



Hong Kong

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SFC SETS STANDARDS FOR LEVERAGED FOREIGN EXCHANGE TRADERS EFFECTIVE 1 JANUARY 2021

The Securities and Futures Commission (the **SFC**) published a Circular to Licensed Corporations¹ and Report on Leveraged Foreign Exchange Trading Activities Carried Out by Licensed Corporations² (the **Leveraged Foreign Exchange Trading Report**) on 9 April 2020. The Leveraged Foreign Exchange Trading Report sets out the findings of a survey of leveraged foreign exchange trading (**LFET**) activities conducted by 32 Type 3 licensed firms during 2018 who together accounted for 77% of market turnover and 41% of all active LFET clients. It also includes expected regulatory standards for leveraged foreign exchange traders which must be complied with by 1 January 2021.

The Annex³ to the circular sets out the SFC's expected standards of conduct and internal controls for SFC-licensed leveraged foreign exchange traders in relation to: (i) customer due diligence; (ii) client order handling; (iii) conflicts of interest; and (iv) provision of information to clients, which have been extracted from the report. The circular reminds the senior management of SFC-licensed corporations of their responsibility for reviewing their policies and controls to ensure compliance with the expected regulatory standards by 1 January 2021.

This newsletter provides a summary of the findings of the SFC's Leveraged Foreign Exchange Trading Report, the

expected standards for SFC-licensed leveraged foreign exchange traders and the examples given of good industry practices implemented by Type 3 licensed intermediaries.

Key Findings

The key findings of the SFC's Leveraged Foreign Exchange Trading Report were that:

- i) 98% of brokers' active clients⁴ were retail investors;
- ii) The gross principal value of the leveraged foreign exchange contracts was \$1,844 million, of which 99.6% were rolling spot forex contracts. Forward contracts and currency options constituted 0.2% of leveraged foreign exchange contracts (collectively referred to as **LFET Products**);
- iii) All leveraged foreign exchange trading was conducted on an over-the-counter (**OTC**) basis;
- iv) 61% of the clients of a smaller sample of surveyed brokers, representing 77% of the 2018 market turnover, incurred a net trading loss and only 39% made net trading profits in 2018;
- v) 26% of the brokers' active clients incurred a net trading loss of over HK\$10,000, while less than

1 <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/supervision/doc?refNo=20EC27>

2 https://www.sfc.hk/web/EN/files/ER/Reports/Report_on_Leveraged_Foreign_Exchange_Trading_Activities_Carried_Out_by_L..._EN.pdf

3 <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/openAppendix?refNo=20EC27&appendix=1>

4 Clients to whom the licensed corporation is required to prepare and issue a monthly account statement for the relevant reporting month under the Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules

1% of their active clients incurred a loss of more than HK\$1million. In the most extreme case, a net trading loss of around HK\$7million was reported;

- vi) 15% of brokers' active clients incurred a net trading profit of over HK\$10,000, and less than 1% of active clients made gains over HK\$1 million. The biggest net trading profit reported was around HK\$9.5million;
- vii) 85% of leveraged foreign exchange trading orders in terms of turnover were placed through internet trading platforms or mobile applications. The remaining 15% of orders were placed via phone, email or in person at the broker's office; and
- viii) Of the complaints the SFC received about brokers or their staff:
 - 62% related to trading disputes;
 - 13% related to services standard and fees;
 - 10% related to misconduct such as cold calling, unauthorized trading and misrepresentation;
 - 4% related to conducting regulated activities without a licence and non-compliance with the relevant laws, rules and codes; and
 - 1% related to fraud or misappropriation.

The SFC notes that regulators in a number of other jurisdictions have also recently reviewed the selling and marketing of OTC leveraged products, including rolling spot forex contracts (for which the payout is based on the fluctuation of foreign exchange rates and the initial maturity of two business days is automatically extended one business day at a time if the contract remains open at the close of trading on the second business day). These products are commonly offered online and include complex features such as automatic close-outs and complex valuation methods and calculations of interest differentials which retail investors may find difficult to understand.

LFET products are generally traded on a margin basis such that investors need only deposit a small proportion of the notional investment amount in order to trade. Investors' exposure to the

volatility of the underlying investment is increased by leveraged trading. The lower the margin amount, the higher the gearing for the product. Investors stand to lose more than the amount of the margin they deposit unless the broker adopts a "no negative balance" policy waiving any excess loss incurred on the position.

The report noted that its findings were based on surveys completed by a limited number of brokers, and thus may not present an accurate picture of the operations of all brokers and the market. However, the SFC stressed that the higher percentage of loss making clients, 61% of clients, compared to 39% of profit making clients, reflects the fact that leveraged foreign exchange trading is risky and may not be suitable for all investors, especially retail investors.

Client Due Diligence

Leveraged foreign exchange products are complex, including rolling spot forex contracts and derivatives such as options and forward contracts, which may be difficult for retail investors to understand. Even for less complex products, the fact that they are not traded on a central exchange means that the pricing methodologies and trading terms vary.

The SFC Code of Conduct requires SFC-licensed leveraged foreign exchange traders to:

- i) Take all reasonable steps to establish the financial situation, investment experience and investment objective of each of their LFET clients (paragraph 5.1 of the Code of Conduct); and
- ii) Assure themselves that clients understand the nature and risks of the LFET products they offer and have sufficient net worth to assume the risks and bear the potential losses of trading in the products (paragraph 5.3 of the Code of Conduct).

Adequate information must be given to clients to enable them to understand the risks associated with LFET. This should include, but is not limited to, information on:

- i) the risks associated with the underlying market;
- ii) the risk of LFET and margin trading (in accordance with Schedule 1 (Risk disclosure statements) to the SFC Code of Conduct);

- iii) the following implications of the LFET product being sold over the counter:
 - a) the broker could be the counterparty to the transaction and the client could be subject to the broker's credit risk;
 - b) the pricing of the LFET product is solely determined by the broker or negotiated between the broker and the client; and
 - c) transacting over the counter may generate greater risk than investing in exchange traded products due to the lack of an open exchange market to sell the product; and
- iv) the risk that the client's order price for the LFET product could be different from the execution price, this difference is generally known as "slippage".

Given that 98% of the surveyed brokers' clients were retail investors, there is a risk that LFET Products may be too complex for them to comprehend. This complexity may be exacerbated by different brokers adopting different pricing methods and trading terms. The SFC found that many of the trading dispute complaints arose from the fact that clients did not understand the operations and features of products and services provided by brokers.

The SFC observed that some brokers adopted the following good industry practices to enhance the transparency of the products or services offered to clients to avoid trading disputes related complaints:

- Numerical examples showing fundamental features of different products, and how trade orders work such as leverage and margin calls and what slippage is; and
- Explaining technical terms and complicated concepts in easily understandable language.

SFC Requirements for Handling LFET Clients' Orders

The Leveraged Foreign Exchange Trading Report found that 85% of LFET client transactions in terms of turnover were placed electronically through internet trading platforms or mobile applications.

SFC-licensed LFET brokers are required to act honestly, fairly, and with due skill, care and diligence, and in the best interest of their clients when handling clients' orders (General Principles 1 (Honesty and fairness) and 2 (Diligence) of the SFC Code of Conduct).

The SFC's expectations for LFET brokers are that they should:

- i) execute client orders on the best available terms and avoid any dishonest and unfair execution practices, such as asymmetrical treatment of positive and negative slippage which enables the broker to earn profits from a favourable price difference and to pass on losses to clients in the event of an unfavourable price difference, known as positive and negative slippage, respectively; and
- ii) implement a fair pricing method:
 - a) referencing the prices quoted to clients to market data;
 - b) using independent, externally verifiable third party sources for the calculation of prices; and
 - c) ensuring that any fees and charges payable by clients are fair and reasonable and are charged on a good faith basis.

The SFC observed that some brokers adopted the following good industry practices in handling clients' orders and minimising slippage:

- Clients set their own maximum acceptable negative slippage amount so that clients' orders will not be executed if the difference in price exceeds that amount; and
- To provide clients with information such as slippage ratios and re-quote and rejection rates to enable them to evaluate the broker's execution quality.

Business Models used by Leveraged Foreign Exchange Traders

Straight Through Processing Model

17 of the 32 active brokers adopted the straight through processing model and 9 of them engaged affiliates as liquidity providers or as one of their liquidity providers.

Straight through processing is an automated electronic payment process with no human involvement in the payment process. No personnel are required to initiate, make or confirm payments.

Brokers operating straight through processing tend to hedge each trade with a liquidity provider on a back-to-back basis, meaning that the broker enters into an equal but opposite transaction with the liquidity provider. The broker's income arises from adding a bid-ask spread to the execution price of the transaction or charging a commission fee on the transaction. Under this model, the broker would have less incentive to pursue its own interests at the expense of its clients since its income will not be dependent on the clients' trading gains or losses. However, a conflict of interests may still arise where the liquidity provider is an affiliate of the broker since the commercial interests of the broker and the liquidity provider will be linked.

Dealing Desk Model

10 of the 32 active brokers adopted a dealing desk model in which they act as a market maker and take positions against their clients. Under this model, there is a conflict of interest because the broker may profit from the client's trading loss. Some brokers may hedge the foreign exchange positions arising from their LFET transactions with clients. Of the 32 active brokers, 2 fully hedged the net position of the transactions, 6 partially hedged the net position of the transactions and 2 did not hedge at all.

The remaining 4 brokers introduced and referred clients or relayed clients' orders to execution brokers, which tended to be their affiliates, and received referral fees from the execution broker. One broker executed trades only for funds managed by its affiliates.

Expected Regulatory Standards and Good Industry Practices

Regardless of the business model adopted, LFET brokers are required to state in the client agreement whether they take opposite positions to client orders (Paragraph 1(d) of Schedule 6 to the SFC Code of Conduct). They are also required to take all reasonable steps to avoid any conflicts of interest, and when such conflicts cannot be avoided, they must ensure that their

clients are fairly treated and disclose any actual or potential conflicts of interest before transacting with clients (General Principle 6 (Conflicts of interest) of the SFC Code of Conduct).

Leveraged foreign exchange traders are required to provide clear and effective disclosure to their clients about how their orders are executed (General Principle 5 (Information for clients) of the SFC Code of Conduct). This should include, among others:

- i) the order execution policy, explaining the methodology used to deliver the best possible outcome when executing orders; and
- ii) the methodology for determining the prices of different leveraged foreign exchange products.

Specifically, LFET brokers should disclose the following information in their order execution policy:

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

Information for Clients of SFC-licensed Leveraged Foreign Exchange Traders

The SFC noted receiving a number of complaints in relation to LFET brokers and their staff, many of which related to trading disputes. The report noted that trading disputes often occurred because clients did not fully understand the features and operations of the products and services provided by brokers. The report reminds brokers to provide appropriate information to clients to enable them to understand the nature and risks of products so that they can make informed investment decisions.

Good industry practices observed by the SFC included:

- i) explaining products using plain language and avoiding technical terms, jargon and ambiguity; and
- ii) using numerical examples to illustrate key features of different products and to explain how trade orders operate, such as product leverage, margin calls and stop-loss mechanisms, and to explain the risk of slippage. These examples should cover both negative and positive scenarios.

Next Steps

The SFC circular states that brokers are expected to comply with the expected regulatory standards by 1 January 2021. Brokers' senior management need to implement a review of their policies, controls and operations to ensure that the expected regulatory standards set out in the Annex⁵ are implemented in time.

⁵ <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/openAppendix?refNo=20EC27&appendix=1>

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