

## **COMMITTEE LETTER**

### **Commenting on the Retail Foreign Exchange Market**

December 9, 2005

Dear Market Participant,

Over the past few years, the Foreign Exchange Committee has studied the market implications of a number of recent industry developments, including the rapid growth of electronic trading platforms, new distribution channels, and business practice developments. The introduction of intermediated distribution and credit arrangements, together with heightened retail investor interest in foreign exchange, has transformed the nature of the relationships among market participants. At the same time, credit and liquidity have become unbundled and repackaged for nontraditional or noninstitutional participants. As the foreign exchange industry continues to evolve rapidly, it is important that institutions be vigilant in mitigating the legal, operational, and reputational risks that might accompany retail foreign exchange trading.

The number of individuals interested in including foreign exchange in their investment portfolios has increased significantly. Technology has allowed price discovery, liquidity, pre- and post-trade information, aggregation, execution, confirmation, and reporting services to be parsed in real, or near real, time. Specialists now offer individual segments of what had historically been bundled transaction services in the foreign exchange distribution channel. Examples of this segmentation include:

- ⌘ Retail aggregation, or the development of portals for retail investors to trade foreign exchange on a margin basis (see Appendix 1); and
- ⌘ White labeling, or the “outsourcing” of foreign exchange pricing and liquidity to a third-party bank, typically through an e-commerce platform (see Appendix 2).

These and other innovations separate the wholesale foreign exchange dealer from the end user, perhaps by multiple intermediaries. Segmentation may complicate the execution of responsibilities that accompany foreign exchange trading—from typical know-your-customer and anti-money-laundering obligations to compliance with statutory and supervisory guidance invoked for particular clients (retail investors) or markets (securities, where foreign exchange is bundled with other products) (see Appendix 3).



Even if not a legal counterparty to a trade with a retail investor, a foreign exchange dealer is exposed to reputational risk if it is linked to a chain of transactions that result in dissatisfaction or litigation or both. Reputational risk is the current and prospective impact on earnings and capital caused by negative public opinion regarding an institution's products or activities. This risk affects the institution's ability to establish new relationships or services or to continue servicing existing relationships. In addition, reputational risk may expose the institution to litigation, financial loss, or a decline in its customer base. Carefully drawn contracts may minimize, but not completely remove, the risk of entanglement in a dispute arising elsewhere in the channel of distribution. Financial institutions may be exposed to reputational damage that exceeds any legal liability.

We encourage market participants to review their legal and contractual relationships with clients, intermediaries, vendors, and other entities that could be considered counterparties. Participants should ensure compliance with anti-money-laundering, counterterrorism, bank secrecy, and privacy regulations. They should also ensure that the existence of intermediaries does not obscure responsibility for these compliance functions by the party or parties that have that legal responsibility. Issues of client sophistication and disclosure, regulatory jurisdictions, and local securities laws should be dealt with, as appropriate. Care should be taken that no party in the foreign exchange distribution channel is misled regarding the rights and obligations of its counterparties.

The promotion of an efficient and vigorous foreign exchange market through ongoing improvements in the quality of risk management is a core element of the Foreign Exchange Committee's mandate. Traditionally, the Committee has focused on market, credit, and operational risks. Although reputational risk is not new to the foreign exchange market, recent developments highlighted in this letter and its appendices suggest that reputational risk may be even more important for market participants going forward. In sum, we advise that each firm carefully review its documentation and consider the commercial benefits and all the potential risks—market, credit, operational, and reputational—as it determines the business models appropriate to its organization.

Very truly yours,

*Mark Snyder*

Chair

Foreign Exchange Committee



## COMMITTEE LETTER

### Commenting on the Retail Foreign Exchange Market Appendix I: Retail Aggregation

*Disclaimer: The following appendices were developed by the Foreign Exchange Committee based on information available to, and collected on a best-efforts basis by, the drafters. The Committee does not guarantee the accuracy of these appendices and notes that, given the fluidity of the foreign exchange market, the data are subject to change. No person should rely on the information provided herein.*

The evolution of electronic trading technology over the past several years has led to the rapid development of the retail aggregator (RA) market segment. Retail aggregators can be either financial institutions (banks, registered brokers) or intermediaries (for example, E-Trade, where foreign exchange is an induced flow from other electronically traded businesses). Many RAs are registered futures commission merchants (FCMs) whose retail foreign exchange business has developed from their retail futures client base.

There are approximately thirty RAs in the United States, with ten significant firms. With the U.S. market reportedly reaching saturation, some U.S. RAs have begun expanding their operations and establishing offices in China, Hong Kong, and Japan to try to capture business in Asia. Retail foreign exchange trading is reportedly well established and widespread in Asia, with more than 100 RAs in Japan alone.

Retail aggregators act as portals through which retail investors can trade foreign exchange on a margin basis, using sophisticated technology. RAs provide a focused client service offering based on foreign exchange spot transactions with consistent tight spreads and foreign exchange orders (both stop-loss and take-profit). They deal

mainly in the G-7 (Group of Seven) currencies; the vast majority of their trades are in the EUR/USD and USD/JPY currency pairs. Clients utilize a web-based interface for trading as well as APIs (application program interfaces) for position management, margin utilization, and reporting. Although automated position rolls are offered, RAs do not offer settlement for their clients.

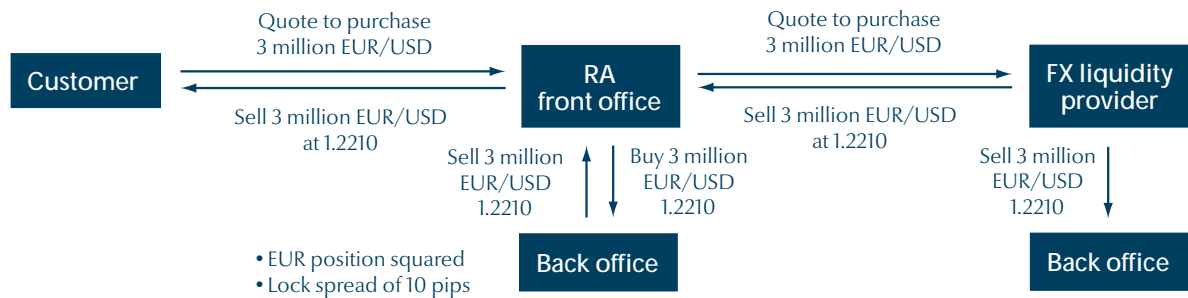
Firms spend tremendous resources to develop a sophisticated business process with cutting-edge technology and marketing. Each firm has only a handful of in-house traders given that all liquidity is quickly outsourced.

The target market for RAs consists of retail investors and small professional counterparties such as CTAs (commodity trading advisors), hedge funds, and banks that want to access the foreign exchange market at “interbank” spreads. RAs offer clients leverage ranging from 50:1 to 400:1, with initial margin requirements as low as \$200 for “mini” accounts. The average size of client trades is in the range of \$100,000 to \$500,000, with a minimum of approximately \$10,000 to establish a regular trading account. While RAs have experienced tremendous growth in total customer accounts, some also report client burnout rates in excess of 50 percent.



Figure 1

## FX Retail Aggregation Process, One-to-One Hedging



RAs have absolutely no risk tolerance toward their clients. They retain the right to reject client deals, and every client request is automatically checked against client limits. Their margin policy is stringent with forced closeouts.

Typically, RAs have minimal capital and no settlement requirements. To manage market risk, RAs may utilize either one-to-one hedges with a liquidity provider so that each client trade is priced according to liquidity provider quotes and back-to-backs executed with the client, or deal aggregation and periodic market risk offsets. With deal aggregation, only minimal foreign exchange risk positions are created (for example, positions of \$3 million to \$5 million, with no strategic foreign exchange positions being held).

RAs depend on the major foreign exchange market makers as liquidity providers. Typically, RAs maintain trading relationships with between two and four providers. In addition to trade execution, RAs often use prime brokerage or CLS services from their key liquidity providers.

RAs generate revenues from the spread on each ticket; increasingly, they charge a

fee for acting as a price provider. They often offer their clients consistent spreads (for example, EUR is always 5 pips wide despite market conditions) and rely upon their ability to obtain liquidity inside the spread they broadcast to their customers. They may also obtain income from rolls, fees (either ticket or subscription), and interest on collateral deposits. Their chief costs are technology and marketing as well as capital costs on collateral or fees paid to liquidity providers for CLS or prime brokerage services.

In the United States, most RAs are futures commission merchants that fall under the regulatory auspices of the Commodities Futures Trading Commission and are fully subject to the USA PATRIOT Act. As such, they are required to have an anti-money-laundering program equivalent to that of banks and broker-dealers, including

- a system of internal controls, policies, and procedures;
- a senior officer responsible for the anti-money-laundering program;
- an anti-money-laundering training program; and



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✎ an independent audit for compliance with the anti-money-laundering program.

In addition, RAs are required to obtain and verify the identity of all their clients, including the client's name, address, social security number, and date of birth, and to compare their client names against government-supplied lists.

Despite the above restrictions, RAs are not required to register as FCMs.



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### Commenting on the Retail Foreign Exchange Market Appendix 2: White Labeling

White labeling is the name given to an arrangement whereby a bank (white-label bank) uses an e-commerce platform to allow its clients to execute foreign exchange transactions at prices quoted by a third-party bank (liquidity provider). Under a white-label arrangement, a client trades with the white-label bank at the price provided by the liquidity provider. At the same time, an equivalent trade is automatically generated between the white-label bank and the liquidity provider, thereby transferring the market risk associated with the initial transaction to the liquidity provider.

White labeling may involve only the outsourcing of market risk management or, additionally, the outsourcing of technology and trading platforms. The latter requires the liquidity provider, or an IT vendor on behalf of the liquidity provider, to provide an e-commerce platform that is branded with the identity of the white-label bank. It is estimated that approximately twenty to thirty institutions have implemented a white-labeling

arrangement, outsourcing both liquidity and technology, while approximately forty to fifty institutions have partially or wholly outsourced liquidity.

The white-label bank is able to offer its clients a broader array of foreign exchange services without incurring the costs of independently developing the associated infrastructure. The arrangement allows the white-label bank to enhance its client relationships without substantially increasing its infrastructure costs. The white-label bank also retains important customer service and credit relationships, while outsourcing foreign exchange pricing and risk management to the liquidity provider. Since the white-label bank retains the credit relationship with the client, it also retains the know-your-customer and anti-money-laundering due diligence responsibilities.

The liquidity provider in a white-labeling arrangement benefits from the creation of a fee- and spread-based revenue stream. The establishment of additional distribution channels may also result in increased

Figure 2  
**White-Labeling Trade Process**



deal volume. In light of ongoing pressures on margins, this greater volume enables the liquidity provider to leverage its investments in technology and infrastructure for greater profitability.

White-labeling arrangements are typically tailored to the individual white-label bank's requirements. For example, a white-label bank may elect to receive prices from the liquidity provider only in certain currencies, deal sizes, or time zones. Examples of these bespoke arrangements include:

- ❧ Small- and medium-sized banks outsourcing liquidity provision "out of hours." The white-label bank is able to offer its customers twenty-four-hour service without dedicating staff resources over the entire period.
- ❧ Regional banks outsourcing currencies in which they have no particular expertise or core competency; for example, a regional North American bank might outsource secondary and exotic currencies.



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### Commenting on the Retail Foreign Exchange Market Appendix 3: Legal Framework for Understanding the Retail-Wholesale Boundary in Foreign Exchange

The Financial Markets Lawyers Group (FMLG) has been asked to provide its views to the Foreign Exchange Committee (FXC) on the legal framework for understanding the retail-wholesale boundary in foreign exchange. This information is being made available to educate foreign exchange market participants about issues that they should consider with their dedicated legal counsel. This document provides a discussion of issues that may arise under United States and New York law as of December 9, 2005. The views expressed in this document are subject to change and to revisions in the law; are not intended to, and do not, constitute legal advice; and do not constitute an official position of the FMLG or the FXC.

#### Executive Summary

The Retail-Wholesale Subcommittee of the Foreign Exchange Committee asked the FMLG a number of questions with respect to the boundary between the wholesale foreign exchange market and the retail foreign exchange market. It is the view of the FMLG that the line between the retail and wholesale markets, and the changing responsibilities of foreign exchange dealers, can only be determined on a case-by-case, product-by-product basis. A transaction that may be thought of as “wholesale” in one situation may more appropriately be thought of as “retail” if, for example, the nature of the counterparty were to change. This contextual approach to the

issue requires that, in order to protect themselves, dealers analyze the product, the transactions, and the counterparty with a view toward properly understanding the risks and allocating those risks in a way consistent with the parties’ expectations.

We note that foreign exchange dealers may take steps to protect themselves from reputational risk or undertake specified contractual responsibilities vis-à-vis their counterparties. However, these voluntary measures should not be construed as implying or giving rise to statutory or regulatory requirements. As described below, the best way to mitigate the risks posed by new products is to provide for clear contractual documentation that reflects the parties’ expectations and allocates the risks and responsibilities between the parties.

#### Statutory and Supervisory Guidance

A useful statutory concept for analyzing this issue is contained in the Commodity Exchange Act (CEA). In the discussions leading up to the adoption of the CEA amendments contained in the Commodity Futures Modernization Act (CFMA) in 2000, participants put forth much effort to distinguish wholesale foreign exchange market futures transactions from retail futures transactions, with the retail futures transactions being subject to the protections of the CEA.



Specifically, the CEA, as amended by the CFMA, excludes from the regulatory jurisdiction of the Commodity Futures Trading Commission (CFTC) foreign exchange futures transactions that involve regulated financial institutions, including banks, broker-dealers, and insurance companies. This exclusion includes transactions between those types of entities and any other person or entity. The theory behind this treatment is that the supervisors of the financial institutions—such as the Office of the Comptroller of the Currency (OCC), the Federal Reserve System, the Securities and Exchange Commission (SEC), and state insurance regulators—are in a better position to police the activities of those entities.

The CEA also excludes from the jurisdiction of the CFTC futures transactions involving “eligible contract participants” (ECPs) that are not regulated financial institutions. The CEA’s framework for nonregulated entities that are ECPs provides some guidance regarding the nature of a retail entity. Broadly, the CEA defines ECPs as:

1. banks, broker-dealers, futures commission merchants (FCMs), and other regulated entities;
2. certain other institutions, such as commodity pools, ERISA (Employee Retirement Income Security Act of 1974) plans, and governments that meet certain size tests;
3. corporations and partnerships having total assets greater than \$10 million or having a net worth greater than \$1 million, and the transaction is for balance sheet management; and
4. individuals having total assets greater than \$10 million or having total assets greater than \$5 million, and the transaction is for balance sheet management.

In effect, the asset tests contained in (3) and (4) create a boundary line for wholesale-retail transactions for purposes of complying with the CEA. Futures transactions involving entities that are not regulated financial institutions, and that are not ECPs because they do not meet the asset tests, are subject to the full regulatory jurisdiction of the CFTC. At this time, however, Congress is considering legislation to reauthorize the CFTC and to amend provisions of the CEA to broaden the jurisdiction of the CFTC over retail futures transactions. The preceding discussion could be affected by such legislation, if it is enacted.

With respect to the regulated financial institutions that are excluded from the CEA, we may look to industry, regulatory, and supervisory guidance to determine the border between the wholesale and retail foreign exchange markets. Recently, efforts have been made to provide a definition of retail for special purposes; for example, the second report of the Counterparty Risk Management Policy Group (2005) provides guiding principles for firms to manage reputational risk associated with the sale of complex structured products to retail investors, who within this context are defined to be individual investors who are not investment professionals and act for their own account. Outside of the CEA, however, no industry, regulatory, or supervisory guidance provides a specific bright-line test for the boundary between retail and wholesale in foreign exchange.

However, supervisory guidance is clear that firms, in order to protect themselves, must take into account the types of counterparties with which they deal and the overall context of the dealing relationship. The Federal Reserve's Trading and Capital Markets Activities Manual emphasizes that firms, depending on the circumstances, must take into account the sophistication of a counterparty, the nature of the relationship, and the type of transaction being contemplated or executed. Specifically, the manual states that with respect to a determination of customer suitability:

For its own protection, a financial institution should take steps to ensure that its counterparties understand the nature and risk inherent in agreed-upon transactions. These procedures may vary with the type and sophistication of a counterparty. When a counterparty is unsophisticated, either generally or with respect to a particular type of transaction, the financial institution should take additional steps to adequately disclose the attendant risks of specific types of transactions. Furthermore, a financial institution that recommends specific transactions to an unsophisticated counterparty should have adequate information on which to base its recommendation—and the recommendation should be consistent with the needs of the counterparty as known to the financial institution.<sup>1</sup>

This approach requires procedures that are variable and flexible. From this it may be inferred that financial institutions should not structure their procedures

around an inflexible definition of retail and wholesale markets. Rather, from the financial institution's perspective, the important inquiry is into the nature of the trading relationship and the nature and sophistication of the counterparty. There is no bright line, but context can alter the duties of a financial institution.

### Questions and Answers

1. Can we define a retail-wholesale boundary?

As described above, there are no bright-line legal rules that describe a clear boundary between retail and wholesale foreign exchange. While some statutory provisions, such as the ECP concept in the CEA, may provide some guidance, a dealer must consider all aspects of a transaction and trading relationship to properly understand its duties and obligations.

2. Do the responsibilities of dealers differ when they are on different sides of that line?

As noted above, the responsibilities of a foreign exchange dealer may differ, but for a regulated financial institution the difference is not based on a legal retail-wholesale boundary line with a specific legal standard. Instead, it is based on the dealer's specific contractual obligations and its prudent risk management of its exposures. To protect itself from risk, a dealer must take into account the overall context of the transaction and the counterparty relationship when determining its responsibilities. These responsibilities

<sup>1</sup>Federal Reserve System, Trading and Capital-Markets Activities Manual, Section 2150.1, "Customer Suitability."



will vary with the financial position of the counterparty, the sophistication of the counterparty, the dealing relationship, the type of transaction, the nature of the product, and other factors. Each of these factors must be considered when a foreign exchange dealer determines what responsibilities it has to its counterparty with respect to disclosure and suitability analysis.

3. **Is the boundary line being blurred by new products?**

As we noted above, a clear boundary line between the retail and wholesale foreign exchange markets does not exist. A dealer must determine its responsibilities and duties based on the overall context of the dealing relationship. The introduction of new products does not alter this analysis; rather, it offers an additional element that must be factored into the overall contextual analysis. Each new product must be analyzed with respect to the particular issues that it raises and the risks that it poses to the dealer. A dealer, in order to protect itself, must examine on a case-by-case basis the required disclosure, due diligence procedures, and documentation. The analysis should consider all the factors

of the dealing relationship in the context of the risks posed by the features of the new product. A dealer will also need to determine what risk mitigation techniques should be used to address the particular risks of new products.

4. **What can be done to mitigate the risks?**

Strong and clear contractual provisions are the most effective tool for mitigating risk. The responsibilities of, and the risks faced by, a dealer with respect to counterparty transactions should always be clearly documented. The absence of clear legal standards imposing specific duties on a dealer requires that market participants use clear contractual language that defines the roles of the respective parties, determines liability upon the occurrence of certain events, and allocates the various risks represented by the transaction, product, or relationship to ensure that all parties are aware of the risks inherent in dealing. Clear contractual language is the best evidence of the intent of the parties with respect to these issues. Accordingly, a dealer should consider contractual provisions that clearly describe the principal-to-principal nature of a transaction or arrangement.

