

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-61090; File No. SR-FINRA-2009-040)

December 1, 2009

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change as modified by Amendment No. 2 to Adopt FINRA Rule 2380 to Limit the Leverage Ratio Offered by Broker-Dealers for Certain Forex Transactions

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act” or “Exchange Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on June 4, 2009, Financial Industry Regulatory Authority, Inc. (“FINRA”) (f/k/a National Association of Securities Dealers, Inc. (“NASD”)) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been substantially prepared by FINRA. The proposal was published for comment in the Federal Register on July 6, 2009.<sup>3</sup> The Commission received 12 comments on the proposal.<sup>4</sup> FINRA responded to the comment letters<sup>5</sup> and filed Amendment No. 1 to the proposed rule change on August 27, 2009. On November 12, 2009, FINRA filed Amendment No. 2 to the proposed rule change.<sup>6</sup> The Commission is publishing this notice to solicit comments on the proposed rule change as modified by Amendment No. 2 from interested persons.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> Exchange Act Release No. 60172 (June 25, 2009), 74 FR 32022 (July 6, 2009).

<sup>4</sup> See infra note 21.

<sup>5</sup> Letter from Gary L. Goldsholle, Vice President and Associate General Counsel, FINRA, to Elizabeth M. Murphy, Secretary, Commission, dated August 27, 2009 (“FINRA Response”).

<sup>6</sup> Amendment No. 2 replaced and superceded Amendment No. 1 in its entirety.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing to adopt FINRA Rule 2380 to prohibit any member firm from permitting a customer to: (1) initiate any forex position with a leverage ratio of greater than 4 to 1; and (2) withdraw money from an open forex position that would cause the leverage ratio for such position to be greater than 4 to 1. In addition, FINRA proposes to exempt from the proposed leverage limitation any security as defined in Section 3(a)(10) of the Securities Exchange Act of 1934.

The text of the proposed rule change is available on FINRA's Web site at <http://www.finra.org>, at the principal office of FINRA and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

FINRA is proposing to limit the leverage ratio offered by broker-dealers for certain forex transactions to no more than 4 to 1. Amendment No. 2 modifies the proposed leverage limitation from the original proposed rule change of 1.5 to 1 to 4 to 1,

and makes conforming changes to Supplementary Material .01.<sup>7</sup> In addition, FINRA proposes in Amendment No. 2 to exempt from the leverage limitation any security as defined in Section 3(a)(10) of the Securities Exchange Act of 1934, by adding paragraph (b) to the proposed rule change. Finally, Amendment No. 2 to the proposed rule change redesignates original paragraph (b) as paragraph (c) with no other modifications to the definitions contained in proposed paragraph (c).

FINRA is proposing to limit the leverage ratio offered by broker-dealers for certain forex transactions to no more than 4 to 1. The proposed rule change addresses forex transactions in the off-exchange spot contract market. This market has grown in recent years following the passage of the Commodity Futures Modernization Act of 2000 (“CFMA”), which permits certain enumerated entities, including broker-dealers, to act as counterparties to a retail forex contract.<sup>8</sup> While most of the growth in this area has been concentrated in the futures commission merchant (“FCM”) channel, recent changes in legislation have brought greater interest to forex by broker-dealers.<sup>9</sup> The proposed rule change seeks to limit investor losses resulting from small changes in the exchange rate of a foreign currency and is intended to reduce the risks of excessive speculation.

Paragraph (a) of the proposed rule change states that no member shall permit a customer to initiate a forex position (as defined below) with a leverage ratio greater than 4 to 1. Thus, at the time a customer initiates a forex position, the customer must deposit

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<sup>7</sup> See supra note 3.

<sup>8</sup> Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763, 2763A-378 (2001).

<sup>9</sup> See CFTC Reauthorization Act of 2008, Pub. L. No. 110-246, 122 Stat. 1651 (2008).

at least 1/4 of the notional value of the contract. Using the example in supplementary material .01, a customer entering into a forex contract representing \$500,000 of a foreign currency must have an initial deposit of at least \$125,000. The proposed rule change differs from the leverage limits in the FCM channel, where depending on the foreign currency selected, a customer at 400 to 1 leverage would need only an initial deposit of \$1,875.

In addition, paragraph (a) also states that “no member shall permit a customer to withdraw money from an open forex position that would cause the leverage ratio for such position to be greater than 4 to 1.” This provision is intended to prevent a customer from depositing funds at the initiation of the forex position and then immediately withdrawing them once the position is established. If a customer were permitted to withdraw the funds once a position is established, the leverage limitation could easily be circumvented as the same deposit could be used to establish multiple forex positions.

The limitation on a customer’s ability to withdraw funds that would cause the leverage ratio to exceed 4 to 1 differs from a maintenance margin requirement in that an adverse movement in a customer’s forex contract will not necessitate the deposit of additional funds. The intra-day and day-to-day pricing changes of a forex contract may cause a customer to have a leverage ratio greater than 4 to 1. So long as a customer does not withdraw funds from those initially used to establish the position, a leverage ratio may exceed 4 to 1. FINRA considered imposing a maintenance margin requirement but determined that the level of initial deposit was sufficiently high that a maintenance margin requirement was not necessary.

The proposed rule change does not impact existing rules addressing the necessary customer funds to enter into and maintain a forex position. For example, Regulation T does not have margin requirements for forex and allows a customer to obtain nonpurpose credit in a good faith account to effect and carry transactions in forex.<sup>10</sup> However, it should be noted that any funds deposited in a margin account to maintain a forex position or any account equity derived from a forex position may not be used to purchase securities in that account.

Paragraph (b) of the proposed rule change exempts from the leverage limitation any security as defined in Section 3(a)(10) of the Securities Exchange Act of 1934.

Paragraph (c) of the proposed rule change establishes the key definitions. The term “forex” is defined to mean a foreign currency spot, forward, future, option or any other agreement, contract, or transaction in foreign currency that: (1) is offered or entered into on a leveraged basis, or financed by the offeror, the counter party, or a person acting in concert with such person, (2) offered to or entered into with persons that are not eligible contract participants;<sup>11</sup> and (3) not executed on or subject to the rules of a contract market,<sup>12</sup> derivatives transaction execution facility,<sup>13</sup> national securities

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<sup>10</sup> 12 CFR 220.6.

<sup>11</sup> “Eligible Contract Participants” (“ECPs”) include regulated entities such as financial institutions, insurance companies, investment companies and broker-dealers. Certain corporations and individuals qualify as ECPs by meeting the requirements under the statute. See 7 U.S.C. 1a(12).

<sup>12</sup> “Contract markets” are markets that are designated by the CFTC that meet the criteria in Section 5 of the Commodity Exchange Act. See 7 U.S.C. 7.

<sup>13</sup> “Derivatives transaction execution facilities” (“DTEFs”) are CFTC-registered trading facilities that limit access primarily to institutional or otherwise eligible traders and/or limit the products traded. See 7 U.S.C. 7a.

exchange,<sup>14</sup> or foreign board of trade.<sup>15</sup> FINRA’s definition of forex is similar to the National Futures Association’s (“NFA”) definition of forex<sup>16</sup> and to amended Section 2(c)(2) of the Commodity Exchange Act which sets forth the scope of the Commodity Futures Trading Commission’s (“CFTC”) rulemaking jurisdiction.<sup>17</sup> The FINRA definition, however, does not contain an exclusion for certain spot and forward contracts found in the NFA and CFTC definitions, which were included due to CFTC jurisdictional limitations.<sup>18</sup>

Paragraph (c) also defines the term “leverage ratio” to mean the fraction represented by the numerator which is the notional value of a forex transaction, and the denominator, which is the amount of good faith deposit or account equity required from the customer for a forex position. For example, if the notional value of a forex contract is \$250,000, and the customer deposits \$200,000, the leverage ratio would be 1.25 to 1.

FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be 30 days following publication of the Regulatory Notice announcing Commission approval.

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<sup>14</sup> A “national securities exchange” is a securities exchange that has registered with the SEC under Section 6 of the Exchange Act. See 15 U.S.C. 78f.

<sup>15</sup> A “foreign board of trade” means any organized exchange or trading facility located outside of the United States.

<sup>16</sup> NFA By-Law 1507(b).

<sup>17</sup> See CFTC Reauthorization Act of 2008, 13101 (to be codified at 7 U.S.C. 2(c)(2)(C)(i)(I)).

<sup>18</sup> NFA By-Law 1507(b) and CFTC Reauthorization Act of 2008, 13101 (to be codified at 7 U.S.C. 2(c)(2)(C)(i)(II)).

## 2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>19</sup> which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. FINRA believes that the proposed rule change is consistent with the provisions of the Act noted above in that it will limit leverage ratios, requiring greater initial deposits that will substantially reduce the likelihood that any small adverse percentage change in the exchange rate of a foreign currency will cause an investor's funds to be wiped out. Moreover, limiting the leverage ratios is intended to reduce the risks of excessive speculation.

### B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

### C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

#### 1. Proposed Rule Change as Modified by Amendment No. 2

No written comments were either solicited or received on the proposed rule change as modified by Amendment No. 2.

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<sup>19</sup> 15 U.S.C. 78q-3(b)(6).

2. Comments Received in Response to Original Proposed Rule Change with 1.5 to 1 Leverage Ratio

The Commission, however, solicited comment on the original proposed rule change which proposed a leverage ratio of 1.5 to 1.<sup>20</sup> The comment period ended on July 29, 2009. The Commission received 12 comments.<sup>21</sup> Commenters generally opposed the original proposed rule change.<sup>22</sup> Retail investors generally opposed the original proposed rule change stating that the original proposed leverage ratio of 1.5 to 1 would effectively ban participation in the forex market for most average retail traders.<sup>23</sup> One commenter stated that it is up to the Federal Reserve to set margin requirements.<sup>24</sup> Three commenters stated that the original proposed leverage limitation of 1.5 to 1 was arbitrary and is unfair to dually-registered FCM/broker-dealers.<sup>25</sup> One commenter suggested that dually-registered FCM/broker-dealers be exempted from the original proposed leverage

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<sup>20</sup> See supra note 3.

<sup>21</sup> See letters from Mike Andrews (February 8, 2009); Mike Andrews (February 8, 2009) (“Andrews 2”); Steve Gallagher et al. (February 11, 2009); Steve Gallagher (February 11, 2009); Mary M. Jackson (February 17, 2009); Aaron I. Cohn (February 21, 2009); George Selinsky (June 13, 2009); Ryan Koester (June 13, 2009); Douglas W. Schriener, CEO, Harrison Douglas, Inc. (July 20, 2009); Interactive Brokers LLC (July 27, 2009); TD AMERITRADE, Inc and thinkorswim Group Inc. (July 27, 2009) (“TD/thinkorswim”); and Futures Industry Association (July 27, 2009) (“FIA”).

<sup>22</sup> Id.

<sup>23</sup> Selinsky; Cohn; Gallagher et.al; Gallagher; Jackson; Koester; Andrews; Andrews 2.

<sup>24</sup> Harrison Douglas.

<sup>25</sup> Interactive Brokers; TD/thinkorswim; FIA.



limitation.<sup>26</sup> FINRA responded to the comments and filed Amendment No. 1 on August 27, 2009.<sup>27</sup> In its response to comments to the original proposed rule change, FINRA noted that the original proposed rule change received almost no opposition from the retail investor community, in contrast to the comments received in response to FINRA Regulatory Notice 09-06 because FINRA believes that these investors now better understand the nature of the proposal and the scope of FINRA's jurisdiction.<sup>28</sup> In addition, FINRA stated that the thrust of the remaining three comment letters is to advance the pecuniary interests of dually-registered FCM/broker-dealers at the expense of investor protection.<sup>29</sup> In response to comments and subsequent meetings with the Commission, however, FINRA filed Amendment No. 2 to the proposed rule change on November 12, 2009 to increase the proposed leverage ratio from 1.5 to 1 to 4:1.

3. Comments Received in Response to FINRA Regulatory Notice 09-06 with Original Proposed 1.5 to 1 Leverage Limitation

In addition, the original proposed rule change was published for comment in FINRA Regulatory Notice 09-06 (January 2009). FINRA received 109 comments in response to the Regulatory Notice. A copy of the Regulatory Notice is attached as Exhibit 2a, the index to the comment letters is attached as Exhibit 2b and copies of the comment letters received in response to the Regulatory Notice are attached as Exhibit

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<sup>26</sup> Interactive Brokers.

<sup>27</sup> See FINRA Response, supra note 5.

<sup>28</sup> Id.

<sup>29</sup> Id. FIA; Interactive Brokers; and TD/thinkorswim.

2c.<sup>30</sup> FINRA's response to these comment letters is discussed in the Exchange Act Release No. 60172, which solicited comment on the original proposed rule change.<sup>31</sup>

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the proposed rule change as modified by Amendment No. 2, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-FINRA-2009-040 on the subject line.

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<sup>30</sup> All references to commenters under this Item are to the commenters as listed in Exhibit 2b to the proposed rule change [SR-FINRA-2009-040].

<sup>31</sup> See supra note 3, Section II.C of original proposed rule change.

Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2009-040. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All

submissions should refer to File Number SR-FINRA-2009-040 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>32</sup>

Florence E. Harmon  
Deputy Secretary

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<sup>32</sup> 17 CFR 200.30-3(a)(12).