



Legal Risk Management Tip November 2008

REGULATORS REACT TO GROWTH IN RETAIL FOREX ACTIVITIES

The foreign currency exchange (forex) market is regulated by the Commodity Futures Trading Commission (CFTC) and the National Futures Association (NFA). Under the U.S. Commodity Exchange Act (CEA), participation in retail forex trading activities is limited to certain regulated entities registered with the CFTC, including Futures Commission Merchants. Registered broker-dealers that are members of the Financial Industry Regulatory Authority (FINRA) are specifically excepted from the jurisdiction of the CFTC and NFA. As a result, many broker-dealers have sought to take advantage of the growth in retail forex market by offering forex trading in addition to their traditional securities or investment banking activities. FINRA has taken note of the increase in retail forex trading by member firms and recently published a Regulatory Notice outlining the applicability of FINRA Rules to such activities.¹

Notably, FINRA has stated that broker-dealers who participate in retail forex trading must comply with all applicable FINRA rules. In evaluating member firms' forex activities, it is possible that regulators may look to the applicable rules and regulations of the NFA for guidance. The Notice identified certain obligations of firms involved in retail forex, including: providing full and accurate disclosure of the risks associated with forex trading; disclosure of the nature of the relationship between the firm and the customer and associated conflicts of interests; performing the required due diligence on forex dealers or introducing brokers; and maintaining the books and records required of forex dealer members by the NFA.

Additionally, firms must comply with the more stringent FINRA rules governing supervision and communications with the public. FINRA's supervisory requirements are comprehensive and firms engaged in forex trading must therefore "establish, maintain, and enforce written procedures to supervise the types of business in which it engages," including procedures addressing the firm's supervision of its forex activities.² Moreover, a member firm's communications with the public must comply with Rule 2210 and therefore, any information about the forex market generally or the firm's particular forex activities must be based on principles of fair dealing and good faith, and must not omit material information that would cause the communication to be misleading. This necessarily requires that member firms comply with the risk disclosure obligations and in addition to the content standards and filing requirements for communications with the public set forth in NASD Rule 2210.

FINRA's recognition of the growth of the retail forex market and its concern over the increase of member involvement signifies that in reviewing membership applications and in performing routine inspections, regulators will closely scrutinize the forex activities of broker-dealers to ensure compliance with FINRA standards as set forth in the recent Regulatory Notice.

For any firm planning to engage in retail forex trading activities, it is of critical importance to ensure that all FINRA guidelines are followed and the relevant rules are fully understood in order

¹ *Retail Foreign Currency Exchange*, FINRA Regulatory Notice 08-66 (Nov. 2008).

² NASD Rule 3010(b).

to satisfy regulators that investors are adequately protected. For more information, please contact us at (619) 298-2880.

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