Report on Leveraged Foreign Exchange Trading Activities Carried Out by Licensed Corporations

April 2020

Contents

A. Background

1. The Securities and Futures Commission (SFC) conducted a survey of the activities of leveraged foreign exchange trading (LFET) brokers[1] between 1 January and 31 December 2018 to better understand the industry's demographics and business practices. A questionnaire was sent to 40 LFET brokers[2] to collect information related to their clientele, products, business models and trading activities. All 40 responded, with eight reporting that they did not conduct or had ceased conducting LFET activities in 2018. This report summarises the key findings of the survey on the 32 active LFET brokers, which will aid the SFC in its supervision of LFET brokers.

2. In a number of other jurisdictions, the sales and marketing to retail investors of over-the-counter (OTC) leveraged products, including rolling spot forex contracts[3], have recently been the subject of regulatory scrutiny. These products are often advertised through online platforms and involve complex and non-standard features[4] which may be difficult for retail investors to understand.

3. In addition, these products are usually traded on a margin basis and investors are allowed to trade after depositing only a small proportion of the notional investment amount to support the position. Leveraged trading increases investors' exposure to the volatility of the underlying investment. The lower the margin amount, the higher the gearing of the product will be. Unless a broker adopts a "no negative balance" policy, which waives any excess loss incurred by the investor on the position, investors may lose more than the amount of margin deposited.

4. In Hong Kong, LFET activities carried out by licensed corporations (LCs) are subject to the SFC's supervision and those conducted by authorised institutions are supervised by the Hong Kong Monetary Authority. However, the LFET activities of companies which are exempt from the licensing requirement under the Securities and Futures Ordinance by virtue of the Securities and Futures (Leveraged Foreign Exchange Trading-Exemption) Rules are not subject to any regulation.

5. The key survey findings in this report are supplemented with some good industry practices observed by the SFC during the course of its regulatory supervision. Guidance on some expected regulatory standards covering customer due diligence, handling of client orders, conflicts of interest and information for clients is also provided. The senior management of LFET brokers should assume responsibility for developing and implementing policies and controls to comply with the expected regulatory standards.

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[1] In this report, "LFET brokers" refers to licenced corporations (LCs) which carry out LFET activities in Hong Kong. These LCs are required to be licensed by the SFC for Type 3 regulated activity.

[2] Except those LCs which had filed a notice of cessation of business or had been served with a restriction notice.

[3] The payout for rolling spot forex contracts is based on the fluctuation of foreign exchange rates and the initial maturity of two business days is automatically extended (by one business day at a time) if the contract is still open at the close of trading on the second business day. These products include economically equivalent leveraged foreign exchange contracts.

[4] Such as automatic close-outs and complex valuation methods and calculations of interest differentials.

B. Key observations

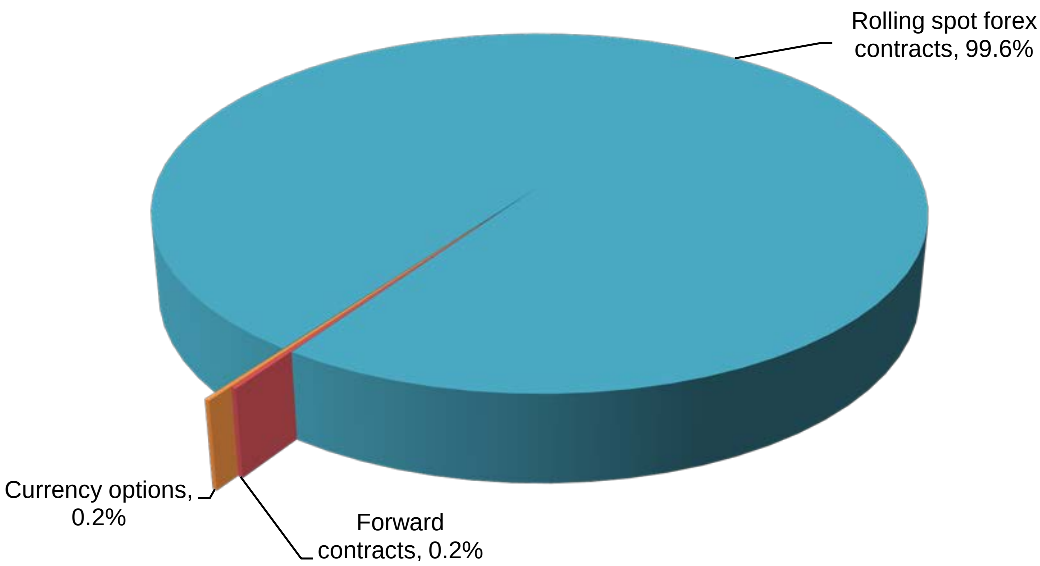
Turnover by product type

6. For the year ended 31 December 2018, the total turnover of LFET brokers in terms of the gross principal value of the leveraged foreign exchange (LFE) contracts executed by them (2018 market turnover) was $1,844 billion, and the average per client was $122 million.

7. Rolling spot forex contracts constituted 99.6% of the 2018 market turnover. Forward contracts and currency options each constituted 0.2%. All of these products were traded on an OTC basis.

8. Rolling spot forex contracts are traded on margin whereby investors are allowed to open a position by depositing collateral (mainly cash deposits) which only represents a small percentage of the gross principal value of the contract. The Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Code of Conduct) requires LFET brokers to set the initial margin and maintenance margin levels at not less than 5% and 3% respectively of the gross principal value of an LFE contract[5].

Chart 1: 2018 Market turnover by product type

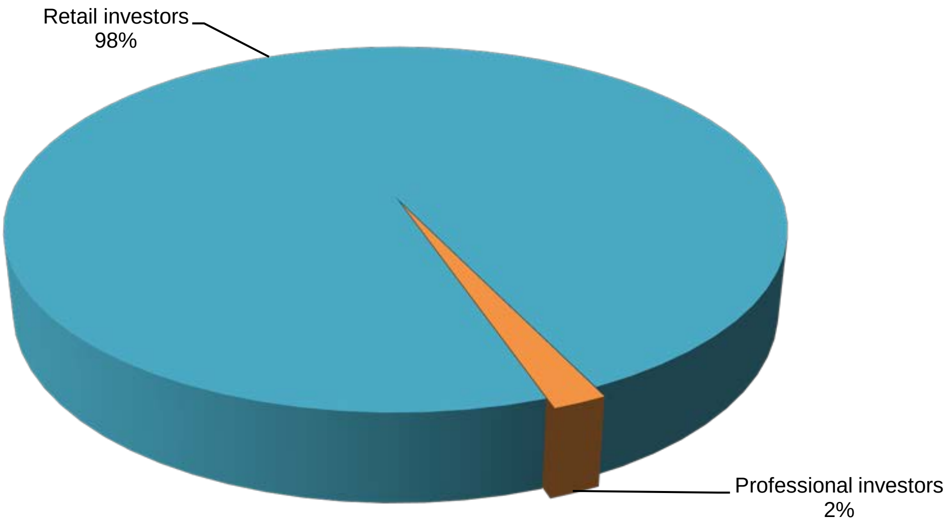


[5] Paragraph 23 of Schedule 6 to the Code of Conduct.

Clientele

9. As at 31 December 2018, LFET brokers reported to have 15,096 active LFET clients[6] in total and 98% of them were retail investors. Over the past 10 years, the number of active LFET clients had increased by 47% from 10,295 in 2009 to 15,096 in 2018.

Chart 2: Distribution of active LFET clients by client type



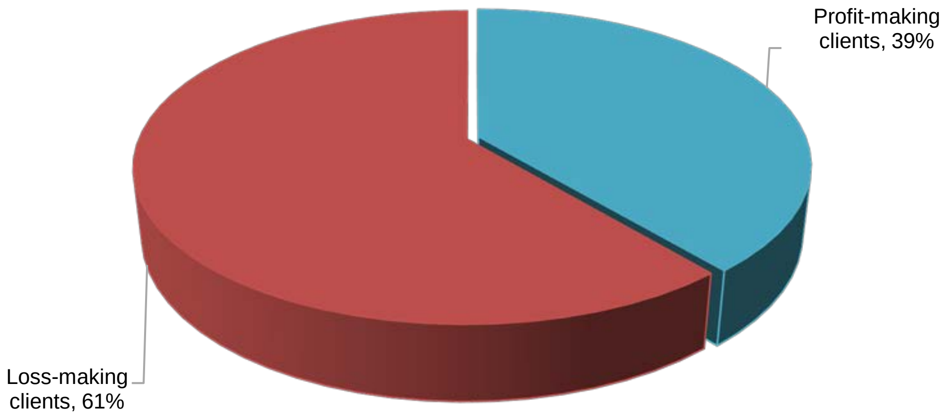
10. In addition, those LCs who acted as introducing agents had, since the date they were licensed, referred a total of 7,636 clients to their overseas affiliates to conduct LFET activities as at 31 December 2018.

[6] Active clients are clients for whom an LC is required to prepare and deliver a monthly statement of account in respect of the relevant reporting month in accordance with the Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules.

Trading performance of clients

11. A sample of LFET brokers (Sampled Brokers) were selected to provide more detailed information. These brokers in aggregate contributed 77% of the 2018 market turnover and 41% of total active LFET clients[7]. According to the Sampled Brokers' information, 61% of their clients made net trading losses and 39% made net trading profits in LFET in 2018.

Chart 3: Distribution of loss-making and profit-making clients of Sampled Brokers



12. Of the active LFET clients of the Sampled Brokers, 26% incurred a net trading loss of more than $10,000, with 1% losing more than $1 million in 2018. The worst case reported to have made a net trading loss of around $7 million.

13. Of the active LFET clients of the Sampled Brokers, 15% incurred a net trading profit of more than $10,000, with less than 1% gaining more than $1 million in 2018. The best case reported to have made a net trading profit of around $9.5 million.

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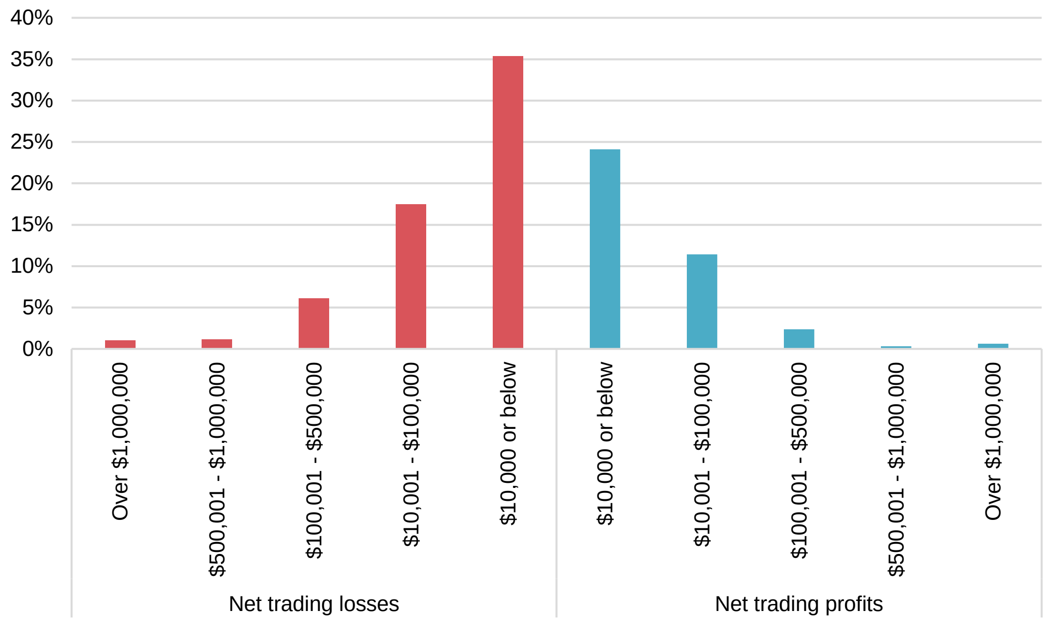
[7] Based on the number of active clients reported by LFET brokers as at 31 December 2018.

Chart 4: Stratification of net trading losses and profits of active LFET clients of Sampled Brokers



14. Although these statistics are generated from data provided by a small number of LFET brokers and therefore may not be representative of the profit and loss distribution of all LFET clients, the high percentage of loss-making clients of the Sampled Brokers suggests that LFET trading can be risky and may not be suitable for all investors.

Expected regulatory standards

15. LFET products include rolling spot forex contracts as well as other complex products and derivatives such as options and forward contracts, which may be difficult for retail investors to understand. Even for less complex LFET products, the pricing methodologies and trading terms may vary as they are not traded centrally on an exchange. It is thus of paramount importance for LFET brokers to:

- take all reasonable steps to establish the financial situation, investment experience and investment objective of each LFET client[8]; and
- assure themselves that the client understands the nature and risks of the LFET products they offer and has sufficient net worth to assume the risks and bear the potential losses of trading in the products[9].

[8] Paragraph 5.1 of the Code of Conduct.
[9] Paragraph 5.3 of the Code of Conduct.

Expected regulatory standards

16. Adequate information[10] should be provided so that client is reasonably able to understand the risks associated with LFET. This should include, amongst others:

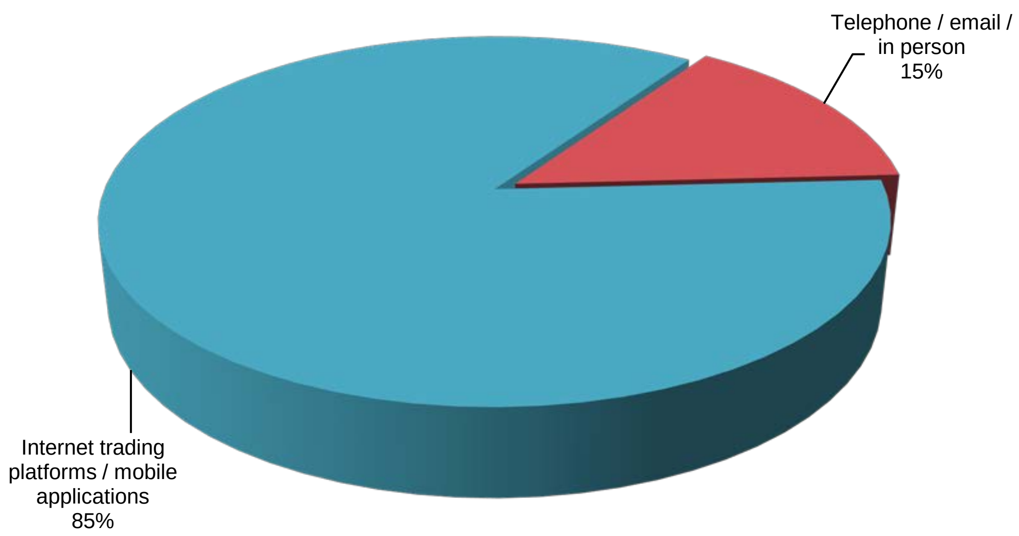
- the risks associated with the underlying market;
- the risk of LFET and margin trading[11];
- the fact that the product is being sold OTC and its implications. This includes, amongst others:
    - the firm may act as the counterparty to the client's transaction and the client may be subject to the firm's credit risk;
    - there is no centralised pricing source and the price of the LFET transaction is determined by the firm or negotiated with the client; and
    - the transaction in OTC products may involve greater risk than investing in exchange traded products because there is no exchange market on which to close out an open position; and
- the risk that the client order price may be different from the execution price, or slippage[12].

[10] General Principle 5 (Information for clients) of the Code of Conduct.
[11] In accordance with Schedule 1 (Risk disclosure statements) to the Code of Conduct.
[12] See paragraph 18.

Handling of client orders

17. The orders for around 85% of LFET client transactions in terms of turnover were placed electronically either through internet trading platforms or mobile applications. The remainder were placed by telephone, email or in person at the LFET broker's office premises (orally or by order ticket to an account executive or other staff).

Chart 5: LFET order channels



18. "Slippage" is the difference between the client order price and the execution price. It is common in LFET transactions and can occur irrespective of which channel is used to place the order. The execution price may be different from the client order price because the market moves while the LFET broker transmits a client order to its liquidity providers for execution. "Positive slippage" refers to a favourable price difference, whereas "negative slippage" refers to an unfavourable price difference.

Expected regulatory standards

19. LFET brokers should act honestly, fairly, with due skill, care and diligence, and in the best interests of their clients[13] when handling client orders. They should:

- execute client orders on the best available terms[14] and avoid any dishonest and unfair execution practices, such as asymmetrical treatment of positive and negative slippage which allow the broker to retain profits arising from positive slippage, whilst passing losses from negative slippage on to the client; and

- adopt a fair pricing methodology[15] by:

  - referencing the prices offered to clients to market data;

  - using independent and externally verifiable price sources or liquidity providers to derive the prices; and

  - ensuring that all charges, mark-ups or fees affecting clients are fair and reasonable and characterised by good faith[16].

Good industry practices

20. There have been complaints about the prices of LFET products. We have noted that some brokers adopt the following good industry practices for handling slippage and executing client orders:

- Allow clients to set their maximum acceptable amount of negative slippage and ensure that orders will not be executed if the price movements exceed that amount; and

- Disclose data relating to execution quality (such as slippage ratios or re-quote and rejection rates) to help clients evaluate the quality of execution delivered by the broker.

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13 General Principles 1 (Honesty and fairness) and 2 (Diligence) of the Code of Conduct.
14 Paragraph 3.2 of the Code of Conduct.
15 Paragraph 54 of Schedule 6 to the Code of Conduct.
16 Paragraph 2.2 of the Code of Conduct.

Business models

21. Of the 32[17] active LFET brokers,

- 17 adopted a Straight Through Processing (STP) model (of which nine engaged affiliates as liquidity providers or as one of their liquidity providers);
- 10 operated a Dealing Desk model;
- four acted as introducing agents and referred clients to execution brokers; and
- one only executed trades for funds managed by its affiliate.

22. LFET brokers adopting an STP model usually hedge each client transaction with a liquidity provider on a back-to-back basis[18]. This way, the LFET broker's income will be independent of the clients' trading profits and losses. Under this model, brokers' income is usually derived from adding a bid-ask spread to the executed price of the client transaction or charging a commission on the transaction.

23. Generally speaking, by adopting an STP model, an LFET broker would have less incentive to pursue its own interests at the expense of its clients'. However, if it executes or hedges client transactions with a liquidity provider which is an affiliate, a conflict of interest may arise as the commercial interests of the LFET broker and the affiliated company are inevitably linked.

24. LFET brokers adopting a Dealing Desk model act as a market maker and take positions against their clients. As such, a conflict of interest will arise because the broker may benefit from clients' losses. These brokers may or may not hedge the foreign exchange positions arising from their LFET transactions with clients. Among the 10 LFET brokers adopting a Dealing Desk model,

- two fully hedged the net positions arising from transactions with clients;
- six partially hedged the net positions (for example, they conducted hedging when the net position in a currency exceeded a limit); and
- two did not hedge any net positions.

25. LFET brokers acting as introducing agents refer clients, or relay client orders, to execution brokers, which are usually affiliates, to enter into LFE contracts. These LFET brokers usually receive referral income from the execution brokers.

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17 Eight LFET brokers did not conduct or had ceased conducting LFET activities in 2018.
18 Entering into an equal but opposite transaction with the liquidity provider.

Expected regulatory standards

26. Regardless of the business model adopted, LFET brokers should state in the client agreement whether they take opposite positions to client orders[19]. They should take all reasonable steps to avoid any conflicts of interest, and when such conflicts cannot be avoided, ensure that their clients are fairly treated and disclose any actual or potential conflicts of interest before transacting with clients[20].

27. LFET brokers should also provide clear and effective disclosure to clients[21] about how their orders are executed. This should include, amongst others:

    - the order execution policy, explaining the methodology they use to deliver the best possible outcome when executing orders; and
    - the methodology for determining the prices of different LFET products.

28. Specifically, LFET brokers should disclose, amongst others, the following information in their order execution policy:

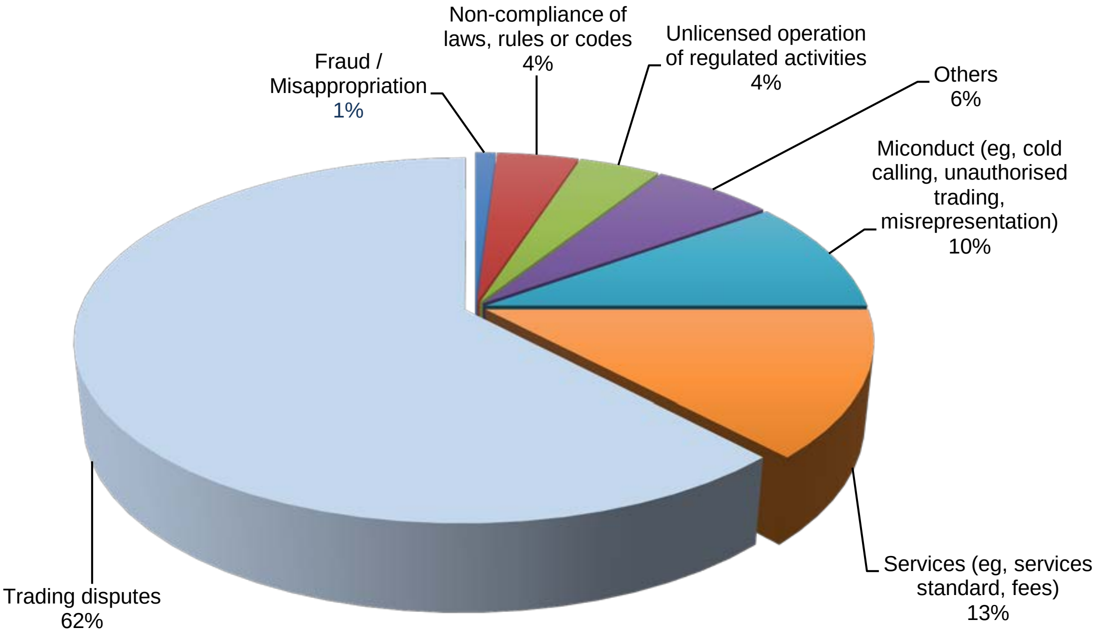
    - for LFET brokers adopting an STP model or executing orders on behalf of clients:
        - the capacity in which they trade with or act for the clients; and
        - any intra-group link or relationship between the firm and the liquidity provider with which the client order is executed or hedged;
    - for LFET brokers adopting a Dealing Desk model:
        - the fact that they act as the counterparty of client orders and take opposite position to a client's order; and
        - the circumstances which give rise to the potential and actual conflicts of interest in their principal-dealing and market-making activities;
    - the features and operation of different order types available to clients (eg, limit order, good-til-cancelled order, market order, stop loss order and liquidation order); and
    - how slippage is handled.

[19] Paragraph 1(d) of Schedule 6 to the Code of Conduct.
[20] General Principle 6 (Conflicts of interest) of the Code of Conduct.
[21] General Principle 5 (Information for clients) of the Code of Conduct.

Information for clients

29. Over the past decade, the SFC has received a number of complaints against LFET brokers or their staff. Most of these complaints (62%) were related to trading disputes.

Chart 6: LFET-related complaints by type (2009 - 2018)



30. In many cases, these trading disputes arose when clients did not fully understand the features and operations of the products and services provided by the LFET brokers. LFET brokers are reminded to provide appropriate information to their clients so that they are reasonably able to understand the nature and risks of the products and consequently, can make informed investment decisions.

Good industry practices

31. We noted that some LFET brokers adopted the following good industry practices to increase the transparency of the products or services offered to clients:

- Use numerical examples to illustrate key features of different types of products, and how trade orders operate, such as product leverage, margin calls, and stop-loss mechanisms, as well as to explain the risk of slippage. These examples cover both negative and positive scenarios; and
- Technical terms, jargon and ambiguity are avoided and explanations are provided in plain language for ease of understanding.

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