

## **[330] NSW Court of Criminal Appeal confirms Contracts for Difference are Division 3 financial products: *Joffe v R*; *Stromer v R* [2012] NSWCCA 277; BC201209881**

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### **Introduction**

In the significant decision of *Joffe v R*; *Stromer v R*,<sup>1</sup> the NSW Court of Criminal Appeal (NSWCCA) confirmed that Contracts for Difference (CFDs) are Division 3 financial products. Both appellants had been convicted of ten counts of insider trading in contravention of the Corporations Act 2001 (Cth) (CA), with six of these counts involving the acquisition of CFDs. In seeking to have their convictions quashed, the appellants argued that CFDs were not Division 3 financial products first through being "credit facilities", and second through being "contracts for the provision of future services", thereby falling outside the definition of derivatives under the CA. This article examines the NSWCCA's reasoning in dismissing both grounds of appeal, thereby adding greater certainty to the proper legal characterisation of CFDs.

### **Contracts for Difference**

CFDs are a highly geared derivative<sup>2</sup> product allowing traders to take a position on the change in the value of an underlying asset or security. They enable traders to take "short" or "long" positions on changes in the value of underlying assets through entering into swap-style arrangements with the CFD issuer. For instance, a trader entering into a long position (buying a CFD) on BHP Limited, for example, is betting that the price of the underlying share will move higher relative to today's price. In contrast, a trader taking a short position (selling a CFD) is betting that the price will move below today's price.<sup>3</sup> CFDs were introduced in Australia in 2000, and their attractiveness to investors has progressively increased, with a 2012 study estimating that more than 400,000 Australians were involved in CFD trading.<sup>4</sup>

In the matter before the NSWCCA, Mr Daniel Joffe and Mr Daniel Stromer (the appellants) had each been charged with ten separate counts of insider trading contrary to s 1043A CA which took place between June 2006 and January 2007. Mr Joffe had been charged with procuring the offences in contravention of s 1043A(1)(d) CA, and Mr Stromer had been charged with acquiring various shares, warrants and CFDs in contravention of s 1043A(1)(c) CA.<sup>5</sup> The CFDs in this case were acquired through CMC Markets Asia Pacific Pty Ltd (CMC), with the terms and legal content applicable to the trading of these CFDs being outlined in a Product Disclosure Statement (PDS) issued by CMC on 1 July 2005 (the CMC PDS).<sup>6</sup>

### **First ground of appeal: CFDs as credit facilities**

After some background discussion on the meaning of "Division 3 financial products",<sup>7</sup> Allsop P considered whether, as the appellants argued, the CFDs traded through CMC would constitute "credit facilities" under s 765A(1)(h) CA and the Corporations Regulations 2001 (Cth) (the Regulations). Regulation 7.1.06 defines "credit" as meaning "a contract, arrangement or understanding: under which: payment of a debt owed by one person (a debtor) to another person (a credit provider) is deferred; or one person (a debtor) incurs a deferred debt to another person (a credit provider)", including (under subreg (3)(b)(i)) "any form of financial accommodation".<sup>8</sup> His Honour then examined the nature and operation of the CFDs traded by the appellants by considering the terms of the CMC PDS -- with cl 2.1 describing the operation of CFDs as follows:

[CFDs] allow you to receive most of the benefits of owning a security without having to actually own the security. In other words you do not take delivery of the security so any difference in the price between when you buy the CFD and when you sell it is settled in cash. The difference is either profit or loss ... Buying and selling the performance of securities or an index using a CFD is

similar to buying the actual underlying instrument using a loan ... You could borrow \$10,000 from a bank to buy shares. You would receive the returns from the shares, but would pay interest on the loan to the bank. CFD's combine this process in a single transaction.

For example, if you want to buy AUD\$10,000 worth of Australian shares you will have to deposit with CMC Initial Margin of AUD\$1,000. You will then be allowed to purchase \$10,000 worth of Australian share CFDs (based on a 10% initial margin percentage). The full \$10,000 value of the share CFDs will be subject to the share price performance. If you want to keep the share CFDs overnight you must pay a financing charge on the total nominal value of the position at the Financing Rate. If a share CFD position is not carried overnight you will pay no financing charge.

As with the underlying securities, share CFDs allow you to benefit from normal market movements. Your open positions are valued every night at the close of business prices. Profits or losses are credited/debited to your Account each day. Adjustments relating to corporate actions, such as dividends, bonus issues and reconstructions in respect of the underlying security are also applied to your Account should they occur.<sup>9</sup>

The appellants argued that where a customer takes an open position this gives rise to a liability for the price of the subject of the contract -- with the obligation to pay this price being deferred by either payment of a deposit until a margin was called for, or until a closing by the acquisition of a "contra" position. They argued the balance of the purchase price was a debt, and placed emphasis on the explanation in cl 2.1 that "buying and selling the performance of a securities [sic] or index using a CFD is similar to buying the actual underlying instrument using a loan".<sup>10</sup>

In rejecting the appellants' argument, his Honour characterised the reference to the "buying and selling the performance of a securities [sic] or index" as reflecting the nature of the CFD contract, which did not involve the buying or selling of an asset for a deferred price as in loan arrangements. Rather, the CFD contract involved the opening of a position by reference to which future fluctuating prices would cause profits or losses by the engagement of payment obligations, based on the daily comparison between the contract price and the fluctuating price.<sup>11</sup>

Noting that the CFDs provided for profit to be secured "by reference to fluctuations in the price of the underlying property or an index", his Honour pointed out that the CFDs did not oblige the *delivery* of such underlying property. This was central to the proper characterisation of the CFDs as not being contracts to buy or sell either the underlying security or any asset of CMC; but rather contracts to pay money by reference to the terms of the contract and fluctuations in the underlying price against the chosen contract price.<sup>12</sup> Barrett JA expressed similar conclusions.<sup>13</sup>

His Honour also noted that if a CFD position remained open overnight, an amount of overnight interest, whether debited to a "long party" or credited to a "short party" would be calculated by reference to the total notional value of the CFD position. However his Honour went on to point out that this overnight interest charge was not a credit charge for money lent or foregone by either CMC or by the customer. Rather, the total notional value of the CFD position represented the full potential loss on the face of a position if the underlying asset was without value; and charging interest on the "notional value" of the CFD position enabled the CMC Product and the risks involved to mimic a fully geared transaction in relation to the underlying asset.<sup>14</sup> Similarly Barrett JA characterised all such "quasi-interest, quasi-dividends and other like items" as "merely calculation factors to ensure that the financial positions of the parties were the same as if they had occupied (as creditor, debtor, holder of instruments or otherwise) positions that they did not in fact occupy at all. The several items only ever reflected an adjustment of the amounts to be paid periodically by one party to the other".<sup>15</sup>

His Honour also noted that the CMC PDS emphasised that CMC's "policy [was] not to provide credit facilities on any accounts". This led his Honour to characterise the objective of the CFDs as not being the lending of money nor deferred prices for property, but rather enabling the payment or receipt of money by the operation of the contract.<sup>16</sup> Barrett JA similarly concluded the requirement that one party to a CFD contract must pay the other did not at any time arise because of a loan, forbearance or any other granting of concession, indulgence, deferral or benefit. Rather, rights to

receive money and obligations to pay arose because the prevailing market price of the underlying instrument, when factored into calculations dictated by the CMC Agreement in relation to the individual contract, produced a particular figure and the contractual terms themselves required payment of that amount.<sup>17</sup>

In their separate judgments both Allsop P and Barrett JA both concluded that because no deferral of the payment of a debt occurred, and no form of financial accommodation was provided, the CFDs traded by the appellants did not constitute "credit facilities" within the meaning of the CA and Regulations.<sup>18</sup>

### **Second ground of appeal: CFDs as contracts for the provision of future services**

The appellants' second ground of appeal was that each individual contract (or CFD) arising from an initiating step taken by the customer under the CMC Agreement entailed the provision of certain services thereafter by CMC to the customer. These "services" that the appellants claimed to have been provided by CMC included CMC making available an equivalent but opposite position upon the customer's request so that the customer might close a position as and when the customer chose to do so; CMC making payments required to be made by it; and CMC providing electronic systems, software and other facilities<sup>19</sup> necessary to make workable the interaction of the parties envisaged by each individual contract created pursuant to the CMC Agreement. The appellants argued that individual CFDs were dependent upon the future provision of such services by CMC for as long as a CFD position remained open.<sup>20</sup>

Barrett JA acknowledged that CMC's provision of such services was required to facilitate the trading of CFDs by customers. However his Honour characterised CMC's provision of these services as no more than ancillary or incidental to the primary purpose and substance of the contractual relationship between CMC and its customers -- this being the creation, in a synthetic way, of financial results that would have been produced by actual transactions in the market for the underlying instruments. As CMC's provision of the various "facilitating" services did not form part of that "substance", his Honour therefore concluded the individual CFDs were not contracts "for" the "future provision of services"; and were therefore not excluded from the definition of "derivatives" under s 761D(3)(b) CA.<sup>21</sup> Allsop P expressed a similar conclusion.<sup>22</sup>

### **Summary and conclusion**

With the NSWCCA confirming that CFDs are financial products, the appeal was dismissed. To date two other ASIC insider trading prosecutions have been concerned with trading involving CFDs. On 2 December 2010, Mr John Hartman was sentenced in the NSW Supreme Court to four years and six months imprisonment on 25 insider trading related charges -- 19 of which involved trading in CFDs.<sup>23</sup> On 7 December 2011, the NSWCCA reduced the length of Mr Hartman's sentence to an overall term of three years.<sup>24</sup> More recently on 17 April 2013, Mr Mathew Tan was sentenced in the NSW Local Court to 200 hours of community service and fined \$40,000 after pleading guilty to a charge of acquiring 10,000 CFDs in Macarthur Coal during 2011 while in possession of inside information from his position as a director of Active Capital management group.<sup>25</sup> As the NSWCCA acknowledged, the questions raised in this appeal were significant both for the operation of the market regulation provisions in Ch 7 of the CA, and in particular the insider trading provisions in Div 3 of Pt 7.1.<sup>26</sup> The NSWCCA's decision has therefore added greater certainty to the proper characterisation of CFDs under the CA.

**[Editorial Note:** In May 2013, the HCA refused special leave to appeal the decision in *Joffe v R; Stromer v R* [2012] NSW CCA 277; BC201209881.]

1 *Joffe v R; Stromer v R* [2012] NSWCCA 277; BC201209881 NSWCCA per Bathurst CJ, Allsop P and Barrett JA.

2 For the definition of derivatives, see s 761D CA.

3 ASIC Report 205 *Contracts for Difference and Retail Investors* June 2010, at 12.

4 Investment Trends, 2012 Contracts For Difference Report, July 2012, at [7].

5 The complete wording of three of the charges against the appellants is outlined at [29] per Allsop P. For a summary of each of the charges, see "Two men charged with insider trading" ASIC MR 10-25A, 16 February 2010.

6 Above, n 1, at [63] per Allsop P.

7 Above, n 1, at [49]-[58] per Allsop P.

8 Regulation 7.1.06(3)(b)(i).

9 Above, n 1, at [73]-[74] per Allsop P.

10 Above, n 1, at [103] per Allsop P.

11 Above, n 1, at [104] per Allsop P.

12 Above, n 1, at [93] per Allsop P.

13 Above, n 1, at [143] per Barrett JA.

14 Above, n 1, at [106] per Allsop P.

15 Above, n 1, at [157] per Barrett JA.

16 Above, n 1, at [108] per Allsop P.

17 Above, n 1, at [158] per Barrett JA.

18 Above, n 1, at [109] per Allsop P; and at [160] per Barrett JA.

19 Including systems, software and facilities for account keeping, preparation of statements, assembling and processing of data concerning underlying instruments and the provision of real-time reporting and calculations.

20 Above, n 1, at [162]-[163] per Barrett JA.

21 Above, n 1, at [169]-[170] per Barrett JA.

22 Above, n 1, at [115] per Allsop P.

23 *R v Hartman* [2010] NSWSC 1422; BC201009317; "Former equities dealer imprisoned on front-running and tipping charges" ASIC MR 10-258AD, 2 December 2010 -- which explained that "Mr Hartman admitted to establishing positions in particular stocks through his CFD account at IG Markets prior to Orion trading in the same stocks on the open market. Mr Hartman was then able to exit his CFD positions and profit from the effect of Orion's trading on the underlying stock price. This conduct is often described as "front-running". The trades were made by Mr Hartman between July 2008 and January 2009 and resulted in a total gross profit of approximately \$1.59 million."

24 *Hartman v R* [2011] NSWCCA 261; BC201109700; "Appeal on sentence upheld for John Hartman" ASIC MR 11-285AD, 7 December 2011.

25 "Former director sentenced for insider trading" ASIC MR 13-083MR, 18 April 2013.

26 Above, n 1, at [5] per Bathurst CJ.

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