

LEGAL ALERT

CFTC PROPOSES EXTENSIVE REGULATORY OVERHAUL OF U.S. RETAIL FX MARKETPLACE

On Wednesday, January 13, the Commodity Futures Trading Commission (“CFTC”) published its long awaited proposal of rules (“Proposal”) to implement the CFTC Reauthorization Act of 2008 (“CRA”, or as sometimes termed, the “Farm Bill”)¹ with respect to off-exchange transactions in foreign currency with members of the U.S. retail public (“Retail FX”). The Proposal signals a significant expansion of existing regulation of over-the-counter (“OTC”) currency markets in the U.S. A substantial portion of the proposed regulations were explicitly mandated by the CRA, and, indeed, are already effectively embodied in compliance rules of National Futures Association (“NFA”), the industry’s principal self-regulatory organization.² However, the Proposal would go further, increasing regulatory restrictions in several dramatic ways, including: (i) drastically lowering the effective leverage that Retail FX dealers offer to Retail FX customers, (ii) requiring Retail FX counterparties to guarantee all introducing brokers, and (iii) requiring Retail FX dealers to track and report the performance of all nondiscretionary accounts within standard risk disclosure statements.³

Summary of the Proposed New Part 5 of CFTC Regulations

The Proposal would create a new part 5 to CFTC regulations titled “Off-Exchange Foreign Currency Transactions.”⁴ New part 5 would generally implement the explicit provisions of the CRA, including registration, reporting, net capital, and risk disclosure provisions. Of note, part 5 defines retail foreign exchange dealers (“RFEDs”) as a new registrant category⁵, and specifies that commodity trading advisers (“CTAs”), commodity pool operators (“CPOs”), introducing brokers (“IBs”) and associated persons (“APs”) that effect or facilitate Retail FX transactions must also register with the CFTC in the appropriate category.

Registration

Proposed Regulation 5.3 implements the CRA’s requirement that Retail FX intermediaries, advisors and fund managers register with the CFTC, and creates a new registration category for Retail FX dealers (“RFEDs”) separate and distinct from the traditional Futures Commission Merchant (“FCM”) category for exchange-traded futures brokers.⁶ FCMs who deal Retail FX but are not “primarily or substantially”⁷

¹ Food, Conservation, and Energy Act of 2008, Pub. L. No. 110-246, 122 Stat. 1651, 2189-2204 (2008).

² NFA Financial Requirements Section 11 requires NFA registered Forex Dealer Members (“FDMs”) to maintain “Adjusted Net Capital” equal to or in excess of \$20 Million.

³ See Proposal at 17

⁴ Proposed Regulation Part 5 et. seq.

⁵ Proposed Regulation 5.1(h)(1). The term “retail foreign exchange dealer” was first used in the CRA. RFED is analogous to the NFA membership category “forex dealer member.”

⁶ Proposed Regulation 5.3(a)(6).

⁷ Proposed Regulation 5.1(a)(g). “primarily or substantially” means, with respect to the traditional commodity trading activity of the FCM, that (1) such activity accounts for more than 50% of the FCM’s annual gross revenues, (2) the FCM receives gross revenues in excess of \$500,000 in any twelve month period from such activity, or (3) the FCM is a clearing member of a registered derivatives clearing organization.

engaged in exchange-traded futures business are required to register as RFEDs,⁸ as are RFED or FCM affiliates who act as Retail FX counterparties.⁹ Persons or entities introducing Retail FX accounts are required to register as IBs.¹⁰ Operators of pooled investment vehicles (e.g., fund managers) that engage in Retail FX transactions are required to register as CPOs, and persons providing Retail FX trading advice are required to register as CTAs.¹¹

New 10:1 Leverage Restriction

The Proposal's most dramatic change to current industry practice is the universal leverage restriction of 10:1 for all Retail FX transactions. Proposed Regulation 5.9(a) would require RFEDs and FCMs engaging in Retail FX transactions to collect from each Retail FX customer a minimum security deposits of: (i) 10% of the notional value of such customer's open Retail FX positions, (ii) 10% of notional value, plus the premium, with regard to short FX options positions, and (iii) with regard to long FX options positions, the full premium.¹² The CFTC did not adopt any exemptions or exclusions from the security deposit requirement as had been previously implemented by NFA¹³ nor did it adopt a graduated range of leverage limits based on the relative volatility of the underlying currencies (as is common in the institutional interbank FX market). Interestingly, the CFTC provided some additional commentary justifying the substantial restriction on leverage, citing the "extreme volatility" of the foreign currency market as well as counterparty credit risk as the major factors compelling the leverage limitation.¹⁴ In arriving at the flat 10% limitation, the CFTC "considered current industry practices, as well as NFA's current leverage restrictions of 100 to 1 on major currencies and 25 to 1 on non-major currencies, and the proposal by the Financial Industry Regulatory Authority ("FINRA") to limit the maximum leverage on certain Retail FX transactions offered by broker-dealers to 4 to 1."¹⁵

Net Capital

The Proposal adopts the general net capital calculation in substantially the same form as currently embodied in NFA Financial Requirements¹⁶. Proposed Regulation 5.7 requires RFEDs and FCMs to maintain minimum adjusted net capital equal to the greater of: (i) \$20 million; (ii) \$20 million plus 5% of aggregate "retail forex obligation" exceeding \$10 million; or (iii) the amount required by a

⁸ Proposed Regulation 5.3(a)(4).

⁹ Proposed Regulation 5.3(a)(1).

¹⁰ Proposed Regulation 5.3(a)(5).

¹¹ Proposed Regulation 5.3(a)(2) and 5.3(a)(3).

¹² Proposed Regulation 5.9(a)

¹³ See e.g.; Former NFA Financial Requirement Section 12(b) "A Forex Dealer Member that that consistently maintains adjusted net capital of at least 150% of the greater of the amount required by Section 11(a)(i) or (ii) of these Financial Requirements is exempt from Section (a) [Security Deposit Requirement] above."

¹⁴ See Proposal at 36. "The CFTC's proposed regulation regarding security deposits is intended to both mitigate the risk to which customers are exposed and to provide some capital to cover customer funds held by a failing firm."

¹⁵ See Proposal at 38. NFA leverage rules are set forth in Section 12, "Security Deposits for Forex Transactions with FDMs", of the NFA rules. On June 4, 2009, FINRA submitted to the U.S. Securities and Exchange Commission a proposed rule change to adopt FINRA Rule 2380 to limit the leverage ratio offered by broker-dealers for certain forex transactions to be a maximum of 1.5:1. 74 FR 32022 (July 6, 2009). FINRA subsequently adopted 2 amendments to this proposal, the second of which revised the maximum leverage ratio from 1.5:1 to 4:1.

¹⁶ See NFA Financial Requirements Section 11(a)

registered futures association.¹⁷ Surprisingly, the CFTC refused to adopt NFA's exemption of RFED's employing "straight-through-processing" (sometimes termed "direct market access") platforms from the foregoing additional 5% requirement.¹⁸ The "retail forex obligation" is defined as the net credit balance resulting from combining all money, securities and property deposited by Retail FX customers into their accounts, adjusted for realized and unrealized net profit or loss, and not including any accounts that contain net liquidating balances.¹⁹ As provided in current NFA Financial Requirements, under Proposed Regulation 5.8(a) qualifying customer assets held by RFEDs (or FCMs) must also at all times equal the firm's "retail forex obligation."

Guarantee of Introducing Brokers

In addition to the registration requirement, the Proposal would also mandate that IBs or applicants for registration as IBs in connection with Retail FX to enter into a guarantee agreement with its RFED or FCM (as applicable).²⁰ Regarding the new guarantee requirement, the Release states:

The Commission will be preparing a new Part C guarantee agreement to the Form 1-FR-IB, modeled on the guarantee agreement existing in Part B of Form 1-FR-IB, that will provide that FCMs and RFEDs that guarantee performance by an introducing broker that introduces off-exchange retail forex transactions will be jointly and severally liable for all obligations of the introducing broker under the Act and Commission regulations with respect to the solicitation of, and transactions involving, all Retail FX customer accounts of the introducing broker entered into on or after the effective date of the guarantee agreement. The Commission believes that the guarantee requirement serves the public's interest in a marketplace where improper practices by IBs are discouraged while still permitting FCMs and RFEDs to make use of outside salespeople. An IB that is guaranteed by an FCM or RFED will not be subject to the minimum capital requirements set forth in Regulation 1.17(a)(1)(iii).²¹

Risk Disclosure

Risk disclosure and general supervision requirements set forth in the proposal by and large track current NFA rules and CFTC Regulations applicable to FCMs generally. One change of note is the requirement that RFEDs and FCMs engaging in Retail FX calculate quarterly the percentage of non-discretionary accounts that were profitable, and to maintain such data for five years.²² In addition, registrants would be required to disclose such performance information to potential customers. Proposed Regulation 5.5 would require registrants to provide Retail FX customers with a risk disclosure statement similar to that currently required by Regulation 1.55 (applicable to FCMs generally) but tailored specifically to address Retail FX. On the specifics of the new risk disclosure proposal, the CFTC notes, "[f]or example, the required risk disclosure statement would also be required to disclose the number of non-discretionary Retail FX

¹⁷ Proposed Regulation 5.7(a)

¹⁸ See Proposal at 31. "The NFA has enacted a similar requirement applicable to all its forex dealer members except those that only provide "straight through processing." The CFTC's proposal has no exceptions for FCMs engaging in off-exchange retail forex or for RFEDs."

¹⁹ Proposed Regulation 5.1(l).

²⁰ Proposed Regulation 5.18(h)

²¹ See Release at p. 21

²² Proposed Regulation 5.18(h)

accounts maintained by an RFED or FCM, the percentage of such accounts that were profitable for each of the four most recent quarters, and a statement that past performance is not necessarily indicative of future results.”²³

Miscellaneous-Offsetting Transactions

The Proposal contains a provision requiring RFEDs and FCMs engaging in Retail FX transaction to close out offsetting long and short positions in a Retail FX customer’s account.²⁴ What’s more, unlike the existing provisions for transactions in on-exchange futures and options contracts, no exception is proposed even where the RFED or FCM’s customer has expressly instructed otherwise.²⁵ In addition, no exception is proposed for omnibus accounts because they are, in the CFTC’s view, “not used in retail forex trading.”²⁶

Public Comment Period and Further Information

CFTC will be accepting comments on the Proposal until March 16. If you would like more specific information regarding the Proposal or this summary, please contact Drohan Lee.

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²³ Proposed Regulation 5.5(e). In discussing the performance disclosure requirement, the CFTC noted “[t]hese transactions serve no broad price discovery function, and the Commission believes both that the vast majority of retail customers who enter these transactions do so solely for speculative purposes, and that relatively few of these participants trade profitably.”

²⁴ Proposed Regulation 1.46

²⁵ See Proposed Regulation 1.46; Proposal at p. 21

²⁶ Id. at 22.