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Forex, Cfds and Other Derivatives: Investments or Gambling?

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Abstract

The attractions to investors of forex and other derivatives derives from their simplicity: to bet on the direction of a price change. Unfortunately, many 'investors' do not realise that short term price changes are not predictable and, inevitably, they will lose their money. This paper explains why this is inevitable. It also argues that the regulation of forex should be handled by a gambling regulator (in the UK, the Gambling Commission) rather than a financial regulator (in the UK, the Financial Conduct Authority) as forex trading is a bet and not an investment.

Keywords: Forex; Gambling; Investments

Abbreviations: CFD: Contracts for Difference; FCA: Financial Conduct Authority; OTC: Over the Counter.

Introduction

Recently, the betting group, William Hill, was fined by the UK gambling watchdog £19.2m for 'serious social responsibility failings', i.e. For failing to protect its customers and stop money laundering by permitting them to risk huge amounts of money. This follows a similar fine £17m for Entain, the owners of Ladbrokes and coral and foxybingo [1].

It is the purpose of this article to show that whist this does not go unchecked by the regulators, similar 'serious social responsibility failings' are present in another betting industry: what is known as 'forex', financial derivatives such as 'contracts for difference' ('CFD'), binary and traditional ('vanilla') options and spread bets, because it is not regulated by the Gambling Commission (GC) but the Financial Conduct Authority ('FCA'). Essentially, these are bets on short term movements in the price of financial assets such as foreign currency, stocks and shares, commodities and cryptocurrency. So if a punter places a bet with the service provider known as the 'broker' (e.g. buys a CFD) for say $100 and the price of the asset increases by 10%, he/she will win $10, but if it falls by 10% they will lose $10. Bets can be placed on both price rises and falls. So, should forex brokers be placed to the same controls as betting companies and should they be regulated by the Gambling Commission? [2].

The Risks

An advantage of derivatives is that the trader commits a minimum amount of money. In financial terminology, the trade is 'highly levered' and, as a result, the trader does not need to put up the entire stake, just a deposit, for example 5%. This means that he can make a much larger bet for the same amount of money rather than purchase the asset.

The effect of margin/leverage on a trader's risk is enormous. Risk increases in proportion to the leverage. With a 5% margin, the trader may make a bet 20 times as large for the same initial payment, i.e. he only pays 5%. A trader can, therefore, start trading with as little as $100 to obtain the effect of $2,000 capital.

With some brokers, the leverage offered may not be 20 times but 100, 150 times and much more, 500 and 1,000 times at the time of writing, although it may vary across assets. However, whilst the profits a trader may make are huge, it is possible that the trader may incur a loss which could be so large as to exceed the deposit raising the possibility of large losses and insufficient funds in the trader's account with the broker to cover possible losses on open trades, known as a 'margin breach' requiring the trader to cover the shortfall, known as the 'maintenance margin', or 'variation margin'[1] (Of course, the trader need not maximise the size of the bet and to do so would probably foolhardy and reckless)[3].

The attraction of 'forex' to investors is because it's so simple. Anyone can guess whether the next change in a market price is going to be positive or negative. But to do this successfully is, in my opinion, impossible. The chance of a winning trade is 50%, simply because the chance of winning or losing are the same, i.e. '50 – 50'. The reason for this is because all existing information is already built into the current price together with certain expectations about the future inferred from that information, Future news is, by definition, not known and is just as likely to be good (forcing a price up) as bad (forcing a price down). It follows that it is impossible to successfully predict short term price changes. It may be possible to forecast long term trends (e.g. the effect of Brexit on the value of the pound or a particular stock) but certainly not price changes over a few minutes, hours or even days as in forex trading.

Therefore, changes in stock market, commodity and forex prices are said to be 'random' in the sense that a price change on day one is uncorrelated with the price change the following day.[2] Hence, share prices are often said to follow what is known as a 'random walk' and financial markets such as the main financial exchanges in respect of stocks and shares, commodities and foreign exchange are regarded by economists as 'efficient' in the sense that prices of the assets adjust 'instantaneously' to new pieces of information affecting their perceived value and their supply and demand.[3]

The important point is that as price changes cannot be predicted (particularly short-term price changes) account managers, 'experts' or professionals are unable to outperform and their success rate can only be around 50%. It follows that they are also unable to trade to lose (i.e. underperform). Their success/failure rate will still be 50%. The reader is referred to the statistical principle of 'reversion to the mean'. This simply states that whilst there is, of course, a one-off chance of winning, the more frequently this is done, the more likely it is to settle on 50%.[4] Take the example of tossing a coin. After just one toss it will fall on a head or a tail and after a very few tosses of the coin the number of times it falls on heads is unlikely to be precisely the same as those times it falls on tails. However, after many tosses (say a hundred) the number of heads will be about the same (but not precisely the same as the number of tails). Brokers, their account managers and other 'experts' are fully aware of this and warn punters. For example, on their websites, brokers such as Plus500 state 84% of retail CFD accounts lose money, eToro 77%, and ActivTrades state 74% of their clients lose money [4].

It is clear why most punters lose money quickly. The broker will impose what is known as a 'spread', (also as in 'Bid/ask spread') by charging a higher price for the derivative than the price of the asset on the open market and broker's asking and bid price of an asset at a particular point in time. For example, say the punter wishes to bet on a rise in the price of a stock, when the buying ('ask') price is 101p and the selling price ('bid') is 100p, i.e. first to buy the asset at 101p (go long) hoping that the bid price will rise to above 101p. (If the punter wanted to bet on a fall, he/she would need first to sell, 'go short' at 100p hoping that the bid price will fall to below 101p before having to buy. Using a CFD, the punter may avoid buying and selling the stock but would have to pay the broker's prices containing a spread. For instance, 101.5p and 99.5p where the broker's bid/ask spread is 2p. So, whilst the punter will be able to avoid financing the purchase and sale of the stock, enabling him/her to embark on a larger bet, the price rise/fall will have to be larger to cover the bid/ask spread. At first glance, the spread may appear small but given the average size of price changes during a day, it may be sufficiently large to cover the spread is unlikely [5].

The bid/ask spread has therefore two effects which work against the trader: it reduces the profitability of the trade to the trader and reduces the likelihood of success. Say the price of a forex currency is $0.77 where the bid and ask prices are $0.768 and $0.772 and the price rose to $0.78 where the bid and ask prices were $0.778 and $0.782. If the trader were wagering on a price rise, he/she would be unsuccessful as the bid price is below the ask price at the time of the trade, i.e. $0.778 < $0.782.

1 The margin rate for a CFD imposed by the broker depends on the market to which the bet relates. For example, a 2% margin requirement for a EUR/USD position, provides 50:1 leverage, meaning that for every dollar of margin, it is possible to control a trade amounting to $50. In which case, if EUR/USD is trading at $1.10, the total margin requirement for a standard lot position of 100,000 units would be $2,200, which controls a total position value of $110,000 (0.02 x $110,000 = $2,200).

2 See, for example, Spurga (2006) or Schwartz (1997).

3 See, for example, Barnes (2009) or Minsky (1982, 1989).

4 See for example, https://www.investopedia.com/terms/m/meanreversion.asp.

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This type of broker is not a 'broker' in the traditional sense as an intermediary. It is an 'Over the Counter' ('OTC') broker and the *counterparty* to one side of the trade. If the punter wins say $100, the broker loses $100, the same amount. Similarly, if the punter loses $100, the broker gains $100. This is a zero-sum game where the broker is acting as the banker or, to use an analogy, it is the equivalent of the house in a casino and not the croupier. In which case, the broker's incentive is to maximise its profit from the punter. As the broker is the counterparty, it will not invest the client's money in a similar investment, i.e. hedge it for a similar period, as in the long term such trades are loss-making and if the trade is short term, impractical. Instead, the broker will encourage punters to continue and to 'invest' and offer incentives if necessary. It may offer free money or matching deposits known as a 'bonus'. Usually, this is not a cash bonus and cannot be paid out but a leverage-based bonus, i.e. it is added to the trader's deposit, thereby raising the amount available to bet, encouraging him/her to risk larger amounts of money and the initial deposit more quickly. Offers of signals and other insights are also provided. It is obvious that both brokers, their employees and other 'experts' are fully aware of this. Offers of signals and other insights (such as the use of algorithms) are often provided or sold but in their, and the broker's, interests, as the counterparty, that the trader loses [6].

Losses and Complaints

Over the last few years, the reputation of 'forex' has been tarnished by allegations and scandals and punters have claimed they have been cheated by brokers avoiding paying winners and hastening and maximising traders' losses. I have acted as an expert witness in 15 UK cases including a criminal case and a large class action. In all these cases, victims had lost hundreds of thousands of pounds and in some instances, individuals lost more than a million pounds, typically over a few weeks or months.

Common complaints are:

1. Aggressive marketing practices, notably cold calling, persistent unsolicited calls promising huge returns etc.
2. Fictitious trades to give the initial impression of successful trading then followed by huge losses.
3. The denial of withdrawal of funds requests, again arising from bonuses and the maintenance margin',
4. Breaches of fiduciary duty, good faith, and fair dealing. A broker's obligation is to act in a client's interests but given its incentives, this may not occur.
5. In addition to offering signals, broker employees trading on the client's behalf claiming expertise etc. (It is ironic that even though the employee may to lose, he/she would still only achieve a 50:50 success rate).
6. 'Churning' when, unknown to the customer, an unnecessary number of trades are made by the broker's employees because they are paid commission,
7. Hidden costs relating to 'slippage' and allegations of hidden spreads and the use of fictitious prices.

As the broker determines the prices shown on the platform for the derivative and not dependent on the stock's actual price changes, it may decide these to its advantage. If, say, the broker stands to lose from trades, it may decide to change its prices. It may decide to suspend or pause dealing preventing a punter from selling at a profit [7].

It is not surprising that many brokerage firms' operations have been suspended by regulators, notably by the FCA in the UK. ASIC in Australia, the SEC in the USA and CySEC in Cyprus where many brokers are based one. Despite this, claims for compensation and class actions have not always been successful.

Final Remarks

Even though many brokers have been closed down for shortchanging customers, forex is a highly profitable business for brokers. In the long term 'heads: the bank wins, tails: the same'. All the broker needs to do is encourage clients to continue to trade, deposit money as in the long term, they will lose. The problem is that many punters do not understand the likelihood of losing and is rarely advertised by brokers [8].

It is outside the scope of this article to compare the two in detail but there is a large difference in focus of the GC on its licensees (gambling firms) and the FCA on its authorised firms that sell derivatives to retail customers. The focus of the GC is the protection of customers. Licensees are required to use various indicators relevant to their customer and the nature of the gambling facilities provided in order to identify harm or potential harm associated with gambling such as: customer spending, patterns, e.g. time spent gambling and other behavioural indicators.[5] On the other hand, the FCA's concern for retail customers focuses on its emphasis on authorised brokers' integrity, due skill, care and diligence and paying due regard to the interests of customers. Additionally, they are compulsorily required to draw to clients' attention to the amount of risk associated with trading forex and other derivatives.[6]

It has been the purpose of this article to highlight the risks associated with forex primarily deriving from their simplicity: to bet on the direction of a price change.

5 See https://www.gamblingcommission.gov.uk/news/article/gambling-commission-sets-new-rules-on-action-for-at-risk-customers.

6 See https://www.fca.org.uk/firms/

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Unfortunately, many punters do not realise that these are not predictable and, inevitably, will result in loss. The situation is made worse by the regulation of forex being handled by the FCA rather than the GC who would treat forex trading as a bet.

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