

SFC scrutinizes leveraged foreign exchange trading activities

April 2020



Do you comply with regulatory standards?

What happened?



SFC survey on LFET activities

In 2018, the SFC surveyed licensed corporations' leveraged foreign exchange trading (LFET) activities. The survey highlighted that retail investors comprise more than 98 percent of active LFET clients, with over 60 percent of clients incurring net trading losses in LFET products in 2018. The high percentage of loss-making clients indicates that LFET has certain risks and may not be suitable for all investors.

LFET products

LFET products include rolling spot forex contracts as well as other complex products and derivatives such as options and forward contracts. These products are usually traded on a margin basis which increases investors' exposure to the volatility of the underlying investment. The pricing methodologies and trading terms may vary since they are traded on an over-the-counter (OTC) basis instead of on an exchange.

Who will be impacted?



The expected regulatory standards are applicable to all SFC-licensed corporations which carry out LFET activities in Hong Kong. These LCs are required to be licensed by the SFC for Type 3 regulated activity. LCs are expected to review their policies and controls to ensure compliance with the expected regulatory standards by **1 January 2021**.

Regulatory expectations



SFC has provided guidance on expected regulatory standards and good industry practices for LFET activities:

1 Customer due diligence

- LFET brokers need to take all reasonable steps to establish the financial situation, investment experience and investment objective of each LFET client.
- LFET brokers should ensure 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.

2 Handling of client orders – best execution

- LFET brokers should act honestly, fairly, with due skill, care and diligence, and in the best interests of their clients when handling client orders. They should:
 - Execute client orders on the best available terms and avoid any dishonest and unfair execution practices.
 - Adopt a fair pricing methodology by:
 - Referencing the prices offered to clients to market data.
 - Avoiding asymmetrical treatment of positive and negative slippage which allow the broker to retain profits arising from positive slippage, whilst passing losses from negative slippage onto the client.
 - Use independent and externally verifiable price sources or liquidity providers to derive prices.
 - Ensure that all charges, mark-ups or fees affecting clients are fair and reasonable and characterized by good faith.

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.
- 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

3 Conflicts of interest

- LFET brokers should state in the client agreement whether they take opposite positions to client orders.
- They should take all reasonable steps to avoid any conflicts of interests, 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.

4 Information for clients

- Adequate information should be provided so that the client is reasonably able to understand the risks associated with LFET, which include:
 - The risks associated with the underlying market.
 - The risk of LFET and margin trading.
 - The fact that the product is being sold OTC and the implications of this, including:
 - 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.
 - The risk that the client order price may be different from the execution price, or slippage.
- LEFT brokers should also provide clear and effective disclosure to clients about how their orders are executed. This should include:
 - The order execution policy, explaining the methodology used to deliver the best possible outcome when executing orders.
 - The methodology for determining the prices of different LFET products.
- Specifically, LFET brokers should disclose the following information in their order execution policy:
 - The capacity in which they trade with or act for the clients (i.e. executing orders on behalf of clients or act as the counter party of client orders).
 - Any intra-group link or relationship between the firm and the liquidity provider with which the client order is executed or hedged.
 - The circumstances which give rise to 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 (e.g. limit order, good-till-cancelled order, market order, stop loss order and liquidation order). How slippage is handled.

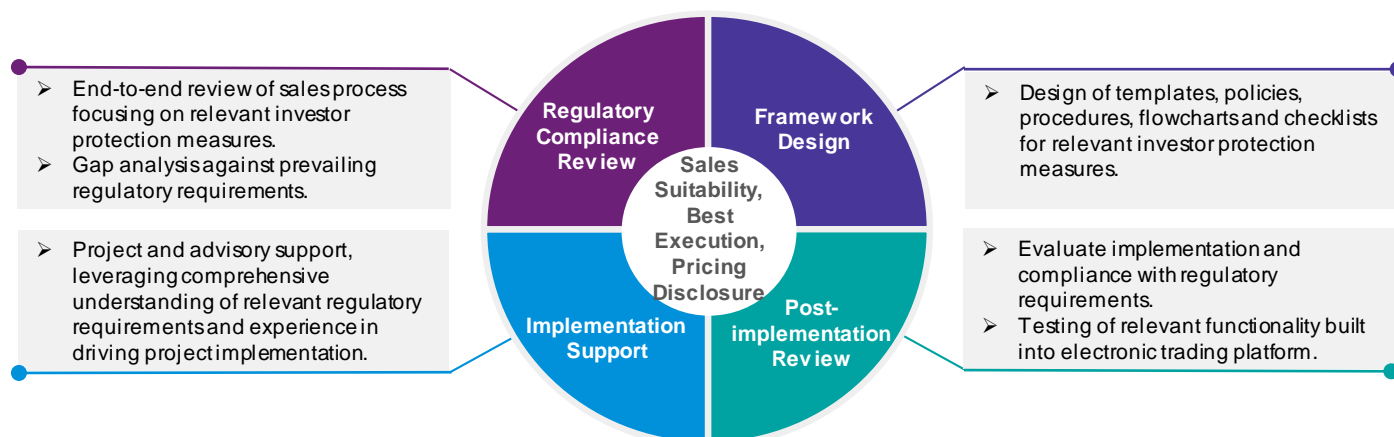
Good industry practices - to increase the transparency of products or service offered to clients

- Use numerical examples to illustrate key features of different types of products and how trade orders operate (e.g. 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.
- Provide explanations in plain language for ease of understanding.
- Avoid using technical terms, jargon and ambiguity.

How can KPMG help?



We have worked across the wealth management industry, examining and building best practices in the selling process, in the areas of **sales suitability, best execution and pricing**. We have developed best-in-class frameworks by understanding the pain points, hidden challenges and cultural shifts required for organisation to get ahead of these challenges. We provide support with practical recommendations to improve these risk areas with the objective of better client outcomes. We have performed a number of internal control reviews of LCs engaged in LFET activities. The work performed included reviewing compliance with relevant requirements in respect of pricing, disclosures, treatment of "slippage" and design and change management of electronic trading platforms.



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