European Securities and Markets Authority

Investor warning
Date: 5 December 2011

Trading in foreign exchange (forex)

Key messages

- *Do your homework: check if the firm is authorised.*
- *Don't use money you can't afford to lose; you could lose more than your initial investment.*
- *Be aware that some product or service offerings could be misleading.*
- *Know the risks involved.*

Why is ESMA issuing this warning?

We have noticed an increase, in some European Union countries, in unauthorised firms offering transactions, or platforms to trade, in currency derivatives in the forex market (such as 'contracts for difference' [CFDs], 'FX forwards', and 'rolling spot contracts'). So, we are warning investors against dealing with unauthorised firms offering foreign exchange investment.

We are also alerting retail investors to the main risks involved in forex trading.

What is foreign exchange (forex) investment, or forex trading?

The foreign exchange market (also called the 'forex market', 'FX market' or 'currency market') is a global financial market that trades in all the world's currencies. It is an international network with no fixed, physical location (i.e. it is 'decentralised'). It is an over-the-counter (OTC) market where brokers and dealers ('intermediaries') negotiate directly with one another.

Forex market participants (for example, banks, investment firms, hedge funds, retail forex brokers and you – the retail investor) buy, sell, and trade in currencies. With just a small amount of money, and access to a computer and the internet, you can easily enter the market using the various electronic online trading platforms made available by forex brokers.

European Securities and Markets Authority

As for any investment in complex or volatile products, investing in the foreign exchange market is not for the unwary or risk-averse investor. If you are a retail investor considering participating in this market, you should fully understand the market, and be aware of the main risks associated with foreign exchange trading, so you can make an informed decision before investing.

If you have any doubts, seek advice from a professional financial adviser who is independent from the forex broker, and who you trust.

Why should investors avoid dealing with unauthorised and unregulated firms?

Many firms, or forex brokers, offer legitimate foreign exchange services and products. But some firms are not regulated, and are not authorised to provide these services or products (including trading platforms).

When searching for an online forex broker, or when contacted by firms or individuals offering these products or services, you may come across some that do not specify whether they are regulated, or falsely claim to be registered, authorised or regulated. Some even falsely claim to be registered, authorised and regulated by ESMA – but we do not authorise or regulate brokers, or any other type of investment firm. This is done by the regulatory authorities in European Union countries.

Be aware of any unauthorised activity: before making a commitment, check with the regulatory authority in your country whether the broker is listed or registered and authorised to provide those products or services.

Many regulatory authorities keep a list of firms (and/or websites) offering forex investments that are not authorised to do so.

If a firm is not authorised (or regulated), it does not have to comply with investor protection rules.

such as safeguarding of client assets, clear information, disclosure of risks, suitability and complaint handling. You will not have access to complaints procedures (financial ombudsmen) or compensation schemes if things go wrong.

What are the main risks associated with retail forex trading?

Complexity

Not all forex transactions are straight-forward. If you do not understand the complex nature of certain transactions in currency-derivatives transactions, you should exercise care.

Before deciding to trade, you should carefully consider your investment objectives, level of experience, and risk appetite.

European Securities and Markets Authority

Volatility

Exchange rates fluctuate depending on a several factors, including political situations, interest rates, monetary policy and inflation. Fluctuations are unpredictable, and the market could suddenly move against your interest. This will affect the price of your forex contract and related potential gains and losses.

Leverage

To start trading, you deposit an amount of money (also called a 'margin', or 'account', or 'security deposit') with your forex broker. Even a small amount of money can enable you to trade large volumes of currency. This is because some forex trading products are highly 'leveraged'.

The smaller the deposit in relation to the underlying value of the contract, the greater the leverage. And the higher the leverage, the more likely you are to lose your entire investment if exchange rates move in a direction you do not anticipate.

When entering into a leveraged investment, you should check with the forex broker what happens when your investment generates a loss. It is very important to understand that although leverage can increase the returns on your investment, it can equally work against you by magnifying your losses. There is a risk that you could lose some of, all, or even more than, your initial deposit.

If a loss is generated, the forex broker may be entitled to unwind the investment which will trigger the loss of your leverage margin. This significantly increases the cost of the investment to the investor.

For example, if you invest €100 with a leverage of 200, you will owe €2000 if the value of the instrument loses 10% of its value (10% of 100 multiplied by 200). In addition to this, you may be obliged to pay transaction fees and/or financing charges.

In a few European Union countries there is evidence that some retail investors suffer substantial losses in this market. You should not invest money that you cannot afford to lose.

Marketing campaigns

As with any other financial product, it is important that you read the marketing material and the contract or legal documents carefully. Exercise care – some advertisements can be misleading and will encourage you to invest without making the risks or the fees clear. Offers of training or trading with 'virtual portfolios' may also encourage you to invest. And some forex brokers use promotional offers such as '10% cash-back up to €500 when you open an account in November: Apply Now'. Be wary of free money.

Don't forget that all financial transactions have a certain amount of risk. Nothing is 'guaranteed' and you could potentially lose all your money. If you don't fully understand how forex trading works, don't be persuaded to invest in it.

Internet trading

When using online electronic platforms for forex trading, you should be careful about using software which automatically generates foreign exchange transactions. You could lose control over any transactions carried out.

You should also exercise care when asked to provide your credit card details in order to start forex trading. Your account may be debited directly without your consent, and it could be very difficult to get your money back.

Further information

If you have any questions or doubts, you should contact the regulatory authority in your country. A list of all the national regulatory authorities, and their websites, is available on our website.