

The unprecedented turmoil in the financial markets in the last year has brought the financial sector to a historic low. Financial institutions from banks to hedge funds have suffered a great deal of loss as a result of failing to properly govern their market risk exposure while taking large bets on the upswing profitability from the first 7 years of this millennium. The recent scandals on Wall Street, Madoff and Stanford, to name just a few--have fueled the fire for regulators world-wide to create greater oversight over financial institutions and their market exposure. Unlike their counterparties (banks), most FX brokers have weathered and arguably profited from this market volatility. However, the foreign exchange industry did not entirely avoid the reactive blitz of regulations.

In the December E-Forex issue we discussed the emergence of FX regulations, which in the first decade of their existence were primarily fueled through the regulatory enforcement efforts. Here we will discuss how the market turmoil has further stimulated regulatory enforcement efforts continue to serve as a catalyst for additional regulatory oversight to prevent any further market destruction.

For those who are new to the world of FX regulation, it is important to note that other than the US, most other regulated jurisdictions do not promulgate specific FX legal authority. Rather, regulators in the UK, Japan, Hong Kong, Singapore, and Canada oversee the FX market in the same manner as other financial industries. In the past year, these regulators have been concerned about the general enforcement and licensing requirements across their states. In comparison, US regulators have concentrated their efforts on drafting FX-specific laws.

Legislators and regulators world-wide continue to take significant steps to prevent market turmoil from driving world economies beyond recessions. In this article we will briefly discuss regulatory updates in a select number of regulated jurisdictions, and hope to cover additional jurisdictions in future issues of E-Forex magazine. We always welcome any comments and suggestions from our readers.

North America

United States

Following a higher bar in the financial requirements, the US FX industry has been undergoing rapid consolidation. While the number of FX firms in the US (currently approximately eighteen) have decreased in the past year, the National Futures Association (“NFA”) has been hard at work drafting regulations specific to the FX industry. In order to create greater transparency, the proposed regulations call for uniformity in (1) customer account statement; (2) disclosure of rollover fee calculations; and (3) greater oversight of electronic trading systems used by FX firms. The key industry participants have largely agreed with the NFA that transparency is a gateway to better market oversight.

These FX brokers, however, have raised concerns over a number of additional regulations that ultimately might make them uncompetitive in the global market. For instance, two proposals, recently approved by the NFA, will require FX firms to collect a minimum 1% margin on the major currencies and 4 % on the minor currencies. This proposal seeks to cap leverage at 100:1.

Currently in the US, there are no restrictions on the amount of margin required to collect for customers. Therefore, some brokers offer their clients leverage as high as 700:1. The intent of this proposed regulation is obvious--over-leveraged clients and institutions alike have failed to properly manage their risk, which was one of the major reasons for the world-wide market turmoil. Arguably, the same cannot be said about the foreign exchange industry. While highly leveraged position can either magnify clients' gains or losses, a broker's automated margin call policy will control and maintain its market risk and exposure.

In support of an additional rule that proposes to regulate FX brokers' market risk, the NFA wants to require firms to maintain an additional 5% of their clients' liability on top of an already high adjusted net capital requirement of \$20 million.¹ However, a caveat to this rule will exempt firms that solely utilize a straight through process to offset their risk with counterparties (banks). In this caveat, no additional capital requirement beyond \$20 million will be required for firms that fall under this exemption. Unfortunately, this proposed rule fails to take into account the ratio of the straight through process transactions versus those that are not. Particularly, any firm that does not immediately offset the risk with its counterparty entirely will continue to subject itself to the additional capital requirement. Arguably, this additional capital requirement will be burdensome for some firms because the rule falls short of taking into account a firm's aggregate market risk and exposure.

Powered with the CFTC Reauthorization of 2008, the Commodities Futures Trading Commission ("CFTC") has been active in pursuit of unscrupulous commodity pool operators. Unlike its regulator cousin, the US Securities & Exchange Commission ("SEC") that has recently been in the spotlight for failing to prevent multinational Ponzi schemes, the CFTC has done a superb job in obtaining civil and criminal judgments against white collar criminals. While the CFTC is still working on drafting its new regulations for the newly created retail foreign exchange dealer category, the rise in the Ponzi scheme enforcement efforts has brought a much needed assurance to US and foreign investors alike.

Canada

In the summer of 2008, two regulatory bodies, the Investment Dealers Association of Canada ("IDA") and Market Regulation Services Inc. ("RS"), have merged, forming the

¹ 5% of all liabilities owed to customers (as defined in Compliance Rule 2-36(i)) exceeding \$10,000,000, except that any Forex Dealer Member that uses straight-through-processing for all customer transactions is not subject to this requirement.

Investment Industry Regulatory Organization of Canada (“IIROC”). Prior to this merger, the IDA was a self-regulatory organization for full service investment dealers and their employees. RS was a joint initiative of the TSX Group and the IDA to oversee investigatory and enforcement powers of TSX and TSX Venture Exchanges. Following this consolidation, IIROC will serve as a self-regulatory organization overseeing investment dealers, which include firms with foreign exchange investment functions.

Europe

Sweden

The Swedish Financial Supervisory Authority (Finansinspektionen) has recently required that financial companies within the European Union (“EU”) that have cross border activities with other EU countries must be registered and report to Sweden’s financial regulator. As a consequence of the market turmoil, in 2008 it proposed amendments to the regulations and general guidelines governing adequacy and large market exposures. The proposed requirement mandates firms to report to regulators on a monthly basis for the first two months of every quarter with regards to its capital adequacy ratio. In the fourth quarter of 2008, Sweden’s financial regulator has fined a Forex Bank for an insufficient anti-money laundering oversight. While barely avoiding suspension this Stockholm-based bank was penalized nearly \$8 million. This enforcement action represents the first penalty taken by the Swedish regulator against a retail FX firm.

Finland

The Finnish regulatory authority has recently mandated that an investment service provider is required to acquire authorization to operate in the Finnish financial market. Authorization is granted by either a Finnish authority or by a corresponding foreign authority, depending on the location of the service providers’ home countries.

Finanssivalvonta (Fiva), or the Financial Supervisory Authority (FIN-FSA), is the new authority for supervision of Finland’s financial and insurance sectors,, responsible, as of January 1, 2009, for most of the supervisory functions previously undertaken by the Financial Supervision Authority and the Insurance Supervisory Authority.

FIN-FSA authorisation is mandatory for service providers from outside the EEA that are seeking to operate in Finland. The regulations in the applicant's home country must meet with the internationally accepted rules governing financial supervision and the recommendations pertaining to the effective prevention of criminal abuse of the financial system. Deposit guarantees and investor protection schemes of foreign financial firms doing business in Finland are also to match those provided for in Finland.

Asia

Japan

Any solicitation and offering of financial products defined under the Financial Instrument Exchange Law (“FIEL”) in Japan must be conducted by registered and licensed brokers and intermediaries under the law. Japan’s Financial Service Agency (“FSA”) is in charge of financial supervision and control of the markets, which includes the retail foreign exchange. Since the enactment of FIEL, the Local Finance Bureau (“LFB”), under the ministry of finance, has played a role entrusted by the FSA with the regional financial surveillance and supervision of FX firms and their activities. By the end of 2008, the FSA and LFB have completed the first inspection round of their FX member firms.. This process took nearly two years to complete. However, following the start of the on-going global financial turmoil, effective this year, the FSA began a monthly monitoring of FX brokers. Some of the monitoring tasks include collection of information on capitalization, trading and execution, margin balance, financial data, as well as other pertinent information relating to operations. The collected information is regularly being shared with the LFB as well as the Financial Futures Association of Japan. This heightened supervision is a proactive step to maintain the confidence of domestic investors in the financial markets during the present financial turmoil.

China

China continues to be a closed market for retail foreign exchange dealers. In recent years the government, including the State Administration of Foreign Exchange (SAFE), has taken affirmative steps in penalizing foreign FX firms who actively solicit retail Chinese investors. The regulators continue to be concerned about the general public’s understanding of the foreign exchange market, believing its risks outweigh the benefits for retail clients.

South America

Colombia

In South America, Colombia is at the forefront of regulating financial instruments, including FX. The Ministry of Finance and Public Credit of Colombia has issued Decree 2558 of 2007 that regulates the promotion of financial, insurance and securities services by foreign financial institutions in Colombia. According to this Decree and the practice of the Superintendencia Financiera de Colombia, the country’s financial regulator, foreign financial firms with local branch offices in Colombia must be regulated and supervised according to the law of the country of their establishment. Furthermore, foreign financial firms interested in promoting financial services and products are required to establish local branch offices or enter into referral agreements with local registered broker-dealers. However, the Decree requires fully independent subsidiaries of

these foreign firms doing business in Colombia to register with the authorities prior to engaging in any financial products or services. Therefore, a foreign FX firm intending to solicit Colombian clients is required to either open a local branch office, enter into a referral agreement with a registered broker-dealer, or alternatively register a subsidiary under the laws of the Ministry of Finance and Public Credit of Colombia.