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Aspects regarding Online Trading Platforms in Romania: Risks and Regulations

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Abstract. This article examines the main risks associated to the FOREX trading platforms, where participants attempt to achieve profit from exchange rate difference. In the last period, the technological progress has enabled the development of tools to obtain financial income using the Internet and one of these tools is the FOREX market, a virtual market where all transactions take place using a trading system. Although these trading services and seem very easy to use and attractive, there are some risks to consider and and it's not surprising that in Romania, a state member of the European Union, the competent institutions for supervision of foreign exchange transactions identified an increase in the number of companies that are providing unauthorized transactions for individual investors on the trading platforms.

Key words: online transactions, Forex trading, risks, supervision.
JEL classification: F31, O16, O24.

1 Introduction

Forex interest among online individual investors revealed a strong enthusiasm for this new type of investment. These transactions are performed by online traders hoping to profit from the speculation of future exchange rates, most often with minimal knowledge relating to such trading as it has been demonstrated by specialized studies. Due to its ease of use, the Forex market became in short time an alternative to the stock market. Participants are attracted by the idea that it’s a market that works by its own rules and has minimum transaction costs. Although has minimal transaction costs, the risks involved by the Forex market are high and therefore, the purpose of this article is to identify and analyze risks arising electronic trading on the Forex market.

2 FOREX Platforms

FOREX (abbreviation from foreign exchange) is as the name suggests a market where offer meets demand for currencies of the world. Specifically, this market involves trading different currencies in the sense that a certain currency can buy another currency. Trading in this market, which involves buying and selling currencies in the world, is carried out by banks, capital investment companies, brokers and, of course, retail investors (traders) who can with a computer an internet connection and a minimal amount of money to have access on the trading platforms in order to obtain quick profits.

Launching the electronic platforms made possible the access of the retail investor on this market dominated by banks and investment companies and the immediate effect was the reduction of the funds needed to start trading (O. David, 2007). Of course, lowering the barriers attracted many individual investors but also many risks that may occur due to the lack of financial and investment education of those performing such transactions.

The foreign exchange market has a global dimension and highly speculated since, unlike other financial markets where investors and various entities are in contact and perform transaction, and due to this it has a high level of decentralization. On this market investor can be any person or legal entity and everyone is directly negotiating the currencies traded price (market makers). All these characteristics have made Forex market an over-the-counter market (OTC market).

Within this market, most of the transactions have a margin and a *leverage effect*, which means that the investment risk for a retail investor is most often very high. Margin in Forex transactions represents the minimum amount of money placed in the investor's account, as a deposit to start trading. This amount of money is a guarantee for the broker when the retail investor transactions have caused him loss. On the other hand, leverage is the difference between the money deposited in the account by retail investors and the money that broker gives for investment. Thus, a leverage of 100: 1 means that if a retail investor deposited in account €100, offered by the broker, the investor can trade €10.000. It is easy to see that an investor can trade with only €100 an amount 100 times greater, which means that profits and losses are calculated by reference to the amount traded and not deposited (profit and loss is 100 times higher). Thus, if a retail investor loses the amount deposited in the account by way of security is not the only loss he may suffer, being forced to cover also additional losses. Transactions performed by a retail investor through trading platforms made available by authorized companies are lacking of the protection mechanisms that investors benefit from when are investing through regulated entities supervised by the competent national authority in the field of financial services and investment. As a consequence, a retail investor will be deprived of the protection mechanisms that can compensate him. However, entities that are not authorized have no reporting obligations and have no obligation to provide information on the risks to which investors are exposed.

3 Trading and associated risks

With the evolution of digital technologies, the brokers in the foreign exchange market have provided to the participants electronic trading platforms in order to facilitate buying, selling and trading different currencies. All the access barriers have been reduced to minimum capital, a computer and an Internet connection.

Online trading currencies exchange offers customer the opportunity to test a platform with a minimum investment and to observe how the market works in real time. This can be done through a demo account with limited platform functions in order to become attractive for potential investors. The interest in Forex trading became in short time very popular among investors, individuals. But in most cases, these retail investors have lost big amounts of money because it was shown in a recent study that treat currency trading like gambling, not based on decision planning (Boris S. Abbey, John A. Doukas, 2014), revealing that these transactions are dangerous in the online environment for an investor who does not have the basic knowledge necessary to initiate a transaction.

A trading platform allows investors to evaluate the risks through a range of order types: stop loss - stop loss, profit collection - take profit, trailing stop, etc. The use of some computer software that are not listed by the Forex market participants are prohibited for the safety of the investor. Such electronic platforms can automatically generate foreign exchange transactions on behalf of the investor, the latter losing control of any transactions. The investor must verify the legality of the trading platform to protect their personal and banking data. In this way he will not risk to open a false trading account and lose money without his consent.

However, when a Forex investor noticed that his counterpart is better informed and traded more, he will tend to change his investment direction, so this will make a visible impact on his trading behavior and volume (L. Menkhoff, M. Schmeling, 2012). From this point of view we can say that trading platforms may train the ability to think ahead. The psychology of trading is based on how investors speculate the decision to combine a technical analysis with the exchange market positioning. Given that financial brokers offer a small margin when operating on trading platforms, the investor will be subject to a permanent emotional scenario related to the currency speculation. From this point of view, trading psychology is likely to train in time, with the acquisition of know-how.

Forex trading always involves risks, especially when retail investors without experience in complex financial instruments are hypnotized by the online environment, with the mirage of consistent and rapid profits. The major risks faced by retail investors are the complexity of derivative transactions with currency, the exchange rate fluctuations, the margin and the leverage effect, the aggressive marketing and the lack of authorized online trading platforms. According to according to ESMA (European Securities and Markets Authority), a product is considered complex when "is a derivative or incorporate a derivative (a derivative is a financial instrument the value is based on the value of another financial instrument or other indices or underlying financial assets such as currencies or interest rates - often they are included in a financial product to produce or enhance a particular investment strategy and to cover or offset the risks); indices or underlying assets is not easy to measure or whose prices or values are not publicly available; has a duration of fixed investment, for example, with penalties for early withdrawal that are not clearly explained; uses several variables or complex mathematical formulas to determine your return on investment; include guarantees or capital protection are conditional or partial or may disappear if certain events occur".

Because many retail investors don't understand the mechanism and complex transactions that they perform, they not only lose the amount invested, but must pay the intermediary trading platform on which traded the money lost and current fees. Regarding the risks arising from fluctuations in exchange rates, it should be noted that these fluctuations directly and unconditionally influence the retail investor gains and losses.

The risks arising from the deposit made for the transaction, called margin and leverage effect, imply that by submitting a small amount as deposit account enables investors to trade large amounts of money (100 times higher than the amount deposited), for which gains and losses are reported in the amount transacted and not in the amount deposited. The leverage effect is nothing but the multiplication of the potential gain and the potential loss.

The risks resulting from aggressive marketing online is currently considered misleading, incorrect and with missing key information about costs and fees. Many campaigns show only the gains but not the risks attached to these gains. In most cases, unauthorized brokers claim that are authorized and the transactions carried out through them that are secured and guaranteed. A constant presence in the marketing campaigns carried out by brokers are those regarding specialized courses through which retail investors are seduced and convinced to trade. Moreover, most marketing campaigns speak about all kinds of promotions for investors such as free trade at the first attempt, free books and guides, trading gains by simply accessing the trading platform, bonus, high leverage, etc.

It is know that transactions of any kind (even those processed through bank accounts) are not without risks. But the risks are more present and imminent when a retail investor is trading online on trading platforms recommended to be safe and secure.

Complaints of those who were fooled by the mirage of big amounts of money in a short term by accessing the online trading platforms, has increased in recent years because of their credulity and naivety, but also due to the lack of legal regulations and coercive means of the competent authorities.

4 Regulations

The risks involved in such transactions, the large number of investors affected, the aggressive and manipulative methods used by entities authorized to perform such services directly affects the investment market in Romania. In this regard, the authority that regulates and supervises all entities operating in the capital market in Romania (Financial Supervision Authority) has put in the public debate (June 2013) a draft statement that was intended to reduce the risks to retail investors, to limit the illegal activity of entities authorized and to regulate the activity of entities and operations on the Forex market.

According to this draft statement, all derivatives transactions such as sale and purchase transactions with currency pairs (Forex) and transactions of sale contracts for difference (CFD), carried out outside a regulated market or an alternative trading system will be supervised by the capital Market authority. Furthermore, according to the draft, intermediaries offering such services outside a regulated market or an alternative trading system must be licensed and registered in the register kept by the capital market authority.

In addition, in order to reduce the risks posed by Forex market transactions, the draft statement provides that the margin held by the investor will be at least 5% of the national transactions. Thus, the draft states that “in transactions involving derivatives with underlying currency / currencies, conducted outside a regulated market or an alternative trading system, the intermediary is counterparty to retail customers; the customers will be maintained a margin of at least 5% of the national transactions”.

The project also provides instruction and rules regarding advertising and promotion for services and activities performed by the Forex market intermediaries. Only registered intermediaries are allowed to contact potential customers about unsolicited investment services offer. When an intermediate unsolicited contacts a potential client, he must explicitly identify in the early communication, ask the permission to continue the communication, and must avoid putting pressure on the client during communication.

Finally, the draft statement provides that noncompliance constitutes a contravention according to Law no. 297/2004. This set of rules, which until now has not the character of a legal act can be considered a positive start for governing operations and abuse that currently exist in the Romanian Forex market.

5 Conclusions

Starting with the assumption that trading Forex is an online business model that can get quick gains by identifying and analyzing risks of the electronic transactions, it is concluded that in order to benefit from currency fluctuations, a trader must rely more on intuition than on experience gained. Moreover, online marketing campaigns are designed to awake the emotional side of man in his desire to get money, misleading many inexperienced retail investors.

Forex remains one of the markets with the highest liquidity and trading volume, due to the technological progress which opened the door for individual investors in this new type of investment through electronic trading platforms. Indeed, the opportunity to earn money from the foreign exchange speculation and being permanently electronically connected is a concern that has dominated many individuals, but what should be emphasized in the end this is that this investment occupation must be fueled by knowledge and experience.

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