Futures & Derivatives Law REPORT
The Journal on the Law of Investment & Risk Management Products
June 2010 ■ Volume 30 ■ Issue 6

Recent Net Capital Increases for FCMs and IBs

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I. Introduction

The Commodity Futures Trading Commission ("CFTC") adopted rules, effective March 31, 2010, which significantly increase net capital requirements for both futures commission merchants ("FCMs") and introducing brokers ("IBs").[2] The National Futures Association ("NFA") has also imposed parallel higher capital requirements for futures commission merchants ("FCMs") effective March 31, 2010.[3] In addition, the CFTC has also proposed a comprehensive regulatory scheme to implement the CFTC's Reauthorization Act of 2008[4] with respect to capital and financial requirements for firms engaged in retail foreign currency ("forex") transactions.

The CFTC Adopting Release, in general, indicated that the basis for proposing the increased financial requirements for FCMs and IBs was due to the recent credit and financial crisis, with the intent of providing additional systemic protection in the event of another general financial crisis or a large firm financial failure.

In contrast, the CFTC's proposed retail forex capital and financial rules are focused primarily on customer protection. The proposed retail forex rules, if adopted, will not only require increased capital for forex firms, but also will require customers to deposit and maintain margin deposits substantially greater than is currently required. As discussed below, it appears likely that these rules, if adopted, may drive the retail forex business offshore.

II. CFTC Amendments to its Capital Rule 1.17

a. Overview

In May 2009, the CFTC proposed changes to CFTC Rule 1.17.[5] Most of these changes were adopted December 31, 2009, with an effective date of March 31, 2010.[6] CFTC Rule 1.17 requires FCMs to have adjusted net capital ("ANC") equal to or greater than various specified or calculated amounts. The adopted amendments of Rule 1.17 for FCMs can be summarized as follows:

1. The required minimum dollar amount was raised from $250,000 to $1,000,000.

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Futures & Derivatives Law Report
West Legalworks
195 Broadway, 9th Floor
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One Year Subscription ■ 11 Issues ■ $438.00
(ISSN#: 1083-8562)

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2. The computation of the FCM margin-based minimum ANC requirement was amended to incorporate into the calculation customer and non-customer positions in over-the-counter ("OTC") derivative instruments that are submitted for clearing by the FCM to a derivatives clearing organization ("DCO") or other clearing organization, all such derivative instruments being defined as "cleared OTC derivative positions."

3. FCM proprietary cleared OTC derivative positions are to be subject to capital deduction in the manner that is consistent with capital deductions required by the CFTC's regulations for FCM proprietary positions in exchange traded futures contracts and options.

4. The applicable percentage of total margin-based requirement for futures options and cleared OTC derivative positions in customer accounts remains at 8% and was increased for non-customer accounts from 4% to 8%. (The CFTC had proposed 10% for both customer and non-customer accounts.)[7]

Last, but not least, the CFTC sought comments on the advisability of increasing the minimum ANC requirement for FCMs and IBs that are also securities broker-dealers registered with the Securities Exchange Commission ("SEC") by the dollar amount of ANC requirement required by the SEC Rule 15c3-1(a).[8]

b. The Impact and Relationship of the NFA's Minimum ANC Rule on FCMs

The CFTC's capital rule 1.17(a)(1)(i) minimum requirements do not have to be met by an FCM that is also a member of a designated self-regulatory organization ("DSRO") provided the FCM conforms to such DSRO's minimum financial rules.[9]

The NFA's financial requirements for FCMs, found in Section 1 of the NFA manual, provide similar but slightly different capital requirements for FCM members. Effective March 31, 2010, the NFA capital rule requires ANC as follows:

(a) Each NFA Member that is registered or required to be registered with the [CFTC] as a [FCM] must maintain [ANC] equal to or in excess of the greatest of:

(i) $1,000,000;

(ii) For Member FCMs with less than $2,000,000 in Adjusted Net Capital, $6,000 for each remote location operated (i.e., proprietary branch offices, main office of each guaranteed IB and branch offices of each guaranteed IB);

(iii) For Member FCMs with less than $2,000,000 in Adjusted Net Capital, $3,000 for each AP sponsored (including APs sponsored by guaranteed IBs);

(iv) For securities brokers and dealers, the amount of net capital specified in Rule 15c3-1(a) of the Regulations of the Securities and Exchange Commission (17 CFR 240.15c3-1(a));

(v) Eight (8) percent of domestic and foreign domiciled customer and non-customer (excluding proprietary) risk maintenance margin/performance bond requirements for all domestic and foreign futures, options on futures contracts and cleared over-the-counter derivatives excluding the risk margin associated with naked long option positions;[10]

The CFTC's and NFA's ANC and other financial requirements for firms engaging in retail forex are discussed at Section V.

c. Discussion of Proposed Changes

This section discusses the impact of various changes adopted by the CFTC to ANC for FCMs. Each of the individual changes outlined above are discussed separately in this section II.C.

1. Minimum Dollar Amount Requirement for ANC

The CFTC raised its minimum net capital requirement from $250,000 to $1,000,000. Of course, as the CFTC pointed out in its release, the CFTC capital rules already required that an FCM meet the greater of the ANC minimum under CFTC rules or the ANC minimum requirement of a registered futures association. Since the NFA is the only registered futures association and the

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NFA's minimum capital requirement for an FCM was already $500,000, as a practical matter, the requirement was only being raised from $500,000 to $1,000,000.[11] The CFTC also commented that the requirement of $250,000, adopted over a decade earlier, was no longer consistent with the regulatory objective of requiring registrants to maintain a minimum base of liquid capital from which to meet current capital obligations, most particularly obligations to customers.

In both Adopting and Proposing Releases, the CFTC noted that there has been a striking increase over the past decade in customer funds deposited with FCMs.[12] As of August 31, 1995, approximately $30 billion of segregated and secured funds were held by 255 FCMs. As of December 31, 2009, the total amount of segregated and secured funds had escalated to approximately $200 billion held by 134 FCMs. The greater concentration resulting from this increase in funds from $30 billion to $200 billion and the decrease in number of firms holding such funds from 255 to 134 does provide a reasonable argument for increasing the minimum requirement. While the CFTC stated that the number of FCMs that may have to add capital as a result of the new $1,000,000 requirement is minimal, it did not address the issue that FCMs must maintain substantially more net capital than the bare minimum requirement. Under CFTC Rule 1.12[13] (the early warning rules), an FCM would have to reduce its operations and might well be liquidated if it just meets the dollar amount of its minimum ANC. For many reasons, including market volatility, potential failure of counterparties and haircuts on proprietary positions, the required ANC can vary considerably and quickly. For operating safety, virtually all FCMs maintain substantially more ANC than the minimum required. The CFTC does not address whether it believes that the increase in capital requirements will cause any FCMs to reassess the appropriate size of such "cushion." Although the CFTC solicited comments with respect to the effective date of the changes, and several comments did request additional time to implement the new requirements, the CFTC only extended the effective date 90 days to March 31, 2010. As discussed below, phasing in the proposed requirements over a period of at least six months would have provided FCMs wishing to add capital with a more realistic time frame to seek additional capital.

2. Amendment to Add "Cleared OTC Derivative" Positions to Computation of FCMs Margin-Based Minimum Adjusted Net Capital Requirement for Customer and Non-Customer Positions

The CFTC amended the computation of an FCM's margin-based minimum ANC requirement to incorporate customer and non-customer positions in over-the-counter ("OTC") derivative instruments that are submitted for clearing to a Derivative Clearing Organization ("DCO") or other clearing organization. Any such positions were defined in the amended rule as "cleared OTC derivative" positions. The CFTC's risk-based minimum ANC requires a percentage of the dollar amount of performance bond for futures and options on futures positions held by the FCM's customers and non-customers. As amended, the performance bond requirement for "cleared OTC derivative" positions will be included in the computation of customer and non-customer positions, in addition to the performance bond requirements for futures and options on futures. The CFTC notes that FCMs and DCOs have become significant clearers of OTC derivative instruments and that this is expected to increase significantly.

CFTC orders have authorized clearing FCMs to commingle customer money, securities and other property margining cleared OTC derivative positions with the money, securities and other property deposited by customers to margin, futures and options positions in segregated or secured accounts. The CFTC correctly notes that the risk exposure of clearing OTC derivative instruments extends not only to the FCM but also to segregated and secured funds of the FCM's futures and options customers. Where OTC customer funds and securities are commingled with that of futures and options customers, the CFTC believes it necessary to include "cleared OTC derivative" positions in the definition of customer and non-

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customer accounts for purposes of computing the risk-based capital requirement.[14]

For these reasons, the CFTC amended and expanded the definition of "customer account," "non-customer account" and "proprietary account" to include "cleared OTC derivative" positions. This was accomplished by amending Rule 1.17(b)(7) (customer account), Rule 1.17(b)(4) (non-customer account) and Rule 1.17(b)(3) (proprietary account) to include "cleared OTC derivative" positions. Rule 1.17(b)(9) was added as a new definition of "over-the-counter cleared derivative instrument." The definition of "customer" in Rule 1.17(b)(2) was also changed to include "cleared OTC customers." Rule 1.17(b)(10) was added to define cleared OTC customer to be any person, not a proprietary person as defined under CFTC Rule 1.3(y) regulations, for whom the FCM carries on its books one or more accounts for cleared OTC derivative positions of such person. This applies to any OTC derivative instrument cleared either in the United States or abroad by any organization permitted to clear such products under applicable law. When the CFTC adopted the risk-based capital requirements for customers and non-customers, it included non-futures positions that were held in customer segregated accounts and secured accounts. The CFTC comments that this change would also include credit default swaps if they are submitted to clearing on any U.S. or foreign clearing organization and carried on the books of an FCM.[15] Adding cleared OTC derivative positions to the definition of customer and non-customer for purposes of computation of the risk-based calculation of ANC will undoubtedly result in significant additional increases in capital required for operations for any FCM engaged in this line of business.

3. Proprietary Cleared OTC Derivative Positions

The CFTC revised Rule 1.17(c)(5)(x) to require FCMs to take proprietary capital deductions for their proprietary "cleared OTC derivative" positions similar to the capital deductions that are presently required for the proprietary futures and options on futures.[16] Under Rule 1.17(c)(5)(x), an FCM's proprietary futures and granted options positions in general require capital deduction equal to 100% of the maintenance margin requirement for positions that are cleared by clearing organizations of which the FCM is a member and 150% of the maintenance margin required for proprietary positions that are cleared by clearing organizations of which the FCM is not a member. The CFTC noted that the change would not apply to covered positions as defined in the CFTC's Rule 1.17(j).

The CFTC did not comment on the amount of additional capital that FCMs will be required to maintain as a result of the inclusion of cleared OTC derivative proprietary positions. However, it appears that it could be fairly significant, with the potential to grow as more and more OTC derivatives are cleared and fall within the definition of cleared OTC derivative positions. For example, it is likely that cleared swaps will be a huge market. This would likely lead to any FCM engaged in this line of business having to substantially increase its capital.

4. Increase in Risk-Based Margin Percentage for Non-Customers

The CFTC also increased the percentage of risk-based non-customer margin that must be maintained for ANC purposes. The amount for "customer" positions which include futures, options on futures and now the "cleared OTC derivatives," will remain at 8%. However, the amount for "non-customer" positions will increase from 4% to 8%. The CFTC had proposed raising the percentage for both customer and non-customer positions to 10%.[17] In the Adopting Release, the CFTC stated that it received no comments supporting an increase to 10% for customer and non-customer positions and for that reason did not increase the percentage to 10%.[18]

The CFTC reversed its previous position that non-customer positions in futures and options did not present as much risk to an FCM as customer positions because these non-customer positions were largely held by employees or officers of FCMs. The CFTC stated: "In more recent times the Commission has observed that the risk associated with non-customer accounts may not

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necessarily be less than the risk associated with customer accounts under conditions of financial stress."[19] The CFTC concluded that it is necessary to increase the percentage for non-customer risk-based margin from 4% to 8%.

In some cases, a clearing house imposes margin or performance bond requirements only at the clearing level, but does not prescribe minimum requirements for customer and non-customer accounts at the FCM level.[20] The CFTC amended Rule 1.17(b)(8) to provide that the term "risk margin" includes the level of maintenance margin or performance bond required for customer or non-customer positions at the clearing level even if no customer margin or performance bond requirement is imposed at the FCM level.

5. Impact on Capital Requirements of FCMs.

Although the CFTC conceded that some FCMs do not have the necessary capital to meet the new requirements, the CFTC stated that an overwhelming majority of FCMs already hold sufficient capital to satisfy the new requirements. However, as noted elsewhere, it is certainly possible that some FCMs may want to increase their capital to provide an additional cushion to meet future increased capital requirements caused by unexpected operational and market changes.

6. Doubling the ANC By Separating the SEC Net Capital Requirement

In the Proposing Release, the CFTC solicited comments on the advisability of requiring FCMs and IBs that are broker-dealers to maintain the amount of net capital currently required under CFTC Rule 1.17 separate and apart from the SEC net capital requirement set out in Rule 15c3-1.[21] This proposal was not adopted without comment by the CFTC. Currently, an FCM that is a broker-dealer must maintain the greater of the ANC requirements of the CFTC or the SEC, but not both the ANC required by the CFTC and the net capital required by the SEC. In the Proposing Release, the CFTC noted that in the event of liquidation, the ANC of a BD/FCM is available to satisfy any unsecured claims, including unsecured claims of both its futures and securities customers.[22] The CFTC noted that having dual registrants meet CFTC and SEC net capital requirements independently would mean that substantially more equity would be available to satisfy unsecured claims of customers in a bankruptcy liquidation. It is true that the proposal would have meant additional capital at dual registrants and, of course, "more is better" with respect to capital in bankruptcy liquidation. However, the proposal would not resolve the conflicts caused by the Bankruptcy Code and its various conflicting definitions when an FCM or IB that is also a broker-dealer is liquidated. More importantly, the amount of capital that would have to be raised by combined firms under this proposal could have been high.

This proposal was interesting because there are significant legal issues and problems under the Bankruptcy Code[23] with respect to allocation of assets of the bankrupt firm between securities customers' claims and futures customers' claims in connection with a liquidation of a combined FCM broker-dealer or IB broker-dealer. The Bankruptcy Code has one set of provisions for liquidation of a "commodity broker,"[24] another set of provisions for the liquidation of a registered broker-dealer[25] and a third set of provisions for a firm that is not a registered broker-dealer but falls within the definition of "stockbroker."[26] When a firm is (1) both a registered broker-dealer and "commodity broker" (FCM or IB) or (2) a commodity broker and "Stockbroker" as defined by the Bankruptcy Code,[27] the Bankruptcy Code has conflicting priority and liquidation provisions. This creates a web of entanglement that can make an orderly liquidation of a combined firm difficult and uncertain. Ideally, Congress would amend the Bankruptcy Code to provide a more rational set of procedures and rules for dividing up in a bankruptcy liquidation the assets and liabilities of an FCM or IB that is also a registered BD. Of course, in our current political environment, the possibility of Congress being able to rationally address the Bankruptcy Code with respect to financial services firms seems virtually impossible.

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III. CFTC Proposed Adjusted Increase in Net Capital for IBs

The CFTC also raised minimum dollar amount of ANC of IBs from $30,000 to $45,000.[28] This change was non-controversial since it conforms to the NFA's rules, which IBs were already required to meet.

IV. NFA Rules Effective March 31, 2010

A. The NFA Changes

On February 22, 2010, the NFA filed revisions in the NFA capital rules for FCMs and requested an effective date of March 31, 2010.[29] The rule changes NFA's ANC requirements as follows:

1. Increases the minimum dollar capital requirement from $500,000 to $1,000,000;
2. Increases the risk-based capital requirement for non-customer accounts from 4% to 8% of the total risk margin requirement for positions carried in non-customer accounts; and
3. Includes "cleared over-the-counter derivative positions" in an FCM's risk-based capital calculations for both customer and non-customer accounts.[30]

The requirement in (2) above applies to all domestic and foreign futures and options on futures contracts and "cleared over-the-counter derivatives position" excluding the risk margin associated with naked long options positions.

B. Discussion of NFA Changes

The CFTC capital rule requires all FCMs to meet the highest of various ANC computations, one of which is the requirement that an FCM's ANC meet the required capital of any national futures association of which it is a member.[31] Since all FCMs and IBs are required to be members of the NFA, the NFA capital and financial requirements apply to all FCMs and IBs and are automatically incorporated into the CFTC's Rule 1.17 capital standards. Here, the NFA's revised capital rules track the CFTC's changes so there is relatively little impact from these changes.

V. Proposed Capital and Related Requirements for Persons Engaging in Retail Foreign Exchange Transactions as an FCM or as a Retail Foreign Exchange Dealer ("RFED")

A. Overview

The CFTC has proposed a comprehensive regulatory scheme to implement the CFTC Reauthorization Act of 2008 with respect to retail forex transactions.[32] The legislation amended the Commodity Exchange Act ("CEA") to extend the CFTC's jurisdiction to include

> **contracts of sale of a commodity for future delivery (or an option on such a contract) or an option (other than an option executed or traded on a national securities exchange) to certain <u>leveraged or margined contracts in foreign currencies that are offered or entered into with retail customers</u> (emphasis added).[33]**

Implementing this jurisdictional grant requires rules addressing registration, disclosure, recordkeeping, financial reporting, minimum ANC, deposits (in the nature of margin or performance bonds), customer asset safekeeping and other operational issue for firms engaged in retail forex transactions.[34] The regulatory scheme is largely set forth in proposed new Part 5 of the CFTC rules and by conforming amendments to many of the CFTC's current regulations.[35] Much of proposed Part 5 is based upon and similar to the CFTC's existing regulations for futures and options on futures as well as the current rules of the NFA that apply to retail forex transactions. The full scope of the forex regulatory scheme is extensive and beyond this article; instead, this section will be limited to discussion of minimum ANC requirements, customer security deposits, and aggregate retail forex assets to be held in safekeeping, which are as follows:

(1) Rule 5.7, minimum ANC,

(2) Rule 5.8, a scheme to provide for the safekeeping of customer funds and securities, and

(3) Rule 5.9, a scheme for various customer deposits of securities or cash.

These rules will apply only to certain FCMs engaged in retail foreign exchange and "RFEDs" as defined.[36] It should be noted that the NFA currently has a scheme dealing with minimum ANC, safekeeping and customer deposits for FCMs engaged in forex activity. The NFA scheme for deposits is somewhat different than that proposed by the CFTC. The CFTC's proposed rules concerning required ANC, customer asset safekeeping and customer deposits of margin or performance bond requirements in the retail forex area and the comparable NFA current rules are summarized in Sections V.B, V.C and V.D below and are discussed in Section V.E below.

B. CFTC Rule 5.7: The Minimum ANC for FCMs and RFEDs

1. CFTC's Proposing Release

Proposed Rule 5.7 provides that each FCM offering retail forex transaction and each RFED must maintain ANC equal to or in excess of the greater of:

(1) $20,000,000;

(2) $20,000,000 plus 5% of the FCM or RFED total retail obligation in excess of $10,000,000; or

(3) the amount required by the CFTC's minimum capital requirements in Rule 1.17, akin to margin or performance bond; or

(4) the amount of ANC required by the regulation of any futures association, mainly the NFA.

Proposed Rule 5.7 also provides that failure to meet the capital requirements requires transfer or refund of all assets associated with retail forex. Proposed Rule 5.7 also details the computation of assets or liabilities and requires such computations to be in accordance with the SEC's capital rule 15c3-1[37] unless specifically stated otherwise by Rule 1.17. Proposed Rule 5.7 also details the accounting treatment, including the methodologies for valuation and deduction for foreign currency, foreign currency options or other contracts or transactions involving foreign currency. These are beyond the scope of this article, but must be referred to when computing ANC.

2. The NFA's Current Capital Rule

The NFA current net capital requirement for member FCMs with an affiliate that engages in forex transactions where the affiliate is authorized to engage in those transactions solely by virtue of its affiliation with the registered FCM is $7,500,000. The alternative requirement for FCMs that are counterparties to forex options transactions is $5,000,000,[38] except a forex dealer member must meet a higher requirement, discussed below. In addition, in Section 1 of the NFA's financial requirements, subsection (d) provides as follows:

(d) No Member FCM may use forex customer equity as capital or may record customer equity as an asset without recording a corresponding liability. For purposes of this requirement:

(i) Forex customer means any person who is not an eligible contract participant, as defined in Section 1a(12) of the Act, who enters into forex transactions (as defined in Bylaw 1507(b)) with the FCM or any of its affiliates described in section 2(c)(2)(B)(ii)(III); and

(ii) Forex customer equity means money, securities, and property received by the FCM or any of its affiliates described in section 2(c)(2)(B)(ii)(III) to margin, guarantee, or secure forex transactions between a forex customer and the FCM or any of its affiliates described in section 2(c)(2)(B)(ii)(III) or accruing to a forex customer as a result of such transactions.[39]

In addition to the NFA financial requirements for FCM in Section 1, there is a separate rule (Section 11, Forex Dealer Members Financial Re-

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quirements) that applies to forex dealer members. The NFA requirements of Section 11 are similar in many respects to the proposed CFTC requirements. Section 11 of the current NFA financial requirements provides as follows with respect to forex dealer members:

(a) Each Forex Dealer Member must maintain "Adjusted Net Capital" (as defined in CFTC Regulation 1.17) equal to or in excess of the greatest of:

(i) … $20,000,000 from May 16, 2009 forward;

(ii) the amount required by subsection (a)(i) above plus 5% of all liabilities owed to customers (as customer is 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; or

(iii) For FCMs, any other amount required by Section 1 of these Financial Requirements.

(b) A Forex Dealer Member may not include assets held by an affiliate (unless approved by NFA) or an unregulated person[40] in its current assets for purposes of determining its adjusted net capital under CFTC Rule 1.17. An affiliate is any person that controls, is controlled by, or is under common control with the Forex Dealer Member.

(c) A Forex Dealer Member may not use an affiliate (unless approved by NFA) or an unregulated person, as defined in section (b), to cover its currency positions for purposes of CFTC Rule 1.17(c)(5).

C. CFTC Rule 5.8: Aggregate Retail Forex Assets

1. CFTC's Proposed Rule

Proposed Rule 5.8 requires that an RFED or FCM offering and engaging in retail forex, separate and apart from its adjusted net capital requirement, must maintain funds or qualifying securities equal to or in excess of the total "retail forex obligation" at one or more qualifying institutions in the United States or money center countries as defined in Rule 1.49 of the CFTC rules.[41] "Retail forex obligation" is defined in §1(d) of the proposed Rules and represents the net obligation to all forex customers (excluding deficit accounts).[42] For assets held in the United States, qualifying institutions include a (1) bank or trust company; (2) registered broker-dealer and member of Financial Industry Regulatory Authority ("FINRA"); (3) registered FCM and member of the NFA. For assets held in a money center country, as defined, a qualifying institution is a bank or trust company that has regulatory capital of at least $1 billion or another entity that is equivalent to a broker-dealer or FCM provided that entity maintains regulatory capital in excess of $100,000,000. Further, the safekeeping agreement entered into with the institution must be approved by the firm's designated self-regulatory organization ("DSRO"). A RFED or FCM may not include aggregate retail forex assets as current assets or record any property from retail forex customers as an asset without recording a corresponding liability to them.

2. The NFA's Current Rule

Section 14 of the NFA Financial Requirements entitled "Assets Concerning Liabilities to Retail Forex Customers" provides a similar scheme for protection of assets covering liabilities to retail forex customers. This scheme essentially provides for the setting aside of customer assets equal to the net liquidating value of each forex account that liquidates to a positive number. Assets must be held in qualifying institutions which are virtually identical to those proposed in Rule 5.8, the CFTC's proposal for assets covering liabilities to retail forex customers. The current NFA rule also requires a qualifying custodian in a money center country to enter into an agreement acceptable to the NFA authorizing the institution to provide information directly to NFA or the CFTC upon request.

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D. CFTC Rule 5.9: Customer Security Deposits

1. The CFTC's Rule

Rule 5.9 defines a scheme for customer "security deposits" which are in the nature of a performance bond or margin. An FCM that engages in retail forex or an RFED must obtain from each retail forex customer a minimum security deposit of cash or securities (that qualify as permissible under CFTC Rule 1.25[43] as a financial asset) for each retail forex transaction equal to or greater than:

1. 10% of the notional value;
2. for short options 10% of the notional value plus the full premium charge;
3. for long options the full premium charge.

Under the proposed rule, if a forex customer's deposit were to be less than the above values of the customer's positions, the customer must deposit additional money or the positions must be liquidated.

This rule, if adopted, would dramatically change the retail forex business, as it would limit leverage to 10:1, far less than the 100:1 leverage that is the industry standard for the most liquid currencies. As is further discussed below, the proposed rule is controversial.

2. The NFA's Current Rule

The NFA currently has a conceptually similar scheme for security deposits for forex transactions with forex dealer members. However, the security deposit amounts required under NFA rules are markedly lower. Section 12 of the NFA Financial Requirements rules provides for the following scheme for security deposits by retail forex customers:

(a) Each Forex Dealer Member shall collect and maintain the following minimum security deposit for each forex transaction between the Forex Dealer Member and a person that is not an eligible contract participant as defined in Section 1a(12) of the Act:

(i) <u>1% of the notional value of transactions</u> in the British pound, the Swiss franc, the Canadian dollar, the Japanese yen, the Euro, the Australian dollar, the New Zealand dollar, the Swedish krona, the Norwegian krone, and the Danish krone;

(ii) <u>4% of the notional value of other transactions</u>;

(iii) for short options, the above amount plus the premium received; and

(iv) for long options, the entire premium.

(b) The Executive Committee may temporarily increase these requirements under extraordinary market conditions.

* * *

(d) In addition to cash, a Forex Dealer Member may accept those instruments described in CFTC Rule 1.25 as collateral for customers' security deposit obligations. The collateral must be in the FDM's possession and control and is subject to the haircuts in CFTC Rule 1.17. (Emphasis added)

Further, the NFA's Executive Committee does have the power to adjust relevant percentages depending on the amount of risk. However, the increase in percentages of security deposit proposed by the CFTC would, if adopted, represent a dramatic change to the forex industry.

E. Discussion of Proposed Rules 5.7, 5.8 and 5.9

These proposals for dealing with retail forex transactions and customers will present a high capital threshold for firms wishing to engage in the retail forex business. Congress has imposed upon the CFTC an obligation to increasingly regulate retail forex activities, including minimum financial requirements, segregation and safekeeping of customer assets and continuing maintenance deposits for customers engaging in retail forex. Many in the industry believe that these regulations as proposed, particularly the high customer security deposit requirement of Rule 5.9,

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will dramatically reduce retail forex activities in the United States.

The NFA submitted a well-reasoned comment letter[44] to the CFTC that points out that retail customer's security deposits are calculated on a different basis under the NFA's Section 12. Under the CFTC's proposed Regulation 5.9, security deposits are required on a fixed-percentage basis of notional amount. The NFA urged the CFTC to consider customer security deposits calculated in a manner that is more related to risk rather than to a fixed percentage of notional amount. The NFA noted that the foreign currency market is not static and urged the CFTC to reject a one-size-fits-all approach to establishing security deposit requirements. The NFA also pointed out that the customer deposit percentage requirement should be periodically reviewed and adjusted.

Further, proposed CFTC Rule 5.9 mandates that the customer must maintain the required amount of the security deposit at 10% or be sold out. The NFA's comment letter noted that most forex firms have autoliquidation practices so that as the account loses money the customer's positions will be closed out automatically before losses exceed the customer's initial investment. By dramatically increasing the customer funds securing positions, the CFTC's proposal could have the unintended consequence of customers suffering substantially greater losses before autoliquidation occurs.

In response to the proposed 10:1 leverage limitations, the CFTC received a substantial number of comments. As a general rule, the comments were strongly opposed to the 10:1 leverage limitation. Many of the comments suggested that imposing such a limitation would cause forex business to move overseas.[45]

It remains to be seen whether CFTC will ameliorate the high capital requirements and the high static margin deposit requirements as a result of comments received.

VIII. Conclusion

The CFTC and NFA have significantly increase minimum capital requirements for FCMs, although there have been no major failures of FCMs and customer losses as a result of the financial crisis.[46] While some increase in capital requirements probably is warranted, the question is whether the increased capital requirements could contribute to additional consolidation, which could create additional systemic risk due to increased concentration. It is hoped that the CFTC will carefully monitor the effect of the new capital requirements for FCMs, including the impact on competition and concentration. If it leads to additional concentration in the industry, that risk must be weighed against the risk of failures of individual firms. This will not be an easy task.

The proposed retail forex rules are essentially mandated by Congress. However, they will require, as explained above, substantial additional capital. The proposed customer security deposit requirement should be and could be ameliorated by using a risk-based standard like the NFA's with appropriate authority by the CFTC to increase or decrease the deposit amount required from time to time. The auto-liquidation provision as suggested by the NFA should be carefully considered. These suggested changes should ameliorate the impact on domestic retail FX firms and should make it easier for retail customers to participate in the market with adequate safeguards.

NOTES

1. Mr. Uhlenhop and Mr. Ruark are members of the law firm of Lawrence, Kamin, Saunders & Uhlenhop, L.L.C., Chicago, Illinois. Mr. Uhlenhop is a member of the Illinois and New York bars. Mr. Ruark is a member of the Illinois bar. The authors would like to thank Suzanne Hennessey, Legal Assistant at Lawrence, Kamin, Saunders & Uhlenhop for her valuable contributions to this article.
2. Adopting Release 74 FR 250, p. 69279 *et seq.* (Dec. 31, 2009) effective March 31, 2010 (hereinafter referred to as "Adopting Release"); Proposing Release 74 FR 87, p. 21290, *et seq.*, (May 7, 2009) (hereinafter referred to as "Proposing Release").
3. Notice to Members 1-10-11 (Mar. 31, 2010).
4. Food, Conservation and Energy Act of 2008, Pub Law 110-246; 122 Stat. 1651, 2189-2204 (2008).
5. 17 CFR 1.17, Proposing Release.
6. Adopting Release, p. 21290.

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7. There is confusion in the Adopting Release as published in the Federal Register and also with respect to the CFTC's Rule 1.17 as shown in the CFTC Rules on-line. At various places, the non-customer margin and performance bond percentage requirement remains at 4%; at other places it is stated to be 8%. Nevertheless, from a practical standpoint, firms will have to follow the 8% requirement for non-customer positions because the NFA has raised its risk-based requirements for non-customers. (17 CFR 1.17(a)(1)(i)(B)).
8. 17 CFR 240.15c3-1(a).
9. 17 CFR 1.17(a)(2)(i).
10. NFA Manual Financial Requirements Section 1 Financial Requirements of FCMs.
11. Adopting Release at 69279-80l; Proposing Release at 21290-1.
12. Adopting Release.
13. 17 CFR 1.12.
14. Adopting Release, pp. 69281-2.
15. Proposing Release, p. 21292.
16. Adopting Release, p. 69281.
17. Proposing Release, at 21292-21293.
18. Adopting Release, at 69281.
19. Proposing Release, at 21293.
20. Adopting Release, p. 69281.
21. 17 CFR 240.15c3-1.
22. Proposing Release, p. 21297.
23. 311 USC §1 *et seq.*
24. 11 USC Subchapter IV, 761 *et seq.*
25. SIPA Securities Investor Protection Act of 1970.
26. 11 USC Subchapter III, §741 *et seq.*
27. 11 USC Subchapter III, §741 et seq.
28. Proposing Release, p. 21291.
29. NFA Ltr to Office of the Secretariat (Feb. 22, 2010).
30. NFA Manual Financial Requirements Section 1(a).
31. 17 CFR 1.17(a)(1)(k)(C).
32. Food, Conservations, and Energy Act of 2008, Pub. L. 110-246, 122 Stat. 1651, 2189-2204 (2008).
33. 17 FR, p. 3281.
34. 75 FR 12, pp 3281-3330 (Jan. 20, 2010).
35. Proposed 17 CFR Part 5.
36. [T]he Proposal would require persons offering to be or acting as counterparties to retail forex transactions but not primarily or substantially engaged in the exchange traded futures business, to register as retail foreign exchange dealers ('RFEDs') with the CFTC. Registered futures commission merchants ('FCMs') that are 'primarily or substantially' (as defined in the Proposal) engaged in the activities set forth in the Act's definition of an FCM would be permitted to engage in retail forex transactions without also being registered as RFEDs.

    The Proposal would further require certain entities other than RFEDs and FCMs that intermediate retail forex transactions to register with the Commission as introducing brokers ('IBs'), commodity trading advisors ('CTAs'), commodity pool operators ('CPOs'), or associated persons ('APs') of such entities, as appropriate, and to be subject to the Act and regulations applicable to that registrant category. In addition, the Proposal would require any IB that introduces retail forex transactions to an RFED or FCM to be guaranteed by that RFED or FCM. 75 FR 3281, at 3282.
37. 17 CFR 240.15c3-1.
38. NFA Manual Financial Requirements Section 1 Futures Commission Merchants Financial Requirements (a)(vi) and (vii).
39. NFA Manual Financial Requirements Section 1 Futures Commission Merchants Financial Requirements 1(d).
40. For purposes of this Section 11 and section (c), a person is unregulated unless it is:

    (i) a financial institution regulated by a U.S. banking regulator;

    (ii) a broker-dealer registered with the U.S. Securities and Exchange Commission and a member of the Financial Industry Regulatory Authority;

    (iii) a futures commission merchant registered with the U.S. Commodity Futures Trading Commission and a Member of NFA;

    (iv) a retail foreign exchange dealer registered with the U.S. Commodity Futures Trading Commission and a Member of NFA;

    (v) an insurance company regulated by any U.S. state;

    (vi) an entity regulated as a foreign equivalent of any of the above if regulated in a money center country as defined in CFTC Regulation 1.49; or

    (vii) any other entity approved by NFA.
41. 17 CFR 1.49.
42. 17 CFR §1(d).
43. 17 CFR 1.25.
44. Comment Letter of the National Futures Ass'n, March 22, 2010; *see* NFA futures.org/nfa regulations.
45. Federal Register Comment File: 10-001, available at http://www.cftc.gov/LawRegulation/Federal Register/MommentFiles/10-001.html
46. Although a number of large financial securities firms had credit issues and several failed, the CFTC/NFA regulated institutions largely remained with adequate capital and were not liquidated.

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