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Forex Dealer Members—The Times, They Are A-changing

On January 15, 2015, two days after the Swiss National Bank reaffirmed its commitment to a three-year peg on the franc, and less than a month after stating that the cap was "absolutely central,"[1] and it would continue to "enforce it with the utmost determination,"[2] the SNB unleashed "Francogeddon" in the foreign exchange (forex) markets by abruptly removing the cap during active trading. The surprise about-face created historical volatility in early trading and sent the franc nearly 30 percent higher than the Euro. SNB Chairman Thomas Jordan was unapologetic and defended the move, saying the peg was unsustainable, and they had to take the markets by surprise.[3]

Despite the SNB's agenda, however, global forex dealers and U.S. clients took an unprecedented hit, with losses in the hundreds of millions. Initially, investors that were traumatized by the very Eurozone crisis that prompted the cap in 2011 bought Swiss francs, believing the stable currency would hold its value and provide a safe haven for their investment. Many of those investors, or their firms, suffered huge losses in the early hours of January 15, and U.S. regulators paid close attention to the turmoil.

On Thursday, after months of development and deliberation, the Commodity Futures Trading Commission created a host of new regulatory protections for those investors, patching what appeared to be a hole after Dodd-Frank. Although forex dealers were pulled into CFTC and National Futures Association jurisdiction under Dodd-Frank, U.S. law did not require certain kinds of segregation of funds.[4] Further, little law protected retail investors against dealer bankruptcy or loss, which happened in spades on and after January 15.

Immediately after the events, the NFA temporarily required investors to front additional cash—5%, up from 2%—when they traded the franc. The requirement came hours after CFTC member Sharon Bowen released a statement calling on the CFTC to enhance regulation of the retail forex industry and calling forex trading "the least regulated part of the derivatives industry."[5] In February, the CFTC publicly detailed its consideration of additional oversight to dealers catering to individual clients, small retail investors, and small companies – the bread and butter of most retail forex dealers. CFTC Chairman Timothy Massad stated that the CFTC found risks stemming from outsize bets made by overseas customers that are not subject

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to U.S. rules,[6] including rules governing the use of leverage.[7] Since forex trading is highly leveraged, even minor market shifts can have major negative implications for traders.

After Massad's comments in February, the NFA proposed a series of rule amendments and an interpretative notice in May and submitted those for review and approval to the CFTC. On Thursday, the CFTC adopted the amendments and notice, enhancing requirements for NFA member forex dealers. Specifically, the new rules do the following: 1) impose additional capital requirements on forex dealer members ("FDMs"), adding 10% of liabilities the FDM owes to eligible contract participant counterparties and 10% of liabilities eligible contract participant counterparty affiliates owe to customers; 2) require FDMs to collect security deposits for off-exchange foreign currency transactions from eligible contract participant counterparties in addition to retail counterparties; 3) require FDMs to adopt and implement rigorous risk management programs, drawn from similar requirements set forth in regulations for futures commissions merchants, swap dealers, and major swap participants[8]; and 4) require FDMs to provide additional market disclosures and firm-specific information on their websites, with regular updates, to permit current and potential counterparties to better assess the risks of engaging in off-exchange foreign currency transactions and with conducting business with a particular FDM.[9]

When the rules were proposed in May, the NFA explained that they determined that FDMs should be subject to risk management program requirements, applicable public disclosures, and an annual report requirement akin to those mandated of Futures Commission Merchants and Swap Dealers. The NFA also said that FDMs should be subject to increased capital requirements because of the risks associated with forex transactions. When the rules were approved by the CFTC on Thursday, Massad stated that the January events were a "stark reminder" of the risks of the forex markets, and customers of retail foreign exchange dealers "do not have the same protections as customers in the futures markets."

The NFA's explanatory statements, Massad's comments, and ongoing crusade to tighten regulation in this area clearly indicates a continual increased focus and crackdown on the retail forex market. And despite the new rules, Bowen stated that regulation in this area has not gone far enough. "[T]hese [NFA rule] proposals are not, by themselves, enough to provide retail commodity investors the basic protections they enjoy for every other commodity except foreign exchange…The CFTC itself needs to adopt more rigorous regulations on retail foreign exchange dealers. Retail customers invest in these markets on a highly leveraged or margined basis, which is a recipe for financial disaster if you cannot afford to lose that money."[10] In her statement, Bowen emphasized the need for protection of retail investors, who have continually been seen by regulators as mom-and-pop individuals who, unlike other derivative traders, cannot afford to make losing bets on leverage.

Because of the shock and the massive effect of the Swiss black swan on the forex market, regulators now appear to believe that the only way to protect the forex market, and in particular, retail investors, is to regulate, regulate, and regulate. This adoption by the CFTC is likely one step in a long walk towards much bigger changes.

[1] "SNB Chairman says cap on Swiss franc absolutely central," *Reuters*, January 5, 2015, *available at* http://www.reuters.com/article/2015/01/05/us-swiss-snb-idUSKBN0KE1DO20150105

[2] Swiss National Bank introduces negative interest rates, minimum exchange rate

reaffirmed, and target range for three month Libor lowered into negative territory, December 18, 2014, *available at* http://www.snb.ch/en/mmr/reference/pre_20141218/source/pre_20141218.en.pdf.

[3] Alice Baghdajin and Silke Koltrowitz, Swiss central bank stuns market with policy U-turn, *Reuters,* January 16, 2015, *available at* http://www.reuters.com/article/2015/01/16/us-swiss-snb-cap-idUSKBN0KO0XK20150116

[4] Furthering the emphasis on heightened vigilance, on August 7, the NFA detailed implementation of "phase 2" of Notice I-14-25, which required FDMs that hold assets used to cover retail forex customer liabilities to report balances in these accounts on a daily basis. Phase 1 required daily reporting on the part of bank depositories holding assets to cover the amount owed to forex customers. Phase 2, effective on September 1, requires all other depositories to report end-of-day balances in accounts holding assets used to cover an FDM's liability to its retail forex customers. This notice clearly underscores regulatory focus and concern with respect to segregation of funds.

[5] Statement of U.S. Commodity Futures Trading Commissioner Sharon Bowen Regarding Recent Activity in the Retail Foreign Exchange Markets, January 21, 2015, *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/bowenstatement012115. "I am concerned that lower standards are putting this industry in a precarious position and placing retail foreign-exchange investors unnecessarily at risk…we should consider establishing regulations on the retail foreign exchange industry that are at least as strong as the regulations on the rest of the derivatives industry." Bowen supplemented this statement in June when she delivered a keynote speech at the Quadrilateral Conference, a gathering held at the European Central Bank in Frankfurt. "[It] makes absolutely no sense to me that retail [foreign exchange] trading is the least regulated part of the over-the-counter swaps market… the time has come to comprehensively regulate this market… Too much retail foreign exchange trading currently occurs over the counter." Keynote Speech of CFTC Commissioner Sharon Y. Bowen before the Quadrilateral Meeting at the European Central Bank (Frankfurt, Germany), June 24, 2015, *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opabowen-5.

[6] US rules currently limit leverage on transactions for retail at 50 to 1; customers in some countries trade with as much as 200-to-1 leverage.

[7] Testimony of Chairman Timothy G. Massad before the U.S. Senate Committee on Appropriations, Subcommittee on Financial Services and General Government, Washington, DC, May 5, 2015, *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-19.

[8] See CFTC Regulations 1.11 and 23.600

[9] CFTC Approves National Futures Association Rules Enhancing Protections for Retail Forex Customers, August 27, 2015, *available at* http://www.cftc.gov/PressRoom/PressReleases/pr7219-15.

[10] Statement of Commissioner Sharon Y. Bowen on Enhancing Protections for Retail Forex Customers, August 27, 2015, *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/bowenstatement082715.