SFC
SECURITIES & FUTURES COMMISSION
證券及期貨事務監察委員會
證監會

Response Of

the Securities and Futures Commission

to the Public Consultation on

the Review of the Leveraged Foreign Exchange

Trading Regulatory System

證券及期貨事務監察委員會

就檢討槓桿式外滙買賣監管制度的

公開諮詢結果的回應

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FOREWORD

In August 1996, the Commission issued a consultation paper on the review of the leveraged foreign exchange trading regulatory system. 18 submissions were received from various market participants and institutions during the consultation exercise. This document summarises the results of the consultation and the responses of the Commission. As a next step, the Commission will formulate detailed rules and regulations on the proposed amendments to the existing leveraged foreign exchange trading regulatory framework.

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EXECUTIVE SUMMARY

Background

1. At the time the Leveraged Foreign Exchange Trading Ordinance ("LFETO") was introduced in September 1994, the Commission undertook to review the regulatory framework in light of experience gained during its initial phase of implementation. Pursuant to this, the Commission commenced a review of the regulatory framework in March 1996 and issued a consultation paper in August 1996 on the outcome of the review. The paper sets out the results of the review and proposes a number of changes to the regulatory framework and invites interested parties to submit comments on the paper.

2. 18 written submissions were received from various market participants and institutions during the consultation exercise. The original period for receipt of comments was one month. However, this period was extended so that all submissions received, including a submission received on 14 October 1996 from an institution, were considered.

3. This document summarises the results of the consultation and the responses of the Commission.

Summary of Comments

4. The comments received from the 18 submissions have been summarised and are discussed in detail in the following section.

5. A number of respondents commended the Commission for taking a more pragmatic approach in respect of the day-to-day trading practices of traders and their clients. One institution pointed out in particular that the proposed recommendations will ameliorate some of the more draconian provisions in the present legislation.

6. As a result of the consultation, the Commission has concluded that while the majority of the recommendations in the consultation paper are supported, amendments to some of the recommendations in the consultation paper are required to take account of points raised by respondents.

Summary of Views of the Commission

7. For reasons discussed in the next section, the Commission has determined to approve the following positions:

Matters on which the Commission has maintained its view

Initial Capital Requirement

Minimum Liquid Capital Requirement

Aggregate Gross Position (AGP) Limit

Margin Level for Cross Currency Trades

Matters on which the Commission has maintained its view but with further safeguards built into the recommendations

No-Over-Loss Rules

Margin Requirements

Extension of Credit

Locked Positions

Matters to be considered further outside the context of the review

Compensation Arrangements

Matter on which the Commission has maintained its view but with further discussion to be held with the Hong Kong Futures Exchange

Segregated Trust Account

Scope of consultation - Other Technical Issues

8. The consultation paper also states that it will take the opportunity of the review to re-visit other aspects of the regulatory framework, particularly the financial resources rules and the accounts and audit rules. One institution suggested that such amendments should be subject to further consultation if they are likely to have any wide-ranging effects.

9. Accordingly, the Commission has determined that any changes to the Leveraged Foreign Exchange Trading (Financial Resources) Rules ("LFET (FRR)") and the Leveraged Foreign Exchange Trading (Accounts and Audit) Rules (aside from proposed incidental changes recommended above) be deferred and the proposed LFET (FRR) changes be incorporated in the general review of the Financial Resources Rules applicable to other registered persons.

Conclusion

10. The Commission believes that the proposals above are consistent with the intent of the LFETO and are aimed essentially at rationalising the regulatory framework and their implementation will not diminish investor protection.

11. In making this determination, the Commission does not think that it will cause systemic problems to the market and concluded that a number of the proposals enhance the present investor protection and systemic stability safeguards.

SUMMARY OF COMMENTS AND RESPONSES

(a) Initial Capital Requirement

External comments

1. Commentators generally supported the Commission's recommendation not to lower the existing initial capital requirement with only one commentator asserting that it was too high compared with those applicable to securities and futures dealers. This commentator proposed that the initial capital requirement be reduced to the higher of $10 million or 5% of client liability.

Discussion

1. The high initial capital requirement ensures that only well capitalised traders are associated with the leveraged forex market and has proven to be an effective entry barrier against the "fly-by-nights". Moreover, the nature of the leveraged forex market is distinct from the securities and futures markets because leveraged foreign exchange traders tend to take proprietary positions against their clients and should therefore be expected to be better capitalised to ensure that they are capable of meeting their obligations.

Commission's response

2. Due to the inherent nature of the business of a leveraged foreign exchange trader, it is proposed that the existing initial capital requirement remain unchanged.

(b) Minimum Liquid Capital Requirement

External comments

1. Commentators generally supported the recommendation to reduce the minimum liquid capital requirement from $25 million to $15 million with a number suggesting that it be lowered further in order to stimulate growth of the industry.

2. One trader, however, expressed concern that business volumes can be expected to rise after implementation of the various proposed changes to the existing regulatory framework and recommended that the minimum liquid capital requirement should remain unchanged to ensure proper risk management.

Discussion

1. The liquid capital requirement is already risk-based and is not a static figure. It rises as business volume increases beyond an initial cap for aggregate gross position of 60 times liquid capital. This cap will not be relaxed. As such, the proposed reduction in liquid capital will not enable traders to run up any additional risks that they could not have assumed under the existing rules. The proposed relaxation, therefore, has no impact on the risk management capabilities of the industry.

2. The objective of lowering the current liquid capital requirement is to free up excessive capital which has hitherto been tied up because of the high limit. As explained above, it does not have any impact on the level of risks that may be assumed by the industry but would make the industry more capital efficient.

3. In any case, our analysis shows that the majority of leveraged foreign exchange traders adopt a fairly conservative risk management approach, laying off their positions to recognised counterparties as volatilities in the market increase. The reduction in the minimum liquid capital is thus also not expected to increase the overall risk assumed by the industry.

4. As regards the suggestion to further reduce the proposed minimum liquid capital of $15 million, we have already indicated in the consultation paper, that reducing the minimum liquid capital requirement too drastically in one step does not appear to be desirable. We will keep this under review and make further changes if necessary.

Commission's response

5. It is proposed that the liquid capital requirement be reduced to $15 million as recommended in the consultation paper.

(c) Aggregate Gross Position (AGP) Limit

External comments

1. Commentators generally expressed the view that the present aggregate gross position limit should remain unchanged with one indicating that an increase to the multiple should be considered due to expected increase in business volume with recommendations in the consultation paper being implemented.

Discussion

1. In the consultation process, the Commission did not make any proposal to change the existing aggregate gross position limit of 60 times the liquid capital. The Commission is of the view that the AGP limit should not be changed.

(d) No-Over-Loss Rule

External comments

1. Practically all the submissions commented on the margin requirements, especially in relation to the no-over-loss proposal. Seven commentators supported the proposal while six opposed it. The remaining commentators suggested, in varying degree, a lowering of the present margin levels.

Discussion

1. The commentators that opposed the no-over-loss proposal centered their opposition on the risk to traders and the attraction of unwary investors to the market by the prospect of unlimited gains but downsides capped to their initial margin outlay.

2. The argument that introduction of a no-over-loss rule would increase risk to licensed traders is without substance. This is because under the existing Financial Resources Rules, a financial adjustment of 3% (less any margin money received from clients) of the gross value of a contract is levied by way of ranking liabilities. The level of the adjustment is based on extensive volatilities studies undertaken by the Commission prior to the introduction of the LFETO regulatory framework, which have since been confirmed by similar studies undertaken independently by the HKFE when it introduced the Rolling Forex contract. The adjustment thus accurately captures the "value at risk" of a trader's position and essentially reflects the primary risk management requirement within the regulatory framework. To the extent that such adjustments directly impact on the amount of liquid capital available to the trader, the amount of risk that a licensed trader is able to assume under the scheme is directly proportional to the level of his capitalisation.

3. Moreover, the adjustments to liquid capital would similarly reduce the aggregate gross position that could be carried by the trader and effectively reduce the amount of market risks that the trader could assume. As such, the no-over-loss rule effectively reduces the overall risks assumed by traders rather than increases it.

4. The suggestion, implicit at least, that the margin requirements were imposed to deter uninitiated and unsuitable investors is, of course, untrue. Margin deposits are essentially "good faith" deposits by clients to demonstrate their ability to meet their obligations as they fall due and help to reduce a trader's counterparty risks. On a philosophical plane, traders particularly in OTC markets like the LFET market, are normally free to assess the creditworthiness of their clients and manage their own counterparty risks by setting margins on a case by case basis, something which every financial institution, such as banks and OTC traders, does everyday. The mandatory margin requirements under the LFET regime, imposed at the initial stages to ensure best practices within the industry, represent a departure from the norm.

5. In discussions with licensed traders during the review exercise, they drew attention to the margin levels imposed by their direct competitors, particularly the banks and traders operating out of Macau, and argued for a level playing field. They suggested

that if exemptive relief from the mandatory margin levels is provided and they are allowed to set their own margin levels, they would be prepared to accept mandatory client suitability rules to ensure that only those who can bear the risk will be allowed to enter the market.

6. In response to our comment that very low margin levels would trigger much more frequent margin calls, and possibly mandatory closing out of positions for failure to meet margin calls, the traders indicated that they would be prepared to accept a "no-over-loss" rule whereby clients would only be exposed to the extent of the deposits with the traders (through a combination of early warning margin calls, early closing out and locking of positions). The adoption of such rules would in their view address our investor protection concerns.

7. The no-over-loss proposal is thus no more than an investor protection tool to complement a reversion to the norm of allowing traders to assess their own credit or counterparty risks. It should thus be seen as a safeguard rather than a relaxation.

8. While the mandatory client suitability rules will ensure that only those clients who are eminently suitable to participate in the leveraged forex market will be accepted as clients, the no-over-loss proposal will cap potential losses of clients allowed to participate in any no-over-loss scheme to the amount of "margin" on deposit. Implementation of the proposal should thus work to the better regulation of the industry, first by ensuring that only those who can afford the risk will be allowed entry into the market and second by ensuring that those allowed entry into the market under any such scheme will only be exposed to the extent of the amount of margins they deposited with the trader, amounts which they had clearly demonstrated that they could afford.

9. It might also be worth noting that the no-over-loss proposal accords with the suggestion of the Hon Huang Chen Ya, Convenor of the Legco Finance and Taxation Panel, made in the Legislative Council on 14 July 1993 while the Secretary for Financial Services was moving the motion for the second reading of the LFET Bill. Specifically, the Hon Huang Chen Ya recommended that the Government should investigate into the means of stepping up internal controls of leveraged forex trading companies, especially for the reason that most of these companies may take opposite position against their clients' orders and should also consider setting up a "stop-loss mechanism" to reduce the losses clients may suffer owing to company mismanagement.

10. However, in view of the reservations expressed by those commentators who opposed the proposal, it is proposed that additional safeguards be built into the current recommendations to ensure compliance with the rules and to prevent abuses of the proposal.

11. It is proposed that, in addition to requiring traders to seek prior approval from the Commission before implementing such an arrangement (during which the Commission will vet the effectiveness of the trader's procedures for ensuring client suitability and risk monitoring), traders which introduce lower than the standard 5% margin

requirements under a no-over-loss arrangement would be required to include into their standard client agreements provisions which state to the effect that:-

a) positions will not be liquidated without prior notice being given to the client, at which point in time the client can either elect to close out the position or to deposit additional margin to preserve the position;

b) if the client elects to liquidate the position, the trader must confirm details of the price at which the position would be liquidated with the client during the course of the telephone conversation; and

c) such discussions must be done either through a telephone connected to the centralised tape recording system or in person with the client. In the event of the latter, the client must sign the trading slip concerned.

12. The above requirements will be applicable to non-discretionary accounts only since, by definition, an account executive managing a discretionary account does not have to seek client authority to open/liquidate positions.

Commission's response

13. It is therefore proposed that, subject to the further requirement set out above, the proposal to allow traders to set their own margin levels under a no-over-loss scheme should remain.

(e) Margin Requirements

External comments

1. As mentioned in the no-over-loss section, practically all the submissions commented on the margin requirements, especially in relation to the no-over-loss proposal. Seven commentators supported the proposal while six opposed it. The remaining commentators suggested, in varying degree, a lowering of the present margin levels.

Discussion

1. As discussed in the section on no-over-loss rule, the proposal to allow licensed traders to set their own margin levels is predicated on the introduction of the no-over-loss rule by the licensed traders. Please refer to the section on no-over-loss rule which contains the responses of the Commission.

Commission's response

2. It is therefore proposed that, subject to further requirements to regulate the implementation of the no-over-loss rule, the proposal to allow traders to set their own margin levels under the no-over-loss scheme should remain.

(f) Extension of Credit

External comments

1. Responses to the proposal to tier the market by allowing traders to extend credit to high net worth clients were split, with an equal number in support and in opposition to the proposal.

Discussion

1. The proposal to allow leveraged forex traders to extend credit in respect of their high net worth clients effectively allows a trader to assess and assume their own credit/counterparty risk vis-à-vis what is normally termed "professional" clients in the securities markets. Dealing with such clients is exempted from regulation under the Securities Ordinance. As well, such a proposal is in line with the practices in other OTC markets.

2. The commentators that oppose the proposal noted that their opposition is not against the concept but against the absence of clear rules to define what is meant by high net worth clients.

3. To allay such concerns, it is recommended that, consistent with the current approach of private banking, the criteria for determining high net worth clients should be based on individual investable financial assets, at the time of investment, in excess of US$1 million. This will prevent traders attracting unsuitable clients to participate in the market through the offer of "free margins".

Commission's response

4. Against this background, we propose that the proposal to allow extension of credit to high net worth clients should remain and that such clients should be defined as suggested above.

(g) Margin Level for Cross Currency Trades

External comments

1. The commentators all supported the proposal to collect only one set of margin for cross currency trades. In fact, some commentators suggested a further relaxation of the requirement by treating different positions in different currencies within the same account as cross currency trades as long as they were on opposite sides of the benchmark US dollar.

Discussion

1. As different currencies do not track each other absolutely against the dollar, the risk for each of these positions should be considered separately and should not, willy nilly, be treated as cross currency trades for the purposes of avoiding the margin requirements.

Commission's response

2. The proposal that a cross currency trade should only attract a single set of margin should remain unchanged.

(h) Locked Positions

External comments

1. Out of the seven submissions received on this issue, five supported the proposal for collecting one set of margins for locked positions while two opposed.

Discussion

1. Neither the leveraged forex trader or his client faces any position risk if a client "locks his positions" by entering into a trade on the opposite side to his original position. However, under the present Financial Resources Rules, the locked position is counted twice for the purposes of margins, calculating the aggregate gross position and setting financial adjustments if the client's equity falls below the maintenance margin level. This is clearly unreasonable and was never intended, particularly when the margin requirements are viewed against the objectives of ensuring capital adequacy and proper risk management.

2. Two commentators were against the proposal on the ground that such "operations are not considered to be prudent and ethical trading tactics." As such, the opposition is based more on ethics and possible abuses rather than capital adequacy or risk management grounds.

3. To ensure that the ethical concerns are properly addressed, it is recommended that the rectification to the Financial Resources Rules requirement in relation to locked positions should only be applicable if:

    a) the locked position is entered into upon the specific request of a client;

    b) proper disclosures are made of the non commercial rationale of such locked positions; and

    c) the request should specify the period for which it is current, but should not in any event remain in force for a period of more than one month.

Commission's response

4. Subject to the requirements mentioned above, the proposal to impose only one set of margin for locked positions should remain.

(i) Segregated Trust Account

External comments

1. The submissions generally supported the proposal to allow traders to lay-off client positions using client funds provided these are adequately safeguarded. However, one commentator objected to the proposal on the grounds that where a client is trading with a trader as principal, there is no reason why the trader should not be using his own monies to hedge that position.

Discussion

1. The argument that the trader should put up his own money for hedging client positions because he is trading qua principal with his client is flawed because the argument, pushed to its logical extreme, must mean that the margin deposits are really not client money but the trader's "income", which he can use as he chooses.

2. The objective of the proposal is to encourage genuine risk reduction operations by traders and to enable them to maintain lower net positions provided the protection to client assets afforded under sections 23 and 24 of the LFETO is safeguarded. This is consistent with the objective of ensuring that the risks in the market are properly managed and will enhance investor protection provided, of course, that the necessary control procedures are properly instituted.

Commission's response

3. It is proposed that the proposal to allow leveraged forex traders to use client monies for the purpose of laying off client positions should remain. However, in drafting rules to implement the proposal, discussions should be held with the HKFE to ensure that the clients' interests are properly safeguarded where these are laid off into the Rolling Forex market.

(j) Compensation Arrangements

External comments

1. None of the submissions favoured the establishment of a compensation fund, although a number supported the fidelity insurance approach as the appropriate compensation arrangements. However, a number of traders (four) were against the setting up of any such arrangement.

Discussion

1. A major trader strongly argued that the setting up of such a fund has the potential of eroding the duty of care on the part of investors to select their counterparties with prudence and is tantamount to the efficient and adequately financed traders paying for the inefficiency and inadequacies of other traders. Moreover, unless a standard fidelity insurance scheme, modeled along the present Brokers Fidelity Insurance, is devised, some traders might have difficulties finding adequate coverage.

2. Another top tier trader commented that any form of compensation arrangement will cause additional financial burden to the traders and suggested further study on cost and coverage before any conclusion is made.

3. While we accept the arguments advanced, we remain of the view that the provision of some safety net, in the form of fidelity insurance, against trader defaults is in the overall interest of the market and affords better protection to investors. However, to ensure adequate insurance coverage, we recommend that implementation of the requirement be coordinated with the implementation date of the fidelity insurance proposals under section 6.11(2)(c) of the draft Composite Securities and Futures Bill. This will ensure equality amongst the different categories of intermediaries and enable adequate supply of such insurance coverage within the market.

Commission's response

4. The proposal that all leveraged forex traders be required to acquire fidelity insurance should be accepted although its implementation should be deferred until the general scheme applicable to all intermediaries regulated by the Commission proposed under the Composite Securities and Futures Bill comes into effect.

(k) Other Technical Issues

External comments

1. The consultation paper also stated that it will take the opportunity of the review to re-visit other aspects of the regulatory framework, particularly the Leveraged Foreign Exchange Trading (Financial Resources) Rules ("LFET (FRR)") and the Leveraged Foreign Exchange Trading (Accounts and Audit) Rules. One institution suggested that such amendments should be subject to further consultation if they are likely to have any wide-ranging effects.

Discussion

1. As the Commission is currently conducting a general review of the Financial Resources Rules applicable to securities and futures dealers, we consider that it is more appropriate to incorporate any amendments to the LFET (FRR) in the forthcoming general review of the Financial Resources Rules.

Commission's response

2. It is proposed that any changes to the LFET (FRR) and the Accounts and Audit Rules (aside from proposed incidental changes recommended above) be deferred and the proposed changes be incorporated in the general review of the FRR.