REGULATION: A MUST FOR RETAIL FX MARKET

by

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Abstract:

The retail FX market is certainly not a new field to Vietnamese, as reports of scams and documentaries of frauds have filled the news in recent years. Domestic investors have ambivalent attitudes towards this market, either associating it with deception and mistrust or enthralled by the enormous payoff this market boasts off. The government has largely neglected the retail market in its policy, concentrating exclusively on regulation of the multinational/interbank FX market. This wide legal gap has facilitated the conduct of numerous scams and frauds, which take the form of FX brokerage, luring investors in with bonuses and promises of easy profits. Most cases are only resolved by authorities after the schemes have been completed and fortunes have been siphoned off. Until then, innocent traders have lost their life savings, mortgage payments, or even their houses.

Observing this alarming situation, I conduct this study to advocate for government regulation in the retail FX market to better protect investors. In order to do so, I have met with experts in the field to procure both practical and legal approaches to the market, as well as consulted several articles, academic papers, and reports on the nature and situation of the market in countries including Turkey, the USA, and Japan.

Through my study, I conclude that regulation is vital to protecting investors in this market, either from engaging in scams or from hemorrhaging from margin trading. Regulation in this market has been implemented successfully by a myriad of developed countries, and the most basic points of their legislations are reported in this paper.

Introduction:

The goal of this paper is to explore whether regulation should be introduced in the retail FX market in Vietnam based on the numerous benefits regulation would bring to clients. I argue that regulation would improve the transparency and integrity of brokers and in turn guarantee better safety for investors.

Through interviews with legal partners, articles references, and official reports, we are able to find insights on how regulation in other countries have been conducted and the positive results of the regulation in reducing the number of scams and frauds and in boosting trading confidence. We also manage to find evidence on how leverage should be controlled using both academic results and real-world cases.

In the first experiment, I inspected regulatory attempts from the US and Turkey and discovered the two countries underwent the same market problems of scams and frauds which necessitated the presence of authority. Although details may vary, regulations in the two countries try to tackle the issue by mandating the registration of FX brokers and setting up rigid requirements for brokerage.

In the second experiment, I make use of both academic and real-world evidence of Japan to prove that high leverage is extremely detrimental to ordinary investors. I manage to conclude that a limit on leverage can be beneficial to traders both on a small and large scale.

The results of these experiments do imply that regulation should be imposed in the retail FX market to protect investors. Not only can regulation fend off 'fake' brokers but it also ensures protection of investors by limiting the risk they are able to take.

Hypothesis:

In this article, we strive to determine how the establishment of authority in the regulation of the retail, over-the-counter FX brokerage can be beneficial to traders.

One of the primary issues in the retail FX market in Vietnam is the establishment or presence of countless scams or ‘fake’ brokers. These ‘fake’ brokers, predominantly headed by Vietnamese people, usually locate their servers in a foreign country, especially Taiwan, Hong Kong, or Singapore, places where Vietnamese authorities cannot enforce legal actions, and these brokers’ establishment is often not recognized in any legislation. The brokers, subsequent to their illicit introduction, will try to lure as many domestic investors into their platforms as possible through unfounded promises of enormous ‘fast’ profits. When enough investors are tricked and enough money dispossessed, the brokers will announce their so-called ‘cease of operation’ before absconding with millions of dollars of traders’ money. In one notorious case, a ‘fake’ broker under the name of FX Trading Markets has successfully attracted more than 60,000 investors nationwide with promises of sky-high profits before suddenly disappearing and siphoning off at least $50 million of investors’ money. The broker indicated clear signs of a Ponzi scheme, a system where newcomers’ investment will be used illegally to pay for the bonuses of the people before them. What is noteworthy is that until the time of this article, 1 year after the mysterious disappearance of the broker, nobody has been indicted and investors are still left in heavy loans and miserable plights. This is just one of the estimated 240 illegal trading floors of gold and foreign currencies in the country in early 2021. Arises from this alarming situation is a strong need to prevent such a scheme from repeating itself in the form of a legal framework that protects investors from malevolent forex brokers.

Secondly, Vietnamese investors tend to fall prey to high leverages in hope of faster, higher profits. The WikiResearch survey reveals that the highest leverage that 70% of the brokers in Vietnam are providing to domestic traders is 500, and that more than three fourths of them believe leverage of 1000 will be even more effective in enticing investors. Being callow and mentally swayable, most of the domestic traders will eventually end up using the leverage unwisely and recklessly. To put this number into perspective, the maximum leverage that regulators from the US and the UK permit is 1:50, ten times lower than the favored leverage in Vietnam. With that being said, there should be a cap on how much leverage should be offered to Vietnamese traders by forex brokers, and that kind of protection against careless betting is one of many advantages that establishing a competent authority in Vietnam to regulate the brokerage operation can deliver.

Methodology:

Interview:

I have interviewed two foreign experts, one a legal partner and the other an author of a renowned FX website.

The first respondent is Demetri Bezaintes, a Registered Foreign Lawyer (RFL) practicing law at Giambrone Law’s office in the UK. He often deals with cryptocurrency, Forex trading disputes, and regulatory investigations in countries ranging from Vietnam, Belize, to Italy, England thanks to his in-depth knowledge of jurisdictions around the world. The second respondent is Arnab Shome, a writer on Finance Magnates, one of the most well-known informational websites in the field of FX trading and cryptocurrency. He has composed over 4700 articles for the website, covering a wide variety of topics from settlement cases to regulatory approaches.

Through the interview, I expect to elicit multiple perspectives on whether the OTC forex market should be and is worth being regulated, and if yes, in what way. The respondents have encountered several legal cases around the world, so what they can provide is an insight into how countries deal with this issue of both scams and investor protection. Additionally, they can voice out their own viewpoints with regard to this market from their experience of working for multiple years in this field.

During the interview, 5 primary questions were asked:

1. Do you think it is necessary for governments to regulate the OTC forex market?
2. What do you think are the reasons why the FX market isn't legal in some countries, including Vietnam, yet?
3. If the government were to regulate FX brokerage, what would be the best possible course of actions to do so? If the government were not, what would the government do to reduce the rate of scams and related illegal activities?
4. Can you point out successful regulation cases around the world? How do governments in those countries deal with scams and protect domestic investors?
5. Do you think the OTC FX market should be suitable for ordinary citizens?

Through their responses, I can observe a coherent belief that the OTC FX market should always be regulated, but governments may vary in their regulations due to different approaches and different situations. Both of the two respondents believe that the OTC FX market is not suitable for the average person as 70% of traders, they point out, either lose or quit in the market in the long term. However, that should not deter regulatory efforts as governments need to protect domestic investors from scams, which are omnipresent in this market, and their own greed, particularly through limiting the maximum leverage.

Literature Review:

I primarily make use of three journal articles throughout this research paper. Here are the ones which contribute the most to my research and have provided invaluable information:

1. "Retail FX Trading in Turkey Gets Unusual Boost" by Joe Parkinson and Yeliz Candemir in the Wall Street Journal. The article explores the regulatory scene in Turkey, one of recent countries that take OTC FX trading into regulation, and reports the subsequent reactions of both traders and brokers involved in the market.
2. "Forex leverage: How it works, why it's dangerous" by Dominic Chu on CNBC. The article refers to specific cases where leverage has proved to be detrimental to retail traders and suggests leverage be used wisely by investors.
3. "Sayonara Mrs Watanabe; Japanese retail investors quit the FX market" on EuroMoney. The article presents statistics, including daily trading volume and number of positions opened daily, to indicate the effects of a cap on leverage on traders and the market in general.

Report:

In conducting this research, I utilized a report by WikiResearch titled "Global Forex Margin Trading Market and User Research Report: Vietnam." It provides me with information on the current retail FX market in Vietnam as well as the average Vietnamese FX traders. From there, I can compare the market and traders in Vietnam to that of other countries which have successfully established a regulatory framework in order to outline what steps the Vietnamese government should make towards the goal of regulation.

Experiments: Statistics, interviews to test the hypotheses

To test my hypothesis on the effects of an authority's presence on traders' safety, we shall look at cases around the globe.

In the U.S. alone from 2001 to 2007, approximately 26,000 individual traders have lost $460 million in fraud relating to forex margin trading. Observing such an alarming situation, a special task force, formulated by the CFTC (Commodity Futures Trading Commision), has been established and has since introduced multiple rigid regulations to ensure the traders' safety. One of the regulations that has been passed is to require all US brokers to have a minimum deposit of at least $20 million. Such a standard has reduced the brokerage operation significantly, and those who remain are legitimate ones, including FXCM, CitiFX Pro, and Gain. Before that, the U.S. was the place to go for FX brokers who are scouting for regions with the least amount of regulations. Although empirical effects have not been determined nor specified, we see that in trying to curb illegal activities in this market, the first step would be the establishment of a competent authority. As Demetri Bezaintes, an associate at Giambrone Law, an award-winning, international full-service law firm, would like to point out in my interview with him, “there should always be a certain degree of regulation required,” and that “It’s not a free land, and we don’t allow just anybody to take people’s money.”

In another case of effective regulation, Turkey’s Capital Markets Board (CMB), the official financial regulatory body in the country, tightened the rules for FX brokerage starting from September 2011. Brokers are obliged to register with the CMB and comply with several stringent new standards, one of which makes it compulsory for brokers to place their collateral in a settlement and custody bank, thus backing the market up with insurance. Prior to the advent of regulation, the retail FX sector in Turkey is best described as ‘chaotic.’ Before, brokers used to offer services under no oversight of any authority and basically were able to swindle investors’ money easily. The market was steeped in allegations of theft and scams, and consumers’ confidence was low. However, things started looking upward for both the traders and the domestic retail FX market since the introduction of rigid rules and requirements. In just over one year, clients’ faith dramatically rose, and daily trading volumes have been reported to triple to $1 billion. Not only that, better regulation has rendered the so-called ‘big players,’ legitimate brokerage houses who have undergone certain auditing, eager to obtain market share in this fast growing market. These established brokers, undoubtedly, will be able to provide much better service and a safer trading environment overall to the domestic traders than the local ones.

On the second hypothesis, a cap on leverage plays a vital role in preventing sudden deaths for investors, as well as reducing the risk of catastrophic collateral damage. In an article published in Journal of Money and Economy in 2019, the two authors, Shahram Moeeni and Komeil Tayebi, suggest that leverage of 1:50 can result in

89.4% probability of loss, and leverage of 1:50 only has less than 2% of winning. On the other hand, however, they also found that leverage ranging from 1:10 to 1:50 rarely renders traders vulnerable to sudden insolvency. In a real-world case, the Financial Services Agency, the watchdog of Japan's foreign exchange transactions, has long been imposing a cap of 1:25 on the maximum leverage that brokers can offer to domestic investors. The country, which boasted 800,000 active forex accounts in 2019, is one of the Forex hotspots around the globe, leading the Asian trading session with $1 trillion in trading volume per day. Therefore, the need to protect these retail investors is one of primary concerns for the country's authority, and the limit on leverage indicates the extent to which Japanese authority strives to protect domestic investors. Before the introduction of the cap, brokers used to offer leverage up to 1:400, which is in itself a recipe for disaster. Gradually, the FSA cut the maximum leverage to 1:50 in 2010 and finally to 1:25 in 2011. Furthermore, in order to ensure the efficiency of the leverage cap, the FSA has banned domestic investors from opening and trading with an offshore account since foreign brokers have often tried to entice Japanese traders with leverage of 1:100 or more.

Market-wise, a cap on leverage can avert the "trickle-down" effect that results from huge bettings that go wrong. For instance, with only low leverage permitted, a loss day will not necessarily turn into enormous losses for everyone, but if high leverage is allowed, then small losses' impact can be magnified, causing a cataclysmic chain reaction. That was exactly the case when in January 2015, the Swiss National Bank (SNB) removed the peg of Swiss francs to euros. For three years, the exchange rate was kept stable at 1.20 Swiss francs per euro. After the abandonment of the cap, the franc soared over 40% against the euro. Such a jolt in the exchange price resulted in the insolvency of multiple brokers, the most noteworthy of which is the bankruptcy of Alpari (UK). What followed was huge losses borne by both brokers and traders and multiple leverage caps introduced by authorities worldwide, including the Japanese FSA.

Country	Regulatory body overseeing retail FX brokerage	Maximum leverage offered by brokers
Vietnam	None	1:500 or more
US	US Commodity Futures Trading Commission & National Futures Association	1:50
UK	Financial Conduct Authority	1:30
Japan	Financial Services Agency	1:25

Regulatory body and maximum leverage in different countries

If the government were to take these two above measures, investors would be benefited in two major ways.

First, a report by WikiResearch indicates that the average FX margin investors in Vietnam are rarely aware of the regulatory situation surrounding the market. In most of the cases, so enthralled are the traders by the enormous payoff that brokers promise that they invest little time researching the legality of this market and the brokers before investing. If a competent authority is set up to control FX brokerage, this would help raise awareness of the investors of the frauds and scams that are omnipresent in this market as well as effectively limit, or terminate if possible, the establishment and operation of ‘fake’ brokers through rigid requirements. Only registered brokers can operate and offer services in the country, and thus, traders would be aware that they are protected by regulations, which in turn boosts consumer confidence.

Second, a cap on leverage is vital to protecting investors from being too rapacious. Many amateurish traders opt for leverage as high as 1:100 or more, but as we have discovered, leverage higher than 1:50 often leads to sudden death for inexperienced investors. Thus, if the government were to introduce a limit on leverage, investors would enjoy a much better chance of surviving and profiting in the long term. Furthermore, a leverage cap might forestall the ‘trickle-down’ effect on a large scale, which is the result of a combination of wrong bettings and high leverages.

Discussion and Limitations:

In conducting this study, I was not able to find evidence from countries that better resemble Vietnam’s economic and social conditions than Turkey, Japan, and the USA. Although problems in this market are relatively similar in different countries, including scams and high leverages, if I were able to assess regulatory attempts from countries like Thailand or Laos, effects of regulation on the Vietnam retail FX market would be more certain to predict.

The research also lacks specific statistics on FX-related scam rate pre-regulation and post-regulation in other countries. If details like this can be included, it can further explain how regulation can help protect investors and offer empirical evidence on the results of regulation. For instance, a statistical set of the number of FX scams reported to authorities before and after the promulgation of regulation and requirement of brokerage authorization would provide empirical support to how operation of scams can be limited.

Given these limitations, the paper's support would be stronger if I were to have access to more surveys and more statistical analysis on the situation of the retail FX market in countries similar to Vietnam.

Conclusion:

In this paper, I argue that the Vietnamese government should regulate the retail FX market. I have conducted a study to find evidence on what benefits regulation would bring to traders in this market Initially, my hypotheses are that regulation would limit the FX-related scam rate, thus effectively defending investors from frauds and schemes, and a leverage limit, once imposed, would prevent and ultimately protect traders from huge betting and hemorrhaging.

By interviewing legal partners and experts and referring to articles and reports, I manage to draw up pictures of pre-regulation and post-regulation in other countries and get insights into the basic actions and results of the regulation. Leverage, through my finding, proves to be detrimental to amateurish investors in most of the cases and should be strictly limited.

The first experiment is to investigate regulations in two countries, the US and Turkey, in order to conclude the situation in which regulatory intervention is necessitated. In both countries, high rates of scams and frauds proved to be a major concern for investors and authorities to the point that legal bodies were tasked with regulating this market. Basic regulations include registration of brokers, and positive results have been reported.

The second experiment is to determine whether a limit on leverage should be imposed as part of a regulatory attempt. By referring to academic findings and real-world evidence, I manage to conclude that leverage is not to be used by ordinary traders and a cap on leverage is indispensable to protecting investors on both small and large scales.

The results of these experiments align with what I have hypothesized, meaning that regulation is needed to ensure a safe trading environment for FX traders in Vietnam, and a leverage cap should be one of the basic legislations in the effort to do so.

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