Annex

The Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Code of Conduct) sets out the principles that licensed corporations, including leveraged foreign exchange trading (LFET) brokers, should follow. The standards of conduct and internal controls the SFC expects of LFET brokers include:

1. Customer due diligence

LFET products include rolling spot forex contracts as well as other complex products and derivatives such as options and forward contracts, which may be difficult for retail investors to understand. Even for less complex LFET products, the pricing methodologies and trading terms may vary as they are not traded centrally on an exchange. It is thus of paramount importance for LFET brokers to:

(a) take all reasonable steps to establish the financial situation, investment experience and investment objective of each LFET client[1]; and

(b) assure themselves that the client understands the nature and risks of the LFET products they offer and has sufficient net worth to assume the risks and bear the potential losses of trading in the products[2].

Adequate information[3] should be provided so that client is reasonably able to understand the risks associated with LFET. This should include, amongst others:

(a) the risks associated with the underlying market;

(b) the risk of LFET and margin trading[4];

(c) the fact that the product is being sold over-the-counter (OTC) and its implications. This includes, amongst others:

  i. the firm may act as the counterparty to the client's transaction and the client may be subject to the firm's credit risk;

  ii. there is no centralised pricing source and the price of the LFET transaction is determined by the firm or negotiated with the client; and

  iii. the transaction in OTC products may involve greater risk than investing in exchange traded products because there is no exchange market on which to close out an open position; and

(d) the risk that the client order price may be different from the execution price, or slippage[5].

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[1] Paragraph 5.1 of the Code of Conduct.
[2] Paragraph 5.3 of the Code of Conduct.
[3] General Principle 5 (Information for clients) of the Code of Conduct.
[4] In accordance with Schedule 1 (Risk disclosure statements) to the Code of Conduct.
[5] Slippage is the difference between the client order price and the execution price.

2. Handling of client orders

LFET brokers should act honestly, fairly, with due skill, care and diligence, and in the best interests of their clients[6] when handling client orders. They should:

(a) execute client orders on the best available terms[7] and avoid any dishonest and unfair execution practices, such as asymmetrical treatment of positive and negative slippage which allow the broker to retain profits arising from positive slippage, whilst passing losses from negative slippage on to the client; and

(b) adopt a fair pricing methodology[8] by:

i. referencing the prices offered to clients to market data;

ii. using independent and externally verifiable price sources or liquidity providers to derive the prices; and

iii. ensuring that all charges, mark-ups or fees affecting clients are fair and reasonable and characterised by good faith[9].

3. Conflicts of interest[10]

Some LFET brokers' business models present inherent conflicts of interest, in particular where a broker takes opposite positions against client orders or hedges client orders with liquidity providers which are affiliated companies.

Regardless of the business model adopted, LFET brokers should state in the client agreement whether they take opposite positions to client orders[11]. They should take all reasonable steps to avoid any conflicts of interest, and when such conflicts cannot be avoided, ensure that their clients are fairly treated and disclose any actual or potential conflicts of interest before transacting with clients.

4. Information for clients[12]

LFET brokers should provide clear and effective disclosure to clients about how their orders are executed. This should include, amongst others:

(a) the order execution policy, explaining the methodology they use to deliver the best possible outcome when executing orders; and

(b) the methodology for determining the prices of different LFET products.

[6] General Principles 1 (Honesty and fairness) and 2 (Diligence) of the Code of Conduct.
[7] Paragraph 3.2 of the Code of Conduct.
[8] Paragraph 54 of Schedule 6 to the Code of Conduct.
[9] Paragraph 2.2 of the Code of Conduct.
[10] General Principle 6 (Conflicts of interest) of the Code of Conduct.
[11] Paragraph 1(d) of Schedule 6 to the Code of Conduct.
[12] General Principle 5 (Information for clients) of the Code of Conduct.

Specifically, LFET brokers should disclose, amongst others, the following information in their order execution policy:

(a) for LFET brokers adopting a Straight Through Processing model or executing orders on behalf of clients:

    i. the capacity in which they trade with or act for the clients; and

    ii. any intra-group link or relationship between the firm and the liquidity provider with which the client order is executed or hedged;

(b) for LFET brokers adopting a Dealing Desk model:

    i. the fact that they act as the counterparty of client orders and take opposite position to a client's order; and

    ii. the circumstances which give rise to the potential and actual conflicts of interest in their principal-dealing and market-making activities;

(c) the features and operation of different order types available to clients (eg, limit order, good-til-cancelled order, market order, stop loss order and liquidation order); and

(d) how slippage is handled.