Regulatory Notice 09-06

Retail Forex

FINRA Requests Comment on Proposed Rule to Establish a Leverage Limitation for Retail Forex

Comment Period Expires: February 20, 2009

Executive Summary

FINRA is requesting comment on a proposed rule prohibiting any member firm from permitting a customer to: (1) initiate any forex position with a leverage ratio of greater than 1.5 to 1; and (2) withdraw money from an open forex position that would cause the leverage ratio for such position to be greater than 1.5 to 1.

The text of proposed FINRA Rule 2380 (Leverage Limitation for Retail Forex) is set forth in Attachment A.

Questions concerning this *Notice* should be directed to:

- Gary Goldsholle, Vice President and Associate General Counsel, Office of General Counsel (OGC), at (202) 728-8104; or
- Matthew E. Vitek, Counsel, OGC, at (202) 728-8156.

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by February 20, 2009.

January 2009

Notice Type

- Request for Comment

Suggested Routing

- Compliance
- Legal
- Operations
- Senior Management

Key Topics

- Forex
- Foreign Currency
- Futures
- Leverage

Referenced Rules & Notices

- NASD Rule 2520
- NYSE Rule 431

FINRA™
Financial Industry Regulatory Authority

Member firms and other interested parties can submit their comments using the following methods:

- Emailing comments to *pubcom@finra.org*; or
- Mailing comments in hard copy to:

  Marcia E. Asquith
  Office of the Corporate Secretary
  FINRA
  1735 K Street, NW
  Washington, DC 20006-1506

To help FINRA process and review comments more efficiently, parties should use only one method to comment on the proposal.

Important Notes: The only comments that FINRA will consider are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the FINRA Web site. Generally, FINRA will post comments on its site one week after the end of the comment period.[1]

Before becoming effective, a proposed rule change must be authorized for filing with the SEC by the FINRA Board of Governors, and then must be approved by the SEC, following publication for public comment in the *Federal Register*.[2]

Background and Discussion

The primary foreign currency exchange market is the interbank market, in which commercial banks, central banks, currency speculators, corporations, governments and other institutions trade currencies amongst themselves. This market is an over-the-counter (OTC), decentralized market without any trade reporting or central clearing facility. In recent years, an electronic, secondary OTC spot contract market has developed for retail customers (retail forex).

The current retail forex regulatory environment is a by-product of the Commodity Futures Modernization Act of 2000 (CFMA)[3] and the CFTC Reauthorization Act of 2008 (Reauthorization Act).[4] The CFMA and the Reauthorization Act amended the Commodity Exchange Act (CEA)[5] by removing some of the legal uncertainty pertaining to the Commodity Futures Trading Commission's oversight of retail forex activity by permitting only certain enumerated regulated entities to act as counterparties to a retail forex contract. Specifically, the CEA allows futures commission merchants, retail foreign exchange dealers, financial institutions, broker-dealers and certain other entities to act as counterparty to retail forex contracts.[6]

Historically, retail forex activity has been concentrated in the futures commission merchant (FCM) channel. Retail forex transactions conducted through a broker-dealer are expressly precluded from CFTC oversight under the terms of the CEA.[7]

In general, the leverage ratios for retail forex by futures intermediaries were set to be comparable to the leverage ratios for currency futures traded on futures exchanges. As such, retail forex contracts in the FCM channel commonly have leverage ratios of 100 to 1 or more. For example, if an investor wishes to purchase $1 million worth of a foreign currency offered with a 100 to 1 leverage, the investor would only need a good faith deposit of $10,000. If the investor deposits only the minimum funds required, and if the value of the foreign currency contract dropped by 1 percent (to $990,000), the account equity would be depleted entirely and the investor's position would be closed out. The investor would lose the entire $10,000 deposit. In the retail forex market, there is neither any margin call nor any notice for an investor to deposit additional funds to maintain his or her position. As a result, even small intra-day swings in currency rates have the potential to close out investors on either side of the market.

FINRA has observed a potential migration of retail forex activity from the FCM channel to broker-dealers. To protect investors, FINRA proposes to limit the leverage ratio a broker-dealer can offer to a retail forex customer. FINRA does not believe that high leverage ratios are consistent with its mandate to protect investors. In the securities industry, the initial margin requirement for marginable equity securities is 50 percent, representing a leverage ratio of 2 to 1.[8] In addition, there are separate, lower maintenance margin requirements.[9] Further, if the current market value of the equity in a securities account drops below the maintenance requirement, the investor would not be immediately closed out, but would receive a "margin call" and have an opportunity to deposit additional funds to keep the position open. FINRA also notes that any funds deposited to maintain a forex position or any account equity derived from a forex position may not be used to purchase securities.

Given the speculative and volatile nature of retail forex activity, FINRA believes the maximum leverage ratio for retail forex should be 1.5 to 1. FINRA also believes a firm should not permit a customer to withdraw money from an open forex position that would cause the leverage ratio for such position to be greater than 1.5 to 1. Requiring greater initial deposits for retail forex will substantially reduce the likelihood that any small adverse percentage change in the exchange rate of a foreign currency will cause an investor's funds to be wiped out. Moreover, limiting the leverage ratios is intended to reduce the risks of excessive speculation.

Endnotes

1 FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. *See NASD Notice to Members 03-73* (November 2003) (NASD Announces Online Availability of Comments) for more information.

2 Section 19 of the Securities Exchange Act of 1934 (Exchange Act) permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily abrogate these types of rule changes within 60 days of filing. *See* Exchange Act Section 19 and rules thereunder.

3 Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763, 2763A-378 (2001).

4 CFTC Reauthorization Act of 2008, Pub. L. No. 110-246, 122 Stat. 1651 (2008).

5 7 U.S.C. §§ 1 – 27f.

6 *See* 7 U.S.C. § 2(c)(2.)

7 *Id*.

8 12 C.F.R. 220.12.

9 *See* NASD Rule 2520(c)(1) and NYSE Rule 431(b)(4).

Attachment A

* * * * *

2380. Leverage Limitation for Retail Forex

(a) Leverage Ratio Limitation

(1) No member shall permit a customer to initiate any forex position with a leverage ratio greater than 1.5 to 1. In addition, no member shall permit a customer to withdraw money from an open forex position that would cause the leverage ratio for such position to be greater than 1.5 to 1.

(b) Definitions

(1) The term "forex" means foreign currency futures and options and any other agreement, contract, or transaction in foreign currency that is:

(A) offered or entered into on a leveraged basis, or financed by the offeror, the counterparty, or a person acting in concert with the offeror or counterparty on a similar basis;

(B) offered to or entered into with persons that are not eligible contract participants as defined in Section 1a(12) of the Commodity Exchange Act; and

(C) not executed on or subject to the rules of a contract market registered pursuant to Section 5 of the Commodity Exchange Act, a derivatives transaction execution facility registered pursuant to Section 5a of the Commodity Exchange Act, a national securities exchange registered pursuant to Section 6(a) of the Securities Exchange Act of 1934, or a foreign board of trade.

(2) The term "leverage ratio" is the fraction represented by the numerator which is the notional value of a forex transaction, and the denominator, which is the amount of good faith deposit or account equity required by the customer for a forex position.

• • • **Supplementary Material ——————-—————**

.01 Leverage Ratio Example - In order to meet the leverage ratio limitations of Rule 2380(a), a customer must deposit at least 2/3 of the notional value of the forex contract. For example, a customer entering into a forex contact representing $750,000 of a foreign currency must deposit $500,000 to achieve a leverage ratio of 1.5 to 1.