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SPREADBETTING101

Claire Loussouarn explains how a gambling instrument became a popular and mainstream investment product in the UK.

The tax-free perk is one of the spread bet's unique selling point to investors, even though it only applies to UK tax-payers.

Spread betting is an unusual name for a financial product. A spread bet is a contract made between a trader and a spread betting company based on a prediction of how much a market in an index, currency pair, share or commodity will move up or down. If the market behaves in favour of the trader, the spread better can potentially win a much bigger sum of money than the one he or she originally invested. These winnings are not classified as capital gains so the investor owes nothing to the taxman. With or without expertise or professional connection to the City of London, anyone can spread bet from their own account on a digital device, from a location of their convenience, through the proprietary trading platforms offered online by spread betting companies.

Sounds easy? There is one common mistake the novice can make when they logon to the visually stimulating screen interface of an online spread betting platform. Constantly flashing real-time prices can fool spread betters into thinking they're taking a stake in the underlying assets they're betting on, when they are actually buying a product offered by the spread betting company that relates only to the movement of prices of those markets. When a spread bet is placed on the platform of a spread betting company, the company automatically becomes the counterparty of a bet. The business operates similarly to high-street bookmaking where the bookmaker takes the opposite side of fixed-odds bets on horse races, sports events and political elections, even though spread bet odds are not fixed. The relationship reflects a particular power dynamic where risk is sold as a consumer product on terms set by a profit seeking enterprise.

Spread betting is a mature market in the UK where it has been growing for almost 40 years. Based entirely in the UK, the industry has expanded worldwide since 2002 under the umbrella of a sister product called a Contract for Difference (CFD), with the exception of the US where both spread betting and CFDs remain illegal. The CFD functions in a similar manner to the spread bet without the embarrassment of the gambling reference, but also without the financial benefit of the full tax exemption. After 2000, when the industry started to operate through the internet, the UK saw an increase in the number of spread betting companies avid for a share of this technological boom. The risk appetite of betting firms, especially the smaller ones, increased as a result of competitive pressure.

Despite growing competition, IG, the oldest running and largest spread betting company in the world represents 44 per cent of the market shares, and serves as a yardstick of the industry's health. In May 2013, IG registered a net trading profit of £361.9 million, a slight slowdown from 2012 but still up £27.6 million from 11 years ago. Given the nature of the product it sells, the company's reported revenue is higher following periods of increased volatility as in 2008, 2009, and more recently June 2013. According to the *Financial Times*, over June, July and August, the FTSE 250 group reported sales of £94m, up from £82m in the same period a year earlier.

Widespread access to the internet and the rise of electronic trading systems have made it possible for firms to market spread betting contracts to pools of traders and wannabe traders that exist outside the closed network of financial professionals. But technology isn't the whole story behind the rapid rise of this industry in attracting investors' money. The emphasis on the democratizing powers of digital infrastructure overshadows the fact that spread betting was not always considered a legitimate form of investment which could be regulated by the Financial Conduct Authority (FCA). What really paved the way for investment capital to flood into this market was the industry's ability to take advantage of a series of regulatory opportunities.

The connection between the business model of spread betting and that of gambling runs deep. Spread betting really did start out as a bookmaking business in 1964, when Coral Index, spearheaded by stockbrokers and capitalised by bookmaker Joe Coral, was the first spread betting company registered under the 1960 Betting and Gaming Act. The act's relaxed legislation was meant to legalise betting outside the racecourse but its framework also provided attractive new business opportunities. In contrast to the higher cost of futures trading and the regulatory limitations imposed on the futures markets at the time, companies could now offer to trade on future prices within a more flexible regulatory framework. In the 1960s, spread betting was a clever device for trading futures-type contracts without the constraints of conventional financial regulation.

In its earliest days, spread betting was a risky business to operate. By taking the opposite side of the bet, Coral Index was literally betting against its punters. What would happen if many of its clients were right at the same time? Inevitably, Coral hit a bad run at some point losing all of its original capital. Despite having lost a lot of money and the financial backing of Joe Coral, the company carried on until 1981 when it was sold to Ladbrokes which was itself acquired by IG three years later.

IG's original business model was somewhat different. The company, started in 1974, offered spread bets on gold, but only when it could hedge the position it held against its customers in the market. It offset risky positions by buying or selling bullion with gold broker Mocatta and Goldsmith. Hedging with physical gold provided the business with a kind of insurance which created a less risky business model to spread betting. The use of hedging combined with little competition meant that profits would come mainly from the spread – commission fee – included in the buy and sell price of a spread bet. IG gradually diversified spread bets to other commodities, as well as indices like the FTSE as well as the Dow Jones, because it was able to hedge risky positions held in those assets in the relevant futures markets.

While the City of London adopted the hedging tools at hand to improve its business model, IG and its competitors – Ladbrokes Index which IG bought over in 1981 and City Index which started much later in 1983 – were still officially operating under betting legislation. The spread bet's status as a gambling product changed with the Big Bang (financial deregulation in the UK) in 1986. Eager to facilitate futures trading at the time, the Conservative government included a clause which would prevent a futures contract from being interpreted as a wager, unenforceable under the Gambling Act of 1845. This regulatory detail was a window of opportunity for spread betting companies.

City Index led the way. In a case known as *Leslie v. City Index*, the firm took one of its customers to court in 1991 for debts accrued after the 1986 financial crash. For City Index, litigation was a means to an end: it wanted the ruling by the courts to establish that spread betting qualified as an investment under the meaning of the 1986 Financial Services Act. City Index won the case and since then spread betting has been regulated as a financial product.

Although spread betting no longer falls under betting legislation it does retain one essential trait that marks its past as a betting product: the winnings remain free from capital gains tax. An important advantage against other taxable forms of financial investment, the tax-free perk is one of the spread bet's unique selling point to investors, even though it only applies to UK tax payers.

Critics like to accuse big financial institutions of engaging in unproductive gambling. The term "casino capitalism" has become a demonic metaphor for denouncing complex products like the infamous Credit Default Swaps (CDS). There is nothing new about this argument. Throughout the history of the City of London the relationship between gambling and finance has been repeatedly painted as one which is detrimental and unproductive for finance. But if the influence of gambling threatens the development of finance as critics suggest, then what are we to make of the profitability and growing popularity of the spread betting market that offers investors the chance to purchase contracts that have so much in common with gambling bets?

Ian Burke, the chief executive of Rank Group, a casino company, is eager to turn old stereotypes around. Last year he argued that the expression "casino capitalism" drew an unfair parallel between a strictly regulated and income tax-generating casino industry and the failings of investment banks (Blitz 2012). The story of spread betting certainly does suggest that gambling is not strictly unproductive and that it might offer a useful perspective for understanding how some financial products are being developed.

References

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