PREPARING FOR REDUCED LEVERAGE IN FOREX MARKETS

Developing methods to manage margin with variable levels of volatility, liquidity and leverage offerings

KNOCKOUT FOREX

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EXECUTIVE SUMMARY

As the preponderance of ineffective, poorly trained and ultimately unsuccessful retail traders has become more widely recognized in the broader Forex brokerage industry, an ever increasing trend toward private liquidity and market-making brokerage models has emerged to capture profits being lost by clients. Coupling the inherent risk to the broker in taking the other side of clients' trades with the increased volatility in the markets has resulted in a widely varied landscape for traders and a regulatory environment that may result in changes that could significantly impact the functionality of the industry and the efficacy of a trader's strategies.

In this analysis, we review some of the most critical components of both private liquidity and institutional liquidity as each relates to the traders' or fund managers' strategy development. Additionally, we review recent regulatory decisions and how these decisions continue to affect markets and shape offerings available to traders.

While we maintain that trade automation is critical to successfully navigating highly volatile Forex markets, we recognize that human intervention at the regulatory level and the potential impact of human intervention in liquidity and leverage policies within brokerages requires human intervention in the adjustment of strategies to continue thriving in these markets. Additionally, we propose a strategic planning of liquidity sourcing for various types of strategies with careful consideration for the benefits and potential risks in the types of liquidity prior to allocating trading capital. While predicting the next major regulatory decree is beyond the scope of this analysis, we review some recent measures taken by regulatory bodies in the most prominent Forex trading markets and prescribe a cautious approach to planning leverage use within automated strategies.

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VARIATIONS IN SOURCES OF LIQUIDITY

Background

Most investors and traders from equities backgrounds and who are new to Forex trading are surprised to learn that their trades may be executed off-market by their brokers. Depending on the structure the brokerage employs, a trader's trade may be handled by one of three different players:

1. Another trader may take the other side of the trade. In this case, the "liquidity" comes from another trader.

2. The broker may take the other side of the trade (referred to as "B-Booking" the trade), thus "making a market" for the trader. In this case, the broker is likely supplying the liquidity or using private liquidity from non-institutional (non-bank) liquidity providers (LP).

3. The broker may submit your trade to the banks to trade on the Interbank exchange, which many regard as the true Forex market. This is referred to as placing the trades on the A-Book.

Brokers may decide to offer any of these means to provide liquidity to clients or may even offer a hybrid model to decide the best way for the brokerage to manage risk (which is highly dependent on the client's success rate), and thus create profitability for itself.

Evaluating Differences between Private and Institutional Liquidity

It is critical for a fund manager (or any trader), trading in Forex, to understand the various benefits and drawbacks to the various sources of liquidity. Here are some items to be considered when deciding on working with institutional liquidity or trading through a market making broker.

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Benefits of Trading with a Market-Making (B-Book) Broker

- Available leverage exceeds Institutional (Bank) Leverage of 50:1. Some Market-Makers offer leverage as high as 1,000:1, using private liquidity rather than Institutional Liquidity.
- Potential for filled market orders during abrupt and significant market movements (albeit often with major slippage).

Drawbacks of Trading with a Market-Making (B-Book) Broker

- Market-making brokers have an unavoidable conflict of interest in order execution, when they take the other side of their clients' trades.
- Market-making brokers may provide worse bid/ask prices than those offered by institutional sources of liquidity.
- It is possible for market-making B-Book brokers to manipulate currency prices to trigger their clients' stop loss orders or block a trader's trades from reaching profit objectives. Some market-making brokers may go so far as to move their currency quotes 10 ,15 or even as much as 20 pips away from market rates available on the Interbank exchange.
- A substantial amount of slippage and re-pricing (adjusting prices after a trade has been reported as executing at a specific price) can occur with market-making brokers during fast market moves, typically when news is released.
- Many market-making brokers have applied a practice of significant spread increases during times of high volatility.
- Market-makers' quote display and order placing systems are often reported to "freeze" during times of high market volatility.
- Many market-making brokers discourage or ban scalping techniques.
- Some market-making brokers have adopted policies of fluctuating margin requirements, in some cases requiring no justification for the fluctuations that may trigger margin calls on open positions to the trader's disadvantage.

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Benefits of Trading with an Institutional STP Broker

- No conflicts of interest as the broker simply submits the trade to the Interbank Exchange rather than taking the other side of the trade.
- Prices are direct from the banks trading on the Interbank exchange and are thus not manipulated.
- Spreads typically remain fixed (or do not atypically vary) regardless of major news etc.
- Margin requirements, while much higher than market making brokers, do not fluctuate wildly at the whim of the broker. They may fluctuate, however, based on bank LP requirements during periods of anticipated high volatility.
- Quote display and order placing systems are not subject to "freezing" during times of high market volatility.
- Scalping may be permitted depending on pre-determined trade frequency requirements.

Drawbacks of Trading with an Institutional STP Broker

- Potential for natural slippage of orders during abrupt and significant market movements when liquidity tightens.
- Available leverage is generally offered at a maximum of 50:1.

Fund managers will need to carefully consider how the allocation of funds to various types of brokerages may impact the strategy(s) employed by the fund manager. As liquidity providers develop new offerings, requirements and risk models, a fund manager will need to be ready to adapt strategies to the changing liquidity landscape.

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SHIFTING LANDSCAPES IN BROKERAGE STRUCTURES

The Potential Risk in the Rise of Private Liquidity

Over the past two to three years, there has been a shift to non-bank liquidity sources among the World's largest brokerages. While some believe that the rise in non-bank participation in the FX market is a complement to the traditional dealer model, others point to the fact that private liquidity, if provided by brokerages and brokerage partners, creates adversarial environments for traders.

Seemingly in parallel with the growth of non-bank liquidity sources, retail traders, having experienced suspect actions on the part of their brokers, have in recent years, quite vocally questioned the legitimacy of this model and have pointed to actions taken by regulators to crack down on unethical practices of some brokers. However, there has been no greater evidence of the potential for systemic fraud in the retail brokerage industry than the recent findings by the CFTC that FXCM, one of the largest U.S. Forex brokerages, had defrauded clients by citing an STP (Straight Through Processing) model with "no dealing desk" while sending orders to a company controlled LP known as Effex Capital and employing "abusive execution tactics". The complaint filed by the National Futures Association (NFA) noted that the tactics included denying clients positive price improvement whereby orders of the clients of the brokerage are said to have been executed at disadvantageous prices to the customers. Employees of FXCM admitted to regulators that two main tactics were employed, including the 'Hold Timer' and 'Previous Quote' tactics. The NFA's complaint states [1]:

> "In cases where the price at the end of the hold timer had moved against Effex and in favor of the customer, Effex would reject the trade. On the other hand, if the price had moved in favor of Effex and against the customer, Effex would execute the trade and give the client negative price slippage"

Incidents like this are certainly ample fodder for further speculation about the motives of brokers using private sources of liquidity. Such speculation undoubtedly crosses the minds of investigators of various regulating bodies as much as it does traders and fund managers. Self-regulating industries will likely become more concerned about the perception of impropriety, as it reflects on the ability of the regulating body to effectively police its members. Additionally, governmental regulating bodies may respond by putting additional pressure on self regulating bodies to aggressively pursue investigations into complaints filed by traders. We anticipate additional large-scale investigations in B-Book brokerage operations worldwide, or at least in the more highly regulated markets.

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Traders bear additional risk in the closing of a brokerage. Such risk will almost certainly include the potential for a prematurely forced closing of positions that comprise an overall strategy. One must also consider the fact that brokerages offering private liquidity also carry risks to the trader if the brokerage is under-capitalized. In such instances, a broker who “warehouses” risk by taking the other side of a trade, may accumulate positions that they must also liquidate in the event of a shutdown. If the brokerage is short on the necessary cash to cover the liquidated positions, the potential for bankruptcy is a very real threat to the trader.

Fund managers, therefore, must be vigilant if using private liquidity and consider the possibility that regulators may take an increasingly active role in policing brokerages with private liquidity. Rather than awaiting additional fallout within the industry, the wise fund manager may find it prudent to move funds to brokerages offering purely Institutional Liquidity and STP processing.

Identifying Risk in Changing Leverage Offerings

The past two years have seen increased Central Bank interventions, political unrest within some of the World’s largest economies, a shift toward automated trading by major banks and institutions, and an environment of ever increasing speculation across a wide variety of investment instruments. The resulting volatility has been met with a series of disparate policies, including regulatory efforts to safeguard traders and brokerage policies that further offload risk to clients [2].

In the disastrous aftermath (for market making brokerages) of the January 2015 SNB decision to cease pegging the Swiss Franc to the Euro, regulators in the U.S., Australia, Europe and Japan began working to address margin levels offered to traders by the retail brokerages. The US Commodity Futures Trading Commission introduced a leverage cap, limiting leverage to 50 times the principal invested in 2015. The UK took quite a bit longer to make a significant change to margin requirement policies and in December of 2016, the Financial Conduct Authority (FCA) proposed a similar cap to that imposed by the NFA of 50:1. Now the Australian Securities and Investments Commission (ASIC) is considering following suit [3][4].

These margin reduction requirements will mirror (or attempt to mirror) the current leverage offered by Institutional LPs, which currently max out at 50:1. While traders can still find leverage of 500:1, 1,000:1, even 3,000:1 in some B-Book brokers in areas of little or no regulation, most inexperienced traders end up doing more damage with the tool than they do to improve their trading results. Both brokers and regulators are well aware of the fact that while higher leverage can allow a trader to control a larger position with less capital, many inexperienced traders, rather than reducing their

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exposure by breaking down their capital contributions to each trade, use their typical capital contribution and end up gambling with their accounts.

Fluctuating Leverage Requirements and Margin Call Policies

Margin reduction regulations may help some traders curb their inclination to over-trade and that could be a good thing for many inexperienced traders, however, the risk of over-trading or getting over leveraged is just one part of the equation. Recent policies of margin fluctuation may pose an even greater risk to traders of all experience levels.

A significant reduction in leverage in the middle of a strategy with multiple positions open can be disastrous as it inevitably results in the closing of positions that the trader is not yet ready to close. Losses on the trade or overall losses on the strategy are the inevitable result. A worse scenario may unfold for traders who are not fully aware of their broker's margin call policies. A review of some B-book brokers' margin call policies reveals a wide variety in how the broker may enact a margin call. Below are some factors to consider:

- Some market making brokers' margin requirements may vary based not only on market conditions but on account size, trading style, and even on the frequency of multiple simultaneously open positions a trader may carry.

- Many market making brokers will fluctuate margin requirements based on currency pairs.

- Some brokers will provide a margin warning to clients, allowing the trader to reduce their own exposure as the trader deems to be least destructive to their account, while other brokers (specifically market making brokers) will provide no warning and simply close positions in the traders' accounts.

- Some brokers may decide on certain positions to liquidate on behalf of a client or liquidate only the necessary amount of trades to bring the trader back into compliance with the margin policy, while others may liquidate all open trades.

While the preceding variations present the potential for numerous pitfalls for traders unaware of the impact of these policies, it is important to note that traders may find more amenable options in brokerages offering purely institutional liquidity and STP execution. Brokerages offering purely institutional liquidity and STP execution operate as a disinterested third party, simply executing trades and collecting the spread. Because of this, a brokerage that neither makes a market nor operates as an agency for private liquidity typically offers terms that are offered to the brokerage by a prime broker

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and or the banks offering liquidity. It is, however, critical to note that the banks are also prone to reducing leverage during times of projected high volatility, often reducing leverage to half of the prevailing leverage. Normal margin requirements typically return within a few days of the high volatility event.

In evaluating the overall landscape available to traders it appears quite evident that there are many more variables that may impact a trader's profitability when trading with a market making broker than one which offers purely institutional liquidity and STP execution. One must consider that in establishing any kind of strategy, be it executed manually or automatically, the ability to eliminate variables that could put one's strategy at a disadvantage is vital to one's potential profitability. Therefore, one must carefully weigh whether or not the advantages of higher leverage are worth the disadvantages of navigating the unknown ramification of policies with as much variability as those offered by most market making brokers.

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SUMMATION

Because Knockout Forex implements a fully automated trading system, we must remain acutely aware of the impact that leverage and margin policy variables may have on our open trade sequences. Increasing volatility and shockwaves like those stemming from events like the SNB decision and the U.K. referendum to leave the Euro are anticipated to exacerbate the problem of fluctuating leverage, creating the need for greater caution in strategy creation and deployment.

While the preceding discussion of the variables that brokerages may present may be enough to caution against the use of a market making brokerage, the advantage of high leverage can be attractive and may play well into a strategy that is designed for minimal capital allocation. It is, however, recommended that this approach is applied to only a small fraction of the overall portfolio to maintain compliance with internal risk controls. It is further recommended that the bulk of any portfolio be traded with institutional liquidity. Additionally, as leverage can be tightened in both institutional and private liquidity settings, a tightly managed capital allocation protocol must be implemented so as to assure that sequences remain open and free to work towards a profitable conclusion.

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