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Gun-Slinging Forex Traders: Meet Up at Online Venues: Retail Players Taking Larger Piece of FX Pie

by: Rob Luke

The latest new frontier in Internet trading is pulling in the pioneers from all over. They might want to consider packing the online version of a six-gun.

The recent surge in interest (and some notoriety) in foreign exchange spot, futures and options markets, or forex, shows many of the same characteristics of new frontiers past. Until 1972, when Nobel Laureate Milton Friedman teamed up with the Chicago Mercantile Exchange and lent his imprimatur on the "opening" of regulated foreign currency markets to the public via FX futures, mortal man had no opportunity to partake of potential gains in these markets. Currencies became the first financial futures market in history, one which, although allowing the public to participate, has been mainly dominated by international banks and corporations with a big stake in unforeseen, adverse currency movements.

Today, like rapid growth fueled by a rush of hopeful newcomers, exaggerated claims of new riches and businesses are popping up (and down) overnight. Not to mention the hustlers, fraudsters and straight-out raiders lurking in every saloon. But, this new frontier also is doing what all new frontiers should: broadening the overall horizons and opening up resources to all. This market now can be traded over the Internet 24 hours a day, mostly with no commission and at bid/ask spreads similar to the interbank market.

"(Unregulated) currency markets have a fast and loose reputation," said Anthony Frisone, owner of Windsor Forex Trading Corp. in Coral Springs, Fla. Nonetheless, he points out: "As the world shrinks, currency markets expand." And, the retail forex-trading market in America has certainly been expanding lately. Traders have noted an increasing number of online currency trading platforms (sometimes called ECNs, for electronic communications network) on the Internet in recent months. By some estimates, according to Frisone, of the approximately $1.5 trillion in forex traded per day, $30-$40 billion of it is retail money compared to almost no retail five years ago. "The market is growing by leaps and bounds," he says.

So, for some forex trading platforms, business is growing at frontier-boomtown rates. Michael Weiner, COO of Plainview, NY-based COESfx, says his service has been growing steadily at a rate of about 20 percent per month. And, Josh Levy, president of Manhattan-based CMC Forex, says his company, which opened the world's first online currency trading service in 1996, increased its customer base 55 percent in three months after opening its first U.S.-based operation. A significant number of those customers, he said, have been trading futures and options, but were looking to expand into other vehicles. "It's a natural progression for (an equity) futures trader, once they've learned the nomenclature, to move to currency trading," says Levy.

Fair Trading?

The dash to this new frontier is understandable on several fronts. Most forex sites charge no commission to enter or exit a position and no extra fees to take a short position, although some charge transaction fees. Rather, most make money on bid/ask spreads, which can be up to 10 points in some cases, or by utilizing professional traders to take counterparty positions to their customers. In addition, because the market is so liquid, they can ensure that, for example, stops are filled at prices close to where they were elected, according to Don Wilcox, president of New York City-based Helia Asset Management. Wilcox, a 15-year veteran of forex trading and long-time online service user, said low costs and some excellent Internet-based trading services were tempting traders to switch to currencies. "They don't charge commissions, and they provide you with charting – it's a very fair playing field. When I get on a platform nowadays, it's just as good as anything I had during my interbank days."

Wilcox praises his preferred platform, CMC Forex, largely because "I understood their stops policy." But, he also points out that CMC Forex can maintain a tighter bid/ask spread (a key consideration in a market with hardly any commissions or fees) by making itself the counterparty to all transactions. "Their time horizons are different, and they have enough experience to handle themselves in the market," Wilcox contends. Most of their customers are essentially currency day-traders, whereas their own traders can take short-term losses for long-term gains.

CMC Forex's Levy calls this business model the direct market-maker model. Using the model, he said, "We disintermediated the broker who just tacks on the brokerage."

Frisone, a self-described "pick-up-the-phone guy," only began trading currencies online in January 2003 when invited to do so by COESfx, which he now uses. What impresses him the most about the service is that the bid/ask spreads it shows (one-two points) are the same as those shown on the interbank markets' EBS ticker (the system that matches up all forex orders on the interbank market and broadcasts a bid/ask spread for all currencies to participants). With a transaction charge of $5 per $100,000, Frisone says he is saving 60 percent a year compared to the major online forex brokers.

The way COESfx keeps spreads low is that all forex trades are matched up on both sides with no human intervention, according to Weiner. He claims that also makes COESfx "the only true ECN out there offering the true ECN model." COESfx matches retail investors with major banks and other institutions by aggregating smaller retail bids or asks to match up with the larger counterparty. As a result "the bank's price goes straight through to the end-user."

SIDEBAR

Know Your Online Venue

The black hats appear to be multiplying out in the Wild West of forex trading. But the sheriffs are fighting back with a bigger arsenal – and more to come.

The National Futures Association (NFA), which oversees forex-dealer members, recently began enforcing a new set of rules imposed on the NFA's forex-dealer members. The new rules (see insert box) were approved by the Commodity Futures Trading Commission (CFTC), which regulates the off-exchange retail forex-trading industry, in August.

The announcement of the new rules coincides with what the CFTC acknowledges is an increase in the number of fraud charges brought by the CFTC against forex dealers. According to the CFTC website, of the 88 cases it prosecuted in the first nine months of 2003, 25 were against companies charged in forex-related activities.

Prior to the new rules, the CFTC and the NFA had taken other steps to protect investors from cowboys in the forex-trading market. In 2001, it launched a Forex Consumer Advisory and, in April 2002, an advisory on how firms can legally deal in retail forex. A few months later, the NFA created a separate membership category for CFTC-registered firms offering off-exchange retail forex products to the public.

To be fair, most if not all of the 25 CFTC cases were a matter of misrepresentation or downright theft from relatively uninformed members of the public. In most cases, the CFTC's alarm bells ring when they hear about or see a forex dealer's marketing offering as high-return, low-risk forex investments, said Hayeck of the CFTC.

The NFA concerns itself more with ensuring that members meet minimum capital requirements and that their books are kept in order. Between creating the forex-membership category in June 2002 and announcing the new rules in August 2003, the NFA took emergency enforcement actions against just three members.

In this context, one of the new rules should give the sheriff an extra bullet in the chamber. It raises the minimum capital requirement for a member from the previous $250,000 to one percent of the total value of customer and non-customer open positions.

Then there's the rule forcing the members (who are almost all futures commission merchants – FCMs) to supervise and take responsibility for the actions of employees, agents and affiliates. As Sharon Pendleton, associate director of compliance for the NFA, pointed out: "Before, (the rule) said you had to be an FCM to trade forex but (said) nothing about entities who introduced the customers to them, meaning they were unregulated."

Closing this loophole looks like being very popular amongst long-suffering traders. Frisone hailed the rule as an attempt to force FCMs to guarantee any trades done through their agents. His immediate response: “Happy day!”

And sheriff NFA will assume more powers soon as the retail forex market continues to heat up. Pendleton said the NFA intends to introduce more rules in the near future. “We have a list of where we want to expand, but we’ll wait a while and see how (the new rules) go.”

Too bad Gary Cooper’s not around anymore.

SIDEBAR

New rules from NFA on its forex dealer members as of December 1, 2003

Members are required to:

a) Observe high standards of commercial honor and just and equitable principles of trade in connection with the retail forex business;

b) Supervise their employees and agents and any affiliates that act as counter parties to retail forex transactions;

c) Maintain a minimum net capital requirement based on the value of open customer positions; and

d) Collect security deposits from those customers.

Wanted Posters
Today’s retail forex trading scene may occasionally resemble Dodge City, but old hands like Wilcox and Frisone have been dodging bullets for years.

Foreign currency markets began initially when exporters and importers wanted to hedge against currency shifts, and were traded strictly on the interbank markets. Unregulated retail forex trading began in the early 1990s when clearing houses opened up to leverage smaller amounts, says Frisone, and soon accounts were being blown out.

The mayhem more or less ended with the passage of the Commodity Futures Modernization Act (CFMA) in 2000. The CFTC was granted power to “close down entities selling illegal off-exchange foreign currency futures and options contracts to retail customers.” But, as the market grew again following the popping of the dot-com bubble and the subsequent bear market in equities, so did the dirty pool and underhand dealing. [See sidebar.]

Most of the CFTC’s cases involve unsophisticated investors. But, Paul Hayeck, associate director of the CFTC’s division of enforcement, says experienced traders get taken in as well. One common way is for forex sites to advertise that they trade on the interbank market, to which only the world's largest financial institutions have access. Instead, he says, "Your money ends up on their trading desk up against one of their professional traders."

Weiner knows all about that problem. He and his partner started COESfx after trading currencies on several other platforms and always ending up on the other side of a professional trader. "It was like Vegas, and we were playing the game with the worst odds," he recalls.

Frisone keeps the hammer on his six-shooter cocked for a different kind of black hat online: those with inflated bid/ask spreads. He compares the spreads he's getting with COESfx with the interbank market (both around 1.5 points) to those offered by most online forex brokerages of between three-ten points.

"Some are showing 40-50 when it's 45-46 on the interbank – at that price it's a lovely casino for them," he says. "These guys don't realize that the spread is tightening, and soon (exchanges like) COES will steal their business. Wilcox, by contrast, has been trading forex online for a number of years and has used a number of different online trading platforms. He says the difference between them is in the integrity with which the service deals with its customers and, therefore, believes that both models – match-up and brokerage – can co-exist.

Frontier Land

Despite the dangers, though, the forex frontier looks sure to lure more adventurers in search of another trading vehicle in which to diversify. Trading price and Internet access aside, trading foreign currency options and futures offers a number of advantages over other markets. The one most-often mentioned is the fact that the market, from its opening on Sunday afternoon in Wellington, New Zealand, to its close on late Friday afternoon, is 24 hours. That means that traders can decide which hours they want to trade, depending on what suits their sleep/wake patterns best. It also means traders can virtually always escape a bad trade.

This non-stop access is generally good but can have a downside, according to experienced traders. Frisone likes the freedom it gives him to check events in the middle of the night for trading opportunities. He then can take naps during periods of slow activity, such as late afternoon in New York. Wilcox generally agrees that the 24-hour routine provides extra trading opportunities and escape routes, noting that he generally goes to bed at 2:00-3:00 a.m. but wakes up during the night to sneak peeks at the market. "Your trading room becomes your bedroom, so to speak," he said. "That can be a problem."

The "bigger picture" reason for bullishness on forex is the growing interaction between countries' economies and, thus, the expansion of trade and currency movements between them. This expansion is expected to propel further liquidity in the foreign currency markets, already the most liquid in the world, and lead to greater "retailization" of the market.

Banks Starting to Take Notice of Retail Guys

Traditionally there have been three tiers of the forex market: interbank (EBS), institutional and retail platform. But, as the retail end of the market has continued to expand, top-tier banks are now taking a serious look at the retail market, according to Wilcox. "The interbank market can remain an exclusive club but can open a kind of country club to tap institutional and retail investors," he contends.

At the mainstream level, forex growth can be noted on active traders' favorite channel, CNBC, according to Weiner of COESfx. "Every 15 minutes they have an update on the euro, yen and dollar. It is the kind of thing that gets the general public interested in trading."

Go West?

For futures and options traders inexorably drawn to the promise of a brave new frontier, old hands have some good news. Experienced traders in other markets can do well in forex, but need to do plenty of homework. Although the forex market lends itself well to technical analysis, traders need to become familiar with a wider range of economic data from different economies, rather than just quarterly announcements from local companies. Then they need to distinguish between currency pairings that are risky to trade and those that are relatively safe.

For example, Frisone warns neophyte forex traders to stay clear of the U.S. dollar/Japanese yen pairing, despite its high profile. "A lot of technical analysis (on dollar-yen) goes out the window because of the import-export factor," he says. "Big-company hedging will shift it." A safer bet, he says, is the dollar/euro pairing, which accounts for 90 percent of forex trading activity."

Frisone also cautions traders to stay clear of high leverage in the currencies markets. "It's all about leverage – if it's too high you can lose five to ten percent in one day," He says the "absolute maximum" level of leverage in this market should be 5:1.

But traders say the real advantage to playing the forex market is the potential returns offered by smaller-market currencies. Wilcox pointed to this year's run-up of the Brazilian real and the Australian dollar as good examples.

Nonetheless, Frisone strongly advises against traders jumping into the market too quickly. "I've seen so many stocks and commodities guys get hammered in currency," he said. "This is where people like me come in - we let you get involved with a professional first and then dabble on your own."

Riding shotgun, as it were.

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