

Regulatory Roundup

Where to draw the line on the issue of leverage

In this Regulatory Roundup feature Felix Shipkevich, General Counsel at CMS Forex, examines the question of leverage and what factors may influence the way regulators draw the line of what is the appropriate level of leverage that should be allowed to be used by retail clients, if any.

Every morning on my way to the office, I pass a small playground located in the middle of a residential area in lower Manhattan. Next to a sandbox and several swings, there is a see-saw that reminds me of my childhood. Growing up on the heavy side, my weight was a perfect tool to take advantage of the skinnier kids by *gearing* them high in the air on a long wooden see-saw. My *secret* mission, to take advantage of my weight on a wooden see-saw beam, got me in trouble a few times with the teachers, who reminded me that *gearing up* innocent kids was a wrong thing to do.

In many respects, the world of foreign exchange regulation is much like a playground. Retail clients sometimes get hurt while playing wildly and recklessly on the playground of the FX market, and regulators act like teachers or parents that oversee the free-spirited retail clients trying to speculate in the FX market in the hope of winning big. Just like children, retail clients are vulnerable. A wrong decision or a wild bet can cause vulnerability in this high stakes game. But is leverage to blame for retail clients' wrong bets?

Generally clients know that higher leverage means the opportunity for higher gains and the risk of greater losses, and FX brokers in the regulated jurisdictions are required to inform clients of these risks involved with leverage. Those who ignore prominently placed disclaimers or notifications of risk typically trade at their own peril. While ignorance is not a defence for mistakes in speculative decision making, leverage is currently under attack, and arguably rightfully so.

In the past two years, we have witnessed an unprecedented fall of leading financial institutions across the globe that were over-leveraged in speculative and exotic products. From banks, broker-dealers, and insurance companies, to hedge funds and private equity firms (the list is quite long), the losses after being over-leveraged were far too great for some to withstand the storm. Although the losses that were publicly vilified were initially sustained by the corporate institutions, it was the retail clients that suffered in the end as a result of these firms over-leveraging their investments.

However, while risky in nature, leverage is not the enemy here. It should be controlled but not capped at a level to make its use futile. Simply said, let's not throw the baby out with the bath water. In recent months, regulators in the United States and Japan have taken steps to cap retail clients' leverage in foreign exchange.

United States

On February 23, 2009, the United States, National Futures Association ("NFA"), announced that it has approved a regulation for its foreign exchange dealer members ("FDMs") that will limit leverage to 100:1 for major currency pairs and 25:1 for minor ones. The regulation is currently pending approval before the Commodity Futures Trading Commission ("CFTC").

According to the explanation in support of this rule, the NFA expressed concern that higher leverage can deplete a customer's account balance — and result in forced liquidation — much faster than retail customers realize. The explanation further stated that of 21 FDMs, eight have the exemption from collecting minimum security deposits. Of these eight, one offers leverage of 700:1, four offer leverage of 400:1, two offer leverage of 200:1, and one offers leverage of 50:1. One of the firms without the exemption also offers leverage of 50:1. A proportionately greater number of firms that offer higher leverage have also been the subjects of NFA complaints, while neither of the firms that offer 50:1 leverage has ever been the subject of an NFA or CFTC enforcement action.

The reaction of FDMs to this rule was mixed. Some firms that historically offered greater than 100:1 leverage felt that they were at a competitive disadvantage to the foreign competitors in regulated jurisdictions like the UK and Japan, where there is no limit on leverage. These firms further argued that they offer greater risk control because FDM systems automatically liquidate positions before the account goes into deficit. Others firms that offered leverage of 100:1 or less supported this rule proposal.

Japan

This rule is expected to be approved in the U.S. sometime in 2009, and Japan's Financial Services Agency ("FSA") is likely to follow suit. A local Tokyo newspaper in April leaked a story about FSA's plans to lower leverage to 25:1. The article brought a lot of attention to Japan's FX community, which eventually spilled over its borders. The FSA initially shunned away from publicly commenting on this rumoured rule. However, the impatience over a possibly devastating rule has caused the Japanese FX community to confront the regulator about the rumour. In response, the FSA recently acknowledged that it was currently studying the effects of losses caused by highly leveraged accounts. The FSA further indicated that it was looking at the systemic risk for firms whose clients go into deficit, which in their view may be a risk factor that leads to insolvency. The agency has not indicated that the rule will bear a limit of 25:1, but neither has it denied it.

Japan currently does not limit leverage in retail foreign exchange transactions. Both domestic and foreign brokers there generally offer leverage of 100:1 and higher. If the rumoured rule is to go into effect, it is likely to cause significant damage to the retail foreign exchange community. Unlike the consolidation of the FX industry in the U.S. following a \$20 million entry barrier, a leverage cap of 25:1 may force Japanese FX brokers to leave the regulated environment for another jurisdiction, and their customers are likely to follow.

Limiting leverage is not a new phenomenon. Hong Kong and Singapore are just two examples of jurisdictions where leverage for foreign exchange transactions is capped at 20:1 (though certain exemptions for foreign brokers exist in Singapore). However, compared to the growth experienced by the retail FX markets in the U.S., Japan and U.K., the growth in Hong Kong and Singapore was slowed due to leverage restrictions. This is not to say that these jurisdictions are less appealing for certain traders, but for smaller retail clients who have limited funds to speculate with, trading with 25:1 leverage would mean that greater margin will be required to open a position. As a result, clients' speculative nature will tend to prefer regulated jurisdictions where the laissez-faire market attitudes on leverage are less restrictive.

The question on everyone's minds in the FX community is where will regulators draw the line of what is the appropriate level of leverage that should be allowed to be used by retail clients, if any. While certain regulators look to restrict the amount of leverage in their jurisdictions, others are leaving decisions of risk up to the retail clients. However, U.S. regulators seem to have found a balance between controlling the maximum risk tolerance and speculation.

In anticipation of the leverage rule being ratified into law, certain U.S. brokers have pre-emptively lowered their maximum leverage. Without doubt, others will follow the trend once CFTC approves the rule, which seems likely. Obviously, many hope that if Japan's FSA was to follow suit that it would do so similarly to that of the U.S, but not further. The eyes and ears of the retail FX community now turn to Japan's FSA in the hope that one of the fastest growing retail financial markets in the world is not disparaged by over-regulation. In recent years, Japan's retail market has positioned itself as a leading regulated foreign exchange jurisdiction in the world. Any step to regulate leverage beyond the standards promulgated in the U.S. can result in devastating losses for the entire prospering FX community.

Conclusion

This brings us back to the see-saw story. The retail FX market is no different than two kids trying to balance themselves on a see-saw. While one kid pushes his feet off the ground to go up, the other gently lowers himself to go down. Retail clients, like children, should have an ability of gearing up in the market. If the appropriate leverage is not available for clients to speculate with, then the retail market in the jurisdiction where leverage is disproportionately capped will leave to other markets where there is little or no regulatory oversight. Regulators in the U.S. have taken steps to put protective gear on clients in case they fall, but cutting the see-saw in half will encourage children to find an unsupervised playground.