a CFD allows an investor to simulate direct investment in the underlying instrument or foreign exchange currency at less cost and increased investment yield. A CFD based on single or cross currency spot rate differential may also be referred to as a "FX Spot Trading" or currency swap transaction.

The following comparative chart illustrates how a typical non-convertible CFD is structured. The parties to the contract are the **issuer, the on-line broker/dealer and the client**. The **issuer** assumes principal risk as the writer of the contract with the **client** that simulates the economic performance of the underlying instrument. The on-line broker/dealer is a market intermediary and primarily acts in an agency capacity in the transaction, but may also act as principal such as in a CFD on foreign currencies in which it hedges its principal FX exposure with another counterparty.

The broker/dealer is registered and licensed by the issuer to distribute its CFD product offerings on an unsolicited on-line trading platform. The trading platform is generally a proprietary system owned by the issuer and its on-line trading software includes: 1) order entry and execution, 2) contract real time pricing for P&L calculation and client equity calculations, 3) risk management tools such as credit and position limit monitoring, and 4) trading records. This software is licensed to the broker/dealer to administer as agent in the execution of the contracts between the issuer and the client. In most circumstances, the issuer and the on-line broker/dealer are related entities.

The traders of the CFD issuer closely scrutinize trading activity on the back-end of the system by monitoring global client positions in each instrument traded. If a client creates a significant position, the issuer may buy or sell the particular instrument in the underlying markets to hedge its risk. The broker/dealer has no principal exposure to the contract and therefore bears no market or credit risk to the traded CFDs. The broker/dealer, in addition to distributing the product offering and acting as agent in the execution of the CFD, is delegated administrative responsibilities for client account opening and monitors credit or account equity deficiency. Margin calls are issued and collected on behalf of the issuer by the broker/dealer. For the benefit of the client, the on-line trading platform offers order entry tools to allow clients to manage their own position. Clients are encouraged to enter limit and stop loss orders at the same time a new contract is entered into.

It is important to emphasize that the principals to the CFD contract are the issuer and the client and discussion in this paper is limited to this legal contractual relationship.

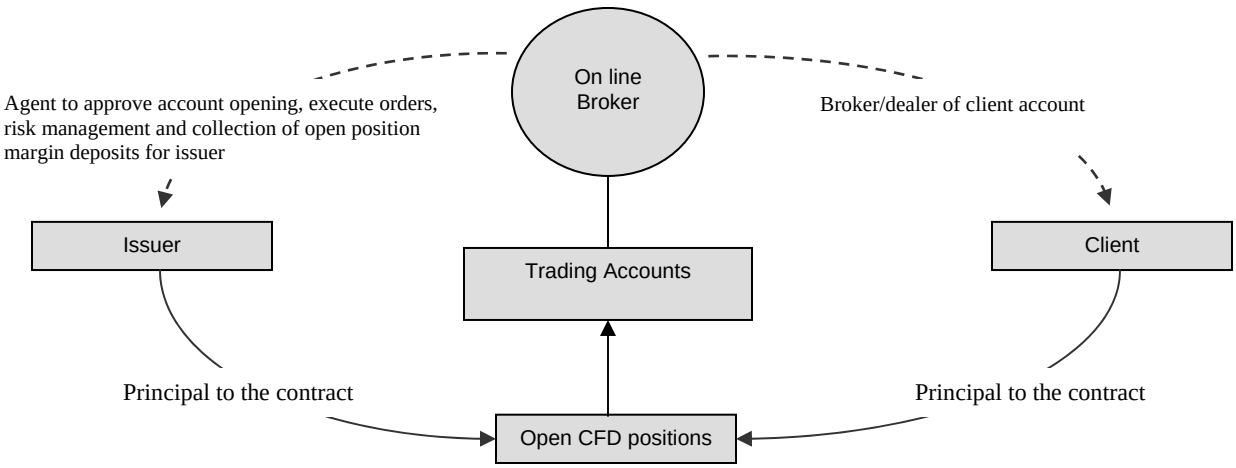
Specifically, this relationship is established in the terms and conditions in the product offering documents, and fully disclosed in the client opening agreements and risk disclosure documents. The provisions include unconditional indemnity by the issuer and the client to the broker/dealer from any liability or performance responsibility in the event of payment default by either principal party to the contract.

2.1 Diagram on the Inter-relationship to the CFD

The diagram demonstrates that the CFD issuer and the client are principal counterparties to the CFD. The broker/dealer requires securities registration for acting as agent for the issuer in the furtherance of a CFD trade.

The following diagram illustrates the inter-relationship between issuer — the on-line registered broker/dealer — and client to the CFD. The on-line broker/dealer acts as agent in the execution and clearing of the CFDs on behalf of the issuer and client. The issued CFDs are recorded on the books of the broker/dealer as open positions in the trading accounts of both the issuer and the client. The broker/dealer manages the collection of margin deposits and transfer of monies representing gains and losses between the trading accounts of the principals (issuer and client) to the contract.

This money transfer is further illustrated in the next diagram in this section.



Note: Client Net Equity = Money in the account – Minimum regulatory margin required on CFD open positions +/- MTM on CFDs (less commission and financing charges)

When a client opens a position and executes a trade, the monies required to fund the trade or margin deposit (plus any charges applicable to the trade such as commission and financing costs) are electronically transferred by wire from the bank account of the broker/dealer to the issuer. Once the client closes its position, the funds (in addition to or less any monies made or lost on the trade and less any commission fee applicable to the trade) are electronically transferred by wire back to the bank account of the broker/dealer. When a client position is left open (meaning roll overnight to the next day), the position is still marked to market and closed at the mid-market price at the end of the day. The funds are then transferred by wire back to the broker/dealer (plus or minus profit or loss for the day). **This is done daily using a fully automated settlement procedure.** The position is then reopened at the mid-market price the next morning and funds required to reopen that position are moved from the broker/dealer bank account back to the issuer (adjusted for financing costs for long and short positions). Normally, contract positions are **NOT** held overnight, but rolled over at a price reset the next business day subject to a financing cost.

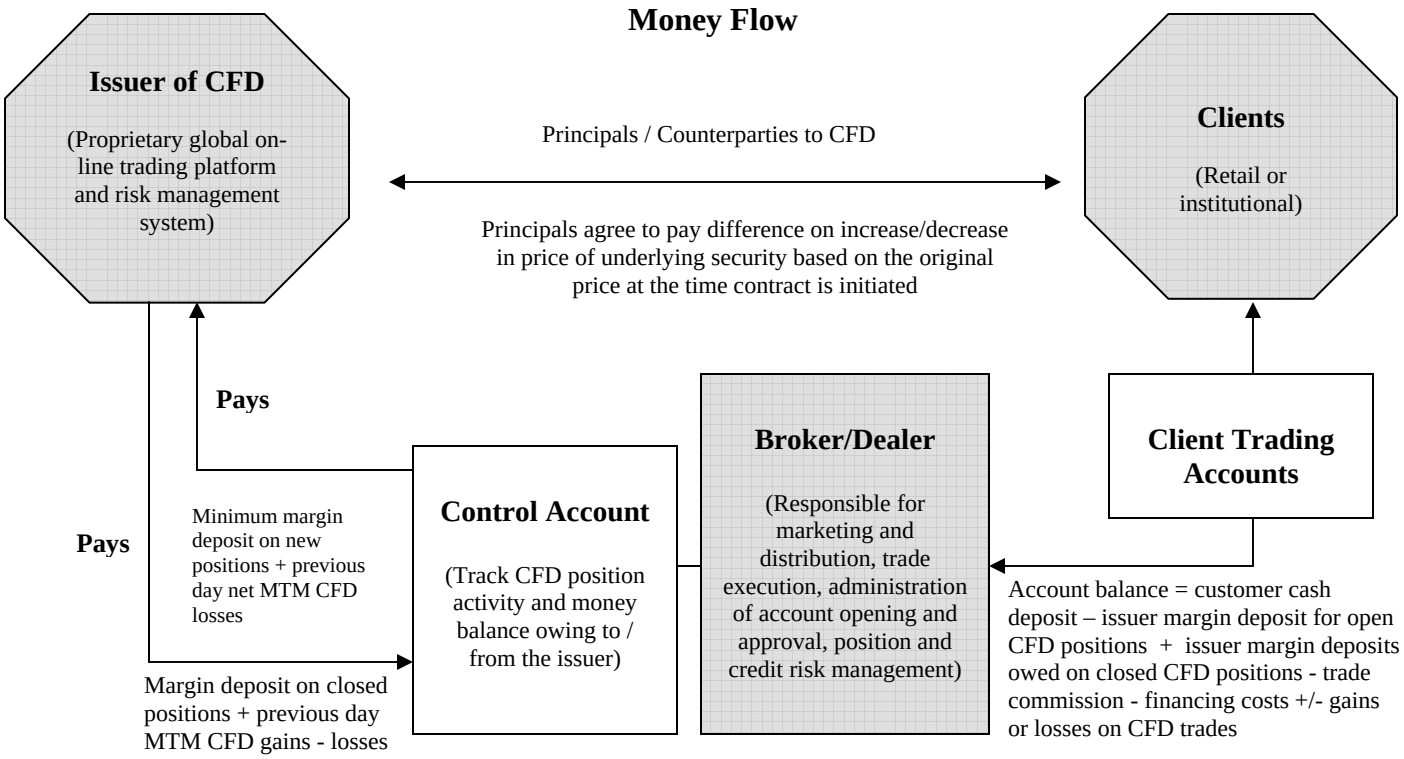
The trading account of the client on the books and records of the broker/dealer is updated in real time to reflect all position trading and balance changes (including mark-to-market gains/losses and dividends on open CFD positions, and applicable charges such as commission and financing costs). The broker/dealer maintains an issuer control account as the offset account to client CFD trading activity and track monies owed to/from the issuer for internal reconciliation purposes.

2.2 Diagram on Money Flow for a CFD Transaction

The relationship of the broker/dealer to the client and the issuer is somewhat similar to that of a clearing agency in the manner in which money flow is managed. Under the securities legislation of several Canadian provinces, however, the definition of a clearing agency **excludes** a registered dealer and, therefore, approval as a clearing agency would not be required in those provinces.

Unlike recognized clearing organizations that act as a central counterparty and guarantees the performance and payment obligations of contract positions to all its participants, the broker/dealer in this situation has no obligations in the event of credit default by the issuer or the client, except to manage the flow of money between the two principals to the contract.

The following chart illustrates the money flow between the CFD issuer, the client and the on-line broker/dealer[4].



[4] This is a common business arrangement. There may be other variations of this arrangement involving the retention of customer deposits, including customer profits by the issuer that will result in capital implication to the on-line broker. This is further examined in section 6 of this study.

2.3 Diagram on the yield sensitivity based on differing margin rates

The following diagram illustrates yield sensitivity (as well as **cost advantage)** to an investor purchasing an over-the-counter CFD from an issuer through an on-line broker/dealer with a three day rolling daily settlement compared to purchasing the underlying securities from an on-line discount broker with a three day settlement.

This example assumes an issuer margin deposit of 5% and 20%, against the lowest regulatory customer margin rate of 30% offered by a discount broker for securities eligible for reduced margin (LSERM) per IDA Regulation 100.2(F)(iv). The execution cost for a CFD is generally 0.10% (minimum of $7.50 and maximum of $40) and the commission charged by discount brokers is as low as $9.99 (maximum of $29). The financing cost for the leveraged CFD position and the debit balance in the discount broker account is 6.75% annually. Both the issuer and the discount broker require minimum margin deposit to be in the account before the trade order is executed, which is a common credit policy amongst most IDA member firm discount brokers.

Buy / Sell	**CFD**	**CFD**	**Listed Security**
	(Issuer)	**(Issuer)**	**(Discount Broker)**
Day 1 Buy 750 ABC @ $12 = $9,000			
Margin rate	5%	20%	30% (LSERM)
Margin deposit	$450	$1,800	$2,700
Commission	$9.00 (0.10%)	$9.00 (0.10%)	$9.99
Cost Comparison – Initial Outlay required to make trade	$459	$1,809	$2,709.99
Day 3 Sell 750 ABC @ $13 = $9,750			
Financing (6.75% Annually)	$4.74	$3.99	$3.50
Commission	$9.75 (0.10%)	$9.75 (0.10%)	$9.99
Gross Profit	$750	$750	$750
Total Cost of Transactions	$23.49	$22.74	$23.48
Net Profit	$726.51	$727.26	$726.52
% Potential Return on initial investment	158.3%	40.2%	26.8%

Note: Cumulative CFD profit and loss based on rollover of the contract over 3 business days.

The analysis shows that the total transaction cost is comparable between a CFD and the underlying security. Both the issuer and the discount broker earn commission and financing charges. To the investor, the difference is apparent in the sensitivity of the potential return on the initial investment under the 3 scenarios depending on the margin rates offered. Unlike a discount broker, for the CFD issuer, as principal to the transaction, the potential to earn a profit is simply a bet with the client on the market price direction of the underlying security.

3. ON-LINE TRADING AND RISK MANAGEMENT SYSTEM

The trading of on-line CFD products in an OTC market requires sophisticated trading software systems that interface the issuer with the intermediary and the end client.

The system must enable the issuer to effectively monitor its exposure to open contract positions that it has issued instantaneously with price feeds from listed markets where the underlying equities and indices trade or OTC market places where underlying bonds or currencies trade. This includes having systems linked to global exchanges to hedge their open contract positions on a net basis. The intermediary must have sophisticated software systems to provide the investor with necessary investment tools such as news, position monitoring, price quotation and charts. This includes an order entry system, open contract position monitoring, and price feeds for valuations to instantaneously track customer equity profit and loss. Given the interdependence of software systems between the intermediary and the issuer, the systems developed by such organizations are generally integrated and proprietary.

Given the competitiveness by CFD providers in setting margin rates, interest rates and commissions, it is software system sophistication, and range of CFD product offerings by the issuers that differentiates them. The suite of software tools (or "bells and whistles") on the system platform available to clients is provided for a fixed monthly fee and may be adjusted based on a grid for trading volumes generated by each client.

Given the day trading nature of the CFDs (where open positions are settled and closed out by the end of the day), speed of order execution for risk management is critical to the client. The CFD proprietary software systems all offer a range of order entry options. The client determines what risks exist in their investment trading strategy and uses the system the way it wants to limit its risk. Given that the leverage offered by issuers on CFD positions (as large as 20% and as small as 1%), the order entry system is a necessary risk management tool for the client. A client trading CFDs is enabled to limit risk by order entry options that include a guaranteed stop-loss facility. This means that CFD positions will be closed at a level pre-selected by the client with no price gaps, in spite of dramatic market movements, effectively limiting the customer's losses. They can be provided by the system because of the inherent nature of the CFD contract which is a principal position between the client and the issuer. The issuer earns an additional fee by charging a premium for a guaranteed stop order.

Order types accepted on-line without charge include: Limits (allowing you to buy or sell at specific prices), Stop-loss, If-Done (contingent orders) and OCOs (combination of a Limit and a Stop Loss order).

From an issuer perspective, the proprietary CFD software system must be capable of providing the issuer with its own risk management functions. This includes monitoring net CFD position concentration in any underlying security and setting single contract position trading limits (net long or short) in order to manage its market exposure. From a credit perspective, continuous monitoring of all customer CFD position losses compared to their account collateral deposits and account equity is critical to minimize bad debt exposure to the issuer in the event of a default by the client. This is accomplished by system parameters that invoke margin calls and liquidating

positions. The client credit risk management and margin call collection is a delegated responsibility by the issuer to the broker/dealer as this is where the client-broker relationship resides.

An example of a credit risk management tool built into such systems is referred to as a "liquidation percentage". A liquidation percentage can be set in the system by the broker for any client so that in the event the client's total account equity expressed as percentage of the total margin based on the market price of the underlying securities in each CFD open position falls below this percentage, the broker is entitled to start liquidating the client's position to prevent the client from moving into negative free equity position. These rights are built into the contract terms of the CFD and the percentages set by the broker as part of the credit assessment of the client. Under the terms of the contract, the broker/dealer does not bear any credit or payment default risk — it rests solely between the issuer and the client as principals to the contract. The broker/dealer is only responsible to the client for its net equity holdings in the account.

Of course, any CFD software system must be capable of producing the necessary audit trail and books and records required by regulatory authorities in the jurisdictions in which the product is offered and traded. This includes trading blotters, customer sub-ledgers, and trade confirmations. Given the on-line nature of the records, these customer records are normally accessed on-line by the client rather than hardcopy as set out in the account opening agreement.

4. RULES IN FOREIGN MARKETS AND REGULATORY JURISDICTIONS

CFDs are currently available in listed and/or over-the-counter markets in the United Kingdom (UK), Germany, Switzerland, Italy, Singapore, South Africa, Australia, and now New Zealand. Some other securities markets, such as Hong Kong, have plans to issue CFDs in the near future.

The product was originally engineered in the early 1990s and became increasingly popular in the UK with the introduction of on-line trading platforms. The initial advantage of CFDs was that they allowed large hedge-fund clients to be able to easily short the market while being able to benefit from effective leverage. It also eliminated the need to physically settle securities transactions and related costs, including stock borrowing costs when shorting the stock.

Towards the end of the 1990s as the dotcom boom started to take hold, the product was made accessible to private clients to trade via the internet directly into the London Stock Exchange order-driven trading systems. For the first time, individuals trading their own accounts, as well as small institutions and investment funds who did not have the resources available to allow them direct connectivity to the London Stock Exchange, could trade the UK equity market on a level footing with the largest institutions.

Although there is no published data, internet based news reports in 2006 claim that up to 30% of all cash equity trading on the London Stock Exchange was attributable to CFDs representing a £3 billion mature market in the UK. It has become an alternative product of choice for active day traders, hedge funds, and money managers worldwide due to the high leverage ratios offered by the issuers and no stamp duty.

Similar products were first introduced in Australia in 2002. In 2006, the Australian Stock Exchange (ASX), in an effort to increase traded volumes and liquidity for its listings, established the world's first exchange-traded market for CFDs on the Sydney Futures Exchange (SFE). It is estimated that in 3-5 years, 20% of the ASX traded volume would be attributed to CFDs. At the time of this report, the formal launch date of listed CFDs on the SFE has been delayed until the 2nd quarter of 2007.

There are a number of CFD dealers in the market, and many can be found on-line by simply searching any web search engine (see Appendix A for search results).

The following is a description of the CFD rules in such foreign jurisdictions. This information on CFDs is based on papers and other published material on the web sites of such regulatory authorities.

4.1 United States

There is no official corollary to Contracts-for-Differences (CFDs) recognized by the US regulatory schema. In the US there is essentially a three part classification of derivative contracts consisting of swaps, futures and options, and single stock futures.

A vanilla CFD is comparable to a swap contract in which two parties agree to swap the economic performance of an underlying security. Institutionally traded swaps are excluded from most US regulation. Both the CFTC and the SEC recognize the existence of OTC Swap Contracts, insofar as institutionally traded OTC Swaps are statutorily excluded from CFTC and SEC oversight.

Futures and options are regulated by the CFTC while shares (in the form of single stock futures) are jointly regulated by the CFTC and SEC. While similar in behavior to CFDs on shares, these contracts still retain the legal fiction of rights in the underlying instrument not otherwise found in OTC CFDs.

The closest product comparison to CFDs in the US is on-line FX spot trading. This market has evolved since 1996 with the development of web-based trading technology and platforms. Given the tremendous growth of FX spot trading in the US and penetration into the Canadian marketplace, it is worthy to briefly cover it here.

Unlike a typical CFD, an FX spot contract is between the broker intermediary (also referred to as a market maker) and the investor. The contract is based on the intra-day FX rate movement for a specific foreign currency compared to a benchmark currency which increases or decreases. Currencies are quoted in pairs i.e. EUR/USD (Euro vs. United States Dollar). The position is closed by the end of the day or can be rolled overnight at the option of the client or automatically. If the position is rolled over, there is a fee calculated at the end of the day based upon the interest rate differential between the two currencies in the pairing.

Identifying fundamental differences between the FX spot and FX futures helps explain the growth of the retail FX spot trading market. Futures are generally based on listed contracts on a recognized derivatives exchange, with typical durations of 3 months. Spot, on the other hand, is traded over-the-counter with a two-day cash delivery or settlement date. While the futures markets were created to hedge out risks and speculate on future market conditions, spot was created to allow actual cash deliveries. Spot developed a two-day delivery date to give those transporting the actual cash a window of time to receive it. While in theory there still is a two-day delivery date imposed after a FX transaction, this is effectively no longer used. Instead, every day at 5 pm EST (the predetermined end of the trading day) spot positions are closed and then reopened. This is done to guarantee an unlimited timeline for delivery. For example, if a spot transaction occurs on a Monday, the delivery date is Wednesday. At 5 pm on Monday, the position is closed and then immediately re-opened; now this is a new position with the close date of Thursday. This daily process allows an investor to hold open a position indefinitely until such time as the investor decides to close and not carry the position any longer.

Foreign exchange spreads offered on web-based trading platforms to retail investors are priced off inter-bank market rates[5]. It is business critical for the market maker, acting as principal to the

[5] Unlike a stock market, where all participants have access to the same prices, the FX market is divided into levels of access. At the top is the inter-bank market, which is made up of the largest investment banking firms. Within the inter-bank market, spreads, which are the difference between the bid and ask prices, are razor sharp and usually unavailable, and not known to players outside the inner circle. As you descend the levels of access, the difference between the bid and ask prices widens. This is due to volume. If a trader can guarantee large numbers of transactions for large amounts, they can demand a smaller difference between the bid and ask price, which is referred to as a better spread. The levels of access that make up the FX market are determined by the size of the "line" (the amount of money with which they are trading). The top-tier inter-bank market accounts for over half of all FX transactions.

long or short client FX contract, to generate significant volumes of order flow in order to buy or sell offsetting positions based on inter-bank FX spreads. The market maker does not charge execution commission but earns revenue on FX spot trades by taking a few basis percentage points (BPS) off the bid and ask spreads offered to retail customers for opening and closing the position[6].

In the US, OTC retail FX spot trading must be conducted in a Future Commodity Merchant (FCM) and is thereby regulated by the CFTC and the NFA (and not the SEC)[7]. These authorities have granted FX spot trading "special" regulatory status within the Commodity Exchange Act that allows these contracts to trade at higher leverage then any other retail product. These margin rules contained in NFA Bylaw 306 allow investors to trade with a deposit as low as 1% margin[8] or leverage of 100:1. FX market makers (broker dealer intermediaries) employ automatic risk management systems, similar to CFDs to close out positions when clients run out of margin (the amount of money in their account not tied to a position). Unlike CFDs as previously described, it is the FX market maker that bears the full credit risk or default of payment on losses incurred by the client.

For example, assuming a leverage ratio of 100:1, if the client has $2,000 in his account, and he is buying a $100,000 lot of EUR/USD, he has $1,000 of his $2,000 tied up in margin, with $1,000 left to allow his position to fluctuate downward without being closed out. Dealers that are regulated by the NFA are required to calculate and collect security deposits that equal or exceed the percentage set by NFA rules[9].This would include FX contracts that are rolled over daily with indefinite spot settlement date.

For a FX spot market maker to be successful it must build critical mass of client order flow or traded volumes to obtain the best spreads.

6 An FX market maker does not charge commissions or transaction fees. Instead, traders need to clear what is called a pip spread. For most currency pairs, there is a 3 to 5 pip spread, meaning that a trader needs a position to grow at least $0.0003 to $0.0005 to break even on the transaction. Pip spreads are largely standardized across the FX industry. The spread is posted as the difference between the "bid" and "ask" prices for a currency pair.

For example, if a client wants to go long on Euros versus US dollars, the posted spread will be $1.2500 bid and $1.2503 ask, which is a 3 pip spread. The client must first buy US dollars at the ask price but can only sell them back to the FX spot dealer at the bid price. The pip difference between the "ask" and "bid" prices is the client's cost per transaction. For a client to realize a profit with a 3 pip spread, the long position has to grow at least 4 pips, at which point the client will generate one pip profit on its leveraged position. The higher the leverage, the more the profit or losses that may be incurred from a 1 pip change.

7 In British Columbia, the BCSC has issued a communiqué that says *"…investors should be aware that dealers or brokers that open trading accounts for B.C. clients are required to be registered in British Columbia, either as an IDA-member investment dealer or an exchange contracts dealer. Investors should check with the BCSC to be sure that a dealer is registered to trade in B.C. before they conduct business with that firm".* (Source - http://www.bcsc.bc.ca/release.asp?id=34).

In Ontario, the OSC has not published or taken a formal position on the issue of registration for entities that offer FX spot trading services to retail clients residing in Ontario.

8 Refer to IDA Member Regulation Notice MR-0351 dated May 12, 2005 for guidance on margin rates application for unhedged FX positions held in customer accounts.

9 Source: NFA rule 2-36 and on-line NFA brochure entitled "Trading in the Retail Off-Exchange Foreign Currency Market – *What Investors Need to Know*" – page 7.

The NFA rule Section 12 paragraph (a)(i)- (iv) requires 1% of the notional value of transactions in the British pound, Swiss francs, the Canadian dollar, the Japanese yen, the Euro, the Australian dollar, the New Zealand dollar, the Swedish krona, the Norwegian krone and Danish krone. For all other currency contracts, the requirement is 4% of the notional value. For short positions, the above noted amount plus premium received and for long options, the entire premium.

Note: NFA [7012] Financial Requirements Section 12 - Financial Requirements Security deposits for FX transactions with FX dealer. It requires that an FX dealer member to collect and maintain minimum security deposit for each FX transaction between the FX Dealer Member and retail customers. The NFA rules further allow under Section 12(b) for an FX Dealer to forgo margin collection if it maintains adjusted net

The only notable difference between FX spot contracts and a plain vanilla CFD is that the market maker is the principal to a FX spot contract with the retail client instead of an agent acting on behalf of a third party issuer. The market maker in turn offsets its principal net FX contract exposure with its clients with offsetting FX contracts entered into with a third party – typically an institutional FX market participant such as a bank or FX dealer that trade in the inter-bank markets.

It is relevant to note that unless the CFD is traded in the OTC market in the US with institutional market participants, similar to swaps, they are not a recognized derivative under the Securities Exchange or CFTC rules[10]. This means that CFDs are prohibited for trading with retail customers, unless they are given a special regulatory status such as OTC retail FX spot trading. It is currently unlikely that equity CFDs in the US will be given similar special regulatory status to trade OTC with retail clients as it would then compete head on with fast growing listed derivative market for single equity futures contracts that currently trade on CME, CBOE, CBOT and NQLX.

4.2 United Kingdom

The Financial Services Authority (FSA) is responsible for the regulation of the securities industry in the UK, including CFDs. As previously noted, the CFD market originated in the UK and is reported to represent a £3 billion mature market in the UK.

In the UK, the FSA has not established margin rates for CFDs and instead they are allowed to be set by the issuers of the contract. The margin deposit ranges from 5% - 10% based on the notional market value of the top 100 (blue chip) stocks listed on the FTSE. The regulatory margin on these stocks which are highly liquid well capitalized firms is 5%. For other less liquid and/or volatile stocks such as tech stocks, the margin is typically 10% - 25%. Contract positions are generally not carried overnight.

In 2006, the FSA announced that it would be incorporating a Market in Financial Instruments Directive (MiFID) into the FSA Handbook. The importance of the MiFID is that it introduces a single market and regulatory regime for investment services across the 27 states of the European Union. The effect of this adoption planned for November 1, 2007 is that most FSA firms that fall within the scope of MiFID will also have to comply with the new Capital Requirements Directive (CRD)/Basel 2 which will set requirements for the regulatory capital a firm must hold. The capital requirement will be based on the higher of (i) a base capital requirement; and (ii) the sum of credit risk, market risk and operational risk. As a result, issuers engaged in the CFD trading in the UK will need to comply with these new capital requirements and in turn may impact margin rates they set.

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capital of at least twice the greater of the amount otherwise required for open FX contract positions. There is no comparable rule for IDA member firms to substitute the requirement to collect customer margin based on a multiple of their excess risk adjusted capital.

[10] The IDA has taken a regulatory position based on a legal analysis prepared by Borden Ladner Gervais LLP in February 2005, that referenced legal jurisprudence in which FX spot contracts are "securities" for purposes of Canadian securities regulation and thereby a permissible activity if conducted by an IDA member firm.

Information to determine the capital impact of CRD/Basel 2 capital requirements on FSA participants that are engaged as CFD issuers is not currently available.

The FSA requires that before a retail customer can trade in CFDs, the account opening process must include an evaluation of the investment knowledge and trading experience of the individual. It also requires that the customer be provided with what is referred to as Intermediate Customer Notice (or ICN). This is a customer risk disclosure document setting out the obligations of the customer and the intermediary. For the most part, it is a risk and suitability waiver acknowledged by the customer.

Although the FSA requires that the customer have some degree of investment knowledge and trading experience, it does not specifically prescribe how the intermediary is to make such a determination. As a result, all broker/dealer intermediaries have established internal policies and procedures that require the customer to undergo an interview and complete a questionnaire to gauge level of knowledge and experience before the customer is approved by the intermediary and an account is opened. As stated, the FSA also requires that the client acknowledge and sign the ICN.

To address concerns as to market manipulation in the markets in which the underlying security to the CFD is traded, the FSA has established a CFD disclosure regime. This enables the FSA regulator to monitor the market effectively and thereby maintain confidence in the financial system and reduce financial crime. The FSA Handbook currently requires CFD transaction reporting by members for positions in excess of 3% of a listed company and in increments of 1% thereafter[11]. The adoption of this rule followed a UK takeover tribunal ruling in or around 2000. At the time, the disclosure ruling required investors to disclose CFDs over stock positions of 3% or more of a company's listed outstanding shares as soon as it entered a bid situation[12]. The basis of this disclosure is to provide market transparency in the event a large short CFD position is accumulated by a client requiring the CFD provider/issuer to go into the underlying listed market to hedge its principal position by selling borrowed listed stocks in the marketplace. As noted by the UK takeover tribunal at the time, a large short is potentially destabilizing for a company's share price. As evidence as to the enforcement of this requirement, the FSA reported in 2004 and 2005 disciplinary actions on authorized members for failure to make accurate and complete CFD transaction reports[13].

Recently in October 2006, the FSA published for comment a regulatory consultation paper — Transparency Directive Rules (policy statement PS06/11). The paper outlined plans for further

[11] Module SUP 17.4 requires authorized firms to make transaction reports in respect of all reportable transactions which it makes, either on its own account or on behalf of another. Reportable transactions (as defined in SUP17.5) include transactions involving contracts for differences on equities (CFDs).

[12] The effect of the rule was illustrated when the Panel forced Och-Ziff and Cycladic Capital, the US hedge funds, to reveal their 19.9 percent CFD interest in Photo-Me International, the UK photobooth operator, following a takeover approach.

[13] Examples of market abuse include Bear, Sterns International Limited (July 22, 2005) financial penalty of 40,000 pounds, and Indigo Capital LLC (December 21, 2004) in the amount of 65,000 pounds by the FSA for failure to report or provide inaccurate information to the FSA. This included having appropriate reporting systems in place to supervise and report CFD positions.

work on the FSA CFD disclosure regime as there was no consensus from respondents to the position paper on the need for such disclosure, but a desire for further work to be done on the issue[14]. The FSA will continue to liaise with the UK Takeover Panel in examining this issue and will publish its conclusions in June 2007. In the meantime, the existing rules noted above continue to apply.

4.3 Singapore

The Monetary Authority in Singapore (MAS) as late as July 2006, published for comment margin rules for CFDs. This paper actually provides comparative insight on other foreign jurisdiction regulators as to the regulatory approach taken in establishing margin rate rules for CFDs. The MAS proposal called to formalize minimum margin requirements for CFDs based on (i) the margin prescribed by an exchange for a comparable contract subject to several conditions, or (ii) a default 20% initial margin and 15% maintenance margin if there is no comparable exchange-traded contract (see Appendix B). Any shortfalls in the margin account for CFDs must be met the next day.

Respondents commented that the proposed minimum margin was notably higher than the industry norms in established CFD markets such as the UK and Australia, especially for non-equity CFDs that respondents planned to introduce in Singapore. On the proposed conditions for comparable contracts, some respondents disagreed with the comparison of CFDs to single stock futures, saying that it would be difficult to find an exchange-traded contract that exactly matches a CFD, and that there would be significant costs in ongoing monitoring. Some respondents also requested for margin calls to be met by T+2, citing practical difficulties.

The MAS response was to maintain their position that minimum margin requirements **are necessary to prevent excessive leverage by investors, and at the same time to institute a reasonable level of risk management within market participants. This was viewed as especially important for an untested CFD market in Singapore and the rationale would be no different in Canada.** After recognizing concerns over consistency with industry norms, the MAS amended its regulatory margin requirements originally proposed for CFDs.

The MAS final margin rules set differentiated regulatory minimum margin requirements for different types of CFDs, depending on the underlying instrument and the risk mitigation features embedded in the CFDs. There is only a single-tier minimum (no maintenance) margin

[14] The paper describes three potential market failures which may arise from the non-disclosure of economic interests:

- inefficient pricing in the equity market as a result of information asymmetries;
- the risk of stealth takeovers by predatory investors using CFDs to bypass the major shareholder notification requirements; and
- weakened market confidence due to the lack of transparency about the identity of investors with undisclosed economic interests.

Any market failure that may exist and the potential costs and benefits of the three principal policy options proposed for addressing these failures are:

- maintaining the regime as it currently stands;
- strengthening the current major shareholder notification regime, addressing instances where CFD holders effectively have constructive options' over shares held in hedge or where banks vote stock in accordance with CFD holders' wishes; and
- introducing a regime similar to the Takeover Panel regime, requiring notification of 'economic interests' in shares held via instruments such as CFDs.

requirement for each type of CFDs with no requirement for comparable contacts. In addition, margin calls must be met no later than 2 business days (instead of one) in line with the practice for futures business and minimizes the compliance burden for futures brokers who also offer CFDs.

The minimum regulatory margin rates for equity CFD range from 10% for index stocks to 20% for non-index stocks. The unique feature in the MAS rules allows for reduced margin if there is a guaranteed stop loss order embedded in the CFD contract with the Issuer. For example, the margin rate is the lower of 10% (for index stock) and the amount at risk. The reduced margin reflects the same market risk as being long a stock position with a put option on the same underlying instrument per IDA rules (see Appendix B for more details on MAS margin rule).

4.4 Australia

In September 2006, the Australian Stock Exchange announced that it was establishing the world's first exchange-traded market for contracts-for-difference on the Sydney Futures Exchange and named eight brokerage firms as designated price-makers.

Current volumes are unknown because CFDs are only traded over-the-counter in Australia. By making an exchange-traded market for the product, the ASX said it would improve transparency and give secure counter-party backing. "*While CFDs have been one of the fastest growing product sectors in financial markets in recent years, the exchange-traded CFDs to be listed on SFE will become the first to offer all the benefits of central counterparty clearing, frontline regulation, liquidity provision and multi-broker access"*, said a statement by the ASX announcing the listing of CFDs on the SFE[15].

It is the first new product offering from the ASX since it merged with the SFE in July 2006. The designated price-makers are Commonwealth Bank, Credit Suisse, IMC Pacific, Optiver Australia, Susquehanna Pacific, UBS Australia, Merrill Lynch and Timber Hill Australia. The SFE said the exchange-traded CFDs will be listed across a broad range of assets, including global equity indices and major Australian stocks. Foreign exchange crosses and key commodities, including gold and oil, will also be included.

The launch date expected in April 2007 has been deferred to the summer and SFE/ASX has yet to announce how much they will require brokers/members to deposit as initial margin for their CFD products. It is speculated from the SFE futures broker community that the margins for individual share CFDs will be around 4% to 5%. However, the SFE is the only 'authority' in this decision. Currently ASIC has not issued guidelines or policy on what is a “suitable” margin for retail investors.

The only known information at this time is that CFD contracts traded on the exchange will have an initial margin as set by the SFE Clearing Corporation (SFECC) and is payable by the next trading day based on the open position. In addition, variation (or maintenance) margin applies and is also determined by SFECC using the Exchange Traded CFD Settlement.

[15] The Australian, “Bourse is world’s first with CFD exchange”, Kevin Andusiak, September 7, 2006.

5. APPLICATION OF IDA CAPITAL AND MARGIN RULES

In Canada, Contracts for Differences are a relatively new product and unknown to most investors and investment dealers. There are no known IDA members currently engaged in the trading of CFDs with their customers. That is expected to drastically change with strong interest expressed by current and prospective IDA member firms that are affiliates of foreign CFD providers that want to introduce the product into Canada.

Currently, there is at least one firm registered as a limited market dealer (LMD) in Ontario acting in the product offering of CFDs through on-line proprietary trading systems. In such cases, the distribution is limited to accredited investors and contracted OTC by offering memorandum or term sheet. Given that LMD registrants do not have specific capital and margin rules, there is no required minimum regulatory margin for open client CFD positions or leverage restrictions. It is another example of regulatory arbitrage between rules that are applicable to investment dealers as opposed to LMDs for the same product offering, albeit limited to accredited investors in the latter case.

Customer documentation and marketing literature provided by the LMD to accredited investors include contract terms and conditions, and risk disclosure statements that indemnify the LMD as agent from loss or issuer default on performance. The documents state that CFDs are speculative products that are highly leveraged and carry significantly greater risk than trading the underlying security. The risk disclosure document states that the customer may sustain losses greater than the margin deposit required to establish and maintain the CFD position; and that the customer is required to seek its own independent financial, legal, taxation and other professional advice to determine whether CFDs are an appropriate investment. This business conduct issue is addressed in the next section of this paper.

5.1 Margin Requirement

As an IDA Member, the distribution of a CFD is examined in the context of existing IDA rules and regulations applicable to products that are analogous to a CFD. For example, the development of listed single equity futures by the Bourse provides a good start in establishing margin rules applicable to CFDs where the underlying is a listed equity. As stated previously in this paper, an equity CFD has substantively the **same risk profile** as a single equity futures contract except for more flexibility in structuring a CFD by varying the quantity and expiry date. The other fundamental difference is that recognized clearing organizations guarantee liquidity for exchange issued and traded contracts, whereas with OTC CFDs, there is no guarantee of liquidity. **The performance to payout on closing a CFD position is limited to the credit worthiness of the issuer which is an investment risk fully disclosed to the client.**

IDA regulations do not contain all margin rules established by the applicable exchanges in which derivative products trade. Instead, IDA rules make reference to the application of margin rules set by the Exchange in which the product is listed and traded. In the case of CFDs for underlying listed equity, it is appropriate to apply the Bourse single equity futures rules which were

introduced in 2001[16]. It is noted that this approach is consistent with the manner in which the Monetary Authority in Singapore (MAS) applied its margin rules for CFDs as noted earlier in this paper.

The margin rules for single stock futures in a client account are set out in Section 9-1, 9-2 and 9-21 of the Bourse rule book. The margin rate for the single stock futures is determined by the sum of the following:

A) the floating margin rate of the underlying interest, and

B) the greater of :
   I) 10% of the floating margin rate[17] of the underlying interest; and
   II) where the floating margin rate of the underlying interest is:
      a) less than 10%, 5%;
      b) less than 20% but greater or equal to 10%, 4%; or
      c) greater or equal to 20%, 3%;

   multiplied by the daily settlement value of the futures contracts.

The Bourse rules require that a customer single stock futures position be margined based on a floating rate applicable to the underlying instrument that is reset at regulatory margin intervals or when a violation occurs. Floating margin rates are calculated internally by the IDA. The IDA applies this floating rate methodology to determine each quarter securities eligible for reduced margin (also referred to as LSERM) such as, for example, Suncor Energy Inc. As at September 30, 2006 Suncor Energy had a floating margin rate set at 12.25%. Applying the single equity futures margin rule described above, would result in a client margin rate of 17.5% for this futures contract position. This rate of 17.5% is comparatively higher than the rates that currently apply in the UK of 5-10% for the top 100 blue chip securities traded on the FTSE, and 10% as set by the Monetary Authority in Singapore for CFD referenced index stocks, but lower than the 20% for single stock futures in the US.

In the case of applying margin rates for CFDs based on underlying securities such as non-option eligible securities, foreign currency rates, and bonds, the margin rules of the underlying security as set out in IDA Regulation 100 apply in margining the CFD position.

5.2 Excess Margin Deposits / Capital Requirement

In addition to regulatory minimum margin requirements for CFD open positions in a customer account discussed above, there may also be counterparty capital requirement implications between an IDA member firm and the issuer of the CFD. It is here that differences may appear in that the margin deposit required by the issuer is not the same as the regulatory minimum margin required to be met by the client with the member firm upon entering into a CFD position.

[16] The Bourse launched its own single stock futures in 2001. The first contract listed was Nortel Networks Corporation and traded until November 10, 2004 when it was suspended and removed from the active list of products traded on the Bourse. Since then there have been no other listings of single stock futures traded on the Bourse.

[17] See Appendix C for definition of floating margin rate per IDA Regulation 100.9(x).

Unless CFDs clear and are guaranteed by a recognized clearing organization, as defined in the IDA Bylaws (such as CDCC in Canada), IDA rules do not allow customer margin rates to be based on the rates quoted by any issuer other than a recognized exchange or clearing organization — as defined in the IDA rules. As a result, there may be a mismatch between the collateral amount to be transferred to the issuer and the regulatory margin that must be met by the client with the member firm. It is not unusual for the margin deposit required by the issuer as collateral for the contracts to be less than the regulatory prescribed margin required from the client. Regardless of any differential in margin under these circumstances, it is the minimum margin rates (subject to higher "house" rates) prescribed by the IDA that must be met by the client with the member firm upon entering into the contract position[18].

Where the margin collateral is transferred to the issuer — the IDA counterparty classification rules must be considered as it may result in adverse capital implications to the member firm. It is critical for the member firm to determine the right counterparty classification of the issuer as set out in Form 1 of the IDA rules. These counterparty categories are defined in the general notes and instructions to Form 1 of the IDA rule book and include: "acceptable institutions", "acceptable counterparties", "regulated entities" and "other". There are different capital charge implications to the member firm for client monies held or owed by the issuer to the member firm's clients depending on the counterparty categorization of the issuer.

For example, if the issuer does not qualify as either a foreign/domestic regulated entity, or foreign/domestic acceptable institution, the client monies representing margin deposits remitted to such entities is treated by the IDA member firm as an unsecured receivable or non-allowable asset. This results in a 100% capital charge against the excess Risk Adjusted Capital of the member for allowing unsecured monies to be held or owed from the issuer outside of its control.

If the issuer qualifies as a domestic or foreign acceptable institution, there is no capital implication to the member firm for any monies or collateral held or owing from the issuer to the member's client.

If the issuer qualifies as a domestic or foreign regulated entity, the capital charge is limited to any excess monies held or owed by the regulated entity in excess of prescribed regulatory margin requirements for all open CFD positions. Monies must be immediately transferred back to the member firm on or before the next business day or it must be accounted for as an unsecured receivable from a regulated entity. As most CFD providers are UK issuers, it is noted that the entity must be classified by the FSA as a "Category A"[19] firm under their regulatory regime in

[18] IDA bylaw 17.11- Every Member shall obtain from clients and maintain in respect of its own account such minimum margin in such amount and in accordance with such requirements as the Board of Directors may from time to time by Regulation prescribe. Such minimum margin shall be used for calculations pursuant to Form 1.

An OTC CFD transaction (including FX spot) is a speculative investment based on a leveraged bet against movement in prices where the ownership or use of the underlying security (or currency) is immaterial. Such contracts never intend to physically settle by delivery of the underlying security which makes them different than traditional equity and bond transactions and should be viewed differently in determining the time frame in which customer margin upon entering into an OTC CFD position must be met.

[19] In May 1997 the supervision of banking and supervision of investment services regulation were merged into the Securities and Investments Board (SIB). SIB was changed to FSA in October 1997. In May 2000 the FSA took over the role of UK Listing Authority for LSE. (Also through legislation, FSA has other regulatory functions such as Securities and Futures Authority).

order to qualify as a regulated entity pursuant to the criteria established in the IDA instructions and definitions in Form 1[20].

The reason for this stringent capital charge application is that from a counterparty risk perspective, all IDA member firms must deal with regulated entities on a value for value basis, without exception.

A "Category A" firm is considered a large firm within the category of investment dealer/stock brokerage activities. Such firm is treated with greater scrutiny and the FSA assigns a direct supervisor to this category of registration

[20] See attached Appendix C for IDA application of regulated entity criteria to "Category A" regulated FSA members.

6. BOOKS AND RECORDS AND BUSINESS CONDUCT REQUIREMENTS

All applicable IDA rules and regulations as noted in this paper must be adhered to by any IDA member firm engaged in CFD trading. In addition, the following are additional requirements that a member must meet before engaging in such business activities:

6.1 Books and Records

The on-line trading platform, including brokerage accounting system used by a member firm, must comply with the minimum books and record requirements set out in Regulation 100.2, in particular:

- Profit and loss and account equity customer reports that provide the member the ability to monitor cumulative customer losses;
- Order entry system that is capable of capturing and storing detail customer order entry activity, including order type, date and time stamp.

The provider of the proprietary CFD trading and risk management system licensed for use by the IDA member must engage external auditors to provide an annual audit opinion on the computer environment controls in a form prescribed by CICA Handbook Section 5970 or equivalent international audit reporting standard.

6.2 Account Opening and Suitability Exemption

A condition precedent for exemption pursuant to IDA Policy 9A, an on-line CFD member must have a qualified futures supervisory registrant and detailed written policies and procedures satisfactory to the IDA[21], including applicable registration (e.g. dual registration in securities and futures) for all personnel who act in the furtherance of a trade with the public.

In addition, the following specific requirements apply:

- Applicable risk disclosure documents and client suitability waivers provided must be in a form acceptable to the IDA.
- The firm's policies and procedures, amongst other things, must assess the depth of investment knowledge and trading experience of the client before an account is approved to be opened[22].
- The relationship and responsibilities, including conflicts of interest between the issuer and the broker/dealer must be fully disclosed to the client and acknowledged in writing.
- Cumulative loss parameters for each customer account must be established.

[21] As precedence, suitability exemptions under Policy 9A have been given to IDA members. These are for order execution trading services offered in a separate division or entity. This includes both securities and futures.

[22] This is currently a requirement imposed by the FSA in the UK. See Appendix D for sample of internal procedure document for account opening customer assessment by a UK CFD issuer.

6.3 Customer Margin Requirements

As described in this paper, the IDA margin rules applicable to CFDs are based on the margin rates set out in Regulation 100 applicable to the underlying security (or currency) in which the CFD is created. For Canadian and US listed equities and indices, the Bourse margin rules for single equity futures contracts may apply with a floor minimum rate of 15%.

Given the uniqueness of OTC CFDs (including FX spot) as products different than traditional equity and bond transactions, it is inappropriate to apply client margin requirements based on "settlement" date. The fact that these types of OTC contracts never intend to physically settle on delivery of the underlying security (or currency) makes them different and requires specific regulatory guidance given the circumstances. For CFDs (including FX spot), **the collection of margin deposits from retail clients must occur upon entering into the contract position,** including prompt collection of margin calls, as required, in the event of adverse market movements. For institutional accounts that meet the criteria of an Acceptable Counterparty per IDA General Notes & Definitions to Form #1, margin required represents the mark to market deficiency in the account.

Single account and overall contract concentration rules are also considered to apply in the same manner as they do for exchange listed futures contract positions.

6.4 Insider Trading

There is currently no market surveillance or reporting regime in place for OTC CFD trading in listed equities in Canada. It is an account opening requirement that all prospective clients disclose whether they are insiders. Based on this information the member firm must have appropriate controls in place to prevent CFD trading for underlying securities in which the client is an insider.

In the absence of a market surveillance regime and to prevent market regulatory arbitrage in Canadian traded CFDs, no member firm should allow a customer (including inventory) to hold more than ½% of the float representing a cumulative interest in a CFD position intraday or rolled over[23].

6.5 Anti-Money Laundering

OTC CFD and FX spot trading is considered by international and Canadian law enforcement authorities to be a popular mode targeting the securities industry to launder the proceeds of money from illegal activities. All member firms, especially those engaged in CFD and FX spot trading must have a heightened awareness of these acts and ensure appropriate account opening procedures and account trading supervision are in place to detect and report suspicious trading to applicable enforcement authorities.

[23] It is a requirement in the UK that any accumulation of CFD positions in excess of 3% (and in increments of 1%) of the equity in a security must be reported to the FSA to monitor against market manipulation and destabilization in the event of a takeover bid.

6.6 Other

Member firms should also consider a final report of the Commodities Futures Act Review Committee which was tabled in the Ontario provincial legislature on Wednesday, March 28, 2007 calling for a principles-based approach to derivatives regulation.

It would be expected that OTC products such as CFD and FX spot involving retail investors will be captured under the proposed principles of regulation. This would be a significant step forward in resolving regulatory arbitrage that currently exists in Ontario by unregistered entities engaged in FX spot retail trading with Ontario residents and IDA member firms that engage in the same activity with defined standards of regulation that are set out in this Study.

APPENDIX A

WEB SEARCH RESULTS FOR CFD PROVIDERS

Barclays Dealers
City Credit Capital
City Index
CMC Markets
FAST CFDs
GCI Trading
GFT Global Markets UK
Global Trader
GNI Touch
Green CFD
Interactive Investor
IG Markets
Tradergate
gtltrading.com
cmgtrading.com
Saxo Bank
Sonray Capital Markets
Macquarie Bank
Marketech
Man Financial
Phillip Securities
Foreign Exchange Clearing House Ltd
Panafex, Ltd.

APPENDIX B

MARGIN RULES FOR OTC CFDS SET BY MONETARY AUTHORITY OF SINGAPORE (MSA)

TYPES OF CFDS	MINIMUM MARGIN REQUIREMENTS
Equity CFDs:	i) 10% for index stocks ii) 20% for non-index stocks
Index CFDs:	5%
Foreign Exchange CFDs:	2%
CFDs with non-guaranteed stop-loss: CFDs with guaranteed stop-loss:	Lower of: i) Amount at risk + 30% of Standard Margin; or ii) Standard Margin Lower of : i) Amount at risk + 10% if CFD is subject to any adjustment for dividend, interest or commission; or ii) Standard Margin where "amount at risk" refers to the maximum loss a customer may incur based on the difference between contract price and stop-loss price; "standard margin" refers to the minimum margin for the CFDs without stop-loss features; and "stop-loss" means a feature attached to an open CFD position to close the CFD if the price reaches a specified level.
Any other CFDs	20%

APPENDIX C

EXTRACT OF IDA REGULATION 100.9(X)

The term "floating margin rate" means:

(A) the last calculated regulatory margin interval, effective for the regular reset period or until a violation occurs, such rate to be reset on the regular reset date, to the calculated regulatory margin interval determined at that date; or

(B) where a violation has occurred, the last calculated regulatory margin interval determined at the date of the violation, effective for a minimum of twenty trading days, such rate to be reset at the close of the twentieth trading day, to the calculated regulatory margin interval determined at that date, where a reset results in a lower margin rate.

For the purposes of this definition, the term "regular reset date" is the date subsequent to the last reset date where the maximum number of trading days in the regular reset period has passed.

For the purposes of this definition, the term "regular reset period" is the normal period between margin rate resets. This period shall be determined by the Canadian self-regulatory organizations with member regulation responsibilities and shall be no longer than 60 trading days.

For the purposes of this definition, the term "regulatory margin interval", when calculated, means the product of:

(C) the maximum standard deviation of percentage changes in daily closing prices over the most recent 20, 90 and 260 trading days; and
(D) 3 (for a 99% confidence interval); and
(E) the square root of 2 (for two days coverage[24]);

rounded up to the next quarter percent.

For the purposes of this definition, the term "violation" means the circumstance where the maximum 1 or 2 day percentage change in the daily closing prices is greater than the margin rate.

[24] For LSERM, this day coverage may be 2, 3 or 4 depending on the traded volume and the public float of the listed shares.

APPENDIX D

IDA CRITERIA APPLIED TO FSA CATEGORY A FIRMS

The following sets out the criteria that IDA staff used to determine whether the FSA Category A firms qualify as a “recognized association” as defined in the General Notes and Instructions to Form 1:

Discussion

1. *Does the FSA maintain or is it a member of an investor protection regime equivalent to the Canadian Investor Protection Fund ("**CIPF**")?*

   The FSA maintains an investor protection regime that is understood to correspond to the CIPF — the Financial Services Compensation Scheme (the "**FSCS**"). The FSCS was created on 1 December 2001 when the Financial Services and Markets Act 2000 came into force, and acts as a "safety net" for clients of authorized firms. The FSCS is available when an authorized firm goes into default, and is unable or is likely to be unable to pay claims made against it by clients. The FSCS pays the first £30,000 of a valid claim in full and 90% of the next £20,000 - up to £48,000 for each client in total.

2. *Does the exchange or association require the segregation by its members of the customers’ fully paid for securities?*

   The FSA in its custody rules relating to segregation, recording, registration and holding of client assets distinguishes between safe custody investments and custody assets.

   Safe custody investment is a designated investment that a firm receives or holds on behalf of client, and custody investments are also designated investments and any other assets that the firm holds for or on behalf of a client. A client safe custody asset cannot be used by the firm unless client provides prior written consent to the firm; the service is supported by an agreement between the firm and the client. These assets must be segregated from a firm’s own investment.

   Client statement must separately identify assets held in client name from those registered in firm’s name (obtain client’s permission) and those custody assets that have been pledged to third parties (upon written permission from client), and their market values.

   Generally, the rules seem primarily to restrict the commingling of client and firm’s custody investments to prevent or minimize the risk of the firm using the assets without clients’ consent. In addition, FSA requires firms to perform a risk assessment of custodians holding client assets on its behalf.

3. *Does the FSA have rules and specific methodologies for the segregation of client credit balances; does the FSA have a process similar to "Statement D" contained in the Joint Regulatory Financial Questionnaire and Report?*

The FSA has established specific rules for the segregation of client funds. In short, all members of the FSA are subject to the FSA client money rules, but "expert" clients (accredited investors) may opt out of the FSA client money rules by expressly waiving the protection.

The client money rule requires that client money has to be kept separate and apart from the firm's own money, Segregation, in the event of a firm's failure, is important for the effective operation of the statutory trust that is created to protect client money. The only money that are to be held in a client account must be amounts required to keep positions open, interest and for temporary reasons. Members have an obligation to monitor the segregation requirement and to sweep funds on a daily basis to ensure the amount of funds held in segregated accounts is greater than the liabilities owed to clients.

There is no equivalent to Statement D.

4. *Does the FSA have rules regarding member firm and customer account margining?*

The FSA has established rules regarding margin, which are available in the FSA Handbook. The level of margin a firm is able to charge will depend on available resources, (which are linked to the financial resources requirement and risk management strategy discussed below).

5. *Does the FSA require periodic regulatory financial reporting and conducts regular examination of its Members and monitors member's regulatory capital on an ongoing basis?*

Members of FSA are subject to "Prudential" regulation in the UK, which means that the members must maintain adequate financial resources to cover the required financial resource requirement (FRR).

The FRR is calculated based on the rules in the FSA Handbook. In short, members must calculate, position risk, counterparty risk, credit risk, etc. and ensure that its financial reserves are always in excess of the FRR.

Reports in respect of the FRR are required to be issued to FSA each month end detailing the FRR and available resources. An annual report is also issued to FSA by members' external auditors, who are required to confirm that they comply with these rules during the course of the year.

The FSA uses a risk formula to prioritize firms for the purpose of assessment to determine the nature and frequency of on-site audits of these firms.

Priority Firm = Probability (of a problem occurring) x Impact (of the problem if it occurs)

This is an example of their risk weighing methodology.

Statutory Objective	**Impact**	**Probability**
Market Confidence	Medium High	Medium Low
Public Awareness	Medium High	Low
Consumer Protection	Medium High	Medium Low
Reduction of Financial Crime	Medium High	Low

Depending on a firm's risk weighing, the frequency of on-site audits are determined. (The above example, a Category A firm would not have an on-site audit until August 2007 from the last on-site audit in August 2005.)

Monthly Financial Report to FSA

With reference to #5 above, a Category A firm submits a balance sheet and income statement on a monthly basis to the FSA. Included with the balance sheet and income statement, are calculations to arrive at excess FRR. FRR is determined as the initial share capital or investment in the firm from which adjustments (reductions) are made for certain balance sheet items based on liquidity — weighing which ranged from 8% to 100% of such items. Examples of such item are intangible, illiquid assets, + YTD profit/loss to arrive at available Financial Resources (FR).

As noted in #5, above, the various types of risk requirements (position risk, foreign exchange risk, counterparty risk, large exposure to a counterparty/issuer (concentration) and reconciliation of accounts) are incorporated in the filing. These calculated risks are then deducted from available FR.

It was also indicated that the formula used including quantification of risks is based on BASLE accord rules and the European Union Directives.

Early Warnings Triggers

A firm would trigger early warning (one of the EW triggers) when FRR is less than 110% of Financial Resources then the firm will have to notify FSA as to what actions are being taken to address the situation and what measures will be adopted to ensure that capital adequacy requirements are maintained in the future. No specific penalty or sanctions are imposed at this time.

Audited Financial Statements

Annually a firm must file its audited financial statement to the FSA.

APPENDIX E

SAMPLE OF AN INTERNAL POLICY STATEMENT OF A UK CFD ISSUER

An account should be rejected immediately if the applicant cannot demonstrate sufficient understanding and trading experience. For an account to be signed off, each application must contain a completed classification questionnaire, filled in by the sales person during a telephone interview with the client. To classify an applicant as an intermediate customer, the following criteria must be met:

- The client must have at least 6 months trading experience and have made over 50 trades for each of the products they wish to trade with us (e.g. 6 months and 50 trades in FX to be classified for FX AND 6 months and 50 trades in shares or CFDs/spread betting if they also wish to be classified for CFD equities).
- If the applicant has traded in a certain instrument then they must state the amount of time that they have traded in that instrument.
- If the applicant has traded in a certain instrument then they must enter their average number of trades and their average size of those trades.
- If the applicant has traded in a certain instrument then they must state the name of the company that they have traded with.
- The applicant must confirm if their trading experience in each product has been on an execution only basis or not.

    - **The firm will only accept accounts from applicants that have previously traded on this basis. Anything less cannot be accepted.**

- The client is then asked a series of questions about the products they wish to trade. They must answer yes to all of these to confirm their understanding of the nature and risks of each product.
- The applicant must also confirm their understanding as to the nature of, and risks associated with margin trading.
- The Sales Admin team need to check that the products circled on the classification by the sales person are correct in light of the experience the client has demonstrated.

    - **If you are in any doubt about an applicant's trading experience, you can request to see trading statements.**

Investment Dealers Association of Canada

The Investment Dealers Association of Canada (IDA) is the national self-regulatory organization of the securities industry. The IDA's mission is to protect investors, foster market integrity and enhance the efficiency and competitiveness of the Canadian capital markets.

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