Mecklai Financial
WHERE RISK MEETS ITS MATCH

Take the Right Route to Trading in Forex

With many risks involved in overseas currency trade, resident Indians who want to benefit from forex movements should trade in the exchange traded currency derivatives available in the country.

The introduction of currency derivatives on regulated exchanges four years back opened up a new asset class to Indians.

But beyond the realm of the country's regulatory landscape, an Internet-based overseas foreign exchange trading market also seems to be thriving. It offers more choices and bigger bets. However, trading on it is illegal for Indians and carries high risks.

VIOLATION OF LAW

Internet portals offering currency trading seem ubiquitous these days. They advertise widely — mainly on a variety of Web sites — luring customers with quick returns and big money. On some portals, smiling faces proclaim how easily they made several hundred dollars in a matter of days and invite others to join them. On others, seemingly successful individuals extol the benefits of forex trading and tell how it helped them earn extra income.

Don't fall for the marketing spiel. Not only do you run the risk of losing your money, but you will find yourself on the wrong side of the law.

The Reserve Bank of India (RBI) has, on more than one occasion, cautioned against overseas foreign exchange trading through Internet trading portals. It first issued an advisory in February last year, and then followed up with two notifications — in April 2011 and November 2011 (see links below).

The RBI has observed that "overseas foreign exchange trading has been introduced on a number of Internet/electronic trading portals luring the residents with offers of guaranteed high returns based on such forex trading". It clarifies that "Any person resident in India collecting and effecting/remitting such payments directly/indirectly outside India would make himself/herself liable to be proceeded against with for contravention of the Foreign Exchange Management Act (FEMA), 1999 besides being liable for violation of regulations relating to Know Your Customer (KYC) norms/Anti Money Laundering (AML) standards."

The message is clear. Remittances for such trades are not permitted under the law. Legal action can be taken against Indian residents collecting and remitting such payments. Forex market experts concur on the legal aspect. Says Anil Bhansali, Vice-President, Mecklai Financial Services, "As per FEMA, all these trades are illegal trades. Collection of margin for such online portals is also a contravention of FEMA". Anindya Banerjee, Senior Manager, Kotak Securities, explains, "The RBI does not permit the use of foreign exchange for leverage trading. Generally, the forex portals offer leverage of 'x' times, hence they violate the guidelines of the RBI."

Companies that offer online trade in currencies are usually based outside the country, often in tax havens such as Cyprus. They do not have addresses and contact numbers in India, though they may appoint agents to liaise and solicit clients on their behalf. As such, these companies may be outside the reach of the regulator.

But Indian residents who get into such trades and entities such as agents, banks and credit card companies which facilitate them would be liable to regulatory action.

According to Vikram Murarka, Chief Currency Strategist, Kshitij Consultancy Services, "Legally, the companies are free to offer online trading as they are not answerable to the RBI. The RBI restrictions apply to the resident Indian nationals. So, legally, they are the ones who are to desist from online trading."

OTHER RISKS

While data on how much volume of trade is routed to Internet trading portals offering forex trading are not available, the trend seems to have caught on. As the RBI has observed, many Indian residents have fallen prey to tempting offers and lost money heavily.

Attracted by the lure of handsome returns, the very high leverage offered (bets as high as 400 times or more allowed on the margin), and several currency pairs to trade on (many entities offer as many as 52 pairs), a lot of traders seem to have tested their luck in the overseas currency market, not always with good results.

The risks arise from many sources. The global currency market is arguably the largest and among the most sophisticated in the world.

Gullible investors without the necessary know-how and buoyed by their 'success' in 'demo' trades can easily burn their fingers in the real game.

Further, overseas currency trading offered by Internet portals may be in the nature of 'contracts for difference' (CFD), a different kind of derivative product which many traders may not be familiar with.

The high leverage too acts a double-edged sword. While it has the potential to multiply profits, it magnifies losses. There is also the conversion risk and cost, and commission charge which Indian residents incur when converting rupees to foreign currency and vice-versa.

Finally, there is counterparty risk to the Indian trader — the danger that the party at the other end may not honour its commitment. Most companies offering overseas currency trades execute their trades not on regulated exchanges where trade settlement is guaranteed but in the riskier over-the-counter (OTC) market.

According to Vikram Murarka, "Such companies do not usually execute the trades on exchanges. They almost always operate in the OTC market."

Companies that offer overseas forex trading in India are outside the purview of the country's regulations. Indian residents who find themselves short-changed may have little or no recourse to have their grievances addressed. Remedies, even when available, could be expensive to implement and be a long-drawn process.

The bottomline: With the legal and operational risks involved in overseas currency trade, resident Indians who have the know-how and want to benefit from forex movements should trade in the exchange traded currency derivatives available in the country.

THE LEGAL CHOICE

Currency derivative trade on recognised exchanges, which was allowed by the RBI and SEBI in 2008, has expanded both in terms of product offerings and volumes. Currently, three stock exchanges — NSE, MCX-SX and the United Stock Exchange (USE) — facilitate these trades. The first product to be introduced was currency futures on the US Dollar –Indian Rupee pair.

Futures trading in the Rupee vis-à-vis three other major currencies — euro, British pound and Japanese yen — followed. In 2010, when currency options were allowed on the USD-INR pair, the NSE and USE introduced the product. After a long regulatory battle, MCX-SX also launched USD-INR currency options in August 2012.

The currency futures contracts have a 12-calendar month cycle, and currency options have a three-calendar month cycle. So, today, currency traders in India have a wider basket to choose from. They can trade in futures and options on four major currencies vis-à-vis the Rupee on three exchanges. Trade settlement is guaranteed by the exchanges. All the contracts are cash-settled with no physical contracts.

The bulk of the trades happen on the NSE and MCX-SX with liquidity recently falling on the USE following regulatory scrutiny. The majority of trades happen in the USD-INR pair.

Better liquidity, more currency pairs, and addressing concerns about the cost structure could help attract more traders in the exchange traded currency derivative market.

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