Chapter 02
The participants and their roles

1. Global Trade And The Currency Market - The Big Picture Matters
2. The Main Players In The Forex Market
3. Doing Brokers Due Diligence
4. True And False Myths

Topics covered in this chapter:
- The case of US trade deficit as a starting point to build your global picture.
- Why Bretton Woods carried the seeds of its own destruction.
- Who makes the exchange rates and how they are made.
- How major participants deal with each other in the interbank, the wholesale market.
- The global currency markets are mostly inhabited by banks, but brokers and dealers create the market at the retail level.
- How a retail broker interacts with the interbank network.
- Technologies and liquidity aggregators that shape the market.
- Choosing a broker: main criteria in a due diligence process.
1. Global Trade And The Currency Market - The Big Picture Matters

Before going into the interbank world and then examine the dealing processes, let's have a second look at some key underlying economic principles of the modern history of global trade and capital flows, partly covered in the previous chapter, and see why these developments still matter today.

As you learned in Chapter A01, representatives from 44 different nations who converged at the Bretton Woods conference in 1944 were determined to cobble together a system that would prevent additional depressions and to ensure a fair and orderly market for cross-border trading conditions. Most countries agreed that international economic instability was one of the principal causes of WW II, and that a new system was needed to facilitate the reconstruction process.

At that time the US was not prepared to pay with their surplus the debt of the countries ruined by war. And these, in turn, did not want to depend forever on the US economy. As a result, an agreement was reached halfway: the conference produced a new exchange rate system which was partly a gold exchange system and also a reserve currency system, with the US Dollar as a de facto global reserve currency.

While in the early 70s many economists supported the idea that the gold-US Dollar peg was not the best regime for a growing international economy, a completely free floating exchange rate system was neither seen as favorable as it could end up in competing devaluations, the destruction of cross-border trade and ultimately lead to a global depression. The Smithsonian Agreement was an attempt to reestablish a fixed rate system but without the backing of gold.

The value of the Dollar could fluctuate in a range of 2.25%, unlike the previous range of 1% during the Bretton Woods. However, this agreement also failed in the end. Under heavy speculative attacks, the price of gold shot to 215 US Dollars per ounce, the US trade deficit continued to rise and the Dollar, therefore, could be devalued more than the 2.25% limit band set in the agreement. Because of this, the currency markets were forced to close in February 1972.

Currency markets reopened in March 1973, when the Smithsonian agreement was already history. The value of the US Dollar would be determined by market forces, and not be confined to a trading band or be tied to any other asset. This allowed the Dollar and other currencies to adjust themselves to the global economic reality and paved the way for an inflationary period never seen before in modern times.
The political understanding that underpinned Bretton Woods is of importance here, as the United States made itself the core of the new system, agreeing to become the trading partner of first and last resort. This has obviously tremendous implications on monetary matters. Although this has apparently no direct implications on your daily trading, it is a key aspect to understand the market flows and many of the monetary decisions taken by nations through their monetary authorities.

While nothing that has been discussed in the previous chapter is wrong, it is only part of the story. For you as a trader and investor, there is a political dimension of the current system that matters, as it can condition your career at some point. **If you learn to identify the underlying forces that move the capital flows, you will be able to develop trading strategies that fit the big picture.**

In words of Van K. Tharp, author of Trade Your Way To Financial Freedom:

> I now recommend that all of my clients develop a business plan in which they play out their own long-term scenarios for trading. In that plan you must ask yourself, What do you think the big picture will be over the next 5 to 20 years? And the answer to that question will help you focus on the markets to trade and the type of trading you might want to do.

> As I was laying out my version of the big picture for you, it suddenly dawned on me that what I’m suggesting is that everyone do some form of mental scenario thinking as the basis for your trading. At one level, you can focus on the big picture as I just did and come up with markets
that you want to concentrate on with some expectation of the type of results you can get. Or, as an alternative, you can drill down into the big picture on a regular basis and become more and more of a mental scenario trader-investor.


Without an explicit mechanism like a gold exchange, the similarities between the original Bretton Woods system and its more recent counterpart are interesting and instructive. Not only the system still relies on the willingness of the participants to actively support it, but also today’s system is characterized by the economic and political relationship the US has with rapidly emerging economies.

For a time, the original Bretton Woods system seemed to favor all nations involved. Considering the desperation and destitution of European countries and Japan, ruined by the war, they were willing to accept nearly whatever was on offer in the hope of their rebuilding process. They were totally dependent upon US willingness to remain engaged. On the other side, in view of the unprecedented and unparalleled US economic strength, economic aid packets were the obvious way to go.

These emerging countries rebuilt their economies on the backs of their growing export markets. The United States would allow Europe nearly tariff-free access to its markets. The sale of European goods in the US would then help Europe develop economically and, in exchange, the United States would receive deference on political and military matters: remember, by then the NATO was born.

In the US growing affluence increased the demand for an ever-growing array of products from overseas markets. Predictably US imports grew and so did the US trade deficit. A trade deficit increases when the value of imports exceeds that of exports, the opposite of a trade surplus. In textbook economic theory, market forces of supply and demand act as a natural correction for trade deficits and surpluses. One would expect the value of a currency to appreciate as demand for goods denominated in that currency increases.
For updated data on the US trade deficit please visit the [US Census Bureau's website](http://www.calculatedriskblog.com/).

Here's a brief video explaining the concept of the current account which will help you understand trade flows, deficits and surpluses.
What happened however with the Bretton Woods arrangements was that the exchange rate system mandated the foreign central banks to intervene in order to keep their currencies from exceeding the Bretton Woods target levels. They did this through foreign exchange market purchases of Dollars and sales of other currencies like British Sterlings, German Marks and Japanese Yen. This procedure resulted in lower export prices from these countries than what market forces would predict, making them still more attractive for US consumers, thus perpetuating a mutual dependency on the system.

Whereas in the original Bretton Woods the greatest limiter was the availability of gold, now it has become and remains to be the whim of the US governments monetary authorities.

Once the monetary system discussed in the Bretton Woods conference was configured according to the US plan, the chance of having a means of payment to cover the needs of international transactions and to establish reserves to address potential deficits, that is, to have the necessary international liquidity, was given by the gold reserves and US Dollars of those countries with some power over the International Monetary Fund.

As many economies grew, more Dollars were demanded to be used in international trade. The fundamental dilemma was: on the one hand, the US had to print more Dollars and run a balance-of-payments deficit in order to satisfy that growing liquidity demand; on the other hand, a continued deficit led the US Dollar to a loss of credibility as a sound reserve currency.
After the WW II, the United States was the only country able to provide all the material needs for the reconstruction. European countries did not have enough Dollars and, since their reserves were low, they had to become debtors of the United States, which meant that their balance of payments would have a surplus. There was no other solution than to "beg" the Unites States to run a balance-of-payments deficit, which by the way was also in the interest of the US.

The perpetuation of US deficits year after year would inevitably entail substantial risks for the gold convertibility which was the backbone of the system. But the only way to provide international liquidity, given the limited flexibility in the extraction of new gold, was deficits in the north-American balance-of-payments or, put in another way, that other countries would deliberately run a surplus in their balance-of-payments by accumulating Dollars.

To this contradiction between the need for Dollars (hence need for US deficits), and the confidence in the Dollar's convertibility to gold (based on US metal reserves), we must add another aspect of the system. This aspect discriminates different countries in relation to the US creating an asymmetry in their economical decision taking processes: if a country had a deficit in its balance-of-payments and expected the situation to continue, that country was under the obligation to proceed with an internal deflationary policy. Ultimately, because the lack of sufficient reserves, the country had to take contractionary measures to devalue its currency. But the US, being the creator of the system's underlying currency, was not forced to take that kind of action.

A revival of Bretton Woods?

Much of the arrangements the Bretton Woods system brought into existence continue to be relevant in today's global market. Some observers call it the "Bretton Woods II" making reference to the system of currency relations in which currencies, particularly the Chinese renminbi (Yuan), remained pegged to the US Dollar. The argument is that a system of pegged currencies is both stable and desirable although this notion causes considerable controversy and opens the question: how long a system of heavily managed exchange rates as seen in many emerging market economies will last?

The answer depends on the expectations of the US creditors, mainly the Asian economies. The similarities between the original system and Bretton Woods II are evident: the US deficit, the US loose monetary policies, the fixed pegs to the US, and the massive ongoing reserve accumulation by Asian central banks. These exchange rate policies can lead to an inflation rise in those emerging economies forcing them to
abandon the pegs and/or letting currencies appreciate at a faster rate as a necessary step to control inflation.

Over the very long term, economies move in cycles and what were yesterday's emerging economies, like Japan or Germany, become today's stable, mature markets while other countries step into the role of the emerging countries and join the globalization party, such as the case of China, India, or Brazil. Suddenly it was 1944 all over again: what made economic sense for the emerging markets of yesterday continues to make sense for those of today and likely for those of tomorrow.

Just like their predecessors, many of these countries, particularly China and other Asian economies, believe today that keeping undervalued currencies is a key to grow and sustain their exports to the developed markets of the US and Europe and thus to increase domestic wealth. This shows why fixed-rate systems never died out completely. These countries' central banks see a weak currency as a critical element of the country's export-oriented economic policy. But on the other side the inflationary pressures derived from this monetary policy are creating serious problems to their economies.

The US trade deficit grew to unprecedented highs throughout the so-called Bretton Woods II, supported by strong US consumer demand and the rapid industrialization of China and other emerging economies. As of today, the US Dollar is still the most extended reserve currency and the form in which many countries hold US debt instruments.

Clearly, any dramatic moves on the part of the countries that have accumulated large holdings of US Dollar reserves to change the status quo arrangement would have the potential to create turbulence in international capital markets. For instance, the political relationship between the US and China is also a significant part of this equation and of the big picture itself. This has always been a sensitive political topic and of much importance when considering the current monetary system.

Joseph Trevisani writes in one of his market views:

"The funds will be borrowed from foreign governments with their own political and economic agendas. For China the logic is clear. China is the world’s largest holder of US Treasury securities with $653 billion in their vaults."

Asian economies seem to be willing to perpetuate this status quo because the US consumer has supported the growth of their economy during the last decades. But at
this point you are surely raising questions like: What happens if they don't want that
debt anymore? Or, what if one or another member of this arrangement concludes that
its self-interest lies in abandoning the system? These are certainly questions that
belong to a broad analysis and for which you should try to find objective answers.

Joseph Trevisani is one of our contributors. Read all you can from this
author to get a clear view of the big picture.

Axel Merk, who shares his insights with us in his regular market outlook, states the
following:

To give a little more background as to why the Dollar may indeed become
a topic of the G-20 Bretton Woods II meeting, some historic perspective
may be in order. In a 2003 analysis entitled Global Warming, we wrote:
The most recent experience to a serious Dollar devaluation dates back to
1971 when the US abandoned the gold standard on August 15. There are
parallels to the events at the time. When the 1944 gold standard (Bretton
Woods agreement) was put in place, the US Dollar quickly became the
world’s preferred reserve currency, as it was not only the only currency
convertible into gold (at $35 an ounce), but - unlike gold - it also paid
interest. In the second half of the 1960s, LB Johnson increased
government spending in a booming economy with full employment
causing major imbalances. LBJ was more interested in re- election than
in taming the economy. As a result, more Dollars were printed and
foreigners started to exchange their US Dollars for gold. By 1970, only
55% of the US Dollar was backed by gold; by 1971, that ratio had fallen
to 22%. To support the Dollar, the German Bundesbank (Buba)
purchased US$4bn in April 1971. On May 4, 1971, the Buba purchased
US$1bn in 1 day, and on May 5, 1971, the Buba purchased US$1bn in
the first hour of trading, after which intervention was given up and
currencies were allowed to float freely. A severe devaluation of the Dollar
ensued. Similar imbalances have been re-created today, except that the
US Dollar is no longer backed by gold and foreigners hold US Treasuries;
Asian countries in particular may have little choice, but to sell their
holdings as they feel obliged to inject money into their domestic
economies.

Continue reading...
While this first part of the chapter covers only few aspects of the big picture and leaves some questions in the air, it should encourage you to complete it and build your own version upon which to develop your trading. You also need to create ways to monitor and measure what might be going on in the world. This way you will be flexible to adapt to new conditions if things change (and they do change), and you will understand that while some aspects of the big picture imply a crisis, every crisis can also be seen as an opportunity.
2. The Main Players In The Forex Market

When the US Dollar went off the gold standard and began to float against other currencies, the Chicago Mercantile Exchange began to create currency futures to provide a place where banks and corporations could hedge the indirect risks associated with dealing in foreign currencies.

More recently, currency gyrations have centered on a massive move away from currency futures to more direct trading in the Forex spot markets where professional currency traders, alongside with forwarding contracts, derivatives of all kinds, deploy their various trading and hedging strategies.

The idea of currency speculation has been actively marketed, and this is having a profound effect on the foreign exchange planning not only of nations - through their central banks - but also of commercial and investment banks, companies and individuals. These are the main categories of participants - a geographically disperse Forex clientele - and as a consequence so is the market as a whole. In practice, the foreign exchange market is made up of a network of players clustered in various hubs around the globe.

The key difference among these market participants is their level of capitalization and sophistication, where the elements of sophistication mainly include: money management techniques, technological level, research abilities and level of discipline.

Among the market players it is the individual trader who has the least amount of capitalization. In the absence of this strength, besides of emulating those other elements of sophistication of the institutional players, individual traders are forced to impose discipline on their trading strategies. Those who can impose discipline will gain the ability to extract positive returns from the Forex markets.
Commercial And Investment Banks

Let's start dissecting the bigger players: the banks. Though their scale is huge compared to the average retail Forex trader, their concerns are not dissimilar to those of the retail speculators. Whether a price maker or price taker, both seek to make a profit out of being involved in the Forex market.

What is a market maker? To be considered a foreign exchange market marker, a bank or broker must be prepared to quote a two-way price: a bid price which is the market makers’ buying price and an offer price is their selling price to all inquiring market participants, whether or not they are themselves market makers. Market markers capitalize on the difference between their buying price and their selling price, which is called the "spread". They are also compensated by their ability to manage their global FX risk using not only the mentioned spread revenues but also netting revenues and revenues on swaps and conversions of residual profits or losses.
The exchange rates can be declared through foreign exchange dealers across the globe over the telephone or electronically via digital dealing platforms.

There are hundreds of banks participating in the Forex network. Whether big or small scale, banks participate in the currency markets not only to offset their own foreign exchange risks and that of their clients, but also to increase wealth of their stock holders. Each bank, although differently organized, has a dealing desk responsible for order execution, market making and risk management. The role of the foreign exchange dealing desk can also be to make profits trading currency directly through hedging, arbitrage or a different array of strategies.

Accounting for the majority of the transacted volume, there are around 25 major banks such as Deutsche bank, UBS, and others such as Royal bank of Scotland, HSBC, Barclays, Merrill Lynch, JP Morgan Chase, and still others such as ABN Amro, Morgan Stanley, and so on, which are actively trading in the Forex market.

Among these major banks, huge amounts of funds are being traded in an instant. While it is standard to trade in 5 to10 million Dollar parcels, quite often 100 to 500 million Dollar parcels get quoted. Deals are transacted by telephone with brokers or via an electronic dealing terminal connection to their counter party.

<table>
<thead>
<tr>
<th>Top 10 Currency Traders</th>
<th>Name</th>
<th>% of Volume</th>
</tr>
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<tbody>
<tr>
<td>% of overall volume, May 2007 Rank</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>Deutsche Bank</td>
<td>19.30</td>
</tr>
<tr>
<td>2</td>
<td>UBS A0</td>
<td>14.65</td>
</tr>
<tr>
<td>3</td>
<td>Citi</td>
<td>9.00</td>
</tr>
<tr>
<td>4</td>
<td>Royal Bank of Scotland</td>
<td>8.30</td>
</tr>
<tr>
<td>5</td>
<td>Barclays Capital</td>
<td>8.20</td>
</tr>
<tr>
<td>6</td>
<td>Bank of America</td>
<td>5.28</td>
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<tr>
<td>7</td>
<td>HSBC</td>
<td>4.38</td>
</tr>
<tr>
<td>8</td>
<td>Goldman Sachs</td>
<td>4.14</td>
</tr>
<tr>
<td>9</td>
<td>JPMorgan</td>
<td>3.33</td>
</tr>
<tr>
<td>10</td>
<td>Morgan Stanley</td>
<td>2.95</td>
</tr>
</tbody>
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Source: http://www.Euromoney.com forex survey

Many times banks also position themselves in the currency markets guided by a particularly view of the market prices. What probably distinguishes them from the non-banking participants is their unique access to the buying and selling interests of their clients. This "insider" information can provide them with insight to the likely buying and selling pressures on the exchange rates at any given time. But while this is an advantage, it is only of relative value: no single bank is bigger than the market - not even the major global brand name banks can claim to be able to dominate the market. In fact, like all other players, banks are vulnerable to market moves and they are also subject to market volatility.
Similar to your **margin account** with a broker, the banks have established debtor-creditor agreements between themselves, which make the buying and selling of currencies possible. To offset the risks of holding currency positions taken as a result of customer transactions, the banks enter into reciprocal agreements to **quote** each other throughout the day on preset amounts. Direct dealing agreements can include that a certain maximum spread will be upheld, except under extreme conditions, for example. It can further include that the rate would be supplied in a reasonable amount of time.

For instance, when a costumer wants to sell 100 million Euro, the procedure is as follows: the bank's sales desk receives the costumer's call and inquires the dealing desk at which exchange rate they are able to sell to the costumer. The costumer can now accept or deny the offered rate.

As a **market maker**, the bank has to handle the order in the **interbank market** and assume the risk for that position as long as there is no counterpart for that order.

Let's assume that the customer accepts the bank's buy price then the Dollars are immediately credited to the customer. The bank has now an open short position over 100 million Euro and has to find either another costumer order to match with this order, or a counter party in the **interbank market**. To do such transactions, most banks are nourished by electronic currency networks in order to offer the most reliable price for each transaction.

The **interbank market** can therefore be understood in terms of a network, consisting of banks and financial institutions which, connected through their dealing desks, negotiate exchange rates. These rates are not just indicative, they are the actual dealing prices. To understand the uniformity of prices, we have to imagine prices being instantaneously collected from crossed prices of hundreds of institutions across an aggregated network.

Besides of the available technology, the competition between banks also contributes to the tight spreads and fair pricing.
Central Banks

The majority of developed market economies have a central bank as their main monetary authority. The role of central banks tends to be diverse and can differ from country to country, but their duty as banks for their particular government is not trading to make profits but rather facilitating government monetary policies (the supply and the availability of money) and to help smoothen out the fluctuation of the value of their currency (through interest rates, for example).

Central banks hold foreign currency deposits called "reserves" also known as "official reserves" or "international reserves". This form of assets held by central banks is used in foreign-relation policies and indicates a whole lot about a country's ability to repair foreign debts and also indicates a nation's credit rating.

While in the past reserves were mostly held in gold, today they are mainly held in Dollars. It is common for central banks nowadays to possess many currencies at once. No matter what currencies the banks own, the Dollar is still the most significant reserve currency. The different reserve currencies that central banks hold as assets can be the US Dollar, Euro, Japanese Yen, Swiss Franc, etc. They can use these reserves as means to stabilize their own currency. In a practical sense this means monitoring and checking the integrity of the quoted prices dealt in the market and eventually use these reserves to test market prices by actually dealing in the
interbank market. They can do this when they think prices are out of alignment with broad fundamental economic values.

The intervention can take the form of direct buying to push prices higher or selling to push prices down. Another tactic that is adopted by monetary authorities is stepping into the market and signaling that an intervention is a possibility, by commenting in the media about its preferred level for the currency. This strategy is also known as jawboning and can be interpreted as a precursor to official action. Most central bankers would much rather let market forces move the exchange rates, in this case by convincing market participants to reverse the trend in a certain currency.

You can access a lot of reports published at FXstreet.com in which jawboning tactics are mentioned.

Paolo Pasquariello explains price action in proximity to interventions stating:

“Central Bank interventions are one of the most interesting and puzzling features of the global foreign exchange (forex) markets. More often than usually believed, domestic monetary authorities engage in individual or coordinated efforts to influence exchange rate dynamics. The need to strengthen or resist an existing trend in a key currency rate, to calm disorderly market conditions, to signal current or future stances of economic policy, or to replenish previously depleted foreign exchange reserve holdings are among the most frequently mentioned reasons for this kind of operations.

Source: “Informative trading or just costly noise? An analysis of Central Bank interventions” by Paolo Pasquariello

As you see, holding reserves is a security and strategic measure. By spending large reserves of foreign currency, central banks are able to keep the value of their currency high. If they instead sell their own currency they are able to influence its price towards lower levels. The consequence of central banks having purchased other currencies in an attempt to keep their own currency low results, however, in larger reserves. The amount central banks hold in reserves keeps on changing depending on monetary policies, on supply and demand forces, and other factors.
In extreme circumstances, for instance after a strong trend or imbalance in a currency exchange rate, keep a close eye on central bankers rhetoric and actions, as an intervention may be adopted in an attempt to reverse the exchange rate and nullify a trend set by speculators. This is not something which happens often but can be seen specially at times when exchange rates get a bit out of hand, either falling or rising too rapidly. At those times central banks may step in in order to generate a specific reaction. They know the market participants pay close attention to them and respect their comments and actions. Their sheer financial power to borrow or print money gives them a huge say in the value of a currency. The opinions and comments of a central bank should never be ignored and it is always good practice to follow their comments, whether in the media or on their website.

You can follow all central bank related topics and news through our RSS.

Interventions may work for a certain period of time. The Bank of Japan has the most active track record in that regard, while other countries have traditionally taken a hands-off approach when it comes to the value of their currencies.

In March 2009 the Swiss National Bank announced it would intervene in the currency market buying foreign currencies to prevent a further appreciation of the Swiss franc. As a result, the Swiss franc weakened significantly and EUR/CHF jumped more than 3% higher. Kasper Kirkegaard from Danske Bank A/S reports the tactic in one of his reports.
Businesses & Corporations

Not all participants have the power to set prices as market makers. Some just buy and sell according to the prevailing exchange rate. They make up a substantial allotment of the volume being traded in the market.

This is the case of companies and businesses of any size from a small importer/exporter to a multi-billion Dollar cash flow enterprise. They are compelled by the nature of their business - to receive or make payments for goods or services they may have rendered - to engage in commercial or capital transactions that require them to either purchase or sell foreign currency. These so called "commercial traders" use financial markets to offset risk and hedge their operations. Non-commercial traders, instead, are the ones considered speculators. It includes large institutional investors, hedge funds and other entities that are trading in the financial markets for capital gains.

In an article taken from the Forex Journal, a special edition by Trader's Journal magazine in November 2007, Kevin Davey details in funny words why you should mimic non-commercial traders:

One automobile company recently attributed a large portion of its earnings to its Forex trading activities. These groups should strike fear into the little minnows because these groups are the professional sharks. These organizations trade day and night, know the ins and outs of the market and eat the weak. Big moves in the market are usually the result of the activities of professionals, so following their lead and following the trends they start may be a good strategy.

In the same waters that the professional sharks swim, there are also a lot of minnows. They are also your competition, so knowing their tendencies can help you exploit them. For example, unsophisticated minnow traders are likely to put stop-loss orders at obvious support or resistance levels. Knowing this, you can exploit this tendency and feed on them.

Also, think about the first sure thing chart formation that you ever learned about. Chances are that new traders are just learning about that formation now, so you could fade their trades and likely do all right. Think of it this way - defeating a foe sitting at his desk in his home office trading the Forex market in his bunny slippers is probably easier than defeating an MBA with a $5000 suit who trades via complex neural network arbitrage programs. So, try to mimic and follow the sharks and eat the minnows. 'This is where having a plan to make you a more agile 'minnow' or even turn you into a 'shark' is critical.
Fund Managers, Hedge Funds and Sovereign Wealth Funds

With Forex trading surging in recent decades, and as more individuals earn their living trading, the popularity of riskier investment vehicles like hedge funds has increased. These participants are basically international and domestic money managers. They can deal hundreds of millions, as their pools of investment funds tend to be very large.

Because of their investment charters and obligations towards their investors, the bottom line of the most aggressive hedge funds is to achieve absolute returns besides of managing the total risk of the pooled capital. Foreign exchange advantage factors like liquidity, leverage and relatively low cost create a unique investment environment for these participants.

Generally speaking, fund managers invest on behalf of a range of clients including pension funds, individual investors, governments and even central banks. Also government-run investment pools known as sovereign wealth funds have grown rapidly in recent years.

This segment of the foreign exchange market has come to exert a greater influence on currency trends and values as time moves forward.

Another type of funds, made up of government-run investment pools, are "sovereign wealth funds”. Read more about this subject.

Internet Based Trading Platforms

One of the great challenges to the institutional Forex and how exchange related businesses are being handled has been the emergence of the Internet-based dealing platforms. This medium contributed to form a diverse global market where prices and information are freely exchanged.

As evidenced by the emergence of electronic brokering platforms, the task of customer/order matching is being systematized as these platforms act as direct
access points to pools of liquidity. The human element of the brokering process - all the people involved between the moment an order is put to the trading system until the moment it is dealt and matched by a counter party - is being reduced by the so called "straight-through-processing" (STP) technology.

Similar to the way we see prices on a Forex broker's platform, a lot of interbank dealing is now being brokered electronically using two primary platforms: the price information vendor Reuters introduced a web based dealing system for banks in 1992, followed by Icap's EBS - which is short for "electronic brokering system"- introduced in 1993; replacing the voice broker.

Both the EBS and Reuters Dealing systems offer trading in the major currency pairs, but certain currency pairs are more liquid and are traded more frequently over either EBS or Reuters Dealing. For instance, EUR/USD is usually traded through EBS while GBP/USD is traded through Reuters Dealing. Cross currency pairs are generally not quoted on either platform, but are calculated based on the rates of the major currency pairs and then offset through the legs. Some exceptions are EUR/JPY and EUR/CHF which are traded through EBS and EUR/GBP which is traded through Reuters.

Kathy Lien explains the cross rating in one of her articles:

For example, if an interbank trader had a client who wanted to go long EUR/CAD, the trader would most likely buy EUR/USD over the EBS system and buy USD/CAD over the Reuters platform. The trader then would multiply these rates and provide the client with the respective EUR/CAD rate. The two-currency-pair transaction is the reason why the spread for currency crosses, such as the EUR/CAD, tends to be wider than the spread for the EUR/USD.

The minimum transaction size of each unit that can be dealt on either platforms tends to one million of the base currency. The average one-ticket transaction size tends to five million of the base currency. This is why individual investors can't access the interbank market - what would be an extremely large trading amount (remember this is unleveraged) is the bare minimum quote that banks are willing to give - and this is only for clients that trade usually between $10 million and $100 million and just need to clear up some loose change on their books.

As mentioned above, the interbank market is based on specific credit relationships between banks. In order to trade with other banks at the rates being offered, a bank may use bi-lateral, or multi-lateral order matching systems, which have no intermediary bank or dealer. These unofficial foreign exchange platforms, like the
ones mentioned earlier, have emerged in the absence of a worldwide centralized exchange. In the early 90s, when these interbank platforms were introduced, it is also when the FX market opened for the private trader, breaking down the high minimum amount required for an interbank transaction.

Along with banks, non-banking Forex participants of all types are being given a choice of available trading and processing systems for all scales of transactions. Around the same time as interbank platforms were introduced, web based dealing systems that corporations could use in lieu of calling banks on the phone also began to appear. These trading platforms include today FXall, FXconnect, Atriax, Hotspotfx, LavaFX and others. All of them are easily available on the Internet for your further research.

These hubs provide a crucial step for the non-banking participants (broker-dealers, corporations and fund managers, for example) allowing them to by-pass bank market makers in the first instance, and reducing costs substantially offering direct access to the market.

These professional platforms were followed by the first web based dealing platforms for the retail sector. Today there are hundreds of online Forex brokers whose business is focused on providing services to the small trader or investor, a phenomenon that mirrors what is already happening at the interbank level.

![Average Daily Turnover by Counterparty](image)

Source: BIS.org Triennial Survey 2007
Online Retail Broker-Dealers

In the previous sections you have come to understand how the Forex market works. Now let's see how its inner workings can affect your trading by learning more about retail Forex brokers.

If you want to exchange one currency for another and make some profit, just like most individuals, you are unable to access the pricing available on the interbank market. You can't just barge into Citigroup or Deutsche Bank and start throwing Euros and Yen around, unless you are a multinational or hedge fund with millions of Dollars. To participate in the Forex, you need a retail broker, where you can trade with much inferior amounts.

Brokers are typically very large companies with huge trading turn over, which provide the infrastructure to individual investors to trade in the interbank market. Most of them are market makers for the retail trader, and in order to provide competitive two way prices, they have to adapt to the technological changes afoot in the industry, as we have seen above.

What does it mean to directly trade with a market maker? Every market maker has a dealing desk, which is the traditional method that most banks and financial institutions use. The market maker interacts with other market maker banks to manage their position exposure and risk. Every market maker offers a slightly different price in a particular currency pair based on their order book and pricing feeds.

As trader, you should be able to produce gains independently if you are using a market maker or a more direct access through an ECN. But nevertheless, it's always essential to know what happens on the other side of your trades. To gain that insight, you first need to understand the intermediary function of a broker-dealer.

The interbank market is where Forex broker-dealers offset their positions, but not exactly the way banks do. Forex brokers don't have access to trading in the interbank through trading platforms like EBS or Reuters Dealing, but they can use their data feed to support their pricing engines. Enhanced price integrity is a major factor traders consider when dealing in off-exchange products, since most prices originate in decentralized interbank networks.

In order to quote prices to their costumers and offset their positions in the interbank market, brokers require a certain level of capitalization, business agreements and direct electronic contact with one or several market maker banks.

You know from chapter A01 that the Forex spot market works over-the-counter, which
means there are no guarantors or exchanges involved. Banks wanting to participate as primary market makers require credit relationships with other banks, based on their capitalization and creditworthiness.

The more credit relationships they can have, the better pricing they will get. The same is true for retail Forex brokers: depending on the size of the retail broker in terms of capital available, the more favorable pricing and effectiveness it can provide to its clients. Usually this is so because brokers are able to aggregate several price feeds and always quote the tighter average spread to its retail customers.

This is a simplified example how a broker quotes a price for the GBP/USD:

<table>
<thead>
<tr>
<th>Bank</th>
<th>Ask</th>
<th>Bid</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank A</td>
<td>1,4720</td>
<td>24</td>
</tr>
<tr>
<td>Bank B</td>
<td>1,4721</td>
<td>26</td>
</tr>
<tr>
<td>Bank C</td>
<td>1,4719</td>
<td>23</td>
</tr>
<tr>
<td>Bank D</td>
<td>1,4722</td>
<td>27</td>
</tr>
</tbody>
</table>

The broker selects the higher ask price (Bank D) and the lower bid price (Bank C) and combines it to the best possible market rate at:

GBP/USD 1,4722 / 23

In reality, the broker adds its margin to the best market quote in order to make a profit. The price finally quoted to the costumers would be something like:

GBP/USD 1,4721 / 24

When you open a so called "margin account" with a broker-dealer, you are entering into a similar credit agreement, where you became a creditor towards your broker and he, in turn, a borrower from you.

What do you think happens the moment you open a position? Does the broker route the amount to the interbank market? Yes, he may do it. But he can also decide to match it with another order for the same amount from another of his clients, since passing the order through the interbank means paying a commission or spread.

By doing so, the broker acts as a market maker. Through complex matching systems, the broker is able to compensate orders of all sizes from all its costumers between
each other. But since the order flow is not a zero equation - there may be more buyers than sellers at a certain time - the broker has to offset this imbalance in his order book taking a position in the interbank market. Obviously, many of these brokering functions have been significantly computerized, cutting out the need for human intervention.

The broker may also assume the risk, taking the other side of this imbalance, but it's less probable that he assumes the entire risk. On one hand, the statistics showing the majority of retail Forex traders loosing their accounts, may contribute to the appeal of such a business practice. But on the other hand, the spread is where the real secure and low risk business lies.

Richard Olsen explains the market maker's business model better than anyone:

In fx you have a wide range of players...with a correspondingly wide range of perceived opportunity sets. But the player with the shortest-term interest is the market maker. And as a counterparty to every trade, he is the master. The market maker earns his profit from an infinitesimally small spread, and that spread has an oh-so-brief shelf life. If at a given price equal portions of buyers and sellers come into the market, the market maker has it easy.

But this is a fast, over-the-counter market; buyers and sellers don’t come in regular, offsetting waves, and when they do come, they all have to deal through the market maker. Whose primary objective is to limit risk (his own) and cover costs (his own). He needs to clear his books as quickly as possible; to reduce his risk he will lay off trades within five seconds, 10 seconds, or 10 minutes. And to offload his inventory he will move the price to attract buyers and sellers. The information is in the price, but what is it telling us?

Is Forex a zero-sum game? Ed Ponsi’s answer to this controversial question throws some light into a subject which is often misunderstood:

There is a misconception among some traders that every trade must have a winner and a loser. [...] suppose you enter a long position on EUR/USD and at the same time, another trader takes a short position in the same currency pair. The broker simply matches the orders and collects the spread. This is exactly what the broker wants, to keep the entire spread and maintain a flat position.
Does this mean that in the above scenario one party has to win, and one must lose? Not at all, in fact both traders can win or lose; perhaps one has entered a short-term trade and the other has entered a long-term trade. Perhaps the first trader will take a profit quickly, but there is no rule that states the second trader must close his trade at the same time. Later in the day, the price reverses, and the second trader takes his profit as well. In this scenario, the broker made money (on the spread) and both traders did, too. This destroys the oft-repeated fallacy that every Forex trade is a zero-sum game.

From the previous chapter, you already know that Forex trading bears its transactions costs (more details on trading costs in the next Chapter A03). Alone these costs prevent the order flow from being an absolute zero equation because entering and exiting the market is not free: every time you trade you pay at least the spread. From this perspective, the order flow is a negative sum game.

As you see from the order matching mechanisms brokers use, not all of the retail orders are dealt in the interbank market and are thus out of the official turnover estimations. Note as well that out of the entire volume transacted in currency exchange, only a part is considered spot Forex, around 1.9 billion Dollars according to the BIS 2007 survey.

In Forex there is another type of brokers labeled "non-dealing-desk" (NDD) brokers. They act as a conduit between customers and market makers/dealers. The broker routes the customer’s order to another party to be executed by the dealing desk of the market maker. For this service brokers generally charge fees and/or are compensated by the market maker for the transactions that they route to their dealing desk.

As you see, either trading with a market maker or with a NDD broker, your order always ends up in a dealing desk.

In comparison with the mentioned brokerage models, the ECN brokers provide collected exchange rates from several interbank and non-interbank participants buying and selling through the platform. With such a platform, all participants are in fact market makers.

Besides trading directly, anonymously and without human intervention, each participant sends a price to the ECN as well as a particular amount of volume, and then the ECN distributes that price to the other participants.
The ECN is not responsible for execution, only the transmission of the order to the dealing desk from which the price was taken. In this system, spreads are determined by the difference between the best bid and the best offer at a particular point in time on the ECN. In this model, the ECN is compensated by fees charged to the customer and eventually a rebate from the dealing desk based on the amount of volume or order flow that it is given from the ECN.

It is important to point out that an ECN usually shows the volume available for trading each bid and offer, so the trader knows what maximum trade can be placed. ECN volume is only a reflection of what is available on any one ECN, not in the overall market. The market maker’s responsibility is to provide liquidity under all conditions to its customers.

For success as a trader, it's not determining whether you trade through a market maker, non-dealing-desk or ECN broker. However, retail brokerage demands a due diligence, particularly in terms of regulation, execution speed, tools, costs and services. So you would do well to investigate thoroughly any broker you're planning to use.

Check the Brokers/FDMs news section to stay informed about the latest releases in the Forex Industry- everything about platforms, regulations, awards and much more.
3. Doing Brokers Due Diligence

Due to enormous competition between Forex broker-dealers, they offer different features and advantages. However, choosing a broker is not an easy task for any new or experienced trader.

There are some key aspects like regulation and capitalization which speak for the reliability and competence of the organization and which can be measured following certain objective criteria.

But the real challenge in choosing a broker comes when you have to determine what attributes you are looking for. Along with the outstanding features, you might find a potential weakness, depending on what you need for your trading style.

For example, if your trading performance depends on guaranteed liquidity but you can account for variable spreads, this may be what you should look for. On the other hand, you might prefer a fixed pip spread if you know you are getting instant executions despite of market conditions, if this is essential for your trading.

There are many Forex brokers to choose from, just as in any other market. Check our comparative table of brokers to see their main characteristics. It is a very comprehensive resource, allowing you to sort the brokers following your criteria.

With so many Forex broker-dealers out there, it may be a little confusing finding the one that fits your technical needs and financial capabilities. To that end, as part of the Learning Center, further below are the main criteria to look for when investigating a broker:
Support

One of the first things you should check in a broker is the support service. Forex is a 24-hour market, so ideally, the broker you choose should offer support at any time.

Which medium is used to contact the help desk: email, chat, or can you speak by phone to a live person? Do the representatives seem knowledgeable? How they respond to your questions can be key in predicting how they will respond to your needs in a real situation.

While trading you can run into technical problems. Therefore try to anticipate those critical situations and simulate those questions and requests to your broker. You can do this while experimenting on a demo account.

The website should already explain things clearly, but be sure to check the quality and efficiency of their support desk before opening an account.

Capitalization

As you already know, the better capitalized the market makers are, the more credit relationships they can establish with their liquidity providers and the more competitive pricing they can get for themselves as well as for their clients.

The OTC nature of the market makes it extremely difficult for a broker to get competitive pricing without a margin deposited in a lending institution or bank. As a result, it is extremely important for individual investors to do extensive due diligence on the Forex broker with which they choose to trade.

If a broker-dealer states that they are safe to work with because they trade in the interbank market, you know what this means. To date, the interbank market is an unregulated and loose conglomerate usually traded by central banks, investment banks and extremely large corporations.

As a member of a regulatory authority, a broker must comply with a minimum capitalization level. This fact has a direct relationship with its ability to stay solvent and is also indicative of the size of the company.

The minimum capitalization required in the US is currently (Jun 2010) at $20,000,000. If the broker does not publish this information, it's a warning sign that...
could mean a lack of solvency.

As an auxiliary data you could try to find out if the broker has big clients such as hedge funds or corporations. Some of these data are public as regulated and audited hedge funds have to mention their access gates to the market. A broker chosen by a large hedge fund is normally indicative that the broker is reliable, complies with all regulations and has enough liquidity.

On the Commodity Futures Trading Commission (CFTC) website you can find out the capitalization level of your broker-dealer versus other dealers in the market and compare if they comply with the net capitalization requirements. Compare the firm’s Net Capital Requirement with its Excess Net Capital as well. Clearly, the more there is the better signal is.

Regulation

Not all countries supervise the Forex brokers and dealers the same way, nor do they have the same regulatory environment and requirements when it comes to financial registration. Therefore, it is important for any trader to choose a broker that is based in a country where their activities are monitored by a regulatory agency. It is also important to know if the broker or dealer is regulated in an on- or offshore country, as the latter can be more liberal with registration requirements.

You want to be aware of the broker or dealer's regulatory status and have a clear understanding of the regulatory body that governs Forex activity where the selected broker or dealer does its business.

The authority of a regulated Forex broker is located in the country where the broker is registered in. For example, Forex brokers in the US should be registered as a futures commission merchant (FCM) with the Commodity Futures Trading Commission (CFTC). The CFTC ensures that the broker meets strict financial standards. The broker should also be a member of the National Futures Association (NFA).

US companies supervised by these three organizations are more likely to be legitimate than those that are not. In addition, there is a lot of information that can be found
with these organizations that can help you further your broker research.

At the National Futures Association (NFA) website, you can check if the broker is a registered FCM (Futures Commission Merchant), and also check for any record of fines or deceptive trade practices by the broker/dealer in question.

Usually, you can spot the registered status of the broker and other financial information on its own website. A regulated Forex broker will not hide the fact of being regulated and who is the authority in charge.

Dealing with a Forex broker-dealer that is registered with the CFTC and the NFA is one way to minimize your vulnerability, but this isn't to say that you should dismiss firms that are based outside the United States or subject to non-US regulators. The Financial Services Authority (FSA) in the United Kingdom, the Australian Securities and Investment Commission (ASIC) and the Investment Dealers Association of Canada (IDA) are also strident in their defense of the rights of retail Forex traders. The point is to do your due diligence on a regular basis verifying that the firm is registered and in good standing with the regulator in place. Also, make certain that you understand your rights and the enforcement mechanisms available to you should you have difficulty with the broker-dealer.

Main regulatory Organizations: This list contains the main regulatory organizations worldwide, and links to their websites.

How do these regulatory authorities keep Forex brokers straight? One of the measures which regulated Forex brokers need to take is to periodically submit financial reports to the authorities. Failure to provide the mandatory information can lead the authorities to remove the broker from their member list.
The regulatory authorities protect traders against fraud, scam and illegal trading practices. In case something goes wrong with your deposit, withdrawal or even with a market position, you can complain, sue or file an appeal regarding your Forex broker.

Do your due diligence before dispatching cash over the Internet. Make sure the entity you are sending money to has satisfied your background check and that they are registered in a country with strong legal laws.

There are some dramatic changes occurring in the financial markets that will affect currency trading. Don't proceed your reading before you listen to what Rob Booker explained in this webinar recorded in May 2008:

How New US Regulations on the Financial Markets will Affect Currency Trading
Expert: Rob Booker, Currency Analyst at Piptopia

Explicit and Implicit Trading Costs

The Forex market, unlike other exchange driven markets, has a unique feature that many market makers use to entice traders to trade: they promise no exchange fees or regulatory fees, no data fees and, best of all, no commissions. In the previous chapter we have already mentioned that this advantage has to be well understood, because when it comes to evaluating costs, it much depends on your trading numbers such as frequency, ratios and other performance related statistics.

Basically, there are three commission structures used by Forex brokers: a fixed spread, a variable spread and/or a commission charge based on a percentage of the spread. Just a quick reminder: spread, usually calculated in pips, is the difference between buying and selling price.

So, which is the best choice?

On the one hand, you may think that the fixed spread is the right choice, because
then you know exactly what to expect. On the other hand, you might think you are getting a good deal paying a variable but smaller spread.

First of all, consider that the best deal you can get is choosing a reputable broker who is well capitalized, has strong relationships with the large foreign exchange banks and can provide the liquidity you need to trade well. Second, you need to calculate the impact of all possible fee structures on your trading model to know which one is more favorable to you.

Be aware there is a difference between explicit and implicit trading costs. To the first group belong spreads, commissions and roll-overs which are dependent on volume traded and equity, and usually relatively easy to calculate. To the group of implicit costs belong things like slippages, delays, requotings and even missed trading opportunities. These are difficult to calculate as they are imprevisible but you should account for them.

Some Forex brokers don't charge a commission, so the spread is how they make money. The lower the number of pips required per trade by the broker is, the greater the hypothetical profit that the trader makes is. Comparing pip spreads of half dozen brokers will reveal different transaction costs. In the case of a broker who offers a variable spread, you can expect a spread that will, at times, be as low as 1 pip or as high as 7 pips on the most major pairs, depending on the level of market volatility.

While market makers provide two-way pricing to customers throughout the day, these prices can be quoted on a fixed basis, meaning that they do not move throughout the day. But they can also use a dynamic spread system, which means the prices change as the liquidity in certain pairs change.

A lack of liquidity in the markets or very volatile market conditions can force the broker to apply a slippage on the pricing. Slippage, also called "requote", occurs when your trade is executed away from the price you were offered, when you end up paying more pips than the average spread. This is perhaps a cost that you don't want to bear if you are trading very short term or if you trade based on economic data releases (news-trading).

Asking your broker how they handle news times and if they have any devise to protect you from experimenting slippage is probably a good idea. You can decide to trade with fixed spreads, even if they are a little higher in average but receive, in exchange, an instant fill of your trades at the desired prices. Some brokers even offer you the choice of either a fixed spread or a variable one.

Other brokers, like ECN brokers, may also charge a small commission, usually in the order of two-tenths of one pip. Whether you should pay a small commission depends
on what else the broker is offering. For example, the broker may pass your orders on to a large market makers conglomerate. You might choose a broker with such an arrangement, if you look for very tight spreads only larger investors can otherwise get.

Nevertheless, the spread with an ECN broker is not fixed, and it always depends on the current market depth. Besides, their platforms may not be so user friendly as retail platforms and they usually lack charting tools. In addition, payment and withdrawal options are less efficient when compared to retail brokers and accounts openings require higher minimum amounts.

But if a broker offers, in exchange of a commission, access to a superior proprietary software platform or some other benefit like a real time news feed, in this case, it may be worth paying the small commission for this additional service.

So what is the bottom line effect of each type of spread or commission on your trading? Given that it much depends on your trading profile, this is a difficult question to answer. There are some factors to take into account when weighing what is most advantageous for your trading and that depends on your trading capabilities and preferences.

**An important and not very discussed aspect when considering trading costs are the rollover charges.** These are determined by the difference between the interest rate of the country of the base currency and the interest rate of the other country. The greater the interest rate differential between the two currencies, the greater the rollover charge. We will cover these concepts in more detail in the next chapter, but as a matter of broker choice, take into account that not all brokers charge the same rollovers for the same pairs.

However, before you jump in and choose a broker based on the type of commission structure, consider the total broker's package, otherwise you may be sacrificing other benefits. For example, some brokers may offer excellent spreads but their platforms may not have that personal preference feature you need for your trading to work.

The information you gathered up to this point will make you enjoy the following webinar, in which John Jagerson teaches not only about the different spread typologies, but also shares a great amount of useful market knowledge for your broker-dealer research.
Platforms

The existing Forex brokers offer different trading platforms for their clients along with extensive tools and research. These trading platforms almost always feature real-time quotes for several currency pairs, integrated charting and news, technical analysis tools, a deal log and even integration for automated trading systems.

Real-time exchange rate quotes are not the only feature a retail platform should provide. Closely examine the screen layout in search for an account summary with your current account balance with realized and unrealized profit and loss; the margin available and locked in open positions; leverage; rollover charges in open positions; open position sizes, and performance reports.

One of the reasons why some of the trading software applications look similar is because some dealers, instead of creating their own software, prefer to offer other platforms for client use which were created by the same manufacturer and "white labeled". Regardless who is the creator, the important factors are always the same: intuitive design, ease of use, speed and reliability.

One of these white-label platforms is the popular Metatrader 4. MetaTrader 4 combines an accessible, user-friendly interface with a wide range of powerful functions, making it a highly flexible platform. Visit our dedicated MT4 section to look for costum indicators, expert advisors, many of them
Most trading platforms are either Web based (in Java), or download trading platforms you can install on your computer.

Which one is better? This is something you should decide by yourself. Web based software is hosted on your broker's server. You won't have to install any software on your own computer and you'll be able to log in from any computer that has an Internet connection.

It should be pointed out that, in most cases, you will only find trading platform applications to run on Microsoft Windows. Using another operating system, you won't be able to install the application and a web based or Java-based trading platform is the solution for those cases.

Java-based software tends to be less vulnerable to attacks from viruses and hackers during transmissions than client-based software. But on the other hand, the client-based programs run faster.

A client-based software will only allow you to trade on your own computer, unless you install the program on every computer you use.

Whether download or web-based, make sure that the trading set-up has every trading tool you need, including charts, news, available currencies etc., and that you have a high speed Internet connection. The Forex market is a fast moving market and you will need up-to-the second information to make informed trading decisions.

**Speed is thus a little bit more subjective and can depend on the speed of your computer and Internet connection. But the actual technology is probably less important than knowing how fast someone will pick up the phone should you have a problem with the software and need to get out of a trade.**

You are free to use a charting platform and an execution (trading) platform from two different providers, and even add a news feed from a third source.

Nearly all brokers align their hours of operation to coincide with the hours of operation of the global Forex market: 5:00 pm EST Sunday through 4:00 pm EST Friday.
Perhaps other valuable differentiators for you are trailing stops to lock in profits, real-time news, wireless trading, or pattern recognition charting.

One of the backbones of any trading platform is the ordering system, whether you can hedge positions, increment or reduce the size of a position, trail stop loss orders, close and invert a position, etc. Get a feel for the options that are available by trying out different demo accounts. Order types will be covered in next Chapter A03 in more detail, but for now remember that the decision about what order types are best depend on each trading style.

Brokers usually also provide technical and fundamental commentaries, economic calendars and other research as part of their service. Ask them if the information is freely available or only to costumers, and compare it with other sources.

Before committing to any broker and opening a real account, be sure to request free trial accounts, so-called "demo" accounts, to test the platforms and its many features. The demo account should be free at least for 30 days, so you can paper trade the platform and test if it fits your needs.

Account Types

Many brokers offer two or more types of accounts. These can be very small mini-accounts and even smaller micro-accounts, or standard accounts, depending on the lots traded. A lot consisting of 100,000 units is called a standard lot; a lot consisting of 10,000 units is called a mini lot; and a lot consisting of 1,000 units is called a micro lot. Some brokers even offer fractional unit sizes which allow you to establish your own position size.

The micro and mini-accounts allow you to trade with a very low minimum of capital, while the standard accounts often require a higher minimum initial capital, varying from broker to broker.

As you see, the account types differ from each other according to the minimum trading size requirements. Choosing a specific account type should be relative to your amount of capital. This concept may seem a bit nebulous if you are just starting out, but rest assured it will be made clear once you start learning about leverage and money management.
Another thing that you should check in a Forex broker-dealer is leverage options and the margin call policy.

Foreign exchange traders, especially aspiring traders with limited capital, tend to like higher leverages and sometimes choose a broker based only on this feature. However, traders should remember that although higher leverage can lead to higher profits, it also increases the level of risk. Understand that leverage is like a loan. It might be just as beneficial as detrimental to your capital. Low margin requirements (meaning high leverage) are great when you make profits, but not so great when you loose.

Some brokers offer fixed leverage levels, while others adjust their leverage based on the currency that is being traded and may also have special policies for carrying a trade over the weekend. For example, less leverage (and therefore less risk) may be preferable if you trade highly volatile (exotic) currency pairs.

**Does lower leverage mean lower risk of a margin call?** Generally speaking yes, but there are cases when an excessive low leverage can be detrimental to your trading. We will cover a case study in the Practice Chapter A at the end of this Unit.

Traders should also take into account their broker's margin call policy. Some companies follow the FIFO (first in first out) method to close trades when margin requirements are not met by current equity, others follow the LIFO (last in first out) procedure, and some simply close all the trades. Depending on one's preferences, this is an issue that should be clearly identified before opening an account.

Maximum leverage levels are more of a concern for aggressive traders who like to use the highest possible leverage, whereas a moderate or conservative trader would be happy with the average leverage levels.

Most brokers pay interest on a trader's margin account. The interest rates normally fluctuate with the prevailing central bank's interest rates of the countries whose currencies you are trading. This is an interest which the margin capital in your account accrues. Ask your broker if there is a minimum margin requirement that allows you to accrue the interest.
Not many traders consider the rollover and interests payed and charged by the broker into their trading performances. If you take this factor into account, you can add substantial profits to your trading revenues, by choosing the right instruments and the right direction to trade. This is the main edge of all carry trade strategies!

Finding the right broker-dealers is a critical part of the process to become a trader and requires some real work on your part. Many of the mentioned criteria will be very relative until you define your trading profile and methodology. Therefore, don't forget to come back to this chapter as you progress in modeling your trader's profile.

Just to summarize: investigate, interrogate and cross-examine a series of Forex brokers before you jump in! Test broker's platform with demo accounts and make sure to scrutinize their terms and conditions to be fully aware of all the nuances that a specific broker may impose on your trading.

Here is a checklist you can use in your due diligence:

- How well capitalized is the broker/dealer?
- Is the company registered, and where? Get the firm's registration ID number and look it up at the above mentioned websites.
- How long has it been in business?
- Who manages the firm and how much experience does this person have?
- Does the firm have partner companies?
- Which and how many banks does the firm have relationships with?
- What is their capitalization level?
- What kind of platform does it offer- web based or client software?
- What is their margin policy?
- What rollover policy does the broker have?
- Does the firm guarantee stop loss execution?
- Does it have the order types that you need for your trading?
- Can you speak to the dealing desk if they have one?
- Do they guarantee liquidity also for big order sizes?
Adhere to our Brokers News RSS to stay informed about new changes in the FX business.
4. True And False Myths

Some traders do not feel comfortable with their broker being on the other side of their trades as they feel it presents a kind of conflict of interest. This is a worthwhile concern, certainly, but the fact of the matter is that the majority of Forex brokers are forced by competition to remain honest. There is no way for a broker to survive in the business unless the company keeps up its end of the deal.

As you already know, most countries have their own body or association that serves to regulate the sector in that country and ensure that clients' rights are protected. This body will insist on its members accepting the decisions of their arbitration panel in case of disputes. This should address the question about the safety of the funds and the lack of overall regulation. There is a lot being done recently in this regard and expect new regulations to come which will provide traders with more protection.

There is another common tendency amongst some retail currency traders to claim that Forex brokers trade against you and their main agenda is to wipe out your account hunting for stops. For an aspiring trader this information is very discouraging.

What happens is that, precisely because of the high **leverage** effect, most retail traders are forced to trade with stop losses. Otherwise, there is a risk of a forced liquidation in the form of a **margin call**. As most of the stop **orders** are programed on the platform, the broker's **dealing desk** has access to this information. Not that the broker is watching your particular position, but rather the entire positions of the entire client base. This includes seeing where the most stop **orders** are clustered.

It's true that Forex broker-dealers, as **market makers**, can expand the spreads at any time. But more than often that is not what happens. You see, the information about price levels where stop **orders** are clustered is passed into the **interbank market** in the case of a non-dealing-desk broker. And the fact is that the market will react to those **orders**. In the Forex market stop losses are interpreted as **orders**, that is as a willingness from market participants to take action at a certain price level. A stop order always corresponds to a sell or buy order, and the market will react to it. This subject will result clearer to you studying the next chapters, as more pieces of the puzzle will be revealed.

Due to non-centralized pricing in the Forex, the broker, as a **market maker**, can expand the spreads at any time. An expansion of the spreads happens specially during the so-called news events or high volatility...
moments, when customer’s stop orders are eventually filled. Take into account that during news events, the broker also experiments higher spreads in the interbank market.

Boris Schlossberg, although in the context of disclosing a trading strategy based on stop order executions, explains the process in his article "Stop Hunting With The Big Players":

Because of this unusual duality of the Forex market (high leverage and almost universal use of stops), 'stop hunting' is a very common practice. Although it may have negative connotations to some readers, stop hunting is a legitimate form of trading. It is nothing more than the art of flushing the losing players out of the market.

In Forex-speak, they are known as weak longs or weak shorts. Much like a strong poker player who may take out less capable opponents by raising stakes and buying the pot, large speculative players (like investment banks, hedge funds and money center banks) like to gun stops in the hope of generating further directional momentum. In fact, the practice is so common in the Forex markets that any trader unaware of these price dynamics will probably suffer unnecessary losses.

It should not be considered stop hunting when the price simply goes against you by 30 or 40 pips all the way to hit your stop order. To move the price by so many pips, the broker would have to accumulate a position of millions of Dollars in the process. Besides, their agenda is to get you to trade more and therefore earn more via spreads, commissions, rollovers, etc. If you wipe out your account they probably loose a costumer.

Richard Olsen explains why the Forex market over-shoots all the time in its pricing:

...The market maker has no psychological attachment to any price level; he only wants to balance his book and exit the position as quickly as possible. In the face of an instantaneous imbalance between buyers and sellers, the market maker will move the price as far as he needs to, in either direction, to solicit the trading action he desires. In extreme cases he will not only move prices but also widen spreads to fend off unwanted increases in position — an action that compounds uncertainty.

This self-interested action moves markets. The new price becomes the reference point for every other position in the marketplace. With way disproportionate consequences: a $200-million trade (which, with
leverage, might require only $20 million in equity) can move EUR/USD, with cascading effects of triggering stop-losses that push prices well outside any “rational expectation.”

The hole in the story is that an artificial movement of the exchange rate represents a huge risk for the broker as well, as this position may have to be compensated in the real market. A different situation is, like Boris Schlossberg points out, that strong market players, like banks or hedge funds, coordinate their actions around key price levels. In such a case, a cascade of stop orders can eventually accelerate momentum and change the direction of a trend.

The question is: is such a myth really unbiased or is it written by traders who emptied their accounts because of lack of experience? After all, we only tend to complain when things go bad!

Taking responsibility not only for your wins, but also for your losses is a personal trait any trader should develop. Learn from your losses and accept them as valuable lessons and you will progress faster on your journey to become a trader.

There is also the myth that a broker without dealing desk or an ECN broker is more likely to be honest about the trades since it passes your trading orders off to the interbank.

John Jaggerson and Wade Hansen explain why NDD brokers and ECNs are not necessarily better than market makers:

A dealing desk is the place at an institution where contracts are bought and sold. Your dealer may imply that by trading with them you will not have to work through a dealing desk, giving you better pricing. This is not true. It may be correct that your order won't be handled by your dealer's own dealing desk, but your order will eventually wind up on someone's dealing desk at one of your dealer's broker banks. If it is going to cost you the same amount of money in the end, does it matter to you whether your order is handled on your dealer's own dealing desk or Goldman Sachs' dealing desk? The dealer you work through and your dealer's broker banks will be compensated for the service they offer, and it will be a cost to you.

And they go on writing:
ECNs are electronic clearing networks that list the orders from professional and retail traders in one place. This adds some nice transparency into where orders are listed, but the actual fills you will get are not usually any better than working with a dealing desk.

The idea behind ECNs is that it should be possible for a retail customer to save some money by setting a limit order in between the normal bid and ask spread. However, you can do the same thing using a regular dealer. Just because an ECN shows you that there are bid and ask orders above and below the current price of the currency pair does not mean that you have any better chance of being filled at one of those levels by trading through an ECN. Those same orders are influencing prices at regular dealers too, even if you can't see them displayed.

ECNs are managed by clearing firms, which are similar to dealers. And just like dealers, the clearing firms that operate ECNs are looking to be compensated for the service they provide. That translates into a trading cost for you.

To every dark side, there is a plus. In the case of retail brokers, they provide an advantage: you can open an account with very little investment and get very high leverage. With an ECN Forex broker the leverage is generally much lower and the minimum account deposits are higher.

These are some criteria that you can follow on your due diligence and that will protect you from the rare but possible event you experience major problems with a broker-dealer. Another measure you can adopt is to split your funds among few brokers. Sometimes even apparently good companies go bankrupt and it can catch you unprepared. Besides, by working with more than one broker, you can profit from more features and get to know which of them make you feel comfortable.

What you have learned from this chapter:

• The conditions resulting from Bretton Woods make international currencies set their value depending on the Dollar, leaving the economies of these countries somehow dependent on the monetary, and also political, decisions of the United States. While this is only part of the big picture, you have learned that building a
macro view on the financial markets, is essential to conduct your business as a trader.

- Central banks or national monetary authorities are active in the markets, buying and selling currencies to influence exchange rates, as a means to control interest rates. You have seen that these interventions can take the form of direct buying or selling to push prices up and down, or using the so called jawboning tactic.
- The wholesale currency market works thanks to credit agreements between main players. It could be not otherwise in a decentralized market- where trading does not take place through an exchange. These credit arrangements are similar to the ones you find on a broker’s margin account.
- Not all broker-dealers intermediate the same way. Some do it through their own dealing desk, others route the orders through another market maker, while still others function as a market maker network.
- Concerning the trading costs, one thing is certain: as a trader you always pay the cost and the intermediary always earns its revenue, be it a market maker, a non-dealing-desk broker or an electronic currency network. This means that trading costs should be considered as a part of the business and never taken as a primary reason for choosing a certain broker/dealer.
- There are a few things that you can do to protect yourself as a trader besides objectively investigating a broker in terms of capitalization and regulation: for instance, diversify your trading capital among several brokers; have direct phone access to their trading desk or support team; and keep investigating, interrogating and cross-examining brokers as you develop your trading profile.

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- Doing Dealer Due Diligence - Webinar Recording
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- Intermarket Relationships - Webinar Recording
- Confessions of A Forex Trader - Part 1: Looking At The Risk - Transcripts Chat Session
- Rob Booker recommends you what Trading Books you should read - Transcripts Chat Session
- The Foreign Exchange Market by Peter Pontikis in The Trader’s Journal
- What You Don't Know Can Hurt You by Ed Ponsi in the Trader’s Journal
- The Six Forces of Forex by FX Engines
This chapter involves a lot of due diligence work on market players and also an awareness of global politics, as the ramifications reach beyond diplomatic relations and go straight into the markets. **Feel free to share your findings and questions about this second chapter in the LC forum!**