Informative Article:

Contracts For Difference (CFDs)

What are CFDs

To put it simply, CFDs are agreements between two parties to exchange the difference between the current price of an underlying asset (which can be shares, currencies, commodities, indices, etc) and its price on the day the agreement expires. The profit or loss is calculated when the contract expires by multiplying the difference between these two prices with the number of CFDs invested in.

CFDs are **leveraged** products, enabling investors to make transactions with only a small margin (deposit). However, although CFDs might look similar to more traditional investments, such as shares, in reality they are very different and far more complex. Due to their complicated structures and the high level of risk they carry, **CFDs are considered by the financial supervisory authorities as being suitable only for professional clients or highly experienced retail investors who can understand how they work and the risks they entail**.

Risks to investors

CFDs are not standardized products and thus each Investment Firm (IF) can apply different terms and charges. As a result, costs for the investor may be difficult to calculate for a given trade and may well outweigh the potential profit.

The risk of investing in CFDs is especially increased when they are highly leveraged. Investors must remember that **leverage can magnify the profits but it can also magnify the losses**.

Further, investment in CFDs carries also a liquidity risk. The margin needed to be maintained by the investor is recalculated on a daily basis, according to the changes in the value of the underlying assets, and if the balance is negative due to a reduction in the price of the underlying assets, the margin position should be restored by the investor. If the investor is unable to cover the loss, then the IF may close the position and liquidate all the CFD positions of the investor, even if the price of the underlying asset subsequently recovers resulting in a profit at a later stage. This is very important since it means that **the investor stands to lose more money than his/her initial capital investment.** Limits placed such as “stop loss” limits cannot always protect the investors from losses.

Unfortunately, and despite efforts from the supervisory authorities to contain such phenomena, companies offering trading in CFDs advertise the potential profits without adequately explaining or highlighting the risks to the investors. Also, various marketing ploys are used to lure investors in investing, such as "free start-up money". This is true especially when transactions in CFDs are offered online.

In addition, CFDs are not suitable for investors who want to "buy and hold" their investments without monitoring their position on a regular basis. The dynamic nature and volatility of the financial markets, together with the leverage, can expose the investor to great risk even by simply maintaining the investment overnight.

How investors can protect themselves

Due to the afore-mentioned and other risks related to CFDs, the European Securities and Markets Authority and the Cyprus Securities and Exchange Authority, have issued warnings to investors, which can be found at http://www.esma.europa.eu/system/files/2013-267.pdf

According to these warnings, **investors should choose to invest in CFDs only if they understand the product, they have extensive experience in trading in CFDs and they fully appreciate the risks involved.** Also, before they decide to invest in CFDs, investors should ensure they have enough time to monitor their investment very frequently.

Amongst other things, investors are advised to carefully read the contract they sign with the IF, making sure they fully understand at least the following:
- the costs of trading CFDs with the IF,
- whether the IF will disclose the margins it makes on the trades,
- how the prices of the CFDs are determined by the IF,
- what happens if the investor holds his/her position open overnight,
- whether the IF provider can change or requite the price once the investor places an order,
- whether the IF will execute the orders even if the underlying market is closed, and
- whether there is an investor or deposit protection scheme in place in the event of counterparty risk (if the IF defaults) or other client asset issues.

Most importantly, **investors are advised not to trade if they do not understand what is on offer.**

Lastly, investors are reminded to check if the IF they intend to receive investment services from is authorised to provide investment services in that particular jurisdiction. To check whether a company is authorized to provide investment services in Cyprus, you can do it by visiting

CySEC's website at the following link www.cysec.gov.cy/licence_members_1_en.aspx (for the CySEC authorised – CIFs) or at www.cysec.gov.cy/licence_members_6_en.aspx (for companies from EU member-states and offer cross-border services in Cyprus) or at www.cysec.gov.cy/licence_members_21_en.aspx (for companies from other EU member-states that offer their services though a branch).

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