

INTRODUCTION TO COMMSEC CFDs



Important Information

This brochure has been prepared without taking account of the objectives, financial and taxation situation or needs of any particular individual. Because of that, before acting on the information in this brochure, you should consider its appropriateness to your circumstances, having regard to your objectives, financial and taxation situation and needs.

OTC CFDs are not suitable for all clients. OTC CFDs involve leverage and it is possible to lose more than your initial investment. You need to consider your own circumstances and should seek independent advice if CFDs are appropriate for you. You must read and consider the CommSec CFDs before taking up this product.

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WHAT ARE COMMSEC CFDS?

An Over-the-Counter Contract for Difference (OTC CFD) is a flexible leveraged product that allows you to gain exposure to the price movements of an underlying security, such as a share, a commodity or a foreign exchange pair, without actually owning it. As its name suggests, the CommSec CFD is a contract between you and CommSec (as the CFD provider), and it is referred to as an 'over-the-counter' product because it is not provided on an exchange. When you trade CFDs with CommSec, we act as a CFD provider — when you open a CFD position, we take the other side of the transaction.

To trade CFDs, you make a small cash deposit as collateral (Initial Margin) and take either a long position (which profits when the underlying share rises) or a short position (which profits when the share falls). Profits and losses accrue in real time as the market moves. You close a CFD position by selling (if you took a long position and bought to open) or buying (if you took a short position and sold to open). In other words, you use the CFD to gain exposure to the price movements of a financial instrument without actually owning that instrument.

Trading CFDs offers the opportunity to make a much higher percentage return on your original outlay than investing directly in the underlying security; this leverage also means that potential losses can be magnified.

A full list of CFDs offered by CommSec is available at commsec.com.au

Below you will find a simple example of a 'long' OTC CFD trade, including some of the key concepts (underlined> which are described on page 3.

EXAMPLE: A 'LONG' OTC CFD TRADE

Let's say you think that a certain share (XYZ), currently trading at around \$5.50, is likely to go up in value. You 'buy' 2000 shares as a CFD (opening your position) at \$5.50, which means that you pay Initial Margin of \$550 (5% of \$11,000). CommSec charges 0.10% commission on the transaction, so you pay \$11 commission.

| | | |
|---------------------|---|---------|
| Initial Margin: | $2,000 \text{ shares} \times \$5.50 \times 5\%$ | = \$550 |
| Opening Commission: | $2,000 \text{ share} \times \$5.50 \times 0.10\%$ | = \$11 |
| Total Outlay: | | = \$561 |

After two weeks, the price of XYZ has risen to \$5.80 on the back of some positive figures, and you decide to take your profit of \$600 (increase of \$0.30 per share).

| | |
|------------------|---|
| Profit on trade: | $(\$5.80 \text{ closing price} - \$5.50 \text{ opening price}) \times 2,000 \text{ shares}$ |
| | = \$600.00 |

| | | |
|---------------------|--|-----------|
| Closing Commission: | $2,000 \text{ shares} \times \$5.80 \times 0.10\%$ | = \$11.60 |
|---------------------|--|-----------|

Your overall profit looks like this:

| | |
|---------------------|----------|
| Profit on trade: | \$600.00 |
| Opening commission: | -\$11.00 |
| Closing commission: | -\$11.60 |
| Overall profit: | \$577.40 |

From your initial investment of \$550, you have made a profit of \$577.40 or 5%.

Please note funding costs will apply to this trade which have not been included in the above example.

KEY CONCEPTS

GOING 'LONG' OR 'SHORT'

One of the major benefits of CFDs is that you can trade them either 'long' or 'short'. 'Going long' means buying with the expectation that the price will rise; 'going short' means selling with the expectation that the price will fall – in other words, you can trade CFDs to potentially benefit in either rising or falling markets.

INITIAL MARGIN

When you trade CFDs, you deposit only a small percentage of the value of the underlying stock in order to open your position and gain exposure to the price movements in that stock. This 'deposit' is known as the initial margin.

How much initial margin is required depends on the liquidity and volatility of the underlying instrument. CommSec operates a tiered system of margining, which means that a very large position in a given stock may attract a higher margin rate. You can find the latest list of margin requirements at commsec.com.au

You can see from the example on the preceding page that if you open a CFD position for 2000 contracts at a price of \$5.50 each, with a 5% margin, your margin will be calculated as follows:

$$2000 \times \$5.50 = \$11,000$$

$$5\% \times \$11,000 = \$550$$

VARIATION MARGIN

While your CFD position remains open, you will be required to provide further margin if the price of the underlying instrument moves against your position – this is known as Variation Margin.

Your positions are marked-to-market in real time, if at any time your margin falls below 95% of the minimum margin required you will be contacted and asked to deposit funds to bring your account back above the minimum margin requirements.

For example, if you have a long position and the price of the underlying security falls, then you are required to pay Variation Margin large enough to cover the loss in the value of the position.

Conversely, if you have a short position and the price falls, you would receive Variation Margin equal to the positive movement in the value of the position.

If you do not meet the Variation Margin in the required timeframe we may close your position without reference to you. This is why it is extremely important that you closely monitor your open positions.

OPEN INTEREST

When you open a CFD position and pay initial margin of, for example, 5%, we are effectively 'funding' the remaining value of the underlying asset. Therefore you pay funding costs (interest) daily on your long positions and receive interest daily on your short positions.

For trades on share CFDs and standard cash indices, this fee is based on the London Interbank Offered Rate (LIBOR) +/-2.5%. For A\$1-denominated CFDs and mini contracts the fee is LIBOR +/-3%.

*Note: The Contract Interest Rate is fixed to a benchmark rate (Interest Rate) in the contract currency of the CFD.

For share CFDs the interest is calculated as follows:

$$D = n \times C \times i / 360^{**}$$

Where:

D = daily interest adjustment

n = number of shares or lots

C = current share or index price

i = applicable interest rate

**Note: The formulas use a 365 divisor for UK, Singaporean and South African shares and indices; all other markets including Australian, US and European, Swiss, Japanese, Hong Kong and Canadian shares and indices use a 360-day divisor.

In the case of foreign exchange CFDs, interest in respect of long or short positions may be debited or credited from your account depending on the overnight Tom-Next. Please see the CommSec OTC CFDs PDS for further information.

DIVIDENDS

For holders of long positions at the close of business on the day before the ex-dividend date net dividends are credited.

As going short is the opposite of going long, net dividends are debited from your account if you hold a position at the close of business on the day before the ex-dividend date.

SHAREHOLDER RIGHTS

As you do not own any actual shares, you are not entitled to any shareholder voting rights.

WHY TRADE CFDs?

CFDs specifically offer a number of benefits that investing directly in the underlying share may not.

| | |
|------------------------------------|---|
| Features | Unlike some other types of derivatives they have no time decay, no expiry date and the price tracks the underlying one for one. |
| Leverage | The small margin requirements for CFDs allow you to maximise your investment power, depositing as little as 5% of the value of the underlying investment for share CFDs. |
| Ability to go short | When you buy shares, you're generally looking for the price to rise so you can sell at a profit. When markets are falling, conventional share investments may not be as attractive. CFDs allow you to potentially profit from falling as well as rising markets. |
| Hedging | CFDs can be used to hedge risks in your existing investment portfolio. You can use them to hedge a single stock holding, a diversified portfolio and even foreign exchange exposure. |
| Flexibility and convenience | With CommSec you can trade CFDs over a wide range of products and markets – shares, indices, commodities, FX rates and more – through your single CFD trading account. |
| 24-hour trading | Share trading is limited to stock exchange hours, but the index market is open for trading 24 hours a day during the week (with CommSec support staff available Monday to Saturday), so you can open and close positions even when the underlying financial markets are shut. |

TRADING CFDs WITH COMMSEC

Trading CFDs with CommSec offers you a range of advantages including:

| | |
|----------------------------------|--|
| Speed of dealing | Whether you are dealing over the telephone or via the internet, transactions are executed very quickly, with internet deals typically transacted in just fractions of a second. |
| Advanced trading platform | Launch our web-based trading platform direct from the CommSec website, with no requirement to download software. The CommSec CFD Trading Platform offers ease of use along with professional tools such as real-time charting and pattern recognition software. The customisable layout means that every trader can design a layout to match their needs. |
| Range of order types | CommSec offers a range of order types that help you manage the risks of leverage trading. Stop losses can be added to your order to close your position if the market moves against you. Guaranteed stops ensure that your position is closed at exactly the price you specify, even if the market gaps. Trailing stops move with your profit, so you don't have to keep checking your trade and adjusting the stop loss when things are going well. |
| Real-time funds transfer | Using our real-time funds transfer you can fund your CommSec CFD account instantly using your linked bank account. This means you can meet margin requirements or top up your account to place a trade without waiting for funds to clear overnight. Log onto the CommSec website at commsec.com.au to take advantage of this feature. |
| 24 hour customer service | Our CommSec CFD dealing desk is available 24hours a day from 8am Monday to 6am Saturday to assist with any questions. Whenever the market is trading we have a dealer available to take your calls. Contact us on 1300 307 853 or via email at cfds@commsec.com.au |
| Low commissions | Our standard commission rate for Australian share CFDs is a competitive 0.10%, with a minimum charge of just \$10. What's more, commissions on CFDs are not subject to GST. |

RISK MANAGEMENT

There are a number of risks associated with CFD trading, so it is important that you understand these risks and the strategies you can take to manage them before you choose to trade CFDs.

Please also refer to the CommSec CFD PDS at commsec.com.au for full details.

| | |
|-----------------------------------|---|
| Market forces | Financial markets can move rapidly. Prices of instruments and securities, including shares, depend on a number of factors such as interest rates, demand and supply, actions by the company or issuer and actions of government. International share markets may be more volatile than the Australian market, particularly developing markets. In some cases underlying instruments or securities may be suspended from trading or have their quotations withdrawn from the exchange where they are traded. These factors will directly affect a CFD's value. |
| Leverage | The high leverage levels of CFDs (that allow for small margin requirements) can work against you as well as for you. Just as leverage can allow you to maximise your potential profits, it can also magnify potential losses. |
| Interest rate fluctuations | The interest adjustments that apply to your open CFD positions will be affected by fluctuations in the applicable interest rate. |
| Foreign exchange exposure | When you enter into CFDs for which the contract currency is not Australian dollars, all cash flows are calculated and payable in the contract currency. You will be subject to foreign exchange rate fluctuations during the term of the CFD. |
| Gapping | <p>All CFDs are subject to the risk of gapping where the market may open at a significantly different price compared to the previous close. This means that a position can have moved against you as the market opens. The market can potentially gap over a non-guaranteed stop loss order and your order may not be filled, or may be filled at a different price to that specified by you. You may suffer losses as a result.</p> <p>Guaranteed Stop Loss orders will be honoured at their specified price even if the market gaps over the trigger price.</p> |

RISK MANAGEMENT TOOLS

CommSec offers a number of tools you can employ to manage the risks involved in trading CFDs.

DEMO ACCOUNT

If you're new to CFDs, a demo account will allow you to trade in a virtual environment, without having to contribute your own funds. Your CFD demo account will be active for 14 days, with \$20,000 in virtual funds for you to try out our platform, test various strategies and experience trading with no risk.

STOP-LOSS ORDERS

A stop-loss order allows you to set a trigger price at which a sell order will be created — so it can help you to limit your potential losses.

If, for example, XYZ is trading at \$1.00, you can set a trigger to sell at \$0.95 to limit your loss. Stop-loss orders are not guaranteed and the possibility exists that during times of high market volatility, you could be 'gapped'. Using the example of XYZ above, the market could close at \$0.96, but open the following trading day at \$0.85, and your limit order would not be filled.

TRAILING STOPS

A trailing stop is similar to a traditional stop-loss but your limit order follows or 'trails' the share price as it advances, allowing you to lock in profits while still limiting your losses.

Say you buy XYZ at \$1.00 and set a trigger of \$0.95. The price of XYZ rises to \$1.10. With a trailing stop, your trigger would automatically reset to \$1.05. Should the price of XYZ continue to rise to say \$1.40, again your trigger would reset to \$1.35, thereby allowing you to lock in a profit.

GUARANTEED STOP-LOSS (GSL)

A Guaranteed stop-loss allows you to lock in profits, even when you do not have time to monitor the market constantly. Unlike traditional stop-loss orders, which can be subject to 'gapping' in times of high volatility, Guaranteed stop-losses allow you to restrict the potential loss on a trade to a fixed amount without restricting your profit potential.

For example, you purchase XYZ at \$1.00 and, at the same time, set a GSL at \$0.95. If the share falls to or below \$0.95, the most you can lose is \$0.05, even in the event that the market opens below \$0.95.

The fee for a Guaranteed Stop is charged when the XYZ position is opened. This is a one-off charge and you can move the level of your GSL at no extra cost.

Please note the size of the position on which we are able to offer a GSL may be limited and GSLs are not available on all instruments. Please contact us for more information on the facilities available for any particular share.

COMMSEC TIERED MARGINING

Tiered margining enables us to set margin rates that reflect and best fit the size of your aggregate position in a particular market. The majority of positions will attract our lowest margin rates, reflecting the liquidity of the market at smaller deal sizes. The largest positions may require a higher margin, as it is more difficult to trade out of these positions quickly.

Your initial margin will be determined using a table of four incremental tiers. The margin rate increases as your aggregate position moves up from one tier to the next. However, only the portion of your position that falls into a higher tier will be subject to that increased margin rate.

The range of the four tiers differs to suit each market, and the margin rate varies according to the type of account you hold.

EXAMPLE: TIERED MARGINING FOR XYZ SHARES

The table below shows how tiered margining applies to XYZ shares.

| | TIER 1 | TIER 2 | TIER 3 | TIER 4 |
|-------------------------------------|--------------|----------------|-------------------|------------|
| Position size (shares) | Up to 40,000 | 40,001-240,000 | 240,001-5,500,000 | 5,500,000+ |
| Margin rate (Trader Account) | 5% | 20% | 40% | 90% |
| Margin Rate (Select Account) | 5% | 10% | 25% | 90% |

As a Trader or Select account holder, if you hold a CFD position of 30,000 XYZ shares, your initial margin will be 5%.

If you are a Trader Account holder with a 50,000 XYZ shares position, your initial margin will be determined as follows:

40,000 at 5% (Tier 1)

10,000 at 20% (Tier 2)

This equates to a weighted average margin rate of 8.0%, which is significantly lower than the outlay required for an equivalent share purchase in the underlying market.

You can find a full list of CommSec's margin tiers can be found on our website commsec.com.au

Remember that the size of your overall position, and not the level of the initial margin, dictates your profit and loss. It is possible for losses to exceed your initial margin.

PRICING MODELS: DIRECT MARKET ACCESS VS MARKET MAKER

There are two methods or models of pricing OTC CFDs – Direct Market Access (DMA) and Market Maker (MM).

Historically CFD providers chose to provide one of the two models, but recent changes in the CFD market has meant that many providers, including CommSec, now offer clients both DMA and MM models.

Both models have benefits and limitations, which are described below. It is important that you make an informed choice.

DIRECT MARKET ACCESS (DMA)

Under the DMA model, all client orders are immediately replicated in the underlying share market order book on terms matching the client request. From a client point of view, trading share CFDs is virtually identical to trading shares on margin.

| Benefits | Limitations |
|---|--|
| <ul style="list-style-type: none">• Transparency in pricing and liquidity.• The ability to trade in opening and closing price auctions.• The ability to put your order in the central order book of the exchange. This allows you to 'set the price' or improve the spread. This may be advantageous on thinly traded shares. | <ul style="list-style-type: none">• Only available for equity CFDs.• Requires the payment of exchange fees for live data. This can prove expensive for the occasional trade on certain markets.• Order types are restricted to the 'exchange' order types. Many exchanges around the world are limited in their available order types. |

MARKET MAKER (MM)

Under the MM model, a CFD provider offers pricing, liquidity and contract specifications aimed at suiting client needs rather than specifically matching an underlying asset.

| Benefits | Limitations |
|--|--|
| <ul style="list-style-type: none"> • MM CFDs are available on a wider range of markets than DMA including commodity, FX and Index products. • Contract size reduction, for example a SPI contract can be reduced from \$25 a point to \$1 or \$5 a point, reducing the minimum trade size to a level more suitable to client needs. • On MM CFDs it is possible for a CFD provider to offer local currency CFDs on foreign instruments, such as offering AUD contracts on commodity CFDs that are traditionally traded in USD. • MM CFDs are not restricted to order types available on public exchanges and can provide additional order types such as guaranteed stop losses. • Exchange data fees are optional, though generally recommended regardless of the model chosen. | <ul style="list-style-type: none"> • The client is always a price taker. While CommSec seeks to match the prices in the underlying market, it is important to note that in many cases it may be possible to ‘improve’ the spread of the underlying market by placing a limit order in between the best bid and offer. This is not possible in a MM trade. • The perception may be that a client having to accept the best bid or offer shown by the CFD provider and the CFD provider possibly hedging on more favourable terms could be seen as a conflict of interest. It is also important to note that a CFD provider in this model may also hedge on less favourable terms. |

TRADING STRATEGIES

There are a number of trading strategies that can be used with CFDs — from the simple to the complex. Some can be used to enhance profit potential, while others are designed to protect your portfolio against losses. A few strategies are outlined below.

HEDGING A SINGLE STOCK

Hedging is a little like taking out insurance on your house or car or any other valuable asset. Share CFDs can be employed to protect a holding against a loss, similar to the process of buying Put Options, where you have the option of selling at a predetermined price, should the underlying share price fall.

The strategy involves selling a share CFD for every share you hold in a company. In a falling market, the short-sold share CFD will appreciate to offset the fall in value of the underlying shareholding.

Market view: long term bullish, short term cautious/bearish.

Example

You hold 1000 XYZ shares, currently trading at \$1. You are concerned about a possible short-term fall in value, so you sell 1000 XYZ Share CFDs. If the value of XYZ shares falls to \$0.80 your shareholding will be worth \$800; however, your CFD position will have increased offsetting your loss.

*Note this scenario does not take into account any interest or dividends that may be applicable.

HEDGING A PORTFOLIO OF SHARES

In the same way as selling share CFDs can protect a particular stock, index CFDs can be used to protect a portfolio of shares. They can be traded in full or mini contract sizes. For contract specifications see commsec.com.au

Example

Say you hold a diverse portfolio of ASX 200 shares that you want to protect. You could do this by selling the Australia 200 CFD.

Let's assume your portfolio is worth \$250,000 and the ASX 200 is trading at 4900 points. To protect your portfolio you would sell a number of contracts so the notional value of the position is roughly equal to the value of your portfolio. To do this simply divide the value of your portfolio, by the price of the index multiplied by the index multiplier:

$$250,000 / (4,900 \times 25) = 2.04$$

You would therefore sell 2 contracts of Australia 200 CFD.

PAIRS TRADING

Pairs trading involves trading two historically correlated securities, such as two bank stocks or two gold mining stocks. When the correlation between the two securities temporarily weakens, ie one stock moves up while the other moves down, the pairs trade would be to short the outperforming stock and to long the underperforming one, betting that the spread between the two would eventually converge.

The divergence within a pair can be caused by temporary supply/demand changes, large orders for one security, or reaction to important news about one of the companies.

Take, for example, two producers of alcoholic beverages, ABC and XYZ. The two have been historically correlated, sharing rises and falls in their share prices depending on the demand for their beverages. If the price of ABC were to rise significantly and XYZ stayed the same, a pairs trade would involve selling (going short) ABC and buying (going long) XYZ in the hope that the prices would normalise. The pairs trade would profit from a fall in the price of ABC and a rise in the price of XYZ.

GLOSSARY

CFD: See Contract-for-Difference.

Contract Currency: The currency in which a particular asset is denominated. For example Australian Share CFDs settle in AUD while a Dow Index CFD settles in USD.

Contract-for-Difference: A CFD is a deal where two parties agree to exchange money according to the change in value of the underlying asset between the point at which the contract is opened and when it is closed.

Dealing: Opening or closing a CFD position.

Direct Market Access (DMA): This means that the CFD order is placed in an order book with buyers and sellers trying to get the prices at the bid and ask. The CFD price will be directly related to the current market price and will be influenced by asset liquidity.

Funding cost: See Open Interest.

Going Short: See Short.

Going Long: See Long.

Hedging: Taking a secondary position in order to protect the value of an underlying asset against adverse price movements. Hedging is usually done with derivatives such as CFDs or Options.

Initial Margin: The minimum deposit required to open a position. The Initial Margin is designed to cover reasonably foreseeable losses on a position between the close of business on one day and the start of business the next day.

Leverage: Also called 'gearing', leverage allows you to gain exposure to a larger value asset than your initial outlay. Leveraging can magnify your gains and losses. Examples of leveraged investment products are margin lending, Options and CFDs.

Long: Buying to open with the expectation that the underlying asset will increase in price, thereby allowing you to sell at a profit.

Margin Rates: See Initial Margin.

Marked-to-market: Where an open position is revalued against the current market for the purpose of calculating Variation Margins.

Market Maker (MM): Where the CFD provider acts as principal, providing a two-way spread based which may not be the same as the market price.

Open Interest: Applies to all CFD positions held overnight. The rate is applied to the full value of your position. If you hold a long position you will be charged a financing cost; if you hold a short position you may receive interest.

Over-the-counter (OTC): Refers to instruments that are not traded on an exchange, rather they are traded directly with another institution or 'counterparty'.

Short: Selling to open a CFD position to profit from an expected decrease in share price.

Stop-Loss: An order placed when the CFD position is opened which triggers when the market price reaches a predetermined level. Stop-losses are used to close out positions that move against the holder in order to prevent further loss.

Variation Margin: The payment of profits or losses following revaluation of a CFD contract. Open positions are revalued (or marked-to-market) daily.

We're here to help

To find out more, call us on **1300 307 853**, from 8am Monday to 6am Saturday, email us at **cfds@commsec.com.au** or visit our website at **commsec.com.au**.

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