Forex, contracts for difference and spread bet losses:

Bad luck or victim of a scam?

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1. Introduction

Recently there has been much interest in forex, not particularly as an investment but more of as a way of making profits through effectively betting on price changes. Stories and adverts have appeared on social media and the press of individuals making huge sums in this way and offering their services to the general public.

Whilst the fraud investigator may be sceptical about all this, it has to be said that betting in this way, mainly on forex, has become popular and with the prospect of continued market volatility and time on their hands for many, it is likely to continue to boom. As a measure of this, the main firms (they like to refer to themselves as 'brokers') are reporting an upsurge in the demand for what may be collectively called 'forbin' products. Shares in three of the largest brokerage firms that are traded on the LSE rose on average by 80% over the last year compared with a fall in the FTSE100 of 11%.

What is/are 'forbin'? In addition to trading directly in forex, they are derivatives: contracts for difference (CFD) spread bets and, until recently, binary options. Traders simply bet on short term price changes but do not buy the actual currency. Also, rather than forex, punters may bet on stocks and shares, indices, cryptocurrency and commodities price changes.

2. Is forbin profitable?

It is unnecessary to go into the ins and outs of trading, suffice to say, the trader can bet on a price rise ('go long') or a fall ('go short'). If the price goes in the correct direction, he wins and if it goes in the wrong direction, he loses. In the case of a binary option, if he wins, he will get

around 60%-80% of the stake irrespective of the size of the price change but if he loses, he will lose his stake.

The huge attraction of forbin trading is leverage; the trader does not need to put up the entire stake, just a deposit. This means that he can make a much larger bet for the same amount of money. With a 5% margin, the trader can bet up to 20 times the size of his deposit!

What are the chances of winning? Consider the likelihood of winning in roulette. If the player wins, the bank (the casino) pays out double the stake. So, the chance of winning is 0.5 and the minimum necessary to break even. In the case of CFDs and spread bets, where the probabilities of a gain and loss are also equal and if the broker's fees are 0.5%, the probability of success would need to be 0.501247 to break even.[1] In the case of a binary option if the pay-out is 75%, the probability of success would need to be 0.5714.[2]

Why is Forex so popular? The average daily[3] price change for forex is about 0.5% whilst for stocks and shares and commodities it is much higher, around 2.0%.[4] As brokers' costs are around 0.5%, it is difficult to see how a trader can earn profits trading forex. Also, forex price movements are more difficult to predict than stock and share and commodity prices as they are mainly the result of market makers balancing day to day supply and demand for the currency, although in the longer term, they will be sensitive to macroeconomic factors affecting a nation's trading prospects. Predicting forex price changes is also difficult as it is expressed in paired prices, where the price of one currency is expressed in terms of another, e.g. GBP/USD, the price of which will move as a result of changes in the value of either currency.

As the likelihood of success is at best only 50%, the trader will lose in the long term. He may make profits initially and during 'lucky periods' but overall, it will even out to 50% and he will

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[1] Here $\boldsymbol{p}.\boldsymbol{g} = (1 - \boldsymbol{p})\boldsymbol{k}$ and $\boldsymbol{k} = 1.005\boldsymbol{g}$ where, $\boldsymbol{p}$ = the probability of success and $\boldsymbol{k}$ and $\boldsymbol{g}$ and represent loss and gain respectively. This simplifies to $\boldsymbol{p} = (1 - \boldsymbol{p})1.005$ so $\boldsymbol{p} = 0.501247$.

[2] Here $\boldsymbol{p}.\boldsymbol{g} = (1 - \boldsymbol{p})\ \boldsymbol{k}$ and $\boldsymbol{g} = 0.75\boldsymbol{k}$ so $\boldsymbol{p} = 0.5714$.

[3] Of course, It could be that there are much larger price changes during the day.

[4] See Barnes (2021) at https://ideas.repec.org/p/pra/mprapa/105580.html.

lose. Most importantly, as the broker is not actually buying or selling the asset but merely accepting a bet, it is the counterparty to these trades, acting effectively as the banker. So, if the trader wins a trade, the broker loses the same amount. This point is significant when examining the broker's motives leading to scams and fraud. All it has to do is encourage customers to keep trading as they will eventually lose their money – just like a casino. Nevertheless, in some cases, brokers do act unscrupulously, unethically and, in some cases, fraudulently, to hasten this. It is not surprising that when they have lost, customers complain and blame the brokers and regulators. The problem for regulators and legal advisers is: are the complaints valid? Have they been defrauded, is it a scam, or have they simply lost their money?

3. Scams and fraud: The regulation of forbin

3a. The law

In the UK, brokerage firms are regulated by the Financial Conduct Authority (FCA).[5] They are either authorised by the FCA under Section 19 of the Financial Services and Markets Act, 2000

(FSMA) or by the European Securities and Markets Agency (ESMA). Under FSMA, the FCA is also able to provide firms that are authorised in the European Economic Area ('EEA') with a 'passport' across border services to UK citizens in line with the Markets in Financial Instruments Directive 2004/39/EC ('MIFID').[6] If the FCA considers an authorised person to have contravened a requirement under FSMA, it may publish a 'Decision Notice' or 'Public Censure' and, if there has been a contravention, it may impose a penalty. The criteria used to determine satisfactory conduct is contained in their 'principles of business'.[7] If a provider is authorised by the FCA and fails, closes down, or goes into liquidation and there is a deficiency in the client money bank account, customers may be covered by the Financial Services Compensation Scheme ('FSCS') up to a maximum of £50,000.

Under EU financial services law, brokerage firms that are legally established in an EEA country may do business in any other country in the area once certain procedural safeguards are met.

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[5] See www.fca.org.uk.
[6] See www.fca.org.uk/firms/passporting.
[7] www.am-online.com/news/2014/3/28/the-fca-s-11-principles-of-business/34723.

In the US, the primary securities regulator at the federal level is the Securities and Exchange Commission (SEC); derivatives are regulated by the Commodity Futures Trading Commission (CFTC).

From April 2019, the FCA has banned firms from selling binary options in the UK. Therefore, as the sale of binary options is now banned, any firm offering them is probably unauthorised, a clone or a scam. They are also banned firms from sale to retail consumers across the EU and are only legally available in the USA through specified exchanges.

3b. Customers complaints and distrust

Here are some of the common complaints:

1.Over-aggressive and misleading marketing in which brokers are effectively 'boiler rooms' or 'bucket shops'. A common device used to persuade traders to continue to trade is the offer of bonuses and promises of guaranteed trades. A bonus added to the customer's existing balance raises the amount available to trade, causing him to risk larger amounts of money and lose their initial deposit more quickly. Whilst brokers often describe bonuses as effectively 'guarantees' and 'insurance' against losses, this is misleading as they are unable to withdraw funds and the refusal by brokers to refund balances is a common complaint by customers.

2. Managed accounts scams

Often, the inexperienced trader may choose not to trade himself but, instead, be persuaded to use a 'professional' or independent 'expert' to decide on and execute deals or be guided by an 'adviser' or account manager employed by the brokerage firm. There have been many complaints about these 'advisers': that they cajole or even order clients to trade recklessly. The purpose of all this is to maximise the amount of money obtainable from a client and run down his balances as quickly as possible.

It is obvious that these 'advisers' are aware of the effects of their efforts and are simply acting in their own and the broker's interests who as the counterparty stands to gain enormously. They may engage in 'churning' when, unknown to the customer, an unnecessary number of

trades are done by the advisers as they are paid commission for each deal executed and, of course, trading for its own sake inevitably results in losses.

Sometimes information purporting to be professional forecasts are sold to inexperienced to novice traders. A recent development of this is the automated trading system (sometimes called 'robots') which claims to be based on an algorithm devised by an expert will trade automatically for a trader.[8] All the trader need do is hand over the money to the firm administrating the service. Unfortunately, in some cases the customer finds that all the money has been lost through a large number of small trades for which the 'adviser' will make excuses about 'market difficulties'.

3. Manipulated buying and selling prices.

There is a potential problem concerning the prices at which trades are made. The customer may believe that he had bought and closed the deal at certain prices. However, when examining the account, he may discover that different prices have been used and recorded by the brokers affecting not only whether the customer has won or lost the trade but also the amount. It is possible that there is a gap, perhaps just a fraction of a second, between when the trader makes a trade and the broker effects it. This is understandable and is called 'slippage' and is likely to occur during a period of high volatility when market orders are made. If slippage does occur, the price recorded by the broker at the time of execution may be different to that of the trader.[9]

Whilst slippage may be understandable and acceptable, a distinction should be made between it and a 'hidden spread' where there is a difference between the price at which the trader executes (or thinks he has executed) a trade and the price applied by the broker is adjusted by the broker to its advantage. With some brokers, the price recorded never appears on the web page (trading platform) and results in a loss to the trader but he may find it difficult to provide documentary evidence.

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[8] For example, Forex Pro Island, www.forexproisland.com.

[9] See for example, https://www.binaryoptionsblacklist.com/tips/slippage-in-binary-options-trading/.

In some cases, traders have complained that brokers have exploited stock market 'pauses' - when the market crashes and trading is halted by the exchange or a 'flash crash'[10] and taken advantage of closing a trade at a price to their advantage. As the trades are through derivatives and not dealt on the market, they are not, and need not be, affected by the suspension of trading.

Final remarks

If a broker has any sense, it will not manipulate the trades or records and just allow the trader to lose his money through the volume of trading. If this happens, the trader will want to blame someone, probably the broker. It may be possible for him to recover his losses If the brokerage firm is authorised by the FCA and it can be proved that the broker's actions amounted to fraud or scam.

[10] For example, the Dow in 2010, the NASDAQ in 2013, the US bond market in 2014, the NYSE in 2015 and the 2016 UK sterling crash.