



Retail Forex Transactions A Regulatory Guide

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Introduction

In December 2000, the Commodity Futures Modernization Act of 2000 (CFMA) was enacted into law. The CFMA amended the Commodity Exchange Act (Act) to clarify the Act's application to off-exchange trading in foreign currency futures and options (forex).

Under the Act, only certain regulated entities may be counterparties to off-exchange (also called over-the-counter or OTC) trades with retail customers. These regulated entities include registered futures commission merchants (FCMs) and certain of their affiliates. All other transactions with U.S. retail customers are unlawful unless done on or subject to the rules of a regulated exchange.

Before going on, you should understand two of the terms that we will use throughout this Guide.

- For our purposes, a **retail customer** is any party to a forex trade who is not an eligible contract participant as defined in the Act. This includes individuals with assets of less than \$10 million and most small businesses.
- As used in this Guide, **forex** transactions are off-exchange foreign currency futures and options transactions with retail customers. In general, any off-exchange transaction by a retail customer to speculate on exchange rates without receiving or delivering the foreign currency is a forex transaction, although this definition is not legally precise.

NFA's forex requirements only apply to Members whose retail forex activities are not subject to oversight by another regulator. Who these Members are is discussed in the section called Forex Dealer Members (page 4).

This Guide should help our Members who are subject to NFA's forex requirements understand those requirements. This Guide does not, however, include every requirement that may apply and does not deal with every detail of the requirements it does include. In addition to this Guide, you should read NFA's rules and interpretive notices and the Commodity Futures Trading Commission's (CFTC) interpretive advisories and letters regarding forex transactions. NFA's most significant rules and an interpretive notice regarding forex transactions are included in Appendices 1 and 2.

Counterparties

A firm may not act as a counterparty, or offer to act as a counterparty, to any forex transaction with a retail customer unless the firm is one of the regulated entities listed in the Act. These entities (authorized counterparties) are:

- financial institutions (e.g., banks and savings associations),
- certain insurance companies and their regulated subsidiaries or affiliates,
- financial holding companies,
- investment bank holding companies,
- registered broker-dealers,
- certain affiliated entities of registered broker-dealers,
- registered FCMs, and
- certain affiliated entities of registered FCMs.

Associated Persons

Individuals employed by an FCM to solicit or accept orders for exchange-traded futures and options must register as associated persons of the FCM. A March 1, 2002 CFTC staff advisory (the Advisory), which is referenced in Appendix 3, states that individuals employed by an FCM acting as counterparty must register as associated persons if they solicit or accept retail forex business for the FCM.

Introducing Entities

A separate entity that introduces customers to an FCM to trade futures or options on an exchange must register as an introducing broker (IB). The Advisory states, however, that entities that introduce retail customers to registered FCMs that act only as counterparties for retail forex transactions are not required to register as IBs, although they may do so voluntarily. If the entity introduces customers to a registered FCM that also solicits or accepts orders for exchange-traded futures or options, the entity should register as an IB or FCM.

The Advisory mentions several situations where a person who claims to be merely introducing business may actually be acting as a counterparty. In particular, a person may be acting as a counterparty if it:

- uses promotional material that fails to identify the regulated counterparty or that fails to make it clear who the counterparty is,
- receives funds from retail customers in its own name,
- sends funds from a regulated counterparty to retail customers, or
- does business with a regulated counterparty on less than a fully-disclosed basis.

In other words, a person is a counterparty, and must fall within one of the regulated categories, if it leads the retail customer to believe that it is the counterparty or if the transaction is structured so that it is actually two transactions – one transaction

between the retail customer and the firm that has the relationship with the customer, and a second transaction between that firm and a regulated entity to offset the risk the firm took by acting as counterparty to the transaction with the retail customer.

Account Managers

Generally, a person exercising trading authority over a customer's futures or options account must register as a commodity trading advisor (CTA). The Advisory states, however, that a person that manages the funds of retail customers held by an authorized counterparty solely to trade forex is not required to register as a CTA but may do so voluntarily. Obviously, if the person also exercises trading authority over a customer's account for exchange-traded futures or options contracts, the person must register as a CTA.

A person exercising trading authority over a retail customer's account may not receive or hold the customer's funds. Those funds must be held by an authorized counterparty.

Pool Operators

The Act defines a commodity pool as an "investment trust, syndicate or similar form of enterprise operated for the purpose of trading commodity interests." Generally, a person who operates a commodity pool must register as a commodity pool operator (CPO) unless an exemption applies. The Advisory states, however, that a person operating a pool that limits its trading solely to forex and only trades with authorized counterparties is not required to register as a CPO but may do so voluntarily.

Forex Dealer Members

NFA Bylaw 306 creates a Forex Dealer Member category for certain NFA Members who act as counterparties in forex transactions with retail customers. An NFA Member is a Forex Dealer Member if it meets two tests: 1) it acts as counterparty to at least one retail customer and 2) it is not otherwise subject to regulatory oversight for its retail forex activities. Members who do not act as counterparties to retail customers in forex transactions are not Forex Dealer Members. The following entities are also not Forex Dealer Members, even if they act as counterparties to retail customers:

- financial institutions (e.g., banks and savings associations),
- certain insurance companies and their regulated subsidiaries or affiliates,
- financial holding companies,
- investment bank holding companies,
- registered broker-dealers that are members of NASD, and
- Material Associated Persons of registered broker-dealers that are members of NASD. These are affiliates for which the registered broker-dealer makes and keeps records under the Securities and Exchange Commission's risk assessment requirements.

Members who introduce retail forex accounts to or manage retail forex accounts with a Forex Dealer Member are not Forex Dealer Members if they do not also act as counterparties. These Members must, however, comply with some provisions of NFA Compliance Rule 2-36 unless they fall within one of the categories listed above.

Soliciting Customers

In developing its forex requirements, NFA's primary concern was to ensure that the requirements provide adequate protection for retail customers without imposing undue burdens on NFA Members. NFA also recognized that, because of the differences between forex transactions and traditional exchange-traded futures and options, some of NFA's futures rules may not be appropriate for forex transactions. Compliance Rule 2-36 sets out the general standards that apply to Forex Dealer Members and their Associates in connection with forex transactions with retail customers, and the Interpretive Notice titled "Forex Transactions with Forex Dealer Members" explains how these standards apply.

Customer Information and Risk Disclosure

The Interpretive Notice requires Forex Dealer Members to obtain certain information from retail customers and to provide them with understandable and timely disclosure on essential features of forex trading. The information must be obtained, and the disclosures must be given, before the customer makes the first trade. Members should update this disclosure prior to entering into new transactions with current retail customers if failing to update the information would make it misleading.

Members or their Associates should obtain, at a minimum, the customer's name, address, principal occupation or business, current estimated annual income and net worth, approximate age, and previous investment and trading experience. All retail forex customers must receive disclosures about the characteristics of the forex transactions and the particular risks of those transactions, and you must supplement this disclosure when necessary. For example, if a customer does not have experience trading forex, you must determine what additional information the customer needs to make an informed decision on whether to enter into forex transactions. In some circumstances (e.g., if the customer is living on social security or is looking for a safe investment), you may even have to tell the customer that forex trading is too risky for that particular customer. A Member is not, however, required to reject the account if a customer still wants to trade forex.

NFA does not require Members to provide their Associates with any sort of grid-like formula to identify those retail customers who require additional risk disclosure. Your firm should, however, be able to articulate the general factors its Associates consider when deciding whether to give additional risk disclosure.

A Forex Dealer Member must provide disclosure on the essential features of forex trading even if it did not solicit the customer. Your firm does not, however, have to obtain the customer information and provide any additional disclosure if the account was solicited by another NFA Member, since that Member is required to do so. If a non-Member solicited the customer, however, these obligations fall on the Forex Dealer Member.

Communications with the Public and Promotional Materials

Forex Dealer Members and other Members doing business with them should adopt and enforce written procedures regarding communications with the public. These procedures should address oral sales solicitations as well as promotional material, and they should be reasonably designed to prevent your firm and its Associates from making any communication with potential or current retail customers that operates as a fraud or deceit, uses a high pressure approach, or implies that forex transactions are appropriate for all customers. For example, you may not represent that forex funds deposited with a Member are “segregated” or given special protection under the bankruptcy laws.

Any mention of the possibility of profit should be accompanied by an equally prominent statement of the risk of loss. In addition, any references to actual past trading profits must also mention that past profits are not necessarily indicative of future results. You should also ensure that the communication does not discuss past performance unless the performance is similar to the actual performance of the firm’s reasonably comparable accounts for the same time period. Finally, promotional materials should never guarantee against loss.

A supervisory employee should approve promotional materials before they are used to ensure that they do not deceive the public or contain any material misstatements of fact. The firm’s written procedures should say who will be responsible for reviewing and approving the promotional material and how that review will be documented.

Your firm must maintain all promotional material for five years from the date of last use and must keep it readily assessable for the first two years. Furthermore, Members must maintain supporting documentation for all statements, claims and performance results included in promotional materials.

Reporting and Recordkeeping

Forex Dealer Members must provide retail forex customers with timely and accurate notice of the status of their accounts. Each Member must also maintain books and records necessary to conduct its business.

Customer Statements

Written Confirmations

Forex Dealer Members should provide written confirmations to retail customers within one business day after any activity in the customer's account. Account activity includes entering or exiting positions, rolling positions over, and delivering the underlying currency.

At a minimum, the written confirmation should include:

- the date of the transaction,
- the currency pair,
- the number of contracts or units,
- the contract or unit size,
- any mark-up or mark-down,
- the amount of any commissions, and
- any other fees or charges associated with the transaction.

The confirmation must disclose the amount of compensation that the Forex Dealer Member receives for the transaction, including any compensation that the Member pays to a third-party for introducing the account. Compensation includes commissions, mark-ups and mark-downs (collectively referred to as mark-ups), rebates, and other fees. If a Forex Dealer Member receives more than one of type of compensation, it must disclose the total compensation it receives.

The confirmation does not have to list the compensation for each particular trade but must provide enough information so that the customer understands how much the Forex Dealer Member receives for entering into the transaction. For example, if the Member routinely marks up certain currency pairs by 1 pip and other currency pairs by 2 pips, it can add a legend to the confirmation form that lists its standard mark-ups. If the mark-up for a particular currency pair fluctuates within a narrow range (e.g., 1-2 pips), it can disclose the range. Similarly, if the compensation for buying a currency pair is different than the compensation for selling the same currency pair (e.g., because the mark-ups are wider at one end of the spread than at the other), the confirmation must disclose the compensation for each type of position. Of course, if the compensation for a particular transaction varies from the standard rates, the Member must disclose the actual compensation. The Member may also use different legends if it has different standard rates for customers introduced by different firms.

A mark-up is the difference between the price the Forex Dealer Member gives its customer and the price at which the Forex Dealer Member can buy the same currency pair for its own account (if the customer bought) or sell the same currency pair for its own account (if the customer sold) in a transaction with an unrelated counterparty. For example, if a firm offers its customers a spread that is one pip wider on each end than the spread the firm would receive for its own trades, the mark-up is one pip. If a firm offers its customers a spread that is skewed to one direction, the firm must separately disclose the mark-ups for buying and selling the currency pair.

Your firm can calculate mark-ups in any manner that reasonably reflects the difference between the price it gives its customer and the price the firm itself would receive. For example, if your firm enters into contemporaneous transactions to hedge its risk, it can use the difference between the price it gave its customer and the price it receives in the contemporaneous transaction. If your firm does not enter into contemporaneous transactions to hedge its risk, it may measure its mark-ups against the contemporaneous prices reported by a reliable source.

NFA considers the following sources to be reliable:

- established price reporting services that continuously report prices of actual currency transactions occurring in the market,
- U.S. banks that make an ongoing market in foreign exchange, and
- exchanges that trade foreign currency futures (but only for those currencies traded on the exchange).

The Forex Dealer Member must document the source or group of sources (if, for example, the Member averages two or more sources), must use the same source(s) for both long and short positions, and must use the source(s) for all pricing purposes, which includes determining notional value when calculating capital requirements. Your firm should also use the same source(s) from day to day unless extraordinary market conditions make it temporarily unreliable, in which case you should document the reason for using a different source. A Forex Dealer Member may, however, use different sources for different currency pairs.

You can contact NFA Compliance staff with questions about the reliability of a particular source or whether a particular method of calculating mark-ups is acceptable.

Monthly Summaries

On a monthly basis, Forex Dealer Members should provide a summary of all forex transactions and other account activity to each retail customer that has open positions at the end of the month or changes in account balance since the prior statement. For all other open accounts, Forex Dealer Members should provide summaries at least quarterly.

With the customer's prior consent, your firm may send confirmations and monthly summaries by facsimile or email, or may post them on a password-protected Internet site. The Forex Dealer Member should maintain a hard copy of the customer's signed consent.

Recordkeeping Requirements

Compliance Rule 2-10 requires each Member to maintain the books and records necessary to conduct its business. Forex Dealer Members and other Members who do business with them should adopt procedures to create and maintain current and accurate books and records to support and explain the Member's forex activities. Your firm must maintain these records at its main business office and must make them available to NFA.

All required books and records must be kept for five years and must be readily accessible for the first two years of the five-year period. Members may keep hard or micrographic copies (e.g., microfilm or microfiche) of these records or may use a suitable electronic storage media. An electronic storage media is suitable if it is a digital storage medium or system that preserves the applicable records in a permanent format, indexes the data and records the data's date, and can be immediately converted to hard copy.

At a minimum, each Forex Dealer Member must make and maintain the books and records listed on page 20.

Forex Dealer Members and their Associates that have supervisory responsibilities must diligently supervise the Member's retail forex business. This includes supervising the activities of the Member's employees and agents and of affiliates that act as counterparties to retail forex transactions. Members who introduce accounts to or manage accounts carried by Forex Dealer Members and their Associates with supervisory responsibilities must diligently supervise their employees and agents.

Members must establish, maintain, and enforce written supervisory procedures reasonably designed to detect and prevent violations of NFA rules. NFA has provided Members with guidance on minimum standards of supervision through interpretive notices issued under NFA Compliance Rule 2-9, which are listed at the end of this Guide. While these interpretive notices do not apply to forex transactions, they do provide useful guidance for supervisory procedures for those transactions.

NFA recognizes that, given the differences in the size and complexity of the operations of NFA Members, there must be some degree of flexibility in determining what constitutes "diligent supervision" for each firm. Your firm should tailor its procedures to its unique circumstances as long as they meet certain minimum requirements.

All Members subject to NFA's forex requirements should have procedures to address the following:

- screening employees who will solicit transactions from, or provide advice to, retail customers or manage retail customer accounts to see if they are subject to any of the statutory disqualifications in Section 8a of the Act and, if so, to determine what supervision they will require;
- monitoring communications with the public, including sales solicitations and web sites, and approving promotional material;
- reviewing the information obtained from and provided to retail customers solicited by the firm and its employees to ensure that the appropriate information has been obtained and provided; and
- handling and resolving retail customer complaints.

A Forex Dealer Member's procedures should also include:

- screening employees who will solicit transactions from retail forex customers to ensure that they are registered with the CFTC as associated persons;
- screening third-parties who introduce retail customer business or manage retail customer accounts to see if the third party or any of its principals is subject to a statutory disqualification under Section 8a of the Act and, if so, determining if the Forex Dealer Member should perform additional background research regarding the third party – the screening process should include checking BASIC and any other readily available sources and asking the third party to represent that neither it, nor any of its principals, is subject to a statutory disqualification or to identify and explain any statutory disqualifications;

- reviewing disclosures provided to retail customers to ensure that they are understandable, timely, and provide sufficient information;
- reviewing and analyzing the forex activity in retail customer accounts, including discretionary customer accounts; and
- handling retail customer funds, including accepting security deposits.

An adequate supervisory program also includes periodic on-site visits to branch offices and guaranteed IBs that conduct retail forex business on behalf of the Member. Your firm should consider the characteristics of the branch office or guaranteed IB when deciding how often to visit it and what the visit should cover. These characteristics include the amount of business it generates; the number of retail customer complaints; the training and experience of its personnel; and the frequency and nature of the problems that originate from that office or IB.

Members must also ensure that their employees are properly trained to perform their duties, to abide by NFA requirements, and to handle retail customer accounts. How formal the training program is will depend on the size of the firm and the nature of its business.

An affiliate of a Forex Dealer Member may act as counterparty to forex transactions with retail customers if the affiliate directly or indirectly controls, is controlled by, or is under common control with the Forex Dealer Member and the Forex Dealer Member makes and keeps records concerning the financial activities of the affiliate under the CFTC's risk assessment requirements. If a Forex Dealer Member has one or more affiliates that act as a counterparty to retail forex customers based on their affiliation with the Forex Dealer Member, that Member must supervise the affiliates' retail forex activities to ensure they comply with the same requirements that apply to the Forex Dealer Member. Your firm should conduct periodic on-site audits of those affiliates and make their books and records available to NFA upon request. NFA can take an enforcement action against a Forex Dealer Member if its affiliate violates the standards imposed by NFA requirements.

Doing Business with Non-Members

Third-party solicitors and account managers are generally not required to register with the CFTC or become Members of NFA. If non-Members solicit customers to open accounts with, or manage customer accounts at, a Forex Dealer Member, however, NFA can take an enforcement action against the Forex Dealer Member for the non-Member's conduct if that conduct would violate NFA requirements when engaged in by an NFA Member. This is true even if the non-Member is not the Forex Dealer Member's agent.

This rule allows NFA to bring a disciplinary action even if a Forex Dealer Member acts diligently and has no knowledge of the non-Member's conduct. As a practical matter, however, NFA will not take disciplinary action unless the Forex Dealer Member knew or should have known of the non-Member's conduct or failed to exercise due diligence when establishing and maintaining the relationship with the non-Member.

There are two exceptions. Forex Dealer Members are not subject to discipline for the actions of non-Members who are exempt from the Forex Dealer Member category based on their status as regulated entities or who would be exempt from CFTC registration if they were acting in the same capacity in connection with exchange-traded futures contracts (e.g., persons located outside the U.S. that solicit, introduce, or manage accounts only for persons located outside the U.S.). Even if your firm is not subject to discipline for a non-Member's actions, NFA can still discipline it for its own actions. For example, a Member violates NFA rules if it has actual or constructive notice that a non-Member has engaged in fraudulent conduct and the Member fails to take appropriate action.

Dues

Forex Dealer Members do not pay assessment fees to NFA on forex transactions since they are not done on an exchange. Instead, NFA Bylaw 1301(e) imposes annual dues that are graduated according to the firm's gross annual revenue from retail customers for these activities. Profits and losses from proprietary trades are **not** to be included in gross revenue for this purpose.

NFA assesses dues on the firm's membership renewal date and will base them on the Forex Dealer Member's most recent certified financial statement. All Forex Dealer Members must file their certified financial statements with NFA even if NFA is not the firm's designated self-regulatory organization (DSRO). If NFA is not the DSRO, the firm may file the statement either in hard copy or through Winjammer, in which case the firm will need to contact NFA for a personal identification number. All other Forex Dealer Members must file through Winjammer.

The following table should help you determine how much your firm will owe in annual dues.

Gross Annual Income from Retail Forex	Annual Dues if NFA is the DSRO	Annual Dues if NFA is not the DSRO
\$100,000 or less	\$7,500	\$2,000
Over \$100,000 but not over \$1,500,000	\$15,000	\$9,500
Over \$1,500,000	\$20,000	\$14,500

Security Deposits

Forex Dealer Members must collect security deposits from retail customers. These security deposits help protect Forex Dealer Members against losses from defaulting customers, which, if significant enough, could cause a Forex Dealer Member to become insolvent and put the funds of its other, non defaulting, customers at risk.

Forex Dealer Members must collect and maintain a minimum security deposit for each forex transaction between the Forex Dealer Member and a retail customer. The security deposit must be calculated on the daily notional value of the contract in U.S. dollars, not on the unit or contract size.

The security deposit must be at least:

- (i) two percent of the notional value of transactions 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) four percent of the notional value of other currency transactions;
- (iii) for short options, the above amount plus the premium received; and
- (iv) for long options, the entire premium.

Forex Dealer Members may, of course, charge their customers higher security deposits.

Where the two currencies are in different categories, the Forex Dealer Member must collect the higher percentage amount. Therefore, if the transaction pairs a foreign currency with the U.S. dollar, the security deposit is based on the foreign currency. If the transaction pairs a currency that qualifies for a 2% deposit with a currency that does not, the Forex Dealer Member must collect a 4% security deposit for the entire transaction.

Example:

<i>Currency Pair</i>	<i>Security Deposit</i>
EUR/USD	2%
CND/JPY	2%
CND/BRL	4%
USD/MXN	4%
BRL/MXN	4%

For short options, the Forex Dealer Member must collect the security deposit plus the premium the customer received. For long options, the Forex Dealer Member must simply collect the entire premium from the customer.

The Forex Dealer Member must calculate the security deposit when the positions are initiated and at least daily thereafter. The firm must make this daily calculation while customer positions are open. In other words, your firm may not calculate the security deposit while the positions are being rolled over if your firm treats its customers as flat during that period. NFA requirements do not, however, prohibit Forex Dealer Members from computing security deposits more than once a day.

Financial Requirements

NFA's minimum financial requirements help protect customers and market participants by requiring Members to maintain enough capital to remain solvent and meet their financial obligations.

Forex Dealer Member Capital Requirements

Each Forex Dealer Member must maintain adjusted net capital equal to or in excess of the greatest of:

- (i) \$250,000;
- (ii) 1% of the total net aggregate notional value of all open forex transactions that are between the Forex Dealer Member and retail customers; or
- (iii) Any other amount required under NFA Financial Requirements Section 1.

The capital requirement based on the net aggregate notional value of all open forex transactions is calculated as follows:

- calculate the aggregate long notional value for each currency pair by adding up the long positions, multiplying by the contract size and converting to U.S. dollars using the relevant exchange rate;
- calculate the aggregate short notional value for each currency pair by adding up the short positions, multiplying by the contract size and converting to U.S. dollars using the relevant exchange rate;
- subtract the smaller value from the larger value to determine the net value for the currency pair;
- add the net values of each currency pair (whether long or short) to arrive at the total notional value; and
- multiply that number by .01.

Example:

<i>Currency Pair</i>	<i>Long Value</i>	<i>Short Value</i>	<i>Net Value</i>
EUR/USD	\$29,518,561	\$12,489,666	\$17,028,895
CND/JPY	25,422,685	15,378,016	10,044,669
CND/BRL	18,123,654	18,876,273	752,619
USD/MXN	5,431,980	6,769,211	1,337,231
BRL/MXN	2,111,789	4,097,815	1,986,026
<i>Total Notional Value</i>			<i>31,149,440</i>
Capital Requirement (\$31,149,440 X .01)			\$ 311,494

This alternative capital requirement is based solely on the firm's exposure to its retail customers. Whether the firm has hedged its net exposure is irrelevant when determining the firm's minimum net capital requirement. As discussed on page 19, however, hedging the firm's net exposure reduces its capital charge on its proprietary positions and increases the amount of capital available to meet the minimum requirement.

Your firm may not avoid the alternative capital requirement by calculating it at the end of the day and claiming that it ends the day flat (e.g., because it rolls the positions over by closing them out at the end of the day and opening new positions at the beginning of the next day). The firm must calculate its net capital requirement at a set point during the day while customer positions are open. For example, if your firm considers the close of the business day to be 5:00 p.m., at which time all open positions are closed and new positions are then opened, you must calculate the firm's capital requirement at a set time prior to 5:00 p.m.

Forex Dealer Members may use any reliable source for the exchange rates used to determine the long or short value of the currency pairs, but your firm must document both the rates and the source. Page 8 of this Guide describes some reliable sources and explains when a firm can change those sources.

Within 17 business days after the end of each month, all Forex Dealer Members must formally compute their adjusted net capital and minimum financial requirement as of the end of that month and must maintain this computation. A Forex Dealer Member must, however, be able to demonstrate compliance with the applicable capital requirements at all times.

Any Forex Dealer Member whose adjusted net capital falls below its minimum capital requirement must immediately give telephonic notice to the CFTC and its DSRO. The firm must also confirm its telephonic notice by telegraph or facsimile.

IB Capital Requirements

Firms that introduce retail forex accounts but do not act as counterparties may register as IBs. These IBs may meet their capital requirements by either maintaining minimum net capital (independent IBs) or entering into a guarantee agreement with a registered FCM (guaranteed IBs).

IBs may not accept customer funds in their own name and may not hold customer funds. IBs may accept checks in an FCM's name with the FCM's permission, but the IB must send those check to the FCM or deposit them in a bank account in the FCM's name on the same day the IB receives them.

Independent IBs

An independent IB must maintain, at all times, adjusted net capital equal to the greater of:

- 1) \$30,000; or
- 2) for Member IBs with less than \$1,000,000 in adjusted net capital, \$6,000 per office operated by the IB (including the main office); or
- 3) for Member IBs with less than \$1,000,000 in adjusted net capital, \$3,000 for each AP sponsored by the IB (including each AP with a temporary license).

Guaranteed IBs

Guarantee agreements must be in the form prescribed by the CFTC, must include the names of both parties (i.e., the FCM and the IB), must give an effective date, and must be signed by both the FCM and the IB. The agreement must be signed by the proprietor if the firm is a sole proprietorship, a general partner if the firm is a partnership, and either the chief executive officer or the chief financial officer if the firm is a corporation.

As long as the guarantee agreement remains in effect, an IB has no further financial reporting obligations. The agreement does not have an expiration date and continues to be in effect until it is terminated.

Either party can terminate the guarantee agreement by giving written notice of its intent at least 30 days prior to the planned termination date. The notice must be filed with the other party, NFA, the CFTC, and the FCM's DSRO. The parties may agree to terminate the guarantee agreement in less than 30 days by signing and filing a mutual determination notice. Finally, if either party feels it has "good cause," it may terminate the agreement immediately upon written notice to the other party and NFA.

An FCM may not enter into new guarantee agreements if the FCM's adjusted net capital is currently less than that required by Section 2 of NFA's Financial Requirements or has been less than that amount as of the end of any of the last three months. Additionally, if the FCM's capital falls below the required level and the FCM cannot bring it back up within 30 days, the FCM must notify all of its guaranteed IB that its existing guarantee agreements will terminate in 30 days (for a total of 60 days). If the FCM's capital increases sufficiently in the 30-day notice period, however, the FCM does not have to terminate its guarantee agreements.

On the termination date, the IB must cease doing business until it either files a new guarantee agreement with NFA or files the necessary financial reports to become an independent IB. The financial filing requirement may be satisfied either by filing an audited Form 1-FR that is less than 45 days old as of the date received by NFA or by filing both an audited Form 1-FR that is less than one year old as of the date received by NFA and an unaudited Form 1-FR that is less than 17 business days old as of the date received by NFA. If the IB files the financial reports to become an independent IB, it must also include a statement describing the source of its current assets and stating that its capital has been contributed for the purpose of operating its business and will continue to be used for that purpose. The IB must also file a written notice electing a calendar year or establishing a different fiscal year end.

A guarantor FCM is jointly and severally subject to discipline under NFA Compliance Rule 2-23 for the IB's acts and omissions that violate NFA rules and occur while the guarantee agreement is in effect.

Net Capital Calculation

The formula for determining Adjusted Net Capital is:

$$\text{Current Assets} - \text{Liabilities} - \text{Charges Against Net Capital} = \text{Adjusted Net Capital}$$

CFTC Regulation 1.17 defines these terms. Your firm's financial statements must be prepared according to generally accepted accounting principles (GAAP). In some cases, however, CFTC Regulation 1.17 is more restrictive than GAAP. You must always follow CFTC Regulation 1.17 when calculating your firm's net capital.

Forex Dealer Members must prepare CFTC Form 1-FR and file it with NFA and its DSRO on a monthly basis. Independent IBs must prepare CFTC Form 1-FR semi-annually, as of the middle and the close of each fiscal year, and must file it with NFA. An independent public accountant must certify the financial statement prepared as of the firm's fiscal year end. Although the Form 1-FR contains a number of different financial statements, only the applicable statements need to be prepared for each filing.

Unaudited Form 1-FR must contain the following:

- statement of financial condition,
- statement of the computation of minimum capital requirements,
- statement of changes in ownership equity, and
- statement of changes in liabilities subordinated to the claims of general creditors pursuant to a satisfactory subordination agreement (if applicable).

The certified year-end Form 1-FR must also include:

- the statement of income and
- the statement of cash flows.

The certified statement must also contain any necessary footnote disclosures, an auditor's opinion covering all statements, and an auditor's supplemental report on material inadequacies.

NFA must receive unaudited Form 1-FRs within 17 business days after the statement date. NFA must receive audited Form 1-FRs within 90 days after the statement date.

The instructions for the Form 1-FR generally say where to classify items on the form. When the CFTC adopted Form 1-FR, however, registered firms generally did not conduct retail forex business. As a result, the form does not clearly indicate how to account for some items related to the forex activities of Forex Dealer Members.

The CFTC is currently in the process of revising the Form 1-FR. Until the CFTC adopts revisions to Form 1-FR, Forex Dealer Members should account for their

forex activities as follows. On the asset side of the balance sheet, you should classify funds received from customers for forex transactions on the line designated as “other assets.” On the liability side, the firm should classify amounts owed to customer under accounts payable on the line designated as “other.” On the Statement of Income (Loss), you should classify the firm’s income or loss from forex transactions under the “other income” section of the statement.

Capital Charges for Forex Positions

Forex Dealer Members must take a capital charge on all uncovered proprietary positions, although the firm may net on-exchange and off-exchange positions when determining the firm’s uncovered position. Uncovered off-exchange proprietary positions are subject to a haircut charge that depends on the underlying currency. Net balances in British pounds, Japanese yen, Canadian dollars, Swiss francs and the Euro are subject to a 6% charge. Net balances in all other currencies are subject to a 20% charge. Uncovered positions on an exchange are subject to a charge equal to 150% of the exchange’s maintenance margin.

When calculating its net position, your firm may include foreign currency held in deposit, investment, or trading accounts at banks, FCMs, broker-dealers, and similar entities if the following conditions are met:

- the foreign currency is unencumbered and immediately accessible, making it available to satisfy your firm’s obligations to its retail customers, and
- your firm treats the foreign currency in the account consistently for capital purposes (i.e., the foreign currency is always included when determining the firm’s net position).

Subordinated Loan Agreements

Proceeds from subordinated loan agreements may be included in the firm’s capital if the agreement meets the requirements in CFTC Regulation 1.17(h) and has been filed with and approved by the firm’s DSRO. The firm must submit a signed copy of the agreement to its DSRO at least 10 days prior to the proposed effective date. Independent IBs must submit these agreements to NFA.

A subordination agreement must include the name and address of the lender, state the business relationship of the lender to the firm, and indicate whether the firm carried funds or securities for the lender at or about the time the firm files the proposed agreement. If a lender contributes 10 percent or more of the firm’s capital, then the firm must list the lender as a principal.

In addition, the Member’s DSRO must approve prepayments or special prepayments, and the Member must give its DSRO notice of accelerated maturity. The Member must also submit amendments to existing subordination agreements to its DSRO for approval. Independent IBs must submit this information to NFA.

Finally, NFA has developed standardized Cash Subordination Loan Agreements and Secured Demand Notes. You can obtain copies of these agreements from NFA's web site at www.nfa.futures.org.

Financial Books and Records

FCM and independent IB Members are required to prepare and maintain ledgers or other similar records that summarize each transaction affecting the Member's assets, liability, income, expense and capital accounts and include appropriate references to supporting documents. These ledgers must be classified into the account classification subdivisions on the CFTC Form 1-FR. Generally, the firm's records would include basic accounting documents such as a General Ledger and a Cash Receipts and Disbursements Journal.

In order to demonstrate compliance with the capital requirements, a Forex Dealer Member should make and maintain daily records showing the transactions executed that day and their effect on the firm's obligations to its customers. The record of daily trades should show the date, time, currency pair, price, and size of each transaction; mark-ups and mark-downs, commissions, and fees; and the person for whom the transaction was made. For options, the record should include whether the option is a put or a call, the strike price, and the premium. The record of obligations to customers should include the gross profits and the gross losses to customers, the firm's open currency exposures to customers, the sum of the customers' cash balances, and the net liquidating value of all customer accounts combined.

Weekly Forex Reporting Requirements

Each Forex Dealer Member must be able to properly account for all funds received from and owed to retail customers. Forex Dealer Members should prepare a daily computation showing the total amount of customer funds on deposit, the total amount of customer open positions, and the total amount due to customers. The firm must file the daily computation prepared as of the last business day of the week with NFA by noon on the following business day. The firm may file this weekly report with NFA via e-mail at the following address: forex_reporting@nfa.futures.org.

Anti-Money Laundering Programs

Federal law imposes significant anti-money laundering requirements on financial institutions, including NFA Members. NFA Compliance Rule 2-9(c) requires each Member registered as an FCM or IB to have an anti-money laundering program, and an interpretive notice to that rule explains the standards the program must meet. Members registered as CPOs and CTAs are not currently required to have an anti-money laundering program, but they should not ignore suspicious activity.

Developing Policies, Procedures, and Internal Controls

Members must establish and implement policies, procedures, and internal controls reasonably designed to assure compliance with anti-money laundering provisions of the Bank Secrecy Act (BSA) and related regulations. A firm's procedures must cover four key areas:

- identifying customers,
- detecting and reporting suspicious activity,
- hiring qualified staff, and
- recordkeeping.

Customer Identification Program

The anti-money laundering program must include procedures to obtain information about the customer and to verify its identity. Unlike NFA's "know your customer" requirements, these requirements apply to all customers, not just individuals.

A Member must obtain the following minimum information before it transacts business (e.g., introduces or opens an account or acts as counterparty) with a customer:

- for individuals, the customer's name, date of birth, and personal or business address;
- for customers that are not individuals, the customer's name, principal place of business, local office or other physical location;
- for U.S. persons, the customer's social security number or taxpayer identification number; and
- for non-U.S. persons, a U.S. taxpayer identification number, a passport number and the issuing country, an alien identification card number, or the number and issuing country for any other government-issued document that shows nationality or residence and contains a photograph or similar safeguard.

In addition to obtaining this minimum information, the Member must take steps to verify the customer's identity. You do not have to verify the customer's identity before transacting business with the customer but must do so within a reasonable time before or after the first business transaction. The procedures for verifying the customer's identity should:

- describe those situations where documents will be used to verify identity and list the documents that will be used (e.g., drivers license, passport, certified articles of incorporation, government-issued business license);
- explain when non-documentary methods will be used either instead of or in addition to looking at documents and describe those non-documentary methods (e.g., contacting the customer at the telephone number or address provided by the customer, comparing the information provided by the customer with information from a consumer reporting agency, checking references with other financial institutions);
- include a mechanism for identifying customers that may be high money laundering or terrorist financing risks (such as customers from particular geographic locations);
- provide a means for notifying customers that the Member will ask them for information to verify identity; and
- describe what the Member will do if it cannot form a reasonable belief that it knows the customer's true identity.

If a Member cannot identify a customer that is not an individual using its normal procedures, the Member may need to obtain information about the individual with authority or control over the account. Your firm's customer identification procedures should describe those situations where the firm will obtain this information.

Members are not required to determine whether a document used to verify identity is valid. If a document appears to be a forgery or there is other evidence of fraud, however, your firm must decide whether it has enough information to form a reasonable belief that it knows the customer's true identity. The same is true if the information provided by the customer is inconsistent (e.g., a home address in New York and a telephone number in California or a birth date that isn't consistent with the customer's apparent age).

A Member may rely on another U.S. financial institution to conduct the customer identification procedures. The law provides a safe harbor if the BSA requires the other financial institution to have an anti-money laundering program, that financial institution enters into a contract with the Member agreeing to annually certify that it has implemented an anti-money laundering program and will perform the required steps, and reliance is reasonable under the circumstances. Your firm's procedures must describe any circumstances where it will rely on another financial institution.

Although the safe harbor does not apply unless all of the above conditions are satisfied, firms may also choose to rely on U.S. financial institutions in other reasonable circumstances. Your firm should conduct a risk-based analysis before relying on those institutions.

Detecting and Reporting Suspicious Activity

A Member's anti-money laundering program must also include systems and procedures designed to detect and report suspicious activity, such as transactions that do not appear to have a business or other lawful purpose, that are unusual for the customer, or that cannot be reasonably explained. Your firm and appropriate personnel should know the nature of the customer's business and the customer's purpose in entering into the transactions. Your firm should also provide employees with examples of activities that raise red flags.

Each firm's program must require employees to promptly notify specified firm personnel of potentially suspicious activity. The appropriate supervisory personnel must then evaluate the activity and decide whether to report it to the firm's DSRO or the Financial Crimes Enforcement Network (FinCEN).

Hiring Qualified Staff

A Member's procedures should describe its policies for ensuring that employees in areas susceptible to money laundering or terrorist financing are properly qualified and trained. Your firm should perform background checks on key employees to screen those employees for criminal and disciplinary histories.

Recordkeeping

The procedures must also describe the firm's recordkeeping policies regarding information and documents obtained during the identification process. Members must keep records of all identifying information obtained from customers, including a copy or detailed description of each document viewed and a description and the results of each non-documentary method used. Your firm must keep records of the information obtained from customers for five years after the account is closed and of the information used to verify identify for five years after those records are made.

Other Requirements

Compliance Officer

Each Member registered as an FCM or IB must designate a qualified individual or individuals to monitor the firm's day-to-day compliance with its anti-money laundering program. For example, a firm with a full-time compliance officer could designate that compliance officer. The designated individual may not be involved in any functional areas where money laundering or terrorist financing could occur and must ultimately report to senior management. This individual does not, however, have to be a principal of the firm or an Associate Member of NFA.

Employee Training Program

Members must provide ongoing training to employees who are involved in areas where money laundering or terrorist financing could occur. These employees should receive annual or more frequent training on their firm's policies and procedures, federal laws, and NFA requirements. Your firm should maintain records to show it has met this training requirement.

Independent Audit Function

A Member's anti-money laundering program must be audited at least annually. The audit may be conducted by internal audit staff or other internal employees if the employees conducting the audit do not have other anti-money laundering responsibilities, are not involved in areas where money laundering or terrorist financing could occur, and are independent of staff with these responsibilities or involved in these areas (e.g., the internal audit staff may not report to a compliance officer responsible for monitoring the firm's day-to-day compliance with the program). In the alternative, the Member may hire an independent outside party with experience in this type of auditing.

The audit staff or outside auditor should document the audit and report the results of the audit to the firm's senior management or to an internal audit committee or department. If the audit reveals any deficiencies, the audit staff, outside auditor, senior management, or internal committee or department should follow up to ensure that the firm has addressed and corrected those deficiencies.

General Requirements

All NFA Members must comply with the federal privacy laws and NFA's business continuity and disaster recovery requirements.

Privacy Rules

The CFTC's regulations restrict a Member's right to disclose nonpublic, personally identifiable financial information about customers and other consumers. These restrictions only apply to information about individuals who obtain financial products or services from the Member primarily for personal, family, or household purposes.

Members must have policies and procedures that describe their administrative, technical, and physical safeguards for protecting customer records and information. The procedures should also address the Member's policies for disclosing nonpublic, personally identifiable financial information and for notifying customers of those policies.

A Member must provide a customer with a privacy notice when the customer first establishes a relationship with the Member and annually after that. Your firm must also notify other consumers of its privacy policies before disclosing nonpublic personal information about those consumers.

Every Member must provide a privacy notice that identifies the categories of nonpublic personal information the Member collects and describes the Member's policies and procedures for protecting that information.

If your firm does not disclose nonpublic personal information to nonaffiliated third parties, or does so in very limited circumstances, the only additional information it must include in the privacy notice is a statement that it shares nonpublic personal information with third parties as permitted by law. CFTC Regulations describe the limited circumstances where Members may disclose the information without having to provide a more detailed privacy notice (e.g., when necessary to process a transaction or provide a service to the customer or with the customer's specific consent).

If your firm discloses nonpublic personal information to nonaffiliated third parties for other reasons, the notice must inform the customer that the firm discloses or reserves the right to disclose nonpublic personal information to nonaffiliated third parties and that the customer has the right to opt out of that disclosure. The notice must identify the categories of nonpublic personal information that your firm discloses and the categories of affiliates and nonaffiliates that your firm will disclose the information to. The notice must inform the customer that it may opt out of the disclosure and must provide a reasonable means for the customer to exercise its opt out right.

Members must provide amended privacy and opt out notices before disclosing information to unaffiliated third parties if either the information or the third party does not fall within a previously identified category.

All privacy and opt out notices should be in writing. Members may deliver these notices electronically if the customer agrees.

Business Continuity and Disaster Recovery Plan

Each Member must establish and maintain a written business continuity and disaster recovery plan. The plan must be reasonably designed to enable the Member to continue operating, to reestablish operations, or to transfer its business with minimal disruption.

Your firm's business continuity plan should address the following areas:

- establishing back-up facilities, systems, and personnel in locations that are geographically separated from the firm's primary facilities, systems, and personnel;
- backing up or copying essential documents and storing the information off-site;
- considering the impact of third-party business interruptions and identifying ways to minimize that impact; and
- developing a communication plan to contact essential parties such as employees, customers, counterparties, vendors, and disaster recovery specialists.

Each Member must update its plan when necessary and must periodically review the plan and keep a record of the review. Your firm should distribute and explain the plan to key employees, communicate the essential parts of the plan to all employees, and maintain copies of the plan at one or more off-site locations that are readily accessible to key employees.

Finally, each Member must provide NFA with the name and contact information for an individual who is authorized to make key decisions and will be the firm's primary contact if there is an emergency. If your firm has more than one principal or is registered as an FCM, it must provide this same information for a second individual authorized to make key decisions in an emergency.

BYLAWS

BYLAW 306. FOREX DEALER MEMBERS.

- (a) Except as provided in section (b), Members of NFA are Forex Dealer Members if they are the counterparty or offers to be the counterparty to foreign currency futures and options transactions offered to or entered into with persons that are not eligible contract participants as defined in Section 1a(12) of the Act and that are not executed on a contract market, a derivatives transaction execution facility, a national securities exchange registered pursuant to Section 6(a) of the Securities Exchange Act of 1934, or a foreign board of trade.
- (b) The following Members are not Forex Dealer Members:
- (i) Entities described in subsection (I) and subsections (IV) through (VI) of Section 2(c)(2)(B)(ii) of the Act;
 - (ii) Entities described in subsection (II) of Section 2(c)(2)(B)(ii) of the Act that are members of another futures association registered under Section 17 of the Act or of a national securities association registered under Section 15A(b) of the Securities Exchange Act of 1934; and
 - (iii) Entities described in subsection (III) of Section 2(c)(2)(B)(ii) of the Act based on their affiliation with an entity described in subsection (II) of Section 2(c)(2)(B)(ii) of the Act that is a member of another futures association registered under Section 17 of the Act or of a national securities association registered under Section 15A(b) of the Securities Exchange Act of 1934.

BYLAW 1301. SCHEDULE OF DUES AND ASSESSMENTS.

Subject to the provisions of Article XII, dues and assessments of Members shall be as follows:

* * *

- (e) **Forex Dealer Members**
- Each Forex Dealer Member shall pay to NFA annual dues in the amount provided under section (b)(ii) of this bylaw if its gross annual revenue from the activities described in Bylaw 306(a) is \$100,000 or less, shall pay that amount plus \$7,500 if its gross annual revenue from those activities is more than \$100,000, and shall pay an additional \$5,000 if its gross annual revenue from those activities is more than \$1,500,000. These dues replace the dues that would otherwise be payable based on the Forex Dealer Member's registration category.

Subject to the two-thirds majority voting requirements contained in Article XI, Section 1, the Board may in its discretion waive or establish lower annual dues for particular Members.

COMPLIANCE RULES

RULE 2-36. REQUIREMENTS FOR FOREIGN CURRENCY FUTURES OR OPTIONS TRANSACTIONS

(a) General Prohibition

No Forex Dealer Member shall engage in any foreign currency futures or options transaction that is prohibited under the Commodity Exchange Act.

(b) Fraud and Related Matters

No Forex Dealer Member or Associate of a Forex Dealer Member engaging in any foreign currency futures or options transaction shall:

- (1) Cheat, defraud or deceive, or attempt to cheat, defraud or deceive any other person;
- (2) Willfully make or cause to be made a false report, or willfully to enter or cause to be entered a false record in or in connection with any foreign currency futures or options transaction;
- (3) Disseminate, or cause to be disseminated, false or misleading information, or a knowingly inaccurate report, that affects or tends to affect the price of any foreign currency;
- (4) Engage in manipulative acts or practices regarding the price of any foreign currency or a foreign currency futures or options contract;
- (5) Willfully submit materially false or misleading information to NFA or its agents with respect to foreign currency futures or options transactions;
- (6) Embezzle, steal or purloin or knowingly convert any money, securities or other property received or accruing to any person in or in connection with a foreign currency futures or options transaction.

(c) Just and Equitable Principles of Trade

Forex Dealer Members and their Associates shall observe high standards of commercial honor and just and equitable principles of trade in the conduct of their foreign currency futures and options business.

(d) Doing Business with Non-Members

A Forex Dealer Member that is the counterparty, or offers to be the counterparty, to foreign currency futures and options transactions for customers shall be subject to discipline for the activities of any person that solicits or introduces a customer to the Member or that manages such customer's accounts, unless such person is a Member or Associate of NFA, meets the criteria in Bylaw 306(b), or would be exempt from Commission registration if it were acting in the same capacity in connection with exchange-traded futures contracts.

(e) Supervision

Each Forex Dealer Member shall diligently supervise its employees and agents in the conduct of their foreign currency futures and options activities for or on behalf of the Forex Dealer Member. Each Associate of a Forex Dealer Member who has supervisory duties shall diligently exercise such duties in the conduct of that Associate's foreign currency futures and options activities for or on behalf of the Forex Dealer Member.

(f) Affiliates

Each Forex Dealer Member that has an affiliate that is authorized to engage in forex transactions solely by virtue of its affiliation with the Forex Dealer Member shall supervise its affiliate's foreign currency and options activities for compliance with the same requirements that apply to the Forex Dealer Member. The Forex Dealer Member shall make the affiliate's books and records available to NFA staff upon request and shall be subject to discipline for acts and omissions of the affiliate that violate the standards imposed by NFA requirements.

(g) Activities of Other Members and Associates

Unless the Member meets the criteria in Bylaw 306(b), Members and their Associates who solicit foreign currency futures and options transactions on behalf of, introduce customers to, or manage accounts for customers that enter into foreign currency futures and options transactions with a Forex Dealer Member shall comply with subsections (a), (b), (c), and (e) of this rule.

(h) Scope

This rule governs foreign currency futures and options transactions that:

- (i) are between a Forex Dealer Member and a person that is not an eligible contract participant as defined in Section 1a(12) of the Act and
- (ii) are not executed on a contract market, a derivatives transaction execution facility, a national securities exchange registered pursuant to Section 6(a) of the Securities Exchange Act of 1934, or a foreign board of trade.

(i) Definition of Customer

For purposes of this rule, the term "customer" means a counterparty that is not an eligible contract participant as defined in Section 1a(12) of the Act.

FINANCIAL REQUIREMENTS

SECTION 11. FOREX DEALER MEMBER FINANCIAL REQUIREMENTS

- (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) \$250,000;
 - (ii) 1% of the total net aggregate notional value of all open foreign currency futures and options transactions in customer and non-customer (but not proprietary) accounts that are between the Forex Dealer Member and a person that is not an eligible contract participant as defined in Section 1a(12) of the Act and that are not executed on a contract market, a derivatives transaction execution facility, a national securities exchange registered pursuant to Section 6(a) of the Securities Exchange Act of 1934, or a foreign board of trade; or
 - (iii) Any other amount required by Section 1 of these Financial Requirements.

SECTION 12. SECURITY DEPOSITS FOR FOREX TRANSACTIONS WITH FOREX DEALER MEMBERS.

Each Forex Dealer Member shall collect and maintain the following minimum security deposit for each foreign currency futures and options 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 and that are not executed on a contract market, a derivatives transaction execution facility, a national securities exchange registered pursuant to Section 6(a) of the Securities Exchange Act of 1934, or a foreign board of trade:

- (i) 2% of the notional value of transactions 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) 4% of the notional value of other transactions;
- (iii) for short options, the above amount plus the premium received; and
- (iv) for long options, the entire premium.

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

FOREX TRANSACTIONS WITH FOREX DEALER MEMBERS INTERPRETIVE NOTICE

The Commodity Futures Modernization Act of 2000 (CFMA), which was signed into law on December 21, 2000, amended the Commodity Exchange Act (CEA) to provide that only certain regulated entities may offer off-exchange foreign currency futures and options contracts (forex) to retail customers.¹ Under the CFMA, registered futures commission merchants (FCMs) and their affiliates are among the entities that may offer forex contracts to retail customers.² As described below, NFA Bylaw 306 creates a Forex Dealer Member category for certain NFA Members who act as counterparties to forex transactions with retail customers.³ This category allows NFA to exercise appropriate regulatory jurisdiction over the retail forex activities of these Members without imposing unnecessary, and potentially duplicative, regulatory burdens on Members that are otherwise subject to regulatory oversight for their activities.

Given the differences between off-exchange forex transactions and traditional exchange-traded futures and options, the Board of Directors does not believe that it is appropriate to apply the full array of NFA's futures rules to off-exchange forex transactions. Therefore, rather than simply incorporating off-exchange forex transactions into the definition of "futures," NFA adopted NFA Compliance Rule 2-36 to govern these transactions.

Bylaw 306 and Compliance Rule 2-36 define forex transactions as off-exchange foreign currency futures and options transactions that are offered to or entered into with persons that are not eligible contract participants as defined in Section 1a(12) of the CEA and are limited to those transactions where an NFA Forex Dealer Member is the counterparty or the person offering to be the counterparty. For these purposes, "forex" does not include transactions executed on a contract market, a designated transaction execution facility, a national securities exchange registered pursuant to Section 6(a) of the Securities Exchange Act of 1934, or a foreign board of trade, which continue to be covered by other regulatory schemes.

Consistent with the provisions of Section 2(c) of the CEA, Bylaw 306 and Compliance Rule 2-36 apply only to transactions with retail customers. In developing its forex requirements, NFA's primary concern was to ensure that they provide adequate

¹ For purposes of this notice, the term "retail customer" refers to any counterparty – domestic or foreign – that is not an eligible contract participant as defined in Section 1a(12) of the CEA.

² Other NFA Members may offer these contracts if they are also registered in one of the other categories listed in Section 2(c)(2)(B)(ii) of the CEA.

³ The Board of Directors has determined that the retail, off-exchange forex transactions entered into by these firms should be subject to NFA's regulatory jurisdiction and are a proper subject of NFA regulation and oversight under Article XVIII(k) of NFA's Articles of Incorporation.

protection for retail customers without imposing undue burdens on NFA Members. NFA also believes that its requirements should, where consistent with customer protection, promote innovation and competition. In order to provide Members with as much flexibility as possible, NFA has chosen to deal with a number of issues by providing guidance under NFA Compliance Rule 2-36 instead of by adopting additional rules.

NFA Compliance Rule 2-36 sets out the general standards that apply to Forex Dealer Members and their Associates in connection with forex transactions with retail customers. Subsection (b) prohibits Forex Dealer Members and their Associates from engaging in fraudulent activities, subsection (c) requires Forex Dealer Members and their Associates to observe high standards of commercial honor and just and equitable principles of trade in connection with their forex business, and subsection (e) requires Forex Dealer Members and their Associates with supervisory duties to supervise their employees and agents. Other subsections address a Forex Dealer Member's responsibility for its unregulated affiliates and third-party solicitors, make Forex Dealer Members subject to discipline for the conduct of certain non-Members with which they do business, and extend certain of the rule's requirements to other Members and Associates who do business with Forex Dealer Members.

This notice has three sections. The first section explains who qualifies as a Forex Dealer Member under NFA Bylaw 306, the second section provides additional guidance about the requirements in Compliance Rule 2-36, and the third section covers other miscellaneous requirements.

A. BYLAW 306

In general, Forex Dealer Members are NFA Members who act as counterparties to retail, off-exchange forex futures and options transactions. This is a self-executing requirement, which means that any Member who qualifies is automatically a Forex Dealer Member. There is no application form and no approval requirement.

Members who do not act as counterparties are not Forex Dealer Members, even if they introduce or manage retail forex accounts. Under NFA Compliance Rule 2-36(g), however, most Members who introduce retail forex accounts to Forex Dealer Members or manage retail forex accounts for customers of Forex Dealer Members are required to comply with subsections (a), (b), (c), and (e) of that rule.

Bylaw 306(b) excludes Members that are otherwise subject to regulatory oversight for their retail forex activities, which means that these Members are not Forex Dealer Members and do not have to comply with Compliance Rule 2-36.⁴ The exclusions

⁴ Compliance Rule 2-36(d) and (g) exclude these same entities when they introduce customers to or manage accounts for customers of Forex Dealer Members.

mostly follow Section 2(c)(2)(B)(ii) of the CEA, although the exclusions for broker-dealers and their affiliates are conditioned on NASD membership. In particular, the following entities are not Forex Dealer Members:

- financial institutions (e.g., banks and savings associations);
- certain insurance companies and their regulated subsidiaries or affiliates;
- financial holding companies;
- investment bank holding companies;
- registered broker-dealers that are members of NASD;⁵ and
- Material Associated Persons of registered broker-dealers that are members of NASD.⁶

B. COMPLIANCE RULE 2-36

As noted above, this section provides additional guidance on what Compliance Rule 2-36 requires. Certain sections specifically refer to Forex Dealer Members. Except for Members that meet the criteria in Bylaw 306(b), all other provisions of this notice also apply to Members and their Associates who solicit retail forex transactions on behalf of a Forex Dealer Member, introduce retail customers to a Forex Dealer Member, or manage accounts for retail customers that enter into forex transactions with a Forex Dealer Member. This notice does not apply to transactions with counterparties listed in Bylaw 306(b) or to transactions between Forex Dealer Members and eligible contract participants.

1. Disclosure – Forex Dealer Members must provide retail forex customers with understandable and timely disclosure on essential features of forex trading.

At or before the time a retail customer first engages in a forex transaction, a Forex Dealer Member and its Associates should provide the customer sufficient information concerning the characteristics and particular risks of entering into forex transactions.

Forex Dealer Members should update any material information that has changed prior to entering into new transactions with current retail customers if failing to update the information would make it misleading.

⁵ Bylaw 306(b)(ii) excludes broker-dealers that are members of any fully-registered national securities association and FCMs that are members of another registered futures association. At this time, however, NASD is the only fully-registered national securities association and NFA is the only registered futures association.

⁶ These are affiliates of broker-dealers for which the broker-dealer makes and keeps records under the Securities and Exchange Commission's risk assessment requirements. See Section 17(h) of the Securities Exchange Act of 1934 and SEC Rule 17h-1T.

2. Reporting – Forex Dealer Members must provide retail forex customers with timely and accurate notice of the status of their accounts.

Forex Dealer Members should provide written confirmations within one business day after any activity in the retail customer's account, including offsetting transactions, rollovers, and deliveries. The confirmation should include the details of the transaction as well as any mark-ups and mark-downs, if applicable, and all commissions, costs, fees and other charges incurred in connection with the transaction.

Forex Dealer Members should provide regular monthly summaries of all forex transactions and other account activity to retail customers for all accounts that have open positions at the end of the month or changes in the account balance since the prior statement. Forex Dealer Members should provide summaries at least quarterly for all other open accounts.

With the customer's consent, confirmations and monthly summaries may be transmitted by electronic means.

3. Supervision – Members and their Associates having supervisory responsibilities must diligently supervise the Member's forex business, including the activities of the Member's Associates and agents. Members must establish, maintain, and enforce written supervisory procedures.

NFA has provided Members with guidance on minimum standards of supervision through interpretive notices issued under NFA Compliance Rule 2-9.⁷ In these interpretive notices NFA recognized that, given the differences in the size of and complexity of the operations of NFA Members, there must be some degree of flexibility in determining what constitutes "diligent supervision" for each firm. This principle also applies to the supervision of a Member's forex business.

Although Members have the flexibility to design procedures that are tailored to their own situation, an adequate program for supervision would include procedures for performing day-to-day monitoring. These procedures would include:

- screening employees who will solicit transactions from or provide advice to retail customers or manage retail customer accounts to see if they are subject to any of the statutory disqualifications in

⁷ See, for example, Compliance Rule 2-9: Supervision of Branch Offices and Guaranteed IBs, NFA Manual ¶ 9019; Compliance Rule 2-9: Supervisory Procedures for E-Mail and the Use of Web Sites, NFA Manual ¶ 9037; Compliance Rule 2-9: Supervision of the Use of Automated Order-Routing Systems, NFA Manual ¶ 9046. These interpretive notices do not apply to off-exchange retail forex activities, but they may provide helpful guidance to Members in connection with those activities.

Section 8a of the CEA and, if so, to determine the extent of supervision they will require;

- monitoring communications with the public, including sales solicitations and web sites, and approving promotional material;
- reviewing the information obtained from and the information provided to retail customers solicited by the firm and its employees to ensure that the necessary account information has been obtained and the appropriate information provided; and
- handling and resolving retail customer complaints.

For Forex Dealer Members, these procedures would also include:

- screening prospective Associates to ensure that they are registered with the Commodity Futures Trading Commission as associated persons;⁸
- screening persons who introduce retail customer business or manage retail customer accounts to see if the firm or any of its principals is subject to a statutory disqualification under Section 8a of the CEA and, if so, determining if the Forex Dealer Member should perform additional due diligence on that person;⁹
- reviewing disclosures given to retail customers to ensure they are understandable, timely, and provide sufficient information;
- reviewing and analyzing the forex activity in retail customer accounts, including discretionary customer accounts; and
- handling retail customer funds, including accepting security deposits.

An adequate supervisory program should also include periodic on-site visits to branch offices, guaranteed introducing brokers, and otherwise unregulated affiliates that conduct retail forex business on behalf of the Member. The Member needs to determine the frequency and nature of these visits. The number of visits will depend on the amount of business generated, the number of retail customer complaints received, the training and experience of the office personnel, and the frequency and nature of problems that arise from the office.

⁸ The Commodity Futures Trading Commission has stated that all employees of an FCM who solicit or accept orders for forex transactions from retail customers must be registered with the Commission as an associated person of the FCM. See Division of Trading and Markets Advisory Concerning Foreign Currency Trading by Retail Customers (March 2002).

⁹ The screening process should include 1) checking BASIC and any other readily available sources and 2) asking the third-party to represent that neither it nor any of its principals is subject to a statutory disqualification or to identify and explain any statutory disqualifications.

Finally, a Member's supervisory responsibilities include the obligation to ensure that its employees are properly trained to perform their duties. The formality of a training program will depend on the size of the firm and the nature of its business. Procedures should be in place to ensure that supervisory personnel know and understand the firm's supervisory procedures and that employees receive adequate training to abide by NFA requirements and to properly handle retail customer accounts.

4. **Recordkeeping – Members must keep books and records relating to their forex operations for a period of five years from the date thereof and shall keep them readily accessible during the first 2 years of the 5-year period. All such books and records shall be open to inspection by NFA.**

Members should adopt and enforce reasonable procedures to create current and accurate books and records and to keep them from being altered or destroyed. The Member should be able to promptly produce its records in a format that NFA can read and reproduce.

5. **Communications with the Public and Promotional Material - No Member or Associate shall make any communication with potential or current retail customers that operates as a fraud or deceit; uses a high-pressure approach; or implies that forex transactions are appropriate for all persons. Promotional material used by the Member or Associate shall not deceive the public; contain any material misstatement of fact; mention the possibility of profit unless accompanied by an equally prominent statement of the risk of loss; or include any reference to actual past trading profits without mentioning that past results are not necessarily indicative of future results.**

No Member or Associate may represent that forex funds deposited with a Forex Dealer Member are given special protection under the bankruptcy laws.

Every Member should adopt and enforce written procedures to supervise communications with potential and current retail customers and promotional material. A supervisory employee should review and approve all promotional material.

All promotional material should be maintained by each Member and be available for examination for the periods specified in the recordkeeping section of this notice, measured from the date of last use.

6. Know Your Customer – Members and Associates have a duty to acquaint themselves sufficiently with the personal and financial circumstances of each retail forex customer to determine what further facts, explanations and disclosures are needed in order for the customer to make an informed decision on whether to enter into forex transactions.

Every Member should determine what information it will obtain from a prospective retail forex customer. At a minimum, the Member soliciting the retail customer to engage in forex transactions with a Forex Dealer Member should obtain the customer's name, address, principal occupation or business, current estimated annual income and net worth, approximate age, and an indication of the customer's previous investment and trading experience. Members and their Associates need to ensure that each retail customer they solicit has received adequate information concerning the risks of forex transactions so that the customer can make an informed decision as to whether forex transactions are appropriate for the customer. These obligations fall on the Forex Dealer Member when a non-Member solicits the customer.

7. Doing Business with Non-Members – Forex Dealer Members are subject to discipline for the activities of most non-Members who solicit or introduce retail forex customers to the Forex Dealer Member or manage accounts for those customers.

If a customer is solicited or introduced by a non-Member of NFA, or if the customer's account is managed by a non-Member, the Forex Dealer Member is subject to discipline for the non-Member's conduct if that conduct would violate NFA requirements when engaged in by an NFA Member. In other words, a Forex Dealer Member is subject to an NFA disciplinary action for the non-Member's activities when soliciting, introducing, or managing accounts for the Forex Dealer Member's retail customers even if the non-Member was not the Forex Dealer Member's agent.

The rule allows NFA to bring a disciplinary action even if the Forex Dealer Member acts diligently and has no knowledge of the third-party's conduct. As a practical matter, however, NFA will not take disciplinary action unless the Forex Dealer Member knew or should have known of the third-party's conduct or failed to exercise due diligence when establishing and maintaining the relationship with the third party.

The Forex Dealer Member is not subject to discipline for the actions of non-Members who are described in NFA Bylaw 306(b). It is also not subject to discipline for the actions of non-Members who would be exempt from Commission registration if they were acting in the same capacity in connection

with exchange-traded futures contracts, such as foreign persons that solicit, introduce, or manage accounts for foreign customers only.¹⁰ For this purpose, foreign persons and foreign customers are 1) natural persons who are not residents of the United States or 2) legal entities that are organized under the laws of a country other than the United States, do not have their principal place of business in the United States, and do not conduct their retail forex activities from a location in the United States. "United States" includes U.S. territories and possessions.

The Forex Dealer Member does, of course, have certain basic duties to its customers, including a duty to supervise its own activities in a way designed to ensure that it treats its customers fairly. Specifically, the Forex Dealer Member would violate this duty if it has actual or constructive notice that one of these entities engaged in fraudulent conduct and fails to take appropriate action.

8. Affiliates – Forex Dealer Members must supervise and are subject to discipline for the activities of affiliates that are authorized to engage in forex transactions solely by virtue of their affiliation with a Forex Dealer Member.

The CEA authorizes affiliates of FCMs to act as counterparties to forex transactions with retail customers if the affiliate directly or indirectly controls, is controlled by, or is under common control with the FCM and the FCM makes and keeps records regarding the financial activities of the affiliate for purposes of the Commission's risk assessment requirements.¹¹ If a Forex Dealer Member has one or more affiliates that act as counterparty to retail forex customers solely on the basis of that affiliation, the Forex Dealer Member must supervise the affiliate's retail forex activities and is subject to discipline for that affiliate's activities.¹² The Forex Dealer Member must also make these affiliates' books and records available to NFA upon request.

¹⁰ For this purpose, foreign persons and foreign customers are 1) natural persons who are not residents of the United States or 2) legal entities that are organized under the laws of a country other than the United States, do not have their principal place of business in the United States, and do not conduct their retail forex activities from a location in the United States. "United States" includes U.S. territories and possessions.

¹¹ See Sections 2(c)(2)(B)(ii)(III) and 4f(c) of the CEA and CFTC Regulations 1.14 and 1.15.

¹² Obviously, the Forex Dealer Member must also ensure that no entity with common ownership engages in the retail forex business unless it is authorized to do so.

C. OTHER REQUIREMENTS

This section of the notice provides guidance on dues, capital requirements, and security deposits. These requirements apply only to Forex Dealer Members.

1. Bylaw 1301

Forex Dealer Members are not required to pay assessment fees on retail off-exchange forex transactions. Instead, NFA Bylaw 1301(e) imposes annual dues that are graduated according to the firm's gross annual revenue from customers (e.g., commissions, mark-ups, mark-downs) for these activities. Profits and losses from proprietary trades are not to be included. To calculate dues:

- Start with the FCM dues imposed by NFA Bylaw 1301(b)(ii);
- Add \$7,500 if the Forex Dealer Member's gross annual revenue from acting as counterparty to retail forex transactions is more than \$100,000; and
- Add an additional \$5,000 if the Forex Dealer Member's gross annual revenue from these activities is more than \$1,500,000.

For example, a Forex Dealer Member with annual revenue in excess of \$1,500,000 for which NFA is the designated self-regulatory organization would pay annual dues of \$20,000, calculated as follows:

Annual dues for an FCM for which NFA is the DSRO	\$7,500
Plus amount for forex revenue over \$100,000	7,500
Plus amount for forex revenue over \$1,500,000	<u>+ 5,000</u>
Total dues	\$20,000

The dues will be assessed on the firm's membership renewal date and will be based on the Forex Dealer Member's latest certified financial statement.

2. Financial Requirements Section 11

Forex Dealer Members must maintain adjusted net capital equal to or higher than the greatest amount required by Section 11 of NFA's Financial Requirements. For Forex Dealer Members, one of those amounts is 1% of the total net aggregate notional value of all open foreign currency futures and options transactions that are between the Forex Dealer Member and any person that is not an eligible contract participant, including foreign persons. To calculate this capital requirement, follow these steps:

- Calculate the aggregate long notional value for each currency pair by adding up the long positions, multiplying by the contract size, and converting to U.S. dollars using the relevant exchange rate;

- Calculate the aggregate short notional value for each currency pair by adding up the short positions, multiplying by the contract size, and converting to U.S. dollars using the relevant exchange rate;
- Subtract the smaller value from the larger value to determine the net value for the currency pair;
- Add the net values of the pairs (whether long or short) to arrive at the total notional value; and
- Multiply that number by .01.

For example:

<u>Currency Pair</u>	<u>Long Value</u>	<u>Short Value</u>	<u>Net Value</u>
EUR/USD	\$29,518,561	\$12,489,666	\$17,028,895
CND/JPY	25,422,685	15,378,016	10,044,669
CND/BRL	18,123,654	18,876,273	752,619
USD/MXN	5,431,980	6,769,211	1,337,231
BRL/MXN	2,111,789	4,097,815	<u>1,986,026</u>
Total Notional Value			\$31,149,440
Capital Requirement (\$31,149,440 X .01)			\$ 311,494

3. **Financial Requirements Section 12**

Forex Dealer Members must collect security deposits from retail customers equal to 2% of the notional value of transactions in specified foreign currencies and 4% of the notional value of all other transactions. Where the two currencies are in different categories, the Forex Dealer Member must collect the higher amount. If the transaction pairs a foreign currency with the U.S. dollar, the security deposit is based on the foreign currency. If the transaction pairs a currency that qualifies for a 2% deposit with a currency that does not, the Forex Dealer Member must collect a 4% security deposit for the entire transaction.¹³ For example:

Currency Pair	Security Deposit
EUR/USD	2%
CND/JPY	2%
CND/BRL	4%
USD/MXN	4%
BRL/MXN	4%

For short options, the Forex Dealer Member must collect this amount plus the premium the customer received. For long options, the Forex Dealer Member must simply collect the entire premium from the customer.

¹³ This same principle applies to capital haircuts for uncovered proprietary positions, where the transaction would be subject to a 20% haircut rather than a 6% haircut.

Appendix 3: Additional Resources

Selected NFA Rules of General Application

- Compliance Rule 2-9(c) – Supervision (Anti-Money Laundering Programs)
- Compliance Rule 2-10 – Recordkeeping
- Compliance Rule 2-38 – Business Continuity and Disaster Recovery Plan

Selected NFA Interpretive Notices of General Application

- NFA Compliance Rule 2-9: FCM and IB Anti-Money Laundering Program (¶ 9045)
- NFA Compliance Rule 2-38: Business Continuity and Disaster Recovery Plan (¶ 9052)

NFA Interpretive Notices that Provide Useful Guidance

- Compliance Rule 2-9: Supervision of Branch Offices and Guaranteed IBs. (¶ 9019)
- Compliance Rule 2-9: Supervisory Procedures for E-Mail and the Use of Web Sites. (¶9037)
- Compliance Rule 2-9: Supervision of the Use of Automated Order-Routing Systems. (¶ 9046)
- Compliance Rule 2-9: Ethics Training Requirements (¶ 9051)

CFTC Rules and Advisories

- CFTC Regulation 1.10, Financial Reports of Futures Commission Merchants and Introducing Brokers (17 C.F.R. § 1.10).
- CFTC Regulation 1.12, Maintenance of Minimum Financial Requirements by Futures Commission Merchants and Introducing Brokers (17 C.F.R. § 1.12).
- Regulations 1.14 (Risk Assessment Recordkeeping Requirements for Futures Commission Merchants) and 1.15 (Risk Assessment Reporting Requirements for Futures Commission Merchants) (17 C.F.R. §§ 1.14 and 1.15). *See also* Section 4f(c)(2)(B) of the Act.
- CFTC Regulation 1.17, Minimum Financial Requirements for Futures Commission Merchants and Introducing Brokers (17 C.F.R. § 1.17).
- CFTC Regulations 160.1-160.30, Privacy of Consumer Information (17 C.F.R. §§ 160.1-160.30).
- CFTC Division of Trading and Markets Advisory Concerning Foreign Currency Trading by Retail Customers (March 1, 2002), available at <http://www.cftc.gov/files/opa/opaforexupdateadvisory3-19-021.pdf>.

SEC Rules

- SEC Rule 17h-1T, Risk Assessment Recordkeeping Requirements for Associated Persons of Brokers and Dealers (17 C.F.R. § 240.17h-1T). See also Securities Exchange Act Section 17(h) (15 U.S.C. § 78q(h)).

Federal Laws

- Commodity Exchange Act Section 2(c), Agreements, Contracts, and Transactions in Foreign Currency, Government Securities, and Certain Other Commodities (7 U.S.C. § 2(c)).
- Commodity Exchange Act Section 8a, Registration of Commodity Dealers and Associated Persons (7 U.S.C. §12a).
- Bank Secrecy Act Section 5318(h), Anti-Money Laundering Programs (31 U.S.C. § 5318(h)).

Appendix 4: Sources of Additional Information

National Futures Association

200 West Madison Street
Suite 1600
Chicago, IL 60606
(312) 781-1410
www.nfa.futures.org

Commodity Futures Trading Commission

Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581
(202) 418-5080
www.cftc.gov