

The Wind of Change is Blowing in Chicago

Change seems to be a common theme in Chicago this year. On Election Day, the new President-elect from the windy city has successfully convinced the American public that he could foster the rebuilding of the recently handicapped domestic financial markets. Similarly, several weeks ago, a hurricane of regulatory proposals has spun out of Chicago aimed at building additional regulation in the retail foreign exchange market.

The wind of change towards greater regulation in the United States began to pick up at the end of last year. Last winter, anticipating the legislative approval of the CFTC Reauthorization, the NFA sent a team of analysts to study business operations of forex firms. The purpose of these educational visits was to better understand the effects **effects** of trading in retail foreign exchange from a customer's point of view. After regulating the on-exchange based futures industry for more than two decades, the NFA wanted to better understand the dealing practices of over-the-counter ("OTC") forex transactions. This was the first time US-based forex firms saw a proactive step towards regulation beyond promotional practices and financial requirements.

The resulting set of proposals covers a number of topics including re-quotes, limit orders, discretionary trading, the hedging feature, customer statements, and independent systems testing. Arguably, these proposals reflect the start of a major regulatory overhaul that whirled out of the Reauthorization. The U.S. regulators appear to be concerned about the lack of uniform regulations between retail FX and commodities and futures markets, that are primarily exchange based industries. That is why the premise of these proposals largely echoes exchange type of rules. While similarities exist between the on-exchange based futures and OTC forex, the business models available in the foreign exchange industry do not resemble that of their on exchange cousins.

In order to efficiently regulate the forex market, it is important to understand the disparities between exchange and OTC business operational models. Without properly addressing the various types of OTC models, regulations cannot adequately provide safeguards for retail customers. For instance, one of the proposed rules requires firms to requote in two directions, both in favor and against the client. Generally, forex firms may requote a client depending on the size of the order and volatility of the market, particularly when the market moves in the opposite direction of an order.

However, not all forex firms requote. Some firms may either execute an order at the new available price (thus slipping the client) or alternatively reject an order entirely. The merit of either type of model is not an issue in these proposals. The regulators are concerned that by requoting in one direction, forex firms may not allow clients the ability to enter the market at a better price. The practice of requoting is a legitimate one that is utilized by forex firms both in US and abroad, and generally only occurs in response to fast market conditions or due to market-depth considerations on large orders.

Requoting may also be one of the many tools some forex firms utilize to control their counterparty risk. While a one sided requote may not appear to be advantageous to a client, its purpose is to fill a client at the same rate that a forex firm gets from a counterparty.

Another proposed rule requires an execution of a limit order when an order is better than the requested price, particularly when the market gaps. The banks that are counterparties to forex firms, however, will not generally execute a limit order at a better price than requested. In order for a forex firm to offset its risk on market gaps and limit orders, it must do the same with its own counterparty or bank. The firm will normally place an equivalent transaction to be executed with the bank. The bank will execute the order at the requested price and not at the prevailing gapped price. If forex firms fill client orders at prices better than those that they receive from a bank, their capitalization may potentially be at risk. Even following the higher capital requirements introduced during Reauthorization, we must be mindful that multiple instances of such examples may ultimately result in undercapitalization.

Forex firms had two weeks to respond to these proposals, a period which seemed short to some firms. However, firms were even more concerned with being given the necessary time in which to implement any requirements that may be enacted into law. The proposed rules encompass a wide variety of aspects of the Forex business which are highly dependent on the current technical infrastructure, trading specifications, and supporting platforms and trading systems used. Any changes to the existing requirements would require substantial modifications to the trading systems and business models currently in use. Somehow, in the past few weeks, the wind of change has quickly turned into a small twister, one which many hope will gradually dissipate in this fast growing industry.