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Division of Clearing and
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DIVISION OF CLEARING AND INTERMEDIARY OVERSIGHT ADVISORY CONCERNING RETAIL OFF-EXCHANGE FOREIGN CURRENCY TRADING

In December 2000, the Commodity Futures Modernization Act ("CFMA")[1] was enacted into law. The CFMA amended the Commodity Exchange Act ("Act")[2] to clarify the jurisdiction of the Commodity Futures Trading Commission ("Commission") in the area of off-exchange foreign currency futures and foreign currency options trading.[3] Since enactment of the CFMA, the Division of Clearing and Intermediary Oversight ("Division")[4] has received numerous inquiries regarding off-exchange foreign currency futures and option contracts trading by retail customers ("forex futures" and "forex options" or, collectively, "forex").[5] The Division is issu-

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1 Appendix E of Pub. L. No. 106-554, 114 Stat. 2763 (2000).

2 7 U.S.C. §1 et seq. (2000).

3 For further background about this topic, including other Advisories and a Consumer Alert, you may consult the Commission's website at http://www.cftc.gov/customerprotection/fraudawarenessandprevention/forex/index.htm.

4 In July 2002, a reorganization of the Commission became effective, and the regulatory oversight functions over intermediaries and derivatives clearing organizations performed by the Division of Trading and Markets, which was dissolved, were assumed by the Division. The use of the term "Division" in this Advisory shall mean the Division of Clearing and Intermediary Oversight.

5 As used in this Advisory, the term "retail customer" refers to any person other than a person that comes within the definition of an "eligible contract participant" pursuant to Section la(12) of the Act. For example, an individual whose total assets do not exceed $10 million is a

ing this Advisory to provide further guidance in this area. This Advisory supersedes any informal guidance that may have been issued with regard to the positions taken herein.

Registration of Associated Persons of Futures Commission Merchants

Generally, the offer and sale of forex is unlawful unless the counterparty is an entity enumerated in Section 2(c)(2)(B)(ii) of the Act. The counterparties enumerated include persons registered as futures commission merchants ("FCMs")[6] and certain affiliated persons of those FCMs that meet specified threshold requirements for adjusted net capital and customer segregated funds, as discussed below.[7] Persons that act as associated persons ("APs") of firms that register as FCMs to act as counterparties for forex transactions must register as APs.[8]

Affiliates of Futures Commission Merchants as Permissible Counterparties

Only those affiliates of FCMs that meet certain eligibility criteria may act as counterparties to forex transactions — specifically, only those affiliates for which an FCM is required to make and keep records under Section 4f(c)(2)(B) of the Act.[9] Under Section 4f(c)(2)(B) and Commission Regulation 1.14, FCMs are *required* to keep records only for Material Affiliated Persons ("MAPs").

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retail customer (or $5 million if the agreement, contract or transaction is entered into for risk management purposes).

[6] For ease of discussion, persons registered as FCMs to engage only in forex transactions will be referred to as FCMs in this Advisory, even if they do not meet the statutory definition of FCM, which refers to the soliciting or accepting of orders, and funds related thereto, for exchange-traded futures or options.

[7] The other enumerated counterparties are: (1) financial institutions; (2) registered securities broker-dealers; (3) certain affiliates of registered securities broker-dealers; (4) insurance companies or regulated affiliates thereof; (5) financial holding companies; and (6) investment bank holding companies. Section 2(c)(2)(B)(ii) of the Act.

[8] *See* Section 4k(1) of the Act.

[9] *See* Sections 2(c)(2)(B)(ii)(III) and 4f(c)(2)(B) of the Act.

Pursuant to Regulation 1.14(d)(1), FCMs that hold customer funds of less than $6,250,000 and have less than $5,000,000 in adjusted net capital as of the FCM's current fiscal year-end are exempt from the recordkeeping requirements for affilliates, so long as the FCM is not an exchange clearing member. Accordingly, only an FCM with at least $5,000,000 in adjusted net capital,[10] or one that holds at least $6,250,000 in customer funds, or that is an exchange clearing member, may permit its affiliate to lawfully act as a counterparty in any forex transaction.[11]

Where the FCM meets the threshold requirements noted above for adjusted net capital and customer funds, or exchange membership, it is subject to the risk assessment, recordkeeping and reporting requirements set forth in Commission Regulations 1.14 and 1.15. These regulations require that an FCM maintain and file with the Commission a comprehensive organiza-

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[10] National Futures Association ("NFA") Financial Requirements Section 1(a)(vi) requires that each NFA member that is registered or required to be registered with the Commission as an FCM seeking to qualify an affiliate to act as a forex counterparty solely on the basis of its affiliation with the FCM (*e.g.*, the affiliate is not also a securities broker-dealer) maintain minimum adjusted net capital of $7.5 million. Thus, effectively, the minimum adjusted net capital criterion for an FCM to qualify an affiliate as a forex counterparty is $7.5 million rather than $5 million.

[11] Two federal district court decisions have directly addressed the issue of the scope and meaning of the "affiliate" language in Section 2(c)(2)(B)(ii)(III) of the Act. Both courts held that the text of Section 4f(c)(2)(B) of the Act, which refers to "the records *required* under subparagraph (A)," and to an affiliate whose business activities are reasonably likely to have a *material impact* on an FCM, means that Section 2(c)(2)(B)(ii)(III) of the Act applies only to those FCMs that are required to keep Section 4f(c)(2)(A) records, and the Commission's recordkeeping requirements enacted pursuant to that statutory provision apply only to FCMs possessing at least $5 million in adjusted net capital at the FCM's fiscal-year end, or at least $6.25 million in customer segregated funds, or who are exchange clearing members. Section 4f(c)(2)(B) of the Act (emphasis added). *See* CFTC *v. Next Financial Services Unlimited, Inc.,* No. 04-80562-CIV-RYSKAMP/VITUNAC (S.D. Fla. June 7, 2005) (order denying motion to dismiss); *CFTC v. G7 Advisory Services, LLC, et al.*, No. 05-80313-CIV-DIMETROULEAS (S.D. Fla. Dec. 5, 2005) (order denying motion to dismiss).

tional chart and designate therein which of its affiliates are MAPs.[12] Criteria for the determination of whether an affiliate is a MAP are provided in Commission Regulation 1.14(a)(2). If an FCM has at least $7.5 million in adjusted net capital,[13] and it has an affiliate that is a MAP, the MAP affiliate is a permissible counterparty. A MAP counterparty remains subject to, among other provisions, the antifraud proscription under Section 4b of the Act.[14]

Segregation

The Division is aware that some entities offering to act as counterparties to forex transactions have made extravagant claims to customers and prospective customers that their funds are protected by special bankruptcy provisions applicable to customer funds held in segregated accounts. Under Section 4d of the Act, customer funds used to support exchange-traded futures and options transactions must be held in accounts segregated from an FCM's proprietary funds. One of the important purposes for segregation of customer funds in the exchange-traded environment is that, in the event of an FCM's bankruptcy, the segregated funds are recognized and held for customers, the bankrupt firm is required to liquidate, and customers have a priority interest in funds of the bankrupt estate over all claims except for those necessary to administer the estate. Section 4d of the Act, however, prohibits funds related to off-exchange transactions from being commingled with customer funds related to exchange-traded transactions. Because forex transactions take place off-exchange, funds held in connection with those transactions may not be held in Section 4d segregated accounts. Thus, FCMs or their affiliates who represent that forex customer funds are protected by the bankruptcy provisions applicable to Section 4d segre-

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12 *See* 59 Fed. Reg. 9689, 9693 (March 1, 1994); 59 Fed Reg. 66674, 66677 (December 28, 1994).

13 *See* footnote 10, *supra*.

14 Section 2(c)(2)(C) of the Act.

gated accounts may be liable for violating Sections 4d and/or 4b of the Act.[15]

Registration of Associated Persons of Introducing Brokers

Entities that introduce retail customers solely to trade forex with persons registered as FCMs that act as counterparties for such transactions are not required to register under the Act as introducing brokers ("IBs"), but may do so voluntarily. Division staff have been asked whether persons acting in the capacity of an AP of a person that voluntarily registers as an IB must register as an AP.

The Act requires that any person that is associated with an IB in any capacity that involves: (i) the solicitation or acceptance of customers' orders (other than in a clerical capacity); or (ii) supervision of such persons, must register as an AP.[16] If an entity chooses to register as an IB, then its partners, officers, employees or agents who act in these capacities must register as APs of the IB, whether their activities involve exchange-traded products or forex.[17]

Introducing Entities Acting as Futures Commission Merchants

If an entity is purportedly introducing retail customers to a registered FCM, but does so in a manner that has the indicia of such entity being the counterparty to retail customers, the entity must, itself, be one of the enumerated counterparties under the Act. Some activities that would

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[15] Indeed, amendments to the NFA Interpretive Notice, "Forex Transactions with Forex Dealer Members," that became effective October 1, 2006, require Forex Dealer Members to disclose affirmatively that customer funds may not be protected under bankruptcy law. *See* the discussion under heading **B 1 Disclosure** in that Interpretive Notice.

[16] 7 U.S.C. §6k(1) (2000). Commission Regulation 1.3(k) defines a "customer" as any person "trading in any commodity named in the definition of commodity." This definition makes no distinction between exchange-traded and off-exchange products.

[17] If an IB is organized as a limited liability company ("LLC"), limited liability partnership ("LLP"), or other legal entity that may lawfully transact business, the terms "partners" and "officers" would include any person that would be deemed a "principal" under Section 3.1(a)(1) of the Commission's Regulations, *e.g.*, the managing member of an LLC.

make a purported "introducing" entity into the counterparty include, but are not limited to: (1) the introducing entity receiving funds from retail customers in its own name; (2) the introducing entity acting as a conduit to return funds due to retail customers from the registered FCM; (3) the introducing entity failing to open and carry each retail customer's account with the carrying FCM on a fully-disclosed basis; or (4) the introducing entity being able to withdraw or transfer customer funds. An introducing entity operating in such a manner may not rely upon the registration status of the FCM with which it is dealing to meet the requirement under the Act that the counterparty to a retail customer be one of the regulated entities listed under Section 2(c)(2)(B)(ii) of the Act. Furthermore, if the purported "introducing" entity uses promotional material or a customer agreement that fails to identify or make clear the role of the registered FCM as the counterparty, this may also suggest that the "introducer" is, in fact, the counterparty. Accordingly, if the purported "introducing" entity is acting in a manner that makes it the counterparty to the transactions, but is not itself one of the enumerated counterparties under the Act, it would be in violation of Section 4(a) of the Act with respect to forex futures, and Section 4c(b) and Commission Regulation 32.11 with respect to forex options, and the registered FCM with which the introducing entity is dealing may be liable for aiding and abetting a violation of the Act.[18]

[18] *See* Section 13(a) of the Act. Because these transactions have a non-enumerated counterparty they are *per se* unlawful, thus, the entire Act and regulations thereunder would apply to them. *See* Section 2(c)(2)(B) of the Act.

Guaranteed Introducing Brokers

Commission Regulation 1.17 requires that an IB maintain at least $45,000 in adjusted net capital[19] unless it enters into a guarantee agreement with an FCM wherein the FCM will guarantee the IB's obligations under the Act. The Commission's Form 1-FR-IB (Part B) guarantee agreement provides that "the [FCM] guarantees performance by the [IB] of, and shall be jointly and severally liable for, all obligations of the [IB] under the [Act], *as it may be amended from time to time,* and the rules, regulations and orders which have been *or may be* promulgated thereunder with respect to the solicitation of and transactions involving all customer and option customer accounts of the [IB] entered into on or after the effective date of the agreement." (Emphasis added.) As noted in footnote 16 *supra*, the term "customer" under the Commission's regulations is not limited to persons engaged in futures or option transactions on designated contract markets or derivatives transaction execution facilities.

The Division also notes that guaranteed IBs are identified as such in the registration database maintained by NFA under Commission oversight, the Background Affiliation Status Information Center, or BASIC. Advisories published on the Commission's website[20] recommend that customers consult BASIC when seeking information on forex firms, and NFA Rule 2-36(g) requires Forex Dealer Members to advise customers at least annually regarding BASIC. The Division believes that it would be confusing to customers and anomalous for the futures industry reg-

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[19] NFA rules, which are incorporated by reference in Commission Regulation 1.17, require member IBs with less than $1 million in adjusted net capital to maintain the greatest of: (i) $45,000; or (ii) $6,000 per office; or (iii) $3,000 for each associated person that the IB sponsors. NFA Financial Requirements Section 5(a).

[20] *See* footnote 3, *supra*.

istration database to reflect an IB's status as guaranteed by an FCM, yet not have that guarantee apply to the forex transactions discussed herein.

Accordingly, because the IB guarantee agreement encompasses forex business, if a guarantor FCM uses a guaranteed IB to introduce forex business as well as exchange-traded futures or options, the guarantee will apply to all of the IB's obligations under the Act, including such things as the antifraud prohibitions pertaining to forex transactions that are subject to the Act.

Commission Regulation 1.57(a)(1) provides "[t]hat an [IB] which has entered into a guarantee agreement with a[n FCM] . . . must open and carry such customer's account with such guarantor [FCM] on a fully-disclosed basis." The regulation encompasses forex transactions as well as exchange-traded transactions. Therefore, guaranteed IBs may introduce forex transactions to their guaranteeing FCMs only, and a guarantor FCM may not permit one of its guaranteed IBs to introduce forex transactions to other FCMs. If the guarantor FCM to which a guaranteed IB is introducing exchange-traded transactions does not wish to engage in forex transactions, but the IB does, the IB would either need to become independent so that it could deal with any FCM, or set up a separate company as an IB to handle the forex business. If the latter course were taken, the new IB could be guaranteed and deal solely with its guarantor FCM, or could be independent and free to introduce business to any FCM. To the extent that any firms are operating in a manner inconsistent with Regulation 1.57, they should cease doing so immediately. Of course, immediate cessation of operations inconsistent with Regulation 1.57 would not prevent the Commission from taking appropriate action with regard to previous conduct, nor would it prevent an FCM from being liable under the guarantee agreement for the actions of its guaranteed IB, *e.g.*, the guaranteed IB introduced forex transactions to another FCM.

Managing Retail Forex Accounts

A person whose futures-related activity consists solely of managing forex accounts where the counterparty to the transaction is an entity enumerated under Section 2(c)(2)(B)(ii) of the Act is not required to register with the Commission as a commodity trading advisor ("CTA"), but may do so voluntarily.

The person exercising trading authority over a retail customer's account may not receive funds in its name for purposes of trading in forex futures.[21] Moreover, the funds of the retail customers must be held by a counterparty enumerated under Section 2(c)(2)(B)(ii) of the Act. If the counterparty to the retail customer is not one of those enumerated under the Act, the transaction is unlawful under Section 4(a) of the Act with respect to forex futures and Section 4c(b) and Commission Regulation 32.11 with respect to forex options. In addition to the counterparty being liable for violating the Act, the person managing the account of the retail customer may be liable for aiding and abetting a violation of the Act.

Operating Pools Trading Exclusively in Forex Futures

A commodity pool is generally defined as an "investment trust, syndicate or similar form of enterprise operated for the purpose of trading commodity interests."[22] Generally, a person who operates a commodity pool is a commodity pool operator ("CPO") and must register with the Commission as such. However, a person operating a pool that limits its trading solely to forex, with an entity enumerated under Section 2(c)(2)(B)(ii) of the Act acting as the counterparty to the pool's transactions, is not required to register as a CPO, but may do so voluntarily. If the counterparty is not one of those enumerated under the Act, the pool's transactions are

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21 *See* Commission Regulation 4.30, 17 C.F.R. §4.30.

22 *See* Commission Regulation 4.10(d)(1), 17 C.F.R. § 4.10(d)(1).

unlawful under Section 4(a) of the Act with respect to forex futures, and Section 4c(b) and Commission Regulation 32.11 with respect to forex options, and the operator of the pool may be liable for aiding and abetting a violation of the Act.[23]

If the activities of such a pool include trading for anything other than forex, such as trading futures contracts on or subject to the rules of an organized exchange, the person operating the pool, absent an exemption, must register with the Commission as a CPO.

Intermediaries Engaged Only in Forex

Although entities introducing retail customers to, managing retail customer accounts held at, and operating pools trading with, a registered FCM, solely with regard to forex are not required to register with the Commission, they remain subject to all relevant antifraud provisions of the Act and the Commission's regulations thereunder. Moreover, in the event that such an entity violates the antifraud provisions of the Act or the regulations thereunder, the registered FCM with which the entity is doing business may also be liable for aiding and abetting such violations.[24]

Registration of Solicitors for Pool Operators and Account Managers

Entities that operate commodity pools or manage individual accounts that are solely involved in forex need not register as CPOs or as CTAs, respectively, but may register voluntarily.

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[23] A commodity pool that has total assets exceeding $5 million and is formed and operated by a registered CPO, or by a foreign person performing a similar function subject as such to foreign regulation, is an "eligible contract participant." Section la(12)(A)(iv) of the Act. Accordingly, such a pool would not be considered a retail customer and would not be limited to entering into off-exchange foreign currency futures and options transactions with counterparties enumerated under Section 2(c)(2)(B)(ii) of the Act.

[24] *But see, Krause v. Forex Exchange Market, Inc.*, 356 F. Supp. 2d 332 (S.D.N.Y. 2005) (claims of principal-agent and control person liability under Sections 2(a)(1) and 13(b), respectively, of the Act related to forex transactions dismissed for lack of subject matter jurisdiction because those provisions of the Act were not included in Section 2(c)(2)(C) of the Act).

If such an entity chooses to register as a CPO or CTA, then its partners, officers, consultants, employees or agents who solicit business on its behalf, or who supervise persons who solicit, must register as APs of the CPO or CTA.[25]

Electronic Risk Disclosure for Forex Options

NFA rules require understandable and timely disclosure concerning forex transactions.[26] If the electronic communication fulfills the general standard of understandable and timely disclosure of the essential characteristics and particular risks of the forex transactions being offered, and the disclosure does not violate the antifraud prohibitions of Section 4b of the Act and Commission Regulation 32.9, it is permissible. The content of the statement, rather than the manner of transmission, is the key element.

Account Statements for FCMs and Their Affiliates

An FCM may choose to conduct exchange-traded futures or options business directly with customers, but may choose to use a MAP of the FCM for forex. When an FCM sends to its customers the monthly and confirmation statements required by Commission Regulation 1.33, the FCM may not include the forex transactions of its non-FCM affiliate in the same account statement, even if it were to list those transactions separately or under a separate heading, because to do so might create confusion or give the misleading impression that customers are transacting through the same legal entity and in a business that is similarly regulated. However, if the FCM itself directly engages with customers both in exchange-traded futures or options

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[25] Sections 4k(2) and 4k(3) of the Act. If a CPO or CTA is organized as an LLC, LLP or other legal entity that may lawfully transact business, the terms "partners" and "officers" would include any person that would be deemed a "principal" under Section 3.1(a)(1) of the Commission's Regulations.

[26] NFA Compliance Rule 2-36; *see also* NFA Interpretive Notice, Forex Transactions with Forex Dealer Members, December 1, 2003 (NFA Manual ¶9053).

business and forex, the FCM's monthly and daily confirmation statements required by Commission Regulation 1.33 may also include forex transactions so long as they are properly identified as such.

Forex Trading Platforms

It has come to the attention of the Division that some entities have offered trading platforms through which retail customers have traded forex directly with one another. These platforms are sometimes referred to as "matching systems." To the extent that retail customers trading through one of these matching systems become counterparties to one another, the requirement that the counterparty to a retail customer be one of the entities enumerated under Section 2(c)(2)(B)(ii) of the Act would not be met, thus, such transactions would violate Section 4(a) of the Act and/or Section 4c(b) and Regulation 32.11 thereunder. The fact that a firm operating such a trading platform is registered as an FCM, or is one of the other counterparties enumerated under the Act, would not be sufficient to meet the requirement under the Act that the counterparty to a retail customer be one of the regulated entities listed under Section 2(c)(2)(B)(ii) of the Act.

This advisory represents the position of the Division only and does not necessarily represent the views of the Commission or any other division or office of the Commission. For further information regarding this advisory, contact Lawrence B. Patent, Deputy Director, or Peter B. Sanchez, Attorney-Advisor, at (202) 418-5430.