

# RETAIL FX INDUSTRY WATCH

"For the first time we may have a situation with Forex that retail traders can have the same opportunities as large market players such as banks and Hedge Funds"



# RETAIL FOREX:

## EVOLUTION, REGULATION, AND CURRENT TRENDS

The retail Forex market has evolved quickly, from being nearly non-existent 20 years ago, to being a major Forex liquidity provider (about 5% of Forex volume is retail traders). Unlike other more established financial markets, such as the Stock, Commodity, and Bond markets, Forex trading didn't start until the early 1970's and the retail Forex market didn't begin until the early 1990's. With the retail offering of forex brokers such as Oanda, Saxo Bank, and others, retail traders had the same access as banks and other large institutions. So retail Forex can be examined and defined by brokers offering retail trading, because without this market access, the retail Forex market would never have evolved.

Also, because Forex was an unregulated market, it allowed for many unethical practices and outright fraud. This has been approached by the regulator, the National Futures Association, although not explicitly a Forex regulator, they became the de-facto global Forex regulation model.

### DEFINING RETAIL

Even the definition of what 'retail' is has evolved. Retail used to be a 100,000 minimum, now at some brokers retail is 100. Generally, retail is considered to be individual traders opening accounts with relatively small deposits. The NFA defines retail as anyone who isn't a QEP (Qualified Eligible Person)<sup>i</sup>. However, reading the regulatory definition precisely, one notes several categories that although QEP's, would by industry standards be considered retail: "non-United

States persons" and "Knowledgeable Employees". The thinking here is that the NFA doesn't regulate foreign persons and foreign markets, which is correct. However most would consider a non-US person from India with a \$500 deposit retail.

Retail traders are - almost by definition - undercapitalized. Thus they are subject to the problem of gambler's ruin. In a "Fair Game" (one with no information advantages) between two players that continues until one trader

goes bankrupt, the player with the lower amount of capital has a higher probability of going bankrupt first. Since the retail speculator is effectively playing against the market as a whole - which has nearly infinite capital - he will almost certainly go bankrupt. The retail trader always pays the bid/ask spread which makes his odds of winning less than those of a fair game. Additional costs may include margin interest, or if a spot position is kept open for more than one day the trade may be "resettled" each day, each time costing the full bid/ask spread.

## DEFINING FOREX INDUSTRY

The Forex industry didn't exist when Forex first started. Banks traded currencies on behalf of their customers and that was it. Now there are companies that specialize in providing services to Forex companies, such as technical services as provided by companies such as FX System Hosting, who offers dedicated servers and domain names specific to Forex companies. The Forex Industry can be defined as the growing number of companies offering Forex specific products and services, and service providers to those companies. There is now a specific registration category in the NFA called RFED, or Registered Foreign Exchange Dealer<sup>ii</sup>. This is a new category that didn't exist 5 years ago.

## PROBLEM OBTAINING DATA

Since Forex data is available on a survey & voluntary basis, data is difficult to analyze. For example, even for the entire Forex market, official BIS data used commonly "4 Trillion per day" is a mere survey. While most accept that it is accurate, the data is obtained by banks volunteering this information to the survey, which is unaudited.

Retail Forex is even harder to quantify. Many brokers are private companies or based offshore. As no reporting of financial or customer data is required, it leaves researchers to only speculate. FXCM can provide a good model because they are considered to be the largest retail broker in the world, and as they are a public company they submit customer and financial

data. According to Google Finance, FXCM has 165,000 customers<sup>iii</sup>.

FXCM releases monthly metrics of their trading volumes on their Investor Relations website.

## The National Futures Association became the de-facto global Forex regulation model



See their latest release:

[May 2011](#)

Retail Trading Metrics:

- Retail customer trading volume of \$328 billion in May 2011, 12% higher than April 2011 and 5% higher than May 2010.
- Average retail customer trading volume per day of \$14.9 billion in May 2011, 7% higher than April 2011 and no change from May 2010.

- An average of 363,579 retail client trades per day in May 2011, 13% higher than April 2011 and 8% lower than May 2010.

- Active accounts of 155,592 as of May 31, 2011, a decrease of 2,410 or 2% from April 2011, and an increase of 26,465 or 20% from May 2010.

- Tradeable accounts of 167,844 as of May 31, 2011, an increase of 1,696 or 1% from April 2011, and an increase of 6,635 or 4% from May 2010.

Institutional Trading Metrics:

- Institutional customer trading volume of \$80 billion in May 2011, 28% higher than April 2011 and 4% higher than May 2010.

- Average institutional trading volume per day of \$3.6 billion in May 2011, 22% higher than April 2011 and no change from May 2010.

- An average of 8,694 institutional client trades per day in May 2011, 28% higher than April 2011 and 95% higher than May 2010.

More information, including historical results for each of the above metrics, can be found on the investor relations page of the Company's corporate web site<sup>iv</sup>.

## WHITE LABELING

Another phenomenon in Forex is the proliferation of White Labeling<sup>v</sup>. Private Labels exist in all industries, however in Forex it is very common. There are a few companies offering platforms and trading strategies, and 10x more who white label that product and market it as their own. For example, Citibank uses a white label of Saxo Bank for their retail business.



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The problem with this when analyzing data is that it is difficult to determine how many unique platforms or strategies there are in existence, compared to how many are simply a white label of another.

### FOREX ATTRACTS CRIMINALS

Since Forex was unregulated, the Forex market attracted a white collar criminal element that used Forex as a story to steal money from people. Unlike the rather sophisticated Madoff operation, many of these criminals simply take money from customers and spend it on lavish lifestyles, sometimes not even trading 1 contract. Another factor is that Forex is unknown to many, and rather complex for someone

who doesn't have a mathematical or financial background. Thus when the criminals explain how big banks trade currencies and make billions, to the average person it sounds exciting.

A good example is provided by the case of Joel N. Ward, currently serving a prison sentence for his crimes which he was convicted<sup>vi</sup>.

Over his trading career, 110 people trusted Ward with \$15 million of their money, with over \$1 million was taken in the final weeks of the scheme. Ward and his employees traded only \$2 million of this money, losing \$1.84 million. Twenty-two of the 24 accounts traded incurred losses, with the profits in the other

two accounts, amounting to less than \$1,000 total. Ward used the rest of the money to pay himself a \$180,000 annual salary, support his trading school business, stay at 5-star hotels at his "trading retreats," and pay out \$3.7 million in "lulling payments" to investors who demanded money from their supposedly profitable trades. He also created fictitious Merrill Lynch account statements to show that one investor had an account balance of \$9.5 million. In August 2006, Washington Mutual Bank contacted the authorities with suspicions about Ward's banking activities. In November 2006 Ward emailed his investors, "There are no funds left in JNF as all monies have been misappropriated." In a handwritten confession that Ward gave his wife and that was later given to the FBI, Ward wrote of much personal distress and even the possibility of taking his own life over his guilt. In that context, he wrote that he "felt like a financial serial killer" and "just another scumbag con artist bilking old people out of their retirement money." He was later divorced. In August 2007, Ward pleaded guilty to nine felony counts, including fraud and money laundering. The U.S. Attorney's office claimed that Ward defrauded more than 100 clients out of more than \$11 million. Separately, Ward is alleged to have defrauded investors in a Mississippi real estate project.

These criminals have given Forex a bad reputation, as explained in the Wikipedia page Forex Scams<sup>vii</sup>.

## FOREX SEO

What made Forex very popular on the internet is a group of international internet marketers who picked up on Forex as something to promote. The reasons that Forex is one of the best product types for these marketers to promote is because it is purely electronic, meaning that your customer could be anyone with a computer and an internet connection (compared with something like automobiles, which can only easily be purchased within a 50-100 mile range). Also there is a high profit margin on many forex products, and the 'pitch pages' usually have wild claims with high rates of return.

Most of these are false claims, however the internet marketers can use Forex to create a compelling argument to 'make a lot of money'. Since many of these individuals are located online, they can live in any country and are not subject to regulations. In the future it may be an issue because while Forex has now become regulated, the internet still is not, so it is difficult to enforce regulations on domains registered private, who are domiciled in foreign countries.

Propelled by the SEO community, Forex became viral. Forums such as Forex Factory, Forex-TSD, FX Street, and others, saw their memberships skyrocket. Retail investors searching for answers

started posting large amounts of questions in the forums and engaging in heated threaded debates. Since anyone can register for a forum, while moderated, the responses were questionably accurate. Most Forex professionals would not spend time answering questions in forums unless they were paid to do so. As there isn't any official Forex knowledgebase, the average client is left to decide on his own of the accuracy of statements.

Having noted the above, the overall

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community is self-moderating and education and knowledge has been increasing. That means over time, the forums have become more accurate, and wild claims such as making 50% / month with no risk, have been filtered out as false. What the forums did accomplish is popularizing Forex on the internet and giving retail customers a means of communicating with other retail customers. Now many brokers offer their own Forums to keep customers from using these uncontrolled, 3<sup>rd</sup> party forums.

## 2005 - 2007 ERA

With the release of Meta Trader 4<sup>viii</sup>, retail Forex went viral globally. Since Meta Trader 4 was free and possible for anyone to download, develop and

test a rule based automated trading system, millions downloaded the software. Tradestation, the industry standard for automated trading systems development, failed to adapt to Forex quickly enough to provide a growing number of hobby developers free development tools. To this day, Tradestation doesn't offer a free downloadable software development environment, although it is still considered by many to be the only software to use when developing quantitative systems.

Brokers at the time such as Alpari and Interbank FX received a flood of clients who wanted to trade MQL based

systems they had developed live in the Forex market, most of which had relatively small deposits. Also, many of these hobby developers began selling their systems for use, as well as forming trading groups where they would exchange development ideas and improvements on their own trading strategies. The financial success of Forex brokerages such as Interbank FX and Oanda caught the attention of investors. In the case of Interbank FX, this resulted in a \$40 Million investment in 2007 by venture group Spectrum Equity Investors. Oanda received \$100 Million in investment capital in September, 2007<sup>ix</sup>. Earlier that year, State Street purchased institutional trading platform Currenex for an astonishing \$564 Million<sup>x</sup>.

While this was going on, the NFA was raising the Net Capital Requirements for brokers, which meant that smaller firms were forced either to be acquired by larger ones or cease to exist. Forum threads called “Dealer Dead Pool<sup>xi</sup>” and “NFA Capital Requirements<sup>xii</sup>” were proliferated on forums, where users speculated on the fate of these firms. Subsequently, a number of firms that existed in 2006 did not exist in 2008.

### DEAD FIRMS WALKING

Out of the following short list of US firms in trouble, only FXDD survived:

One World Capital (\$1,105,000), Velocity4X (\$1,587,000), Direct Forex LLC (\$1,523,000), FiniFX (\$1,464,000), GFS Futures & Forex (\$3,074,000), Nations Investments (\$1,699,000), Royal Forex Trading (\$1,102,000), SNC Investments (\$1,565,000), FXOD (\$78,000), I Trade FX (-\$3,039,000! Close to Bankruptcy!) Money Garden (\$3,399,844), United Global Markets (Bankrupt).

In some cases, as with Velocity4x, which was shut down and customers were acquired by Forex.com – customers had to move their accounts but no losses occurred. In other cases, such as One World Capital, customers’ capital was wiped out. One World Capital was finally determined to be a fraud<sup>xiii</sup>.

### INDUSTRY CONSOLIDATION & REGULATION

While the US is not the only



The financial success of Forex brokerages such as Interbank FX and Oanda caught the attention of investors

regulatory environment in the world, and there are many Forex firms registered offshore, the US has always provided a framework for foreign regulators. In the case of retail Forex, many believe that regulation is needed. The argument may be different for Hedge Funds for example, where you have professional traders meeting sophisticated QEP investors who understand the complexities of Finance. The retail Forex investor may not be sophisticated (although many of them will spend hundreds of hours researching before opening their \$1,000 account). Also fraud and unethical practices have been

abundant in Forex. Of the major US based FCM’s/FDM’s offering Forex, only a few have escaped NFA complaints (Most notably, Oanda, GFT, and FXDD). Regulation is an important part of the discussion of retail Forex, because Forex by itself doesn’t have any official framework or standards. Each broker handles rollover charges differently, although many follow some rules established by common practice. In fact, Forex regulation without considering retail market is nearly irrelevant, as most participants in Forex on an institutional basis have already been regulated and mostly work with other institutions or QEP’s as they are defined by the CFTC.

It should also be noted that most of the problems plaguing the Forex industry were mostly on a retail level. Dealing Desks common in a retail environment are nearly unheard of in an institutional environment, such as Deutsche Bank's Autobahn<sup>xiv</sup>.

## DEVELOPMENT TRENDS

Expert development as proliferated by the MetaQuotes platform created a large global community of traders developing their own automated trading systems. These systems were initially simplistic, some relying on simple indicator signals such as Moving Average crosses and RSI. Others called "Grid Trading" systems, simply bought and sold above and below the current price – while EUR/GBP was in a trading range, the system never lost money. As soon as EUR/GBP began trending, many accounts had severe losses. Now, strategies are becoming increasingly more complex and robust. Some tools allow for the importing and exporting of data between MT4 and other platforms such as Tradestation, MatLabs, and Microsoft Excel.

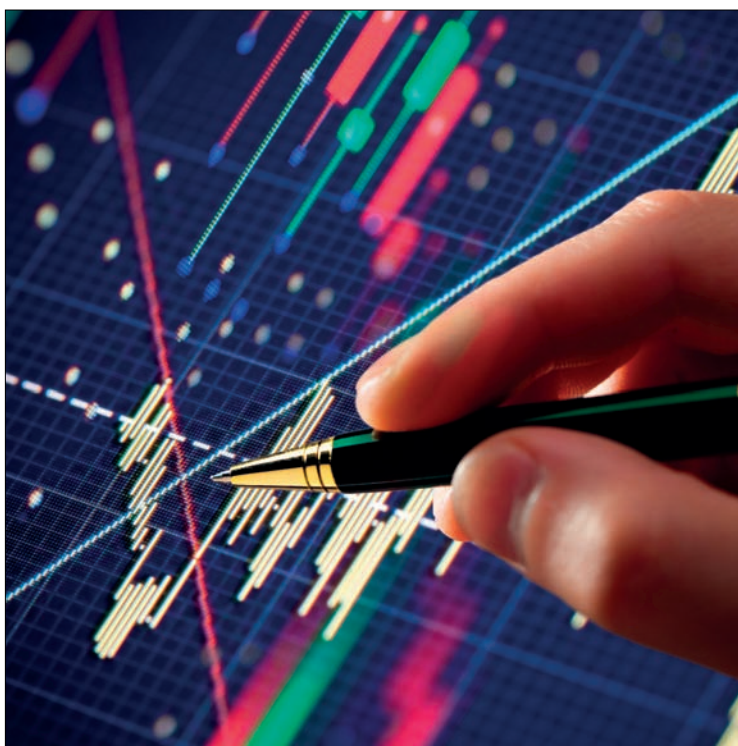
Also, new platforms on the

market are now competing with MetaQuotes. While it is unlikely that any will replace MetaQuotes due to their wide proliferation, it is important to note the amount of new platforms that have been recently launched, catering to a growing number of automated Forex developers. Also, manual

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traders have discovered the use of automated tools. While many still trade manually (by deciding themselves when to buy and sell) they heavily use automated assistants, such as opening order scripts, dynamic indicators, and account monitors.

## CURRENT STATE OF RETAIL FOREX

The Forex industry is in a different state than it was years ago. A few trends that have emerged:

- Many traders are now aware of the games brokers play, and are demanding real, instant execution
- The demographic of retail Forex has expanded beyond the hobbyist, and now includes many non-FX money managers (such as stock or bond traders), corporations, and high net worth individuals
- Brokers are more capitalized
- While the number of brokers due to consolidation has possibly decreased, the number of well capitalized brokers has increased, allowing more choices
- Brokers have become more competitive
- Ability to trade smaller lot sizes such as Micros
- Brokers offering more services, such as VPS included with accounts
- Established brokers such as Oanda have started offering Managed Accounts
- Plethora of 3<sup>rd</sup> party tools such as ZuluTrade and Currensee.

One trend is the rebate is becoming smaller or even non-existent. Some CTA companies now offer an interbank feed with spreads as low as

.4 EUR/USD to retail traders<sup>xv</sup>, with an LOD with 5% performance fee. While this may sound strange, why would a client pay a % of his profits to the CTA, you actually are always paying the spread when you enter a trade, and if the broker has slippage, 5 pips is \$50 on a 100,000 unit position. Also with the performance based model, if the account is negative there is no fee, so over time they believe this will equal lower trading costs and provide a fairer, transparent trading environment. In initial testing, systems show greater profitability with the reduced spread and instant ECN style execution.

Of course as with many of these changes, these are things that should have existed in the first place. It's

not fair that dealers pray on retail customers that don't have sophisticated knowledge of the markets. So for the first time we may have a situation with Forex that retail traders can have the same opportunities as large market players such as banks and Hedge Funds. As the Forex markets themselves become more complicated, and as Central Banks engage in competitive devaluation of their respective currencies, retail Forex may become a new asset class in its own right: retail investors doing their own currency investing with the use of provided tools such as analysis, automated systems, and custom indicators.

*Elite Forex Training*

- i <http://www.investopedia.com>
- ii <http://www.nfa.futures.org>
- iii <http://www.google.com>
- iv <http://www.fxcm.com/>
- v <http://www.saxobank.com>
- vi <http://en.wikipedia.org>
- vii <http://en.wikipedia.org>
- viii <http://www.ibfx.com>
- ix <http://www.oanda.com>
- x <http://www.bizjournals.com>
- xi <http://www.fxfisherman.com>
- xii <http://www.forexfactory.com>
- xiii <http://eliteeservices.blogspot.com>
- xiv <https://autobahn.db.com/>
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