Securities and Futures Commission

Consultation Paper on the Review of the Leveraged Foreign Exchange Trading Regulatory System

12th Floor, Edinburgh Tower
15 Queen's Road Central
The Landmark
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TABLE OF CONTENTS

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I. INTRODUCTION

1. Following numerous complaints of fraud and abusive trading practices, the Leveraged Foreign Exchange Trading Ordinance ("LFETO") was enacted to regulate the retail end of leveraged foreign exchange trading in Hong Kong. This came into effect on 1 September 1994.

2. The LFETO established a regulatory system based on:

    a) A licensing system to ensure that all persons engaged in the businesses are "fit and proper";

    b) Financial resources requirements to ensure the financial soundness of the traders;

    c) Conduct of Business rules to ensure traders have continuing high standards of integrity, treat investors fairly and disclose relevant information to clients; and

    d) Investigatory and enforcement powers to back up the regulatory requirements.

3. However, in the 18 months since the implementation of the LFETO, the industry has experienced a significant contraction, both in terms of business volumes and in the number of active firms. Out of an estimated population of some 300 firms prior to the implementation of the LFETO, only 52 applied for a licence; 11 applications were withdrawn and 8 licences were surrendered; leaving 31 licensed traders, with two applications outstanding.

4. The possible reasons for the decline in the industry are:

    a) the poor reputation of the industry following the scandals in 1992/93, which severely affected investor confidence;

    b) the impact of regulation, particularly the minimum margin requirements plus the prohibition of credit for margin deposits, the ban against cold calling/hawking etc., which has prevented the product from being marketed to persons who could not afford the risks involved, e.g. housewives, the young and the elderly;

c) migration of the lower (and probably wilder) end of the business to Macau;

d) the ban imposed by the People's Republic of China authorities on financial futures, including leveraged forex, which has deprived the industry of a significant number of big ticket clients; and

e) increased competition from Authorised Institutions, particularly the large retail banks who have entered the retail end of the market in a big way since the introduction of the LFETO.

5. At the time the LFETO was introduced, the Commission undertook to review the regulatory framework in light of experience gained during its initial phase of implementation. The decline in business volumes has also resulted in calls by the industry for a review of the regulatory framework with a view to relaxing some of its key features. The primary focus of the industry's demands for relaxation are:

a) the minimum margin requirements, which some felt to be the main cause of the loss of business to the banks and to Macau; and

b) the minimum liquid capital requirements, which has resulted in large chunks of capital having to be left idle by licensed traders.

6. At the same time, the collapse of Canwell Forex International Ltd. ("Canwell"), resulting in the inability of clients to withdraw their margin deposits from the company, has led to calls for some form of compensation arrangement to protect investors in the event of defaults.

7. In view of the above, the SFC has conducted a thorough review of the regulatory framework in light of the experience in operating the system since its implementation in 1994.

8. This document sets out the results of the review and proposes a number of changes to fine-tune the existing regulatory framework to ensure that it remains appropriate.

9. In the process of the review, extensive discussions were conducted with relevant parties to collect background information and to help identify the main issues. The process included focus group meetings with selected

licenced traders, meeting with the Hong Kong Futures Exchange Limited ("HKFE") on linkages between the one day rolling currency futures contracts market ("rolling forex") and the LFET market and questionnaires to licensed traders and their selected clients to solicit views on a range of potential solutions to the problems raised by the industry.

10. The SFC wishes to record its appreciation for the valuable contributions made by these respondents.

11. The SFC invites interested persons to submit written comments on this Consultation Paper by 30 September 1996. Comments should be sent to:

The Securities and Futures Commission
12th Floor, Edinburgh Tower
Queen's Road Central
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For the attention of the Secretary to the Commission.

The Consultation Paper is available on the SFC Internet Home Page at http://www.cuhk.edu.hk/sfc. Interested persons may also submit comments on the Paper by e-mail to sfc@hk.super.net.

II. THE REVIEW

12. The Review concluded that implementation of the LFET regulatory framework has successfully injected a degree of discipline into the industry and appeared to have afforded the necessary protection to investors against the previous abusive practices. This is borne out by the substantial decline in the number of complaints received and, more importantly, by the fact that the nature of the complaints have changed dramatically subsequent to 1 September 1994. From previous allegations of fraud, abuse of discretionary authority, particularly churning of accounts, theft and other malfeasance, the complaints are now primarily "normal" commercial disputes in relation to an industry of this nature, e.g. disputes regarding arbitrary closing of positions following a failure to meet margin calls, the pricing of closing out transactions, timeliness of execution etc.

13. Our discussions with the industry and clients of licensed traders have also confirmed general support for the concept of subjecting the industry to regulation and acceptance of the broad parameters of the regulatory framework. In addition, other than in relation to the initial capital and minimum margin requirements, no objection was received in relation to the main business conduct requirements.

14. The review, therefore, concentrated on the following areas:

    (a) Initial Capital Requirement;
    (b) Minimum Liquid Capital Requirement;
    (c) Margin Requirements;
    (d) Segregated Trust Accounts Rules; and
    (e) Compensation Arrangements.

    These are discussed in the following sections.

(a) Initial Capital Requirement

15. The LFETO requires licensed traders to have a minimum paid up capital of $30 million. This compares very unfavourably with similar requirements for the other industries regulated by the SFC, viz. $5 million for securities dealers, $2 million for futures dealers and a simple solvency test for advisers. This has led to calls by some LFET traders for a relaxation of the requirement.

16. The SFC is not in favour of any move to lower the initial capital because a high initial capital is necessary:

    a) to act as a sort of entry barrier against the "fly-by-nights" which plagued the industry prior to the introduction of regulation; and

    b) to ensure that traders are adequately capitalised to meet the risks associated with the highly leveraged forex market, particularly as many of the traders take principal positions against their clients.

17. In any event, those traders who do not take principal positions against their clients, i.e. who act purely in a broking capacity, has the option of applying to become an introducing broker, which attracts a much lower capital requirement of $5 million.

18. The SFC would also point out that as the existing licensed traders have met the entry requirement, a relaxation would only result in letting in less well capitalised firms and/or enable existing licensed traders to retire their existing capital for return to their shareholders. In the SFC's view, neither development is in the interest of the market and the investors. The SFC, therefore, does not recommend any change to the existing initial capital requirement.

(b) Minimum Liquid Capital Requirement

19. The LFETO requires licensed traders to maintain, at all times, a liquid capital of not less than $25 million.

20. The basic concept of the minimum liquid capital requirement is to introduce a net asset test to ensure that licensed traders have the necessary liquidity to meet their financial commitments as they fall due. This covers the day-to-day costs of the normal operation process and, more importantly, the risks arising from the business activities of the licensed trader.

21. It should be pointed out that the main business risks of the licensed traders arise when they take proprietary positions against their clients and that the objective of the minimum liquid capital requirement is not for the purposes of protecting client assets. Withdrawals of client monies come out of the designated trust accounts which are kept separate and segregated from the traders' assets.

22. The transaction risk of a licensed trader can be measured by the cash positions resulting from its proprietary trading. Our analysis show that, on average, this tends to be around 6% of the average liquid capital maintained by the traders, i.e. approximately $2.5 million. The relevant statistics are:

Semi-annual Analysis of Capital Utilisation (all amounts in HK$'000)
(Average for all traders other than introducing agents)

	Dec-94	*Jun-95*	*Dec-95*	*Jun-96*	*Average*
Actual Liquid Capital Maintained (LC)	43,253	43,375	39,795	40,455	41,720
Required Liquid Capital	25,000	25,000	25,000	25,000	25,000
Excess	18,253	18,375	14,795	15,455	16,720
Aggregate gross position	457,781	419,006	358,692	685,720	480,300
Fluctuations in liquid capital due to trading (as % of LC)		3.9%	8.0%	6.3%	6.1%
Liquid capital required to cover trading		1,692	3,184	2,549	2,475

23. The above statistics show that, based on actual trading outcome over the past 18 months, the average net loss of liquid capital, an indicator constructed to measure the demand on liquid capital, arising from the level of proprietary trading of a trader is 6% of the level of liquid capital maintained by the trader. This is equivalent to a level of $2.5m liquid capital requirement or 10% of the statutory level of $25m. As a result, the industry would appear to be maintaining liquid capital of some $864m to off-set risks of about $33m. (In arriving at this figure, we have avoided consolidating trading profits of one trader with losses suffered by another to avoid "queering" the analysis since one trader's profits cannot be used to offset another trader's losses and the loss-making trader must have the necessary liquidity to pay his losses as they fall due.)

24. From a capital efficiency viewpoint, a minimum liquid capital requirement well in excess of what is actually required to meet the "risks" involved in running a LFETO business is undesirable as the traders are not able to maximize the financial resources committed to the business.

25. The concerns of the licenced traders thus appear to be well based and that there is room to improve the minimum liquid capital requirements to make the business more capital efficient whilst retaining the necessary regulatory comfort.

26. Given a 5% intra-day volatility and the gearing involved, a 10% minimum liquid capital requirement appears low. This is, however, a reflection of the conservative risk profiles of the traders, who tend to lay-off their positions whenever the market experiences high volatility to reduce their own exposures.

27. On this basis, i.e. using the average fluctuations of liquid capital experienced by the industry of 10% plus an add-on of say 8%, the factor used by the Basle Group of bank regulators under their building block approach to meet operational costs, the minimum liquid capital requirement could be pitched at about $4 million without undermining the regulatory integrity of the requirements.

28. However, reducing the minimum liquid capital requirement so drastically in one step does not appear to be desirable. We, therefore, propose to take a first step by reducing the minimum liquid capital to $15 million. We will keep this under review and make further changes if necessary.

29. To ensure that a trader does not over extend its proprietary positions as a result of the reduction in liquid capital requirement, we propose to maintain the present cap on the trading activity of a trader. This is presently fixed at the aggregate gross positions of a trader not exceeding 60 times the liquid capital maintained by it. Retention of this cap ensures a linkage between the available risk capital and the volume of business undertaken. This would not remove the relief offered by the reduction in the minimum liquid capital requirement to the traders as the present activity level, is on average in the low 20's.

(c) Margin Requirements

30. Prior to the LFETO, margin levels were traditionally set at 0.5% of the contract size, with some traders dispensing entirely with margins, to attract business. Apart from the high gearing ratio, approximately 200 times, such low margin levels had a number of undesirable effects:

(a) it enabled persons who could not afford to trade such products to enter the market, exposing them to enormous risks. This resulted in numerous complaints of unwary small investors losing their entire life savings trading such products; and

(b) it enabled unscrupulous traders to close out client positions literally at will, sometimes ex post facto, since the low margin levels were clearly insufficient to withstand even minor fluctuations in forex prices. This is particularly so as the forex market is essentially a 24-hour operation and investors are unlikely to be able to watch the market closely to ensure that their accounts stayed within positive levels at all times.

31. To address these two concerns, the Conduct Rules made under the LFETO oblige licensed traders to require their clients to deposit a minimum initial margin of 5% before opening positions and set a maintenance margin level of 3%, prior to which a licensed trader may not arbitrarily close out a client's position even where the client has failed to meet a margin call.

32. These levels were arrived at on the basis of volatility studies undertaken by the SFC prior to the enactment of the LFETO. The outcome of these studies have since been confirmed by volatility studies undertaken independently by the HKFE when developing their rolling forex contract. (The only difference between the two sectors is the 4% initial margin offered by the HKFE's Rolling Forex contract on Deutsmark contracts.)

33. Some traders have argued that the introduction of the minimum margin requirements, coupled with the ban against extending credit for margin deposits, have discouraged participation by clients. They noted that the margin requirements imposed by the regulated exchanges, e.g. Simex, IMM etc. are somewhat lower. They also noted that since the entry into force of the LFETO, many Authorized Institutions have lowered their margin thresholds from the traditional 10% to the same level as the LFETO. Some even offer effectively margin free trading facilities, albeit

against deposits held. They have, therefore, urged that the existing maximum margin requirements be relaxed.

34. They pointed out that the margin deposit is essentially a "good faith" deposit on the part of a client to reduce a licensed trader's counterparty risk and that, on a philosophical plane, a trader should be allowed to assess the creditworthiness of its clients and assume its own counterparty risks by setting its own margin levels on a case by case basis.

35. These licensed traders have 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. In addition, 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 the investor protection objectives behind the current minimum margin requirements.

36. Other traders, while supporting such a relaxation, have argued that the "no over-loss" rule should not apply to the high net worths who trade significant sizes but could afford the concommitant losses. These traders have contended that in respect of such clients they would like to have the option of extending credit for margin deposits instead because such high results have turned to trading with the banks to avoid the loss of liquidity as a result of tying up vast sums in margin deposits with the traders.

37. We are sympathetic to the proposals put forward by the traders because apart from the fact that introduction of the LFETO regulatory system have successfully injected much needed discipline into the industry, our analysis of the trading patterns of the licensed traders have demonstrated that they are quite prudently managed, possibly to the extent of being conservative in their risk taking. We therefore believe that the concept of allowing licensed traders to assume their own risks and possibly to adopt different approaches depending on the creditworthiness of their clients is now a viable regulatory option.

38. We, however, believe that such facilities should only be available to licensed traders who have adequate internal control systems to prevent abuses/malpractices to ensure that the original policy objectives behind the minimum margin requirements are preserved. We, therefore, do not

recommend an across the board relaxation of the existing margin requirements but propose to allow for such flexibility only in the event that a licensed trader can satisfy management capability criteria of a sufficiently high level.

39. We propose that rules be made to empower the SFC to amend the minimum margin requirements in respect of specific institutions which have introduced a no over-loss rule into their standard client agreements and which can demonstrate their ability to ensure compliance with the rule. In addition, we propose that the no credit on margin deposit rule should also be amended to empower the SFC to waive the requirement provided that the licensed trader applying for the waiver can demonstrate to the satisfaction of the SFC that it has clear rules to define such high networth clients, that it has the necessary control systems to restrict such a facility to genuine high networth clients and has adequate systems properly to assess the credit worthiness of its clients.

40. The combination of the two proposals would effectively result in a tiering of sorts for the market. This is consistent with the current approach in private banking, commission rebates for private portfolio managers and the so-called professional investor exemption under the current securities legislation.

Margin level for cross trades

41. A cross trade is one in which the client takes a position between two currencies other than the US dollar. As transactions are normally valued against the US dollar, a cross trade in fact involves two simultaneous transactions against the US dollar. For example, a yen/mark cross involves buying yen against the dollar and shorting an equivalent quantity of marks against the dollar or vice versa. As such a trade involves two concurrent transactions, clients doing a cross trade are required to post two sets of margins for the one trade. A financial adjustment of 3% is levied by way of ranking liabilities if only one set of margin is collected by a licensed trader

42. Licensed traders have complained that such a requirement is unnecessary and unduly affects their competitiveness vis-a-vis other forex traders, particularly the banks.

43. We have reviewed the daily price fluctuations of the actively traded currencies for the period 1 February 1994 to 31 January 1995. The analysis shows that the volatility compares favourably to straight

contracts and that no cross trade fluctuated by more than 5% within any one trading day.

44. The analysis suggests that only one set of margin requirements for cross-rate contracts would be adequate for prudential reason. We therefore recommend that a cross trade should only attract a single set of margin. However, to avoid traders exploiting the facility by treating a series of unrelated transactions as cross trades, a trader must be able to demonstrate to the satisfaction of the SFC that it has adequate control systems to establish an adequate audit trail to substantiate that the transactions are indeed cross trades before they will be allowed to require only one set of margin for cross trades.

Locked Positions

45. Locking a position refers to the situation where a client simultaneously holds an equal long and short position of the same currency. This "strategy" is used when a client wishes to hold his losses without liquidating the position. Depending on which way the market then goes, the client could "unlock" the position by closing out either leg of the position. Due to past client complaints, locked positions are not allowed for discretionary accounts except at the specific request of the client.

46. Under such a scenario, the client faces no position risk, but incurs expenses due to the spreads between the two positions, the difference between the lending and borrowing interest rates of the same foreign currency and the additional transaction costs.

47. One consequence from potential problem for traders for holding such locked positions is the impact on its aggregate gross positions. In addition, if a client's equity falls below the maintenance margin, the resultant financial adjustment on the trader's liquid capital calculations will be imposed twice on such positions.

48. The traders have argued forcefully that they are being penalized for positions that pose no risk.

49. While there are residual concerns that relaxing the requirements may result in traders using it as a selling point to encourage clients to enter into locked positions which may not have any actual commercial benefits to the clients, we are sympathetic to the argument that the maximum exposure of such positions is essentially on only one side of the position. We recommend therefore that the FRR be modified such that countermanding positions of the same client in the same currencies could

be counted as one position only for the purposes of margin requirements and AGP calculations.

(d) Segregated Trust Account Rules

Money in segregated Trust Account for use as margin deposits

50. Sections 23 and 24 of the LFETO requires the segregation of clients' money and assets into trust accounts with approved financial institutions. This lies at the heart of investor protection as it ensures that if a licensed trader goes into default, the money and assets of its clients are protected and can be returned to the clients quickly.

51. Licensed traders have complained that the non allowance of using client funds to lay off their positions discourages hedging activities as the traders will have to utilize their own funds in so doing. They argued that a procedure to allow them to access client monies in the segregated trust accounts for laying off client positions will encourage genuine risk reduction operations and enable them to maintain lower net positions.

52. We believe that, provided the protection afforded under sections 23 and 24 of the LFETO is safeguarded, any procedure which serves to reduce the risks of licensed traders should be encouraged.

53. In order to ensure this, the account opened by the licensed trader for the purpose of laying off client positions must be for the benefit of the segregated trust account and be clearly identified as such with no right of set-off or counter-claim against money in the account in respect of any sum owed on any other account of the licensed trader. In addition, such transactions should only be done with institutions that are financially sound in order to guarantee the integrity of the funds.

54. We, therefore, propose to relax the rules to enable licensed traders to lay off client positions with institutions approved by the Commission for the purposes of using moneys on deposit with the trader provided traders can demonstrate to the satisfaction of the SFC and the safeguards mentioned in para 53 above have been established. (Under section 69 of the LFETO, the SFC already has the power to waive/modify the requirements in section 23.)

Transfers from Segregated Trust Account

55. It has also been suggested by some traders that section 23 of the LFETO should be modified to allow traders to transfer excess client funds from

the segregated trust account into other segregated trust accounts of the client with another Group company under standing instructions from the client. They argued that such an arrangement does not undermine the integrity of the client funds but will enhance the level of client service by facilitating the use of excess funds in a client's LFETO segregated trust account to meet margin calls made of the client arising from his other trading activities.

56. We do not support the suggestion as we are firmly of the view that there should be no automaticity in the meeting of margin calls by clients. Clients should be encouraged to review their trading positions in such an event to determine whether to maintain the positions by meeting the margin calls or whether the positions should be closed out to reduce their losses. Any automaticity, in the form of standing instructions, militate against such a policy stance and cannot be supported. In any event, such an arrangement is aimed primarily at facilitating licensed traders, or members of their group companies, to collect their margin deposits and cannot be regarded as an enhancement of their service levels for the benefit of their clients.

(e) Compensation Arrangements

57. Following the collapse of Canwell, the Panel on Financial Affairs of the Legislative Council called on the SFC to consider the establishment of some form of compensation arrangements for clients in the event of a default by a licensed trader. The Review, therefore, also examined the viability of establishing such arrangements for the industry.

58. Two forms of compensation arrangements currently exist within the financial markets in Hong Kong: Compensation Funds and Fidelity Insurance. These cover slightly different default situations: with compensation funds covering the collapse of an intermediary, whatever the cause, and fidelity insurance covering fraud, malfeasance or negligence by an intermediary, irrespective of whether these bring down the firm.

59. In addition, the two possible arrangements are structured differently. Compensation funds are established through capital contributions from members of the industry while fidelity insurance are taken out individually by members of the industry with their insurers. Independent expert estimates provided to the SFC indicate that, on the basis of current trading volumes, a starting point for the Compensation Fund would be between $50 million to $100 million, i.e. an initial contribution of about $2 million to $3 million per trader. The cost of fidelity insurance would

obviously vary from trader to trader but would be in the region of a 3% premium with a deductible of a few million per trader.

60. Both forms of arrangements have their strengths and weaknesses:

(a) While the Compensation Fund approach results in an up-front pool of cash to back up potential defaults within the industry, thereby offering a high confidence level, it is less capital efficient, to the extent that it locks up a large amount of idle cash. In addition, given its limited size, the Fund would need to cap its exposure somehow. The Unified Exchange Compensation Fund, with a current value of $450 million, caps liability at $8 million per member. Compared with total liabilities within the LFET industry of about $900 million, or about $25 million per trader as at 30 June 1996, an equivalent cap would on average provide a 30% safety net at current levels. Obviously, for clients of big firms, this would be much lower, in the region of 5% for the larger firms.

(b) The fidelity insurance approach would, however, ensure coverage or protection commensurate with the liabilities of each trader, thereby offering better protection. In addition, it would avoid the sterilization of a large chunk of capital. However, it tends to be more costly over time, since the premia are on-going and unrecoverable.

61. While it is obviously open to us to require the establishment of both forms of compensation arrangements, we do not believe that this is justifiable, particularly given the current state of decline in the industry.

62. The SFC tends towards supporting the fidelity insurance approach for the following reasons:

(a) given the prudent manner in which the industry is currently being managed, the risks of a trader collapsing from huge trading losses would appear to be lower than the risks of it going into default because of fraud, malfeasance and/or negligence by its staff;

(b) the availability of fidelity insurance to cover such fraud, malfeasance and/or negligence could protect the traders concerned against default arising from claims against them for such occurrences, thereby offering better systemic stability;

(c) the protection level would be more tailored to the individual circumstances of individual traders, thereby offering clients a better level of protection;

(d) the fidelity insurance would be available even when the trader concerned is not bankrupt; and

(e) the better managed firms are likely to already have such insurance coverage available, thereby reducing the net additional costs to the industry for introducing such a system.

63. We therefore recommend that licensed trader should be required to take out fidelity insurance to the satisfaction of the SFC. To provide traders with the necessary time to set up such arrangements, they should do so within 12 months of the implementation of the requirement.

(f) Other Technical Issues

64. We have also taken 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. A number of technical amendments will be introduced in these respects to find-tune them and to make them better reflect the practices within the industry.

III. CONSULTATION

65. The SFC invites interested persons to submit comments on this Consultation Paper. Comments should be addressed to the Securities and Futures Commission, 12th Floor, Edinburgh Tower, 15 Queen's Road Central, The Landmark, Hong Kong and should reach the Commission before 30 September 1996.

66. The Consultation Paper is available on the SFC Internet Home Page at http://www.cuhk.edu.hk/sfc. Interested persons may also submit comments on the Paper by e-mail to sfc@hk.super.net.

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