Retail Prop Trading: Rebuilding Trust

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A Primer on the Industry

Retail proprietary trading firms, or retail prop firms, use their capital to fund retail traders. These firms offer a unique opportunity for retail investors to experience proprietary trading experiences that are inaccessible through standard retail offerings, allowing traders to take on large positions without risking their capital. Making it easier for traders to use professional tools and borrow money to buy more stocks creates a helpful partnership. These companies are essentially invested in traders' success because each company funds these traders with its own money. In essence, prop firms democratize the trading experience for retail investors without the barriers to entry of large capital requirements. FTMO, a market-leading company in the industry, reported its fiscal 2023 total payouts amounted to nearly $75 million.

A Retail Prop Firms' Business Overview

The retail Forex market is characterized by two widely acknowledged facts: the arduous nature of retail traders' generating consistent profit and their persistent engagement despite the challenges. Prop firms are born to capitalize on retail traders' pursuits.

From a foundational standpoint, the rationale is to position oneself on the opposite side of customers' trades. If their clients desire to buy a currency, they would sell it, and vice versa. The core refinements to the business model could be categorized into these 3 main strategies:

1. Commissions and Spread Charges

Retail traders lose money over time by making random chance bets on price movements with zero expected value and losing money via commissions and spread charges. It is not always the case that someone consistently loses money from taking on losing trades; the unavoidable costs related to trading are what ensure net loss for the traders. Prop firms systematically charge high spreads and commissions to maximize profits, leading to traders paying high commission costs that erode their capital regardless of their trading performance.

Retail prop firms and traditional brokerages differ in their revenue models and how they interact with the market and their clients. Proprietary trading firms, which trade their own capital and sometimes offer retail traders to trade with the firm's capital, have a distinct position in the market. They generate revenue not only from successful trades but also from commissions and spreads charged to their traders. In contrast, traditional brokerages primarily make money by facilitating trades for retail traders who use their own capital, either charging a set amount per trade or earning through the spread—the difference between the buying and selling price of an investment.

2. Trade "Bucketing" Mechanism

In recognition of the logistical intricacies and expense associated with physically executing currency transactions, such as going into the physical market and buying JPY when a customer says, "I want to buy $1,000 worth of JPY," prop firms implement a sophisticated "bucketing" strategy. When a customer wants to execute a trade, prop firms record this desired transaction as a notional value in their financial books rather than engaging in actual currency exchanges. Hence, this nuanced approach allows the platform to profit without directly participating in the actual FX market, streamlining operational efficiency and mitigating resource-intensive processes.

3. FX Futures Taking Bets on Margin

Prop firms allow customers to take more bets on margin via FX Futures by giving them more purchasing power. Instead of providing a customer $1,000 to buy $1,000 worth of JPY, this same trade could be executed while only requiring $100 from the customer. If JPY moves 1 percent against them, they lose all their money. If JPY moves in their favour by 1 percent, they will double their money. To mitigate the risk associated with margin trading, firms diversify their investments across different instruments by setting strict risk parameters with stop-loss orders and enforcing margin calls to protect their capital. They monitor positions in real-time to respond to market changes, maintain internal risk limits to control margin exposure, and use derivatives like options and futures for direct hedging. Moreover, firms prioritize liquidity management and adhere to regulatory capital adequacy requirements. Hence, these risk management practices are crucial for prop firms to maintain financial stability and safeguard against potential losses. However, despite these measures, the odds remain in the prop firm's favour.

Case Study: MyForexFunds

MyForexFunds, a popular prop firm, was charged by the CFTC for fraudulently soliciting over $300 million from customers. MyForexFunds uses software to manipulate trade executions, hindering transparency and regulatory compliance. MyForexFunds misrepresent their services of promising customers to trade with the firm's capital against 3rd party liquidity providers; in reality, they counter all customer trades and engage in deceptive practices. The firm profited from customer losses, creating a conflict of interest that was hidden from the clients. It used manipulative software to alter trade executions, introducing delays and slippage, resulting in less favourable trade outcomes for its customers. This manipulation made it difficult for traders to realize profits. The firm also imposed misleading commission charges and unjustly terminated customer accounts, often citing rule violations as a pretext to seize funds and profits. Successful traders were handicapped by the firm through automatic delays and slippage, reducing their profitability. All these practices were part of a broader scheme of false promises and misrepresentations made to retail customers, who were lured with the prospect of becoming professional traders using the firm's resources. Collectively, these actions constituted a breach of trust and legal compliance, leading to regulatory action against MyForexFunds. The CFTC's action underscores the need for firms to adhere to legal and ethical standards to maintain market integrity and protect investors. Hence, the industry is now contending with increased scrutiny and tighter regulations in the future. From an end-user perspective, they are drawn to these firms expecting to engage in fair and transparent trading activities. At the same time, the developments of this situation are likely to lead to a more stringent verification process for traders, limiting access to prop trading opportunities for some.

Deceptive Practices With MyForexFunds

The enforcement action of the Commodity Futures Trading Commission (CFTC) against MyForexFunds unveils the following shady practices:

Misleading Commissions

MyForexFunds misrepresented commissions as charges imposed by third-party liquidity providers, while in reality, they are deducted directly from customer account equity. MyForexFunds does not face any third-party commissions for trades where it acts as the counterparty. Essentially MyForexFunds told their customers they had to pay fees to other people for trading, but instead, they were taking the fees directly from their customers' money without telling them.

Slippage Manipulation

Some of their customers have to wait longer for their trades to happen, making it harder for them to make money. In a process to add additional hurdles to profitable traders, the company resorts to a process known as "STP'ing." Although this is rare, a selected few are routed to an off-exchange leveraged forex and commodities dealer outside of the U.S., which results in worse price execution than MyForexFunds would by negotiating with the external dealer. MyForexFunds sends their trades to a different place where they don't get as good deals, which makes it even harder for them to win in the trading game.

Recent Developments

In the aftermath of the MyForexFunds case, the U.S. Securities and Exchange Commission (SEC) and CFTC have enforced regulations prohibiting trading Contracts for Differences (CFDs) under securities law. MetaQuotes, the developer behind the most prominent trading platforms in the prop industry, MetaTrader 4 (MT4) and MetaTrader 5 (MT5), has implemented stricter licensing rules, leading to the termination of services for firms like FundingPips, FundedEngineer, etc., due to the presence of active U.S accounts. MetaQuotes's decision to crack down on firms with a U.S. Client Base has significantly influenced the prop trading industry within the past few weeks. Given the abrupt licensee cancellation, this has caused a significant disruption in prop firms' operations. Prop firms that relied heavily on MetaTrader platforms faced immediate operational challenges, as their ability to offer trading services was directly tied to the licensing agreements with MetaQuotes. Traders depend on the stability and reliability of their platforms for their trading activities, and sudden service disruptions could undermine trust and confidence. This is particularly true for traders with open positions or pending payouts, as the continuity of their trading activities and the security of their funds have been jeopardized. There may be a shift towards prioritizing regulatory compliance and transparency to mitigate the risk of sudden license cancellations in the coming days and build resilience against similar disruptions. In addition, the impact on other market players, such as liquidity providers and technology partners, is also significant as these entities may experience a loss of business from prop firms that are forced to cease operations or switch platforms. This makes the case for reshaping the market landscape and influencing the development of new regulatory-compliant business models.

Problems With Grey-Labeling

The common denominator across current firms that have temporarily paused their services is using grey-labeling proprietary technology instead of building it in-house. Grey-labeling is when firms partner with established brokers to use their trading infrastructure and branding. This allows them to offer trading services without needing to develop and maintain their own technological stack, which is a cost-effective solution for smaller prop firms and could be deployed quickly. PurpleTrading, ThinkMarkets, and EightCap are brokers that grey-label their services to 80 percent of all prop firms. However, outsourcing to a 3rd party comes with limitations in terms of control and customization. The absence of direct oversight on their technological infrastructure leaves prop firms vulnerable to their platform providers' decisions, including how and when to implement regulatory changes and control over consumers' data. Regulatory changes exacerbate this issue, given the platform providers' limited flexibility. The fallout from the stoppage could be complex as it forces firms to build their own technology or switch brokers. Migrating into a new broker's server could be filled with technical obstacles and complications to compensate traders, as well as putting customers in a bind as they lose access to their preferred trading platform.

A Potential Remedy

In response to recent turbulence, prop firms should explore alternative solutions while navigating through the complexity of the regulatory landscape. A viable strategy for firms is to emulate the business model of FTMO, another trading company, as they have demonstrated consistent resilience and innovation by earning recognition of Deloitte Fast 50 awards. To seek long-term stability in the industry, firms should start investing in building robust in-house technology tailored to the firm's operational needs and customization preferences. Although developing proprietary technology requires significant initial investment in research and development, as well as significant ongoing maintenance and updates to ensure the platform remains competitive and secure, it is vital as it would remove the reliance on outside trading platforms. While other firms adopt a grey-labeling approach, FTMO has strategically acquired its own MetaQuotes licensing, a move that underscores the firm's commitment to providing a stable and reliable trading environment for its clients. By securing direct licensing from MetaQuotes, FTMO ensures uninterrupted access to the popular MetaTrader platforms, granting them greater control over their trading infrastructure and the ability to offer consistent services to traders.

In the case of FTMO, they also provide a comprehensive education program and psychological support to enhance their platform's appeal. The firm provides extensive learning resources about market dynamics and trading techniques to empower traders with knowledge to make informed decisions. In addition, FTMO's innovative approach includes psychological sessions led by experts, helping traders develop mental resilience and discipline. Other firms could replicate this approach of fostering a conducive environment for traders to drive and making their platforms more attractive.

Another option is to integrate the DXtrade trading platform as it is designed to comply with U.S. regulations, thus allowing firms to continue offering services to their U.S. clients. Integrating the DXtrade trading platform offers proprietary trading firms a compliant solution for serving U.S. clients, aligning with U.S. regulations, and potentially avoiding conflicts with the SEC and CFTC. The platform's customization capabilities allow firms to tailor the trading experience, while advanced risk management tools help safeguard against losses. However, the transition to DXtrade could pose integration challenges and necessitate a learning period for both staff and clients, potentially disrupting trading activities. Firms could also explore temporarily excluding U.S. clients, allowing them to focus on markets where their business model is permissible and lucrative, lowering the chance of getting tampered with by the SEC and CFTC.

In conclusion, the proprietary trading platform industry faces a pivotal moment after the MyForexFunds case and subsequent regulatory actions. The situation with MyForexFunds has underscored the importance of transparency and regulatory compliance in this sector. Companies that commit to ethical practices will shape the industry's future, especially the ones with clear communication about fees and processes. Additionally, firms that facilitate their in-house technology and adopt innovative solutions like FTMO would likely come to the forefront. As the industry navigates through turbulent times, the commitment must be to create a fair and transparent trading environment for the traders to secure the long-term viability and integrity of the proprietary trading industry.