

Regulatory Notice

08-66

Retail Foreign Currency Exchange

FINRA Addresses Firms' Retail Foreign Currency Exchange Activities

Executive Summary

The retail over-the-counter foreign currency exchange (retail forex) market is opaque, volatile and risky. Broker-dealers who engage in forex business with their retail customers must comply with the FINRA rules that apply to those activities.

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Background & Discussion

The primary forex market is the interbank market, in which large banks, financial institutions and other eligible participants trade currencies amongst themselves. In recent years, however, an electronic, secondary over-the-counter (OTC) market has developed. Retail customers participate in the secondary OTC market with retail dealers, albeit typically at different prices and with higher spreads than those that occur in the interbank market. Broker-dealers who participate in this retail market must comply with applicable FINRA rules.

In the retail market, customers trade currencies through spot, forward and swap transactions with forex dealers acting as counterparties. These transactions are quoted in pairs, with the first currency representing the base currency and the second currency representing the quote currency. The quoted price, or rate, is the amount of the quote currency required to purchase one unit of the base currency. For example, a quote for EUR/USD

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Notice Type

- Guidance

Suggested Routing

- Advertising
- Legal and Compliance
- Registered Representatives
- Senior Management

Key Topic(s)

- Anti-Money Laundering
- Communications with the Public
- Customer Protection Rule
- Foreign Currency Exchange
- Just and Equitable Principles of Trade
- Membership Rules
- Net Capital
- Over-the-Counter Market
- Retail Market

Referenced Rules & Notices

- 31 CFR 103.19(a) of the Bank Secrecy Act
- NASD Rule 1010(i)
- NASD Rule 1014(a)(3)
- NASD Rule 1017
- NASD Rule 2110
- NASD Rule 2210
- NASD Rule 3011(a)
- Section 15 of the Securities Exchange Act
- Securities Exchange Act Rule 15c3-1



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expresses the price of the Euro in U.S. dollars. If a customer shorts the EUR/USD, then the customer will experience a loss if the Euro gains value relative to the U.S. dollar. A customer who is long the EUR/USD will experience a loss if the Euro loses value relative to the U.S. dollar.

Most retail trading occurs online through electronic platforms provided by the dealer, who acts as counterparty to the retail customer's trades and sets the execution price and the spread. The retail customer typically does not have pricing information and cannot determine whether the price quoted by the dealer is fair. Moreover, the dealer acts as counterparty and establishes the price, which means that the dealer has a conflict of interest in the transaction. Price comparisons are also complicated by different compensation structures: Some firms charge per-trade commissions, others impose wider spreads, and some do both. Other transaction costs can include account maintenance charges, software licensing fees and commissions paid to introducing brokers or other third-party service providers.

The currency market is extremely volatile and retail forex customers are exposed to substantial currency risk. Some currencies are significantly more volatile than others. Many forex dealers extend leverage to their customers at ratios of 400:1 or higher, which allows customers to control contracts worth significantly more than their cash investment. The high leverage ratios magnify even minor fluctuations in currency rates, exponentially increasing a customer's losses and gains. Even a small move against a customer's position can result in a significant loss. Unlike margin in a securities account, forex customers are typically closed out of their position once their loss exceeds their initial investment. However, if, for any reason, the position is not closed out at a zero balance, the customer could be liable for additional losses.

Customers also face counterparty risk, as there is no central clearing organization for forex transactions. Customers may not know where their funds will be held or by whom. They may also not know that, unlike securities, funds deposited into an account with a broker-dealer for investment in any currency, or which are the proceeds of the sale of a currency position, or any currency in an account with a broker-dealer, are not protected by the Securities Investor Protection Corporation (SIPC).

For all of these reasons, retail forex trading is risky, and the only funds that should be invested in the retail forex market are those that the investor can afford to lose. Nonetheless, retail interest in the market is growing, in part due to aggressive, and sometimes misleading, advertising that minimizes risks and exaggerates potential returns.

Under the Commodity Exchange Act (CEA), only certain regulated entities may act as counterparty to a retail forex transaction. The approved entities include Futures Commission Merchants (FCMs) registered with the Commodity Futures Trading Commission (CFTC), as well as banks, insurance companies, and registered broker-dealers. The CFTC and the National Futures Association (NFA) oversee the forex-related activities of registered FCMs. In May 2008, Congress amended the CEA to expand and clarify the CFTC's jurisdiction over the retail forex market. Among other things, the amendments:

- Require CFTC-regulated forex dealers to register with the NFA in the newly created capacity of Retail Foreign Exchange Dealers (RFEDs);
- Raise net capital requirements for RFEDs to \$10 million initially, and to \$20 million by May 2009; and
- Subject RFEDs to anti-fraud and certain other provisions of the CEA.

However, Congress did not extend these new net capital requirements or other provisions to registered broker-dealers or the other financial institutions that are not subject to CFTC oversight but that may act as counterparties in retail forex transactions. As a result, FINRA has seen an increase in membership applications from firms interested in conducting retail forex business. FINRA has also seen an increase in retail forex activities among current FINRA members, including broker-dealers acquired by forex dealers.

Applicability of FINRA Rules to Retail Forex Activities of Broker-Dealers

Just and Equitable Principles of Trade

NASD Rule 2110, which applies to every FINRA member, requires that firms, in the conduct of their business, observe high standards of commercial honor and just and equitable principles of trade. Rule 2110 applies to all of the business of a broker-dealer, not only to its securities and investment banking business. In determining appropriate standards and principles in the context of retail forex activity, FINRA will look to the forex-related rules and interpretations adopted by the NFA to govern the retail forex activities of its members. Therefore, in order to ensure compliance with Rule 2110, we expect broker-dealers to conduct their retail forex activities in a manner consistent with the regulatory requirements applicable to NFA members that are engaged in the same activities.

Under this standard, forex-related conduct that would constitute a violation of Rule 2110 includes, but is not limited to:

- Misappropriating or mishandling customer funds;
- Failing to disclose that the firm is acting as counterparty to a transaction;
- Failing to adequately disclose the risks associated with forex trading;
- Using, selling or leasing electronic trading platforms that allow “slippage” of trade executions in a manner that disproportionately or unfairly affects the customer;
- Manipulating or displaying false quotes;
- Offering mock, or “demonstration,” accounts that do not accurately reflect the risks of forex trading;
- Issuing to customers false reports or account statements that represent false profits or that conceal misappropriations or losses;
- Making post-execution price adjustments that are inappropriate and unfavorable to the customer;
- Creating false books and records;
- Failing to adequately disclose to customers the risks and terms of leveraged trading;
- Soliciting business for and introducing customers to a forex dealer without doing adequate due diligence about the forex dealer, or in a way that misleads the customer about the forex dealer or forex trading, including how customer funds will be held;
- Failing to conduct due diligence into any solicitors that introduce forex customers to the firm, and failing to supervise any unregistered solicitors that are employees or agents of the firm; and
- Accepting forex-related trades from an entity or individual that solicits retail forex business on behalf of the firm in a misleading or deceptive way.

Communications with the Public

NASD Rule 2210, applicable to all FINRA members, prohibits firms from making any false, exaggerated, unwarranted or misleading statement or claim in any communication with the public. Rule 2210 is not limited to a broker-dealer’s securities and investment banking business. A firm’s forex-related communications – whether the firm is acting as a dealer or is soliciting forex business for a dealer – must be fair and balanced and based on principles of fair dealing and good faith, and firms must provide a sound basis for evaluating the facts regarding both the forex market generally, as well as the customers’ specific transactions. These obligations may not be waived or met by disclaimer.

New FINRA member firms that engage in forex-related activities must file their advertisements with FINRA. Rule 2210 requires any firm that has not previously filed advertisements with FINRA to file all of its advertisements at least 10 days prior to first use; this filing requirement continues for one year from the first submission. Rule 2210's internal approval, filing requirements and recording-keeping provisions also apply to forex-related communications. The rule requires that a registered principal give written approval of all advertisements and sales literature prior to use.

Rule 2210 prohibits predictions or projections of performance, or the implication that past performance will recur. Communications used by firms in connection with retail forex activities may not tout future returns. The rule prohibits the omission of material facts or qualifications that would cause a communication to be misleading. Accordingly, firms' communications must adequately disclose the risks associated with forex trading, including the risks of highly leveraged trading. Firms must also make sure that their communications with the public are not misleading regarding, among other things:

- The likelihood of profits or the risks of forex trading, including leveraged trading;
- The firm's role in or compensation from the trade;
- The firm's or the customer's access to the interbank currency market; or
- The performance or accuracy of electronic trading platforms or software sold or licensed by or through the firm to customers in connection with forex trading, including falsely advertising claims regarding slippage rates.

FINRA also reminds firms that SIPC rules prohibit references to SIPC membership or protection in communications regarding commodities, including forex.

Membership Rules

In accordance with FINRA's membership application process, applicants must include a detailed description of their business plan that adequately and comprehensively describes all material aspects of their business activities, as well as the nature and source of the firm's capital. Applicants must be able to demonstrate their capacity to comport with the federal securities laws and FINRA's rules, and to observe high standards of commercial honor and just and equitable principles of trade. Applicants formerly registered with the CFTC should be aware that NASD Rule 1014(a)(3) lists a range of events, including disciplinary actions and customer claims, or any pending adjudicated or settled regulatory action or investigation by the CFTC, that FINRA considers when weighing whether an applicant can meet these standards.¹

Current FINRA member firms should also be aware that expansion into retail forex constitutes a material change in business operations under NASD Rule 1010(i). Therefore, before engaging in over-the-counter forex business, a firm must first file for and receive approval of change in business operations under NASD Rule 1017. Any such filing will be closely reviewed under the guidelines and standards set forth in this *Notice*.

Net Capital Calculations and Customer Protection Rule

Firm Investment in Forex

If a firm that must present its financials in U.S. dollars invests in forex, the currency must be converted to U.S. dollars as of the balance sheet date. Further, in computing its net capital, the firm must take a currency charge, the amount of which depends on the currency involved. The charge is not applied for firms with an off-setting liability payable in the same currency. In addition, other off-sets with respect to hedged transactions may be available.

Receivables Associated with Forex Transactions

Firms engaged in retail forex should review the requirements of Appendix B of Securities Exchange Act (SEA) Rule 15c3-1, governing net capital calculations for broker-dealers, to ensure the accuracy of their net capital computations. In general, when a customer or counterparty owes the broker-dealer money with respect to a forex transaction, the firm must treat the unsecured portion of the receivable as a non-allowable asset. Appendix B (a)(3)(xviii) of Rule 15c3-1 contains the conditions that must be met in order to consider the receivable secured, and therefore an allowable asset.

Rule 15c3-3 Reserve Formula Treatment

In accordance with SEC Release 34-9922, firms are required to include the net balance due to customers in non-regulated commodity accounts, reduced by any deposits of cash or securities with any clearing organization or clearing broker in connection with the open contracts in such accounts. This requirement would also apply to forex transactions.

Anti-Money Laundering

NASD Rule 3011(a) requires FINRA member firms to establish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of suspicious transactions. Further, 31 CFR 103.19(a) of the Bank Secrecy Act requires broker-dealers to report suspicious transactions, as defined under the Rule, that are conducted or attempted by, at, or through their firm. FINRA member firms engaging in retail forex activities should ensure their Anti-Money Laundering Program addresses the risks associated with the business and includes procedures for monitoring, detecting, and reporting suspicious transactions associated with their retail forex activities.

Conclusion

FINRA is concerned about the rapid growth of the retail forex market generally, and about the retail forex activities of broker-dealers in particular. We expect firms to review and monitor their forex activities to ensure compliance with all applicable rules, and FINRA will look to the rules and interpretations issued by the NFA to govern its members' retail forex business as a basis for determining whether the same activities, when conducted by a broker-dealer, meet the high standards of commercial honor and principles of just and equitable trade required under FINRA's rules.

Endnotes

- 1 See, e.g., *FINRA Notice 04-10* (SEC Approves Amendments to Membership Application and Continuation Rules (Rules 1011, 1014, and 1017)).