A contract for difference (CFD) is a derivative that involves an agreement between a buyer and a seller to exchange the difference in the price of a stock, bond, commodity or other asset between the opening and closing dates of the contract. If the price is higher on the closing date, the buyer profits. If the price is higher on the open date, the seller is profiting. CFDs are not available in the US to retail investors due to Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) regulations. . However, they are widely available in the UK, Europe and Asia.

Definition and examples of contracts for difference

There are always two parties to a CFD, a "long position" (the buyer) and a "short position" (the seller). CFDs are offered by brokers who can act as either party. CFDs are different from options and futures available in the US because there is no expiration date, there is no standard contract size, and contracts are individually negotiated. The trading of this product depends on the jurisdictions, for example [Xtrade – CFD trading in Australia] is available here in Australia, we need to understand that CFDs are a tool for traders to speculate on the direction of short-term prices. term of thousands of financial instruments and money managers to hedge their portfolio positions. CFDs are leveraged derivatives, which means that investors only need to deposit 3.3% -50% of the trade value depending on the contract. Australian brokers who carry out trading activities by managing and trading CFDs lend the balance to the investor at interest. Spread investments are similar to CFDs. They are leveraged derivatives and a speculation tool for traders. The key difference between the two is that spread betting has an expiration date and CFDs do not, in most cases. Spread betting is popular in the UK because the tax treatment is more favorable than CFDs.

How a CFD works

CFDs are traded in units equal to the "ask" or "bid" price of the financial instrument used, depending on the transaction. The offer price is the price you sell.

The investor would buy 1,000 CFDs at the asking price of $ 10.00 to open a $ 10,000 CFD buy or "long" trade because he believes the price will rise. The margin rate set by the CFD broker is 5%, so the investor deposits $ 500. The CFD broker lends the investor the balance of $ 9,500.

If our bullish investor is right and a week after the ABC offer rises to $ 10.50, the position is now worth $ 10,500.

What it means for individual investors

Although CFDs are not available in the United States to retail investors, CFDs, swaps and other highly leveraged derivatives are used by institutional investors. These big bets can go horribly wrong as they did in 2008. When they do, small investors can be involved in the damage.

However, Archegos Capital's 2021 crash illustrates how leveraged derivatives can still pose a threat to markets and small investors. Archegos Capital is a family office, which means it is a money management company owned by an individual, in this case, the billionaire trader Bill Hwang, or family and only manages his money. Family offices are exempt from the Investment Advisers Act of 1940 and from the rules governing money management companies

According to a Bloomberg report, Archegos capital has traded swaps and CFDs worth billions of dollars, making highly leveraged bets on Viacom and other stocks with investment banks such as Morgan Stanley, Credit Suisse, Nomura and Goldman Sachs. Those bets went bad when those stocks saw a sell-off in March 2021 and Archegos didn't have enough money to meet margin requirements. Investment banks reportedly organized the sale of large holdings of Archegos, including Viacom, to raise money. These large deals, known as block deals, have further reduced the price of Viacom and other stocks.

After the waters calmed, Archegos and Bill Hwang would have lost $ 20 billion. 2 Investment banks also reported big losses: Morgan Stanley $ 900 million, Credit Suisse CHF 4.4 billion (about 4.7 billion dollars) and Nomura about 2 billion dollars. the Viacom holding (VIAC) also suffered the brunt of the decline in the stock. Amid these losses we need to report also very generous gains by small investors on trading platform dealing with CFDs, small individual investors don’t make news and their gains goes under the radar, but this proves that the CFDs can be a good tool for individual investors.