



A capital idea

New NFA proposal could cause significant shakeup among forex brokerages

New rule changes proposed by the National Futures Association (NFA) could have a significant effect on several brokerages that trade foreign exchange.

The NFA wants to raise capital requirements for all registered Forex Dealer Members (FDM) to \$5 million, plus it wants improved accounting standards. The NFA is hoping the increased standards will prevent the ongoing problem of forex brokerages going bankrupt and/or committing fraud.

The proposal could potentially wipe out 90 percent of existing forex brokerages, although it's likely major consolidation would occur if the rule passes. Forex brokerage FXCM has been the most vocal supporter of the rule, although they have received support from some other big firms.

Naturally, there is opposition from the less-capitalized firms. In a comment letter to the NFA, Knight Capital Group, which owns Hotspot FX, agreed that greater oversight is needed but doesn't think a "one-size-fits-all" solution will work.

"Certain FDMs, like Hotspot, do not operate their business like a traditional dealer. They automatically offset (real-time) all client trades with bank market makers or client subscribers.

As such, Hotspot effectively operates on a 'riskless principal' basis on behalf of its clients, thereby reducing dramatically any associated risk with that transaction and its clients' funds," Knight said in the letter.

"Thus, since Hotspot and other FDMs similarly situated do not directly offset client trades, they are not subject to the same market volatility and risk as are FDMs that take the other side of client trades and put their client accounts (deposits) at risk."

Since 2000, the NFA has authorized Forex Dealing licenses to more than 50 firms. However, many of these firms went out of business because they were undercapitalized, and fraud continues to be a problem in the forex brokerage arena.

As of July 2007, there were 43 licensed FDMs operating. According to the NFA, 30 have adjusted net capital of less than \$5 million, and only four of those 30 have more than \$3 million. The average adjusted net capital of those 30 firms is less than \$1.5 million.

The NFA estimates the new rules, combined with existing rules, will force firms to have at least \$10 million in adjusted net capital to remain in business.

According to data obtained from the CFTC, the new rules would leave only six forex brokerages: FXCM, GFT Forex, Oanda, FXSolutions, Gain Capital, and CMS.

NFA's concerns

The NFA listed four specific reasons for the rule change. First, trading spot forex, which FDMs do, creates more risk than trading futures and options listed on an exchange.

Second, since spot forex is not a priority under the NFA's Bankruptcy Code, it's particularly important for FDMs to have adequate capital.

Plus, two of the three bankruptcy proceedings in which the NFA has taken part in the past four years have involved smaller FDMs, and with the cumulative amount of retail funds under account surpassing \$1 billion, the NFA is concerned that an FDM might be unable to meet its financial obligations to its customers.

Earlier in the year, Concorde Forex Group (CFG Trader) was shut down by the NFA and forced to liquidate all open positions because it was undercapitalized. CFG Trader customers collectively lost about \$1 million, and the NFA says this incident was a catalyst for the new rule, particularly the new accounting requirements.

When CFG's books were examined after its trading was suspended, it was discovered the firm's assets were held in multiple accounts, company and customer funds were commingled, CFG had no anti-money laundering program and no internal compliance staff, and it had never been audited.

As a result, firms that meet the new capital requirements will also have to file an internal control report prepared by an independent auditor, and the NFA would have limited ability to request certification of an FDM's finances. Also, each FDM would have to designate an individual to oversee the firm's finances, and that person would be subject to discipline if accounting and capitalization rules are not followed. ☐

Spot on

USFE to list forex futures

The United States Futures Exchange (USFE) will begin offering spot equivalent futures (SEF) on Sept. 21. The contracts will trade 23 hours per day.

The USFE will begin with six contracts — U.S. dollar/euro, U.S. dollar/British pound, U.S. dollar/Australian dollar, Japanese yen/U.S. dollar, Swiss franc/U.S. dollar, and Canadian dollar/U.S. dollar.

The contracts are retail-sized, with a tick worth \$5 for the three U.S.-dollar based contracts, 500 yen for the JPY/USD contract, and five Swiss franc and five Canadian dollars for the CHF/USD and CAD/USD contracts, respectively.

SEFs are structured to automatically allocate the cost-of-carry associated with holding a spot forex position open overnight, making them identical to a spot position. ☐