

January 13, 2010, is a date that many of us in the world of Forex regulation will not soon forget. On that day, the United States Commodity Futures Trading Commission (“CFTC”), after almost two years of deliberation, proposed a set of regulations that created a tsunami of outcry in the retail foreign exchange market. These long-awaited rules were a product of the 2008 Farm Bill that intended to require registration of US introducing brokers, commodity trading advisors and commodity pool operators. Instead, these 192 pages of densely-worded legislation created an international uproar due to the CFTC's efforts to curtail leverage limits to historic lows.

The purpose of the Farm Bill, and the ultimately the purpose of these rules, was to provide adequate customer protection in what has been unfortunately called “a loosely regulated market.” Like children waiting for their birthday gifts, registered US foreign exchange brokers have been impatiently waiting for these rules to legitimize the industry by imposing registration requirements on introducing brokers, CTAs and CPOs. Their impatience, however, was dubiously rewarded with a set of proposed regulations that, if enacted, would ultimately drive most of these Forex brokers and their clients abroad.

In an economy already facing with historically high unemployment, the set of proposed rules was intended to bring legitimacy, reputation and growth to an industry that was already damaged due to the lack of regulation and legal loopholes that allowed fraud to flourish in the first decade of this millennium.

Let's step back and remind ourselves why these rules were proposed in the first place. After a number of adverse decisions against the CFTC in two federal appellate circuit courts, the Farm Bill intended to clarify the CFTC's jurisdiction over the retail foreign exchange area. This legislation specifically sought for the CFTC to promulgate a set of industry rules in order to effectively regulate the retail FX market as well as provide the necessary customer protection to its clients.

After years of fraud, countless Ponzi schemes and unregistered solicitation activities by introducing brokers, money managers and commodity pool operators, the US foreign exchange dealers have lobbied in support of these registration requirements. The purpose of these rules was to provide the CFTC with the necessary tools to put the bad guys away while allowing reputable and well-capitalized FX brokers to flourish in this land of opportunity.

The rules that were meant to benefit the industry instead caused a major public and industry outcry, particularly against the proposal for limiting leverage to 10 to 1. Just a few months ago, the CFTC's designated self-regulatory organization, the NFA, has set forth leverage limits at 100 to 1 for the major currency pairs and 25 to 1 for minors.

The CFTC then opened a 60-day comment period for the public to address these proposed rules. In the first few weeks, over 6,000 comments were received by the Commission. Additionally, major US industry brokers have formed the Foreign Exchange Dealers Coalition (“FXDC”) to lobby against the proposed leverage.

The FXDC has already made significant strides in lobbying against this insensible proposal, and has set up a website ([www.fxdc.org](http://www.fxdc.org)) encouraging the public to voice their opinion by emailing the

Secretary of the CFTC. Similarly, most of the Coalition members have encouraged their employees and clients to do the same. As one industry CEO has recently stated, this proposal looks more like a typo rather than what the actual requirement should be.

In the past four years, the number of foreign exchange brokers in the US has decreased from over 40 to just about a dozen today. The FXDC has argued that a reduction in leverage to 10:1 would further eradicate this industry in the US. Ultimately, most US clients as well as foreign clients who currently do business with US foreign exchange brokers will likely rush to open accounts with foreign and often unregulated brokers.

While some of the regulated jurisdictions already include a cap on leverage, none have imposed such a drastic limit. Some jurisdictions--like the United Kingdom, a comparably regulated jurisdiction compared to the United States--currently do not enforce leverage limits in FX. If the proposed leverage were to go into effect, many retail clients will take their business to places like the United Kingdom rather than forfeit their ability to trade FX in the US. Consequently, US brokers and their US-based employees will be harmed as well. The industry currently employs thousands of employees, contractors and vendors in the United States. According to FXDC, the industry generates over \$1 billion of revenue. This means that with a 10 to 1 leverage cap, thousands of jobs and over a billion dollars in annual revenue will be lost. In today's economy, this is not something that the US government can afford to lose to other jurisdictions.

Although leverage has been a focal point of this regulatory overhaul, a number of other proposals will also significantly affect the US FX business. The current US administration has emphasized the importance of harmonizing the rules throughout the financial sector. This harmonization, unfortunately, is nowhere to be seen in the proposal to require all introducing brokers to be guaranteed by RFEDs, since the same is not required by futures and commodities IBs.

In 2010 it is difficult to comprehend that a registration requirement for FX introducers, money managers and commodity pool operators has not been codified into law. Arguably, millions of dollars have been stolen, misappropriated, or misled by unregistered solicitors in the US in the last decade. Without these registration requirements, US FX brokers are left with the task of policing the activities of their introducers and money managers on their own. In fact, one NFA supervisory rule specifically holds FX brokers' supervisory principals personally liable for any wrongdoing by these unregistered entities. Somehow, the CFTC wants to expand this personal liability to RFEDs' Chief Compliance Officers. The only difference, however, is that this personal liability would extend to Chief Compliance Officers for supervising the activities of their respective brokers. Specifically, each Chief Compliance Officer would be required to certify annually to the CFTC that its respective RFED has in place policies and procedures reasonably designed to achieve compliance with the commodity exchange act and the CFTC rules. Surely current and future Chief Compliance Officers are scratching their heads today, wondering whether their positions are worth keeping under this rule that can potentially jeopardize their career.

While RFEDs are lobbying against this leverage cap, another industry group would be affected by these proposals as well. The CFTC seeks to require IBs to be guaranteed by RFEDs, with each IB being guaranteed by only one RFED, which means that they can only exclusively do business with one broker.

This again brings us to the principle of rule harmonization. Following the financial collapse of the US banking system, the Obama administration put emphasis on the need to harmonize the rules across various financial sectors. However, the administration's harmonization agenda was not followed in this proposal. As mentioned above, such a restriction is not mandated upon the futures and commodities industry IBs, so restricting Forex IBs to do business with only one RFED clearly falls short of this harmonization effort. Furthermore, this restriction will only discourage IB registration and will likely push this sector to move abroad.

IBs should be availed an opportunity to introduce their clients to more than one RFED. The argument that clients would be better protected by dealing with a guarantee rather than an independent IB does not hold water. IBs are defined as financial institutions and, as such, their clients should be allowed to open accounts with more than one brokerage, as each broker may provide different platforms, products and types of services to suit the individual needs of their respective clients. Restricting IBs to deal solely with one RFED will leave their clients with fewer options in selecting different types of services, products and pricing available from other RFEDs.

Requiring IBs to be guaranteed by RFEDs does not justify the CFTC's customer protection argument. IBs, like other NFA members, are subject to the CFTC and NFA rules and regulations. There is no explicit or apparent reason why an RFED guarantee will provide better customer protection for retail clients. On the contrary, without much economic and financial reason to be guaranteed by RFEDs, it is likely that US IBs will follow suit by moving their business abroad, thereby defeating the purpose behind regulatory customer protection.

The proposed retail client protection rules have other aims, as well, and there are long sections of proposals that will likely take many pages to properly explain. A proposal to require specific risk disclosures from FCMS, RFEDs and IBs, for example, has particularly raised eyebrows. This section in part requires these entities to provide their retail clients with a risk disclosure statement indicating the number of non-discretionary retail Forex accounts that might be obtained by them, the percentage of such accounts that were profitable for each of the four most recent quarters, and a statement about past performance not necessarily being indicative of future results.

While the good intention to warn retail clients about the risks of trading in the over-the-counter FX market is a vital part of the proposed regulation's customer protection goal, it isn't clear why the CFTC felt it would be necessary for the RFEDs to disclose the number of profitable accounts for each of the four recent quarters.

Disclosure of risk is an integral preamble of engaging in any financial transaction with retail clients. Though often ignored by retail clients, risk disclosure is a necessary stepping stone to warn the sophisticated and unsophisticated investor alike that financial transactions akin to Forex are risky, urging them to think twice before chasing a dream that can sometimes end in a painful reality. In my years of

practicing as an attorney in the equities, commodities, futures and Forex market, I have yet to see a regulator requiring such disclosure of profitability (or unprofitability) to justify its customer protection goal. Arguably, the good intentions to protect customers in FX may have gone too far here. Yet again, these rules will likely overly burden and unnecessary harm the retail FX business in the US rather than protect its clients.

The proposals discussed above are just the tip of the iceberg, and for the most part they will probably do more good than harm. While the public and the industry are highly critical of certain parts of these proposals, the aim of what they seek to accomplish must be acknowledged. Historically, US regulators have been considered leaders of financial reforms, and their good deeds in these efforts were often followed by other jurisdictions. Let's hope that the same will be said about the current CFTC proposals, which the FX industry dearly takes to heart, yet hopes that some of their critical yet harmful rules will be codified in a more reasonable form.