FINRA ADDRESSES BROKER-DEALER REGULATORY REQUIREMENTS IN THE RETAIL FOREIGN CURRENCY EXCHANGE BUSINESS

OVERVIEW

Retail over-the-counter foreign currency exchange ("retail forex") is a highly volatile market, exposing customers to substantial market and counterparty risks. These risks, coupled with the rapid growth of the retail forex market, prompted the Financial Industry Regulatory Authority to issue a Regulatory Notice, which explains how FINRA rules apply to broker-dealers engaged in the retail forex business.

FINRA Regulatory Notice 08-66 ("Regulatory Notice") addresses the regulatory requirements imposed on broker-dealers that engage in the retail over-the-counter foreign currency exchange market. This article discusses the Regulatory Notice and the FINRA rules applicable to the retail forex business.

BACKGROUND

The retail over-the-counter foreign currency exchange market is an electronic secondary market in which customers can trade currencies through spot, forward and swap transactions with forex dealers acting as counterparties. Unlike the primary forex market, or the interbank market, where large banks, financial institutions and other eligible participants trade currencies among themselves, the retail foreign currency exchange market is characterized by higher price volatility and higher spreads. The heightened risks of the retail forex market are magnified by the fact that forex dealers often extend leverage to their customers at ratios as high as 400:1, allowing customers to exponentially increase or decrease their profits and losses. Retail customers also face counterparty risk because no central clearing organization exists for forex transactions. As a result, customers do not know where funds they deliver to forex dealers for exchange transaction purposes will be held. In short, retail forex customers are exposed to substantial risks that customers in the securities markets do not face.

In order to address these risks, in November 2008, FINRA issued the Regulatory Notice which describes the FINRA rules applicable to broker-dealers that engage in retail over-the-counter foreign currency exchange activities. The Regulatory Notice states that, due to the "volatile and risky" nature of the retail foreign currency exchange market and the recent increase in retail forex activities among FINRA members, broker-dealers must be vigilant to ensure that they are in compliance with FINRA rules.

JUST AND EQUITABLE PRINCIPLES OF TRADE

The Regulatory Notice addresses NASD Rule 2110, which applies to every FINRA member and "requires that firms, in the conduct of their business, observe high standards of commercial honor and just and equitable principles of trade." FINRA notes that Rule 2110 applies to all businesses of a broker-dealer, including retail forex activities. FINRA will look to the forex regulatory requirements adopted by the National Futures Association for the currency forex market to determine the appropriate standards and principles to be applied to the retail forex market under Rule 2110. According to FINRA, forex-related conduct that would constitute a violation of Rule 2110 includes:

- Misappropriating or mishandling customer funds;
- Failing to disclose that the firm is acting as a 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 consumers 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 solictors that are employees or agents of the firm; and
- Accepting forex-related trades from any entity or individual that solicits retail forex business on behalf of the firm in a misleading or deceptive way.

COMMUNICATIONS WITH THE PUBLIC

The Regulatory Notice addresses the responsibilities incumbent on broker-dealers when communicating with the public. Rule 2210 regulates communications with the public and "prohibits firms from making any false, exaggerated, unwarranted or misleading statement or claim in any communication with the public." According to FINRA, a broker-dealer's communications must be "fair and balanced and based on principles of fair dealing and good faith, and must provide a sound basis for evaluating the facts regarding both the forex market generally, as well as the customers' specific transactions." These obligations cannot be waived or met by disclaimer. Rule 2210 requires new FINRA members to file their advertisements with FINRA at least 10 days prior to first use. This filing requirement continues for one year from the first submission. A registered principal also must give written approval of all advertisements prior to use.

Any advertisement or communication with the public cannot include predictions or projections of performance or imply that past performance is an indicator of future performance. Communications must accurately disclose the risks associated with retail forex trading, including the risks of highly leveraged trading. Omissions of material facts or qualifications that would cause a communication to be misleading include omissions related to the firm's role in or compensation from forex trades; the firm's or customer's access to the interbank currency market; or the performance or accuracy of electronic trading platforms licensed by or through the firm.

REQUIREMENTS FOR FINRA FIRMS ENTERING THE RETAIL FOREX BUSINESS

Under the Regulatory Notice, applicants that are not already FINRA members must include a detailed explanation of their business plans that "adequately and comprehensively describes all material aspects of their business activities, as well as the nature and source of the firm's capital." In addition, applicants must be able to demonstrate their capacity to comport with federal securities laws and FINRA's rules, and observe high standards of commercial honor and just and equitable principles of trade.

A current FINRA member firm must file for and receive approval of a change in business operations under NASD Rule 1017 if it wishes to enter the retail forex business, as such activity constitutes a material change in business operations as defined by NASD Rule 1011(k). This filing would be reviewed under the guidelines discussed in this article.

REPORTING REQUIREMENTS

The Regulatory Notice highlights notable reporting requirements for firms that engage in retail forex activities. For example, if a firm that must report its financials in U.S. dollars invests in forex, any currency must be converted to U.S. dollars as of the balance sheet date. Further, in computing net capital, the firm must take a currency charge, the amount of which depends on the currency involved. The charge does not apply, however, if the firm has an off-setting liability payable in the same currency.

Firms engaged in retail forex activities should review the requirements of Appendix B of Securities Exchange Act Rule 15c3-1 to ensure the accuracy of their net capital computations. Generally, if a customer owes a broker-dealer money with respect to a forex transaction, the firm must treat that 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.

In calculating a reserve under Rule 15c3-3, firms are required to include the net balance due to customers in retail forex accounts, reduced by deposits of cash or securities made with any clearing organization or clearing broker in connection with the open contracts in such accounts.

ANTI-MONEY LAUNDERING

The Regulatory Notice references the anti-money laundering rules applicable to FINRA members.

NASD Rule 3011(a) requires FINRA members to "[e]stablish 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 that are conducted or attempted by, at or through the firm. FINRA member firms should ensure that their anti-money laundering program addresses procedures for monitoring, detecting and reporting suspicious retail forex transactions.

CONCLUSION

The Regulatory Notice reminds broker-dealers of regulatory requirements in light of the rapid growth of the retail forex market. All FINRA firms should review and monitor their retail forex activities to ensure that they are in compliance with all applicable rules. It is important to note that FINRA will look to the rules and interpretations issued by the NFA to determine whether activities conducted by a broker-dealer comply with the high standards of commercial honor and just and equitable principles of trade required under FINRA Rule 2110.

ABOUT CURTIS

Founded in 1830, Curtis, Mallet-Prevost, Colt & Mosle LLP is a global law firm headquartered in New York, with offices in the United States, Europe, Mexico, the Middle East and Asia. Lawyers in the Firm's government enforcement and white-collar criminal group have experience at every level of the federal and state courts and before regulators. Curtis lawyers serve companies and individuals in enforcement proceedings initiated by criminal prosecutors, federal and state agencies, and self-regulatory organizations.

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