FOREX REGULATION BITES BUSINESS

BY TAM HARBERT

Forex traders who visited the website of CMC Markets U.S. LLC in early October found a lone page that was striking in its brevity: "CMC Markets regrets to announce that it has decided to wind down its U.S. operations." The company gave no explanation of the decision.

That left some forex dealers speculating that CMC's exit was prompted by coming changes in U.S. regulation of the retail forex market. Hugo Valdivia, the compliance officer at forex dealer Bacera Corp., for example, pointed to CMC's U.S. closure when he was explaining his company's struggle with the new regulations. With adjusted net capital of only $5.4 million, investors of Bacera were still deciding what to do on Oct. 29, just two days before the minimum capital requirement for forex dealers was to be raised to $10 million.

There may be other reasons for CMC's exit (informed observers think that the firm was not producing enough business, but CMC would not say), but it is easy to see why forex dealers have drawn their conclusions. Given the morass of changing rules and not-yet-written regulations that enveloped the industry starting last fall, it's a confusing time for forex dealers in the United States. When the smoke clears, some think the U.S. forex market will be better off because of the latest round of regulations; others think it will be worse off. But all agree on one thing: There will be fewer forex dealers.

"At the end of the day, there will probably only be about five retail FX firms left in the United States," says Marc Prosser, chief marketing officer of forex dealer FXCM.

STUMBLING TOWARD REGULATION

Originally, forex was not regulated in the United States. But in an attempt to eliminate fraud in the market by some bad actors, Congress in the Commodity Futures Modernization Act of 2000 gave limited regulatory authority over forex dealers to the Commodity Futures Trading Commission (CFTC). However, poor wording of the bill allowed retail forex subsidiaries and affiliates, such as introducing brokers, to go unregulated. Then in June 2004 a court ruled in the Zelener case that the CFTC had no jurisdiction over the rolling spot contracts common in off-exchange retail forex, leaving the regulation of forex in limbo.

Between 2000 and 2004, when the Zelener ruling put the brakes on CFTC action, the CFTC filed 98 enforcement actions against firms and individuals selling illegal forex futures and options contracts, says CFTC Commissioner Michael Dunn. The cases involved more than 25,000 victims and losses of more than $400 million, and resulted in judgments for civil monetary penalties and restitution of more than $1 billion.

Forex dealers account for less than 1 percent of National Futures Association membership—about 26 firms out of 4,000 members—according to NFA President and CEO Daniel J. Roth. Yet they have been responsible for more than 20 percent of customer complaints, more than 50 percent of NFA's enforcement docket and more than 50 percent of the emergency enforcement actions at NFA, according to Roth's testimony to Congress in 2007.

That's why both the CFTC and the NFA backed the regulatory changes in the CFTC Reauthorization Act of 2008, passed in May. The new legislation:

1. Closed the Zelener loophole, clarifying that the CFTC's anti-fraud authority applies to certain retail off-exchange forex transactions.
2. Created a new CFTC registration category for retail forex dealers, and required registration for

those who solicit orders, exercise discretionary trading authority and operate commodity pools with respect to off-exchange retail forex transactions.

3. Imposed minimum capital requirements for FCMs and retail foreign exchange dealers that act as counterparties in off-exchange retail forex transactions.

The reinstatement of CFTC's authority was effective immediately, and in August the commission launched a special task force on retail forex fraud. The task force consists of three trial attorneys and draws on support from other attorneys, investigators and paralegals in the enforcement division, says Dunn, who heads the task force. In late October, Dunn said that the task force was pursuing some 20 different leads and that he anticipated enforcement actions soon.

But the new registration categories and minimum capital requirements specified in the bill require the CFTC to write new regulations. Although Congress asked the CFTC to complete the regulations within four months of the law's passage, as of November, they still were not completed and Dunn did not expect them until after the first of this year.

The NFA, however, moved quickly last fall, proposing several amendments to its forex rules to reflect the new provisions. First it proposed, and the CFTC approved, that forex dealer members (FDMs) be required to meet minimum net capital requirements of $10 million as of Oct. 31, 2008; $15 million as of Jan. 17, 2009; and $20 million as of May 16, 2009. The $20 million figure was based on two factors, according to Roth: a precedent Congress set in 1978 when it set minimum capital for dealers options at $5 million, which in today's dollars would be $18 million, and recognition of the fact that forex dealers are different than traditional FCMs in that they play the role of FCM, exchange and clearinghouse.

"The risks that forex dealers run are different than the risks that are run by a traditional FCM, and that should be reflected in their capital requirements," he says.

In addition, the NFA plans to require firms that act only as the counterparty to retail off-exchange foreign exchange contracts to register as Retail Foreign Exchange Dealers (RFEDs). An RFED or an FCM that is substantially engaged in on-exchange activities and acts as a retail forex counterparty will be designated by NFA as an approved Forex Dealer Member (FDM), according to the NFA's fall newsletter. Further the NFA proposes that FCMs, introducing brokers (IBs), commodity pool operators (CPOs) and commodity trading advisors (CTAs) whose activities involve retail forex be designated specifically as forex FCMs, forex IBs, forex CPOs and forex CTAs, while associated persons (APs) will be designated as forex APs.

The NFA created the separate designations so it could track which firms and individuals are engaged in retail forex activities, according to Tom Sex-

FIGURE 1: Leading Retail FX Firms

COMPANY	HEADQUARTERS	SERVICE LAUNCHED
CMC Markets	London	1996
dbFX	New York City	2006
FXCM	New York City	1999
FXDD	New York City	2002
FX Solutions	New York City	2001
GAIN Capital	Bedminster, N.J.	1999
GFT	Ada, Mich.	1997
Saxo Bank	Copenhagen	1998

Source: Aite Group LLC

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ton, NFA's senior vice president and general counsel. In addition, NFA has developed a new proficiency exam for retail forex, called the Series 34 exam, according to Greg Prusik, NFA's vice president of registration. "We have recommended to the CFTC that its forex rules require any individual applying for registration as a forex AP to take and pass both the Series 3 exam and the Series 34," he says.

HIGHER NET CAPITAL MINIMUMS, LESS COMPETITION?

All these changes, particularly the higher minimum capital requirements, will have a major impact on the U.S. retail forex business during the next six months. The industry was already consolidating, but mergers and acquisitions seemed to intensify just before the first minimum capital hike on Oct. 31. In September, for example, City Index Group merged two wholly owned subsidiaries—FX Solutions LLC and IFX Markets Inc.—each of which had less than $20 million in net capital, according to the companies' Sept. 30 financial filings with the CFTC. In mid-October, futures clearing firm Rosenthal Collins Group LLC acquired forex firm MG Financial LLC, which reported net capital of about $5.4 million as of Sept. 30.

"The smaller ones with good reputations will have no choice but to try to combine with larger entities," says Sang Lee, co-founder and managing partner focused on securities and investments at Aite Group LLC, an independent research and advisory firm for the financial services industry. "The bad ones will simply have to shut down."

Lee says that many forex firms welcome the new regulations. "They've been very concerned that there are a few bad seeds out there that make this whole part of the industry look bad," he says.

Dunn says he's hearing the same. "Forex is an important part of the futures business, and there are a lot of good, legitimate folks in the forex industry trying to do their best to keep this industry as clean as possible," he notes. "And those folks are all saying the same thing: Get these fraudsters and charlatans out of the business. We don't want the business to be associated with them at all."

FXCM's Prosser thinks the regulations are good for the industry and for his firm. The rules will "raise the business to a more professional level," he says and by eliminating some of the bad actors, will create more business for FXCM and other legitmate companies. Previously, "we were losing business to people that were making claims that we would never make or allow," he explains.

"Every time you move the bar up, smaller competitors get left behind," agrees Ken Lazzara, head dealer of Easy-Forex U.S. Ltd. "It's unfortunate for some of them maybe, but it's going to be easier for bigger firms such as ourselves to shine."

Although Easy-Forex U.S. Ltd. reported only $9.8 million in net capital as of Sept. 30, Lazzara says that its global holding company, Easy-Forex Ltd., will be injecting enough capital for the U.S. operation to meet the rising minimums. "My understanding is that we are at the required cap right now and are fully prepared to meet the next level."

But other forex dealers worry that the capital requirements have been raised too high. Such a dramatic increase over so short a period will "eliminate competition in the retail market," says Russell Wasendorf Jr., president and COO of futures and forex firm PFGBest.com. And that will be bad for retail investors, he warns. "You'll see spreads go up and costs go up for the investor."

He says the new minimums are actually higher than at first glance. In order to avoid being put under early warning under the NFA's rules, an FCM must maintain 150 percent of the minimum capital requirement. Under the new minimums, therefore, dealers would have to maintain a minimum of $22.5 million as of Jan. 17 and $30 million as of May 16 in order to avoid being under early warning, he says.

But NFA's Roth points out that a recent change in the rules means that forex dealers will not suffer many

REGULATORS MAY TURN UP THE HEAT ON OVER-THE-COUNTER PRODUCTS

In the wake of the economic chaos caused last fall by the credit crisis, some experts think more regulation is coming to the over-the-counter markets.

Michael Greenberger served as director of the CFTC's division of trading and markets in the late 1990s and is currently a University of Maryland law school professor. He unequivocally supports the new minimum capital requirements for forex dealers. "The CFTC has confronted many serious problems over the years, but the longest standing and among the most serious has been with forex retailers," he says. "It's rife with fraud."

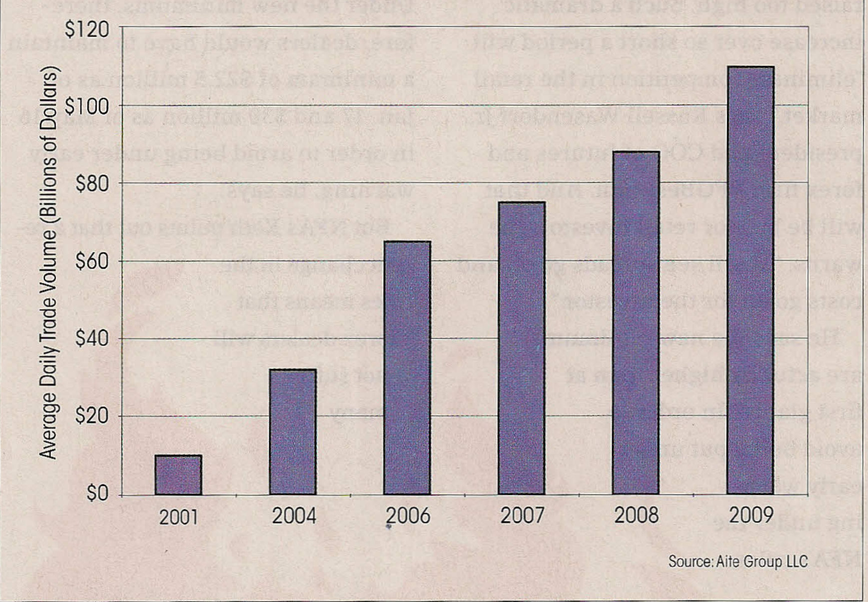
And the CFTC and other regulators may not stop there. "One of the major lessons to come out of the credit crisis was the failure to impose minimum cap requirements on unregulated derivative transactions," including credit default swaps, he points out. He believes the next Congress will be looking carefully at OTC derivatives, including forex. "The entire sector is going to be picked apart with a fine-tooth comb."

Although he does not necessarily support this idea, some are suggesting abolishing OTC derivatives completely—even forex OTC trading among the so-called "sophisticated" investors—and requiring that they be listed on exchanges, Greenberger says.

The financial crisis has made the CFTC "much more mindful of risk," and it will be looking closely at the risks of the various products under its purview, says CFTC Commissioner Michael Dunn.

Ken Lazzara, head dealer of Easy-Forex U.S. Ltd., senses a storm coming. "I think the CFTC is going to turn up the heat," he says. "There's going to be a magnifying glass on everybody."

FIGURE 2: Estimated Average Daily Trade Volume in Retail FX



consequences for being under early warning. Previously, NFA prohibited FCMs who were under early warning from entering into new guarantee agreements with IBs. But in August that rule was changed and it no longer applies to forex dealers, so FDMs are eligible to enter into new agreements as long as they maintain their minimum capital, he says. "So right now the only consequence of being under early warning is filing monthly capital reports, which they have to do anyway," Roth says.

However, there is another negative consequence, Wasendorf maintains. "You have to publicly report to regulators that you are under early warning," he says, which can needlessly alarm customers and harm a firm's reputation. Even though a firm may only have $1 million worth of business, it can be under early warning if it has $10 million—more than enough to ensure the safety of customer funds, he points out.

Wasendorf calls on regulators to get rid of the early warning rule for FDMs or to at least reduce the level at which it kicks in to 110 percent of the minimum capital requirement as it is for FCMs.

There have been indications that the CFTC is considering such a move, but such changes won't be known until the regulations are published. Meanwhile, small and midsized firms will continue to struggle and may go out of business because of the onerous requirements, Wasendorf says.

While there is no doubt that the industry is changing, Lee sees a bright future for retail forex. In the long run, the regulatory changes should help the retail forex market increase its legitimacy, which in turn should help the market grow even more, he says. Today, retail accounts for only 2 percent to 3 percent of the total $4 trillion-a-day FX marketplace, which leaves a lot of running room for this market. "I think we've really just scratched the surface of where this market could go."

Tam Harbert, a freelance journalist based in Washington, D.C., has covered business, technology and public policy for more than 20 years. You can see more of her work at TamHarbert.com.