July 6, 2011

MEMORANDUM TO: The Board of Directors

FROM: Sandra L. Thompson
Director, Division of Risk Management Supervision

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General Counsel

SUBJECT: Final Rule pursuant to § 742(c) of the Dodd-Frank Wall Street Reform and Consumer Protection Act for the purpose of adding 12 C.F.R. Pt. 349 to regulate FDIC-supervised entities engaged in retail forex transactions.

I. RECOMMENDATION

Staff recommends that the Board of Directors approve the issuance of a Final Rule (the "Final Rule") which would impose requirements on insured depository institutions supervised by the FDIC that engage in certain retail foreign currency transactions that otherwise will be prohibited by Section 2(c)(2)(E) of the Commodity Exchange Act ("CEA"), as added by Section 742(c) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The Final Rule would also cover other foreign currency transactions not subject to the prohibition but for which the staff recommends similar requirements. The Final Rule would adopt the proposed rule with few modifications.

II. EXECUTIVE SUMMARY

Section 742(c) of the Dodd-Frank Act prohibits a financial entity from engaging in retail futures and options in foreign currency except pursuant to rules and regulations promulgated by the appropriate Federal regulatory agency. Such transactions are considered "retail" if conducted with a counterparty that does not satisfy the definition of "eligible contract participant" ("ECP") under the CEA. An individual with $10 million or less, or in the case of certain risk mitigation transactions, $5 million invested on a discretionary basis would not qualify as an ECP.[1] In addition, section 742(c) requires that the rules and regulations governing retail futures and options in foreign currency treat in a similar manner all retail futures and options in foreign currency, and all agreements, contracts and transactions in foreign currency that are functionally and economically similar to retail futures and options in foreign currency.

In addition to the futures and options, the requirements of the Final Rule also apply to retail foreign exchange transactions that are so-called "rolling spot" contracts. Staff believes that these transactions are functionally and economically similar transactions to futures and options. Furthermore, the Final Rule provides for a reservation of authority to include in the scope of retail forex transactions those transactions that may not otherwise satisfy the definition of retail forex transaction. However, staff believes that the requirements of the Final Rule would not apply to foreign exchange transactions that are spot contracts or forward contracts irrespective of whether the customer is or is not an ECP. Additionally, the Final Rule provides, on a

[1] Certain commercial entities with $10 million or less in total assets or, in the case of certain risk mitigation transactions, $1 million or less in net worth would not qualify as eligible contract participants.

case by case basis, exemptive authority for a transaction that may otherwise be determined to be a retail forex transaction.

Section 742(c) requires that any rules and regulations under which retail foreign exchange transactions may be permitted must at a minimum include appropriate requirements concerning disclosure, recordkeeping, capital and margin, reporting, business conduct, and documentation, and may also include such other standards or requirements as the appropriate Federal regulatory agency determines to be necessary.

The Final Rule is modeled after the Commodity Futures Trading Commission's ("CFTC's") final retail foreign exchange regulation published on September 10, 2010.[2] The Final Rule follows the CFTC's final regulation where practicable. For instance, the Final Rule generally has similar provisions regarding prohibited transactions, application and closing out of offsetting long and short positions, disclosure, margin percentage requirements, recordkeeping, requirements for monthly customer reports and confirmation statements, the definition of unlawful representations, prohibition of guarantees against loss, authorization to trade, trading and operational standards, supervision, notice of transfers and customer dispute resolution. However, the Final Rule diverges from the CFTC regulation with respect to areas in which the character of the FDIC's existing regulatory regime or the nature of the banking industry make such divergence appropriate. The Final Rule also would prohibit the use of predispute mandatory arbitration agreements, which the CFTC's rule permits.

While section 742 does not require joint rulemaking by the Federal regulatory agencies, Congress intended that the Federal regulatory agencies promulgate

[2] See 75 Fed. Reg. 55410 (Sept. 10, 2010).

"comparable" rules.[3] On April 22, 2011, the Federal Register published the Office of the Comptroller of the Currency ("OCC's") notice of proposed rulemaking,[4] and the Final Rule follows closely the OCC proposed rulemaking and draft final rule. Staff recommends that the FDIC promulgate the Final Rule so that any insured depository institution under the FDIC's supervision would not experience a business disruption or competitive disadvantage by being subject to the prohibition yet would be required to follow appropriate guidelines when engaging in covered retail foreign currency transactions. Unlike the OCC's proposal and draft final rule, this Final Rule would prohibit predispute mandatory arbitration agreements.

However, in overall substance, the staff believes that the Final Rule is comparable to the OCC's draft final rule and to the CFTC's regulation. Additionally, Federal Reserve staff have indicated that they plan to recommend that the Federal Reserve Board publish a notice of proposed rulemaking shortly. While the FDIC is currently reviewing possible retail foreign currency activity by insured depository institutions under the FDIC's supervision, we are currently aware of only two such institutions that may be engaged in activity subject to the Final Rule.

III. BACKGROUND

On July 21, 2010, President Obama signed into law the Dodd-Frank Act. As amended by the Dodd-Frank Act, the CEA provides that a U.S. financial institution for which there is a Federal regulatory agency shall not enter into, or offer to enter into, with

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[3] See 111 Cong. Rec. S5924 (daily ed. Jul. 15, 2010) (statement of Senator Lincoln) (alteration in original): "Section 742 requires that the agencies regulating [broker-dealers, banks, future commission merchants, and retail foreign exchange dealers] have comparable regulations in place before their regulated entities are allowed to offer retail foreign currency trading. This will ensure that all domestic retail foreign currency trading is subject to similar protections."

[4] Retail Foreign Exchange Transactions, 76 FR 22633 (Apr. 22, 2011).

a retail customer futures and options in foreign currency as described in section 2(c)(2)(B)(i)(I) of the CEA except pursuant to a rule or regulation of a Federal regulatory agency allowing the transaction under such terms and conditions as the Federal regulatory agency shall prescribe (a "retail forex rule").[5] Section 2(c)(2)(B)(i)(I) describes the specific transactions subject to this restriction as "an agreement, contract, or transaction in foreign currency that . . . is a contract of sale of a commodity for future delivery (or an option on such a contract) or an option (other than an option executed or traded on a national securities exchange registered pursuant to section 6(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78f(a))."[6] Further, the CEA requires that a Federal regulatory agency's retail forex rule must treat all such futures and options, and all agreements, contracts, or transactions that are functionally or economically similar to such futures and options, similarly.[7]

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[5] See Dodd-Frank Act § 742(c)(to be codified at 7 U.S.C. § 2(c)(2)). In this preamble, citations to the retail forex statutory provisions will be to the section where the provisions will be codified in the CEA. For the purposes of this rule, a "financial institution" includes "a depository institution (as defined in § 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813))." 7 U.S.C. § 1a(21)(E). A "Federal regulatory agency" means the CFTC, the Securities and Exchange Commission, an appropriate Federal banking agency, the National Credit Union Association, and the Farm Credit Administration. Section 2(c)(2)(E)(i)(III) of the CEA, as amended by § 742(c). Finally, an "appropriate Federal banking agency" is defined by reference to § 3 of the Federal Deposit Insurance Act (12 U.S.C. § 1813(q)), which includes, of course, the FDIC. Section 1a(2) of the CEA.
When the proposed rule is published in the Federal Register, the FDIC will be the appropriate Federal banking agency for any State nonmember insured bank and any foreign bank having an insured branch. 12 U.S.C. § 1813(q)(3). When the powers of the Office of Thrift Supervision are transferred to the Office of Comptroller of the Currency, the FDIC and the Board of Governors of the Federal Reserve System, the FDIC will also be the appropriate Federal banking agency for any State savings association. See Dodd-Frank Act § 312(c) (amending 12 U.S.C. § 1813(q) to redefine "appropriate Federal banking agency").
[6] 7 U.S.C. § 2(c)(2)B(i)(II).
[7] See 7 U.S.C. § 2(c)(2)(E)(iii)(II). One example of a functionally or economically similar transaction is the rolling spot contract. In CFTC vs. Zelener, 373 F.3d 861 (7th Cir. 2004), reh'g and reh'g en banc denied, CFTC v. Zelener, 387 F.3d 624 (7th Cir. 2004), the Seventh Circuit held that rolling spot contracts in foreign currency are not futures contracts but may be economically equivalent to futures contracts. In CFTC vs. Erskine, 512 F.3d 309 (6th Cir. 2008), the Sixth Circuit held that spot contracts in foreign currency are forward contracts, not futures contracts. Although rolling spot contracts have been subject to judicial interpretation as to whether they are forwards or futures, there is a strong argument that the intent of § 742(c) of the Dodd-Frank Act was to require that these transactions be subject to the regulations promulgated thereunder. See 111 Cong. Rec. S5924 (daily ed. Jul. 15, 2010) (statement of Senator Lincoln):

The prohibition in section 742(c) takes effect 360 days from the enactment of the Dodd-Frank Act, i.e., on July 16, 2011.[8] On that date, an insured depository institution for which the FDIC is the "appropriate Federal banking agency" pursuant to section 3(q) of the Federal Deposit Insurance Act (an "FDIC-supervised IDI") may not engage in foreign currency futures and options with a customer who does not qualify as an ECP under the CEA except pursuant to a rule issued by the FDIC.

The restrictions in the Final Rule do not apply to (1) transactions with a customer who qualifies as an ECP, or (2) transactions that are spot contracts or forward contracts irrespective of whether the customer is or is not an ECP. Staff believes that the Final Rule should apply to "rolling spot" transactions in foreign currency. See the discussion of the definition of "retail forex transaction" in the Section-by-Section Analysis of section 349.2 of the Final Rule in the proposed Federal Register Notice of Final Rule accompanying this memorandum regarding the distinctions between rolling spot transactions and spot and forward contracts. Collectively, the futures and options in foreign currency that are subject to the prohibition and those transactions that are not subject to the prohibition, but that are subject to the requirements of the Final Rule, are referred to herein as "retail forex transactions."

"Section 742 includes several important provisions to enhance the protections afforded to customers in retail commodity transactions... First, Section 742 clarifies the prohibition on off-exchange retail futures contracts that has been at the heart of the Commodity Exchange Act (CEA) throughout its history. In recent years, there have been instances of fraudsters using what are known as "rolling spot contracts" with retail customers in order to evade the CFTC's jurisdiction over futures contracts. These contracts function just like futures, but the court of appeals in the Zelener case... based on the wording of the contract documents, held them to be spot contracts outside of CFTC jurisdiction. The CFTC Reauthorization Act of 2008, which was enacted as part of that year's Farm Bill, clarified that such transactions in foreign currency are subject to CFTC anti-fraud authority. ... Retail off-exchange transactions in foreign currency will continue to be covered by the "Zelener fraud fix" enacted in the Farm Bill."

[8] See Dodd-Frank Act § 754.

Finally, the statute requires that any regulation published under section 2(c)(2)(E) of the CEA address certain subjects. In particular, any such rule must prescribe appropriate requirements with respect to disclosure, recordkeeping, capital and margin, reporting, business conduct, and documentation requirements, and may include such other standards or requirements as the Federal regulatory agency determines to be necessary.[9]

On September 10, 2010, the CFTC adopted a retail forex rule for persons subject to its jurisdiction. The CFTC's regulation does not govern transactions by entities subject to prudential regulation by other Federal regulatory agencies including transactions entered into by insured depository institutions subject to the FDIC's supervision. As discussed above, the CEA, as amended by section 742, requires the appropriate Federal regulatory agency to have a retail forex rule in place in order for the prohibition against retail foreign exchange futures, options on futures, and options to not take effect.

In the preamble to its final rule, the CFTC stated: "Given the principal-to-principal nature of retail forex transactions and the inherent conflicts of interest in the relationship between the retail customer and the dealer/counterparty, the lack of transparency in the pricing and execution of such transactions, and the volume of fraud the Commission has seen arising from such transactions, the Commission has determined to promulgate some regulations that are unique to, and tailored to, retail forex transactions."[10] The legislative history of section 742 indicates that retail forex rules of

[9] 7 U.S.C. § 2(c)(2)(E)(iii)(I).

[10] See 75 Fed. Reg. 55410 (Sept. 10, 2010). Since 2001, the CFTC has issued a number of foreign currency trading (forex) fraud advisories. In its current "Fraud Advisory from the CFTC: Foreign Currency Trading (Forex) Fraud," the CFTC highlights that there are two kinds of common fraud: (1) unregulated firms offering/selling foreign currency futures and options contracts to the public, and (2) forex fraud by registered firms and affiliates. See

the various agencies are intended to be comparable.[11] On April 22, 2011, the OCC caused to be published in the Federal Register a notice of proposed rulemaking,[12] and on May 17, 2011, the FDIC caused to be published in the Federal Register its NPR.[13] The OCC is expected to approve its final retail forex rule shortly. The Final Rule and the OCC's draft final rule contain comparable limited changes and clarifications from the respective proposed rules. The staff believes that the Final Rule is comparable with the OCC's final rule and with the CFTC's regulation. Additionally, Federal Reserve Board staff has indicated that it plans to recommend that the Board publish a notice of proposed rulemaking shortly.

The FDIC has identified possible retail forex activity at only two FDIC-supervised IDIs. Staff recommends that the FDIC promulgate the Final Rule so that these two and any other FDIC-supervised IDIs would not experience a business disruption or competitive disadvantage by virtue of the statute's prohibition. Any FDIC-supervised IDI engaged in these covered activities would be required to do so pursuant to policies, procedures, and risk management systems and controls that will ensure safe and sound operations and appropriate customer protections. Moreover, publication of the Final Rule would limit legal uncertainty over the scope of covered transactions and the possible resulting curtailment of traditional spot or forward currency transactions that

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http://www.cftc.gov/ConsumerProtection/FraudAwarenessPrevention/CFTCFraudAdvisories/fraudadv_forex.html .

[11] See 111 Cong. Rec. S5924 (daily ed. Jul. 15, 2010) (statement of Senator Lincoln):

> "...Section 742 addresses the risk of regulatory arbitrage with respect to retail foreign currency transactions. Under the CEA, several types of regulated entities can provide retail foreign currency trading platforms--among them, broker-dealers, banks, futures commission merchants, and the category of "retail foreign exchange dealers" that was recognized by Congress in the Farm Bill in 2008. Section 742 requires that the agencies regulating these entities have comparable regulations in place before their regulated entities are allowed to offer retail foreign currency trading. This will ensure that all domestic retail foreign currency trading is subject to similar protections."

[12] Retail Foreign Exchange Transactions, 76 FR 22633 (Apr. 22, 2011).

[13] Retail Foreign Exchange Transactions, 76 FR 28358 (May 17, 2011).

business customers who qualify as retail customers may currently be using to hedge their business risks. With respect to rolling spot transactions, which are not covered by the prohibition, promulgating rules would establish important protections for retail investors engaged in such activities.

The requirements of the Final Rule would overlap with some portions of the 1994 Interagency Statement on Retail Sales of Nondeposit Investment Products (NDIP), which broadly govern insured depository institutions' sales of all nondeposit investment products to retail customers. As discussed in the preamble to the Final Rule, the banking agencies continue to expect their regulated entities to meet the expectations set out in the NDIP to the extent such expectations do not conflict with the requirements of the Final Rule. The Final Rule's "eligible contract participant" definition of retail customer does not interfere with and does not displace the definition of "retail" for purposes of the NDIP.

The Division of Depositor and Consumer Protection has reviewed and provided comments with respect to the Final Rule.

IV. SUMMARY OF COMMENTS

The FDIC received six comments, two comments from banks, one from a trade organization, and three from individuals. The comments addressed various aspects of the rulemaking, including the applicability of the NDIP policy statement; the scope of covered transactions; the extraterritorial reach of the rule; applicability of FDIC insurance coverage; margin requirements; disclosure requirements; reporting requirements; recordkeeping; business conduct; and interagency coordination.

NDIP Policy Statement

One commenter inquired whether retail forex transactions would be subject to the NDIP policy statement, and, if so, which portions would apply.

Scope of Covered Transactions

Two commenters sought clarification regarding the scope of the proposed rule. One commenter agreed that the regulation should apply to off-exchange futures and rolling spot transactions, but asked for clarification that it does not apply to foreign exchange for delivery at maturity. The commenter believed that the scope of applicability of the rule should be margined or leveraged transactions that do not result in delivery at maturity and that are used for speculative purposes. The commenter believed that transactions that convert or exchange currencies for commercial or investment purposes should be excluded from the regulation. The commenter also sought clarification that the regulation does not apply to identified banking products. Another commenter asked whether the proposed rule applies to traditional foreign currency forwards or spot transactions engaged in by either non-business customers or non-ECPs. Additionally, the commenter sought clarification of whether a non-deliverable forex forward contract, where frequently the physical delivery of the currency is prohibited by a governmental entity, would be considered a traditional foreign currency forward and not subject to the proposed rule.

Extraterritoriality

With respect to extraterritoriality, one commenter stated that the regulation should not apply to transactions between foreign branches of U.S. banks and non-US customers.

Another commenter stated that foreign branches, including those with overseas U.S. customer accounts, should not be subject to the regulation.

FDIC Insurance

Three commenters provided comments regarding FDIC insurance in connection with retail forex margin accounts. Two commenters stated that FDIC-insured institutions should be able to hold customer cash used to margin foreign exchange trading in a manner that results in FDIC insurance covering available margin balances. One of these two commenters said that a cash margin account would not be anything other than a deposit account. Further, although the transactions themselves are not FDIC-insured, a commenter said that a margin account may be eligible for FDIC insurance. In addition, these two commenters stated that the mandatory disclosure language in the Proposed Rule regarding FDIC insurance may be misleading because it may suggest that margin accounts can not be FDIC-insured.[14] Another commenter requested clarification as to whether a margin account is required for a fully collateralized transaction, whether a certificate of deposit linked to a foreign exchange option is acceptable collateral and may be FDIC-insured and whether a demand deposit account is an acceptable form of margin.

Set-off

In response to the proposed restriction against cross-collateralization and setoff, one commenter stated that banks should be able to obtain a security interest in and set-off customer accounts or assets outside of the margin account to satisfy the customer's forex

[14] Proposed § 349.6(d) requires a form disclosure that states in part the following:

(5) THIS TRANSACTION IS NOT INSURED BY THE FEDERAL DEPOSIT INSURANCE CORPORATION.

(6) THIS TRANSACTION IS NOT A DEPOSIT IN, OR GUARANTEED BY, AN FDIC-SUPERVISED INSURED DEPOSITORY INSTITUTION.

debts. This commenter also stated that, to better serve individual customers, the parties should not be limited in the permitted types of collateral. Further, the commenter requested clarification that the margin could be held in an omnibus customer account, and that margin requirements would only apply to initial, rather than variation, margin. Another commenter requested clarification as to the proposed rule's definition of the term "account."

Margin Requirements

Several commenters stated that they believed that the proposed margin requirements are over-extensive. One commenter stated that the margin requirements would disadvantage U.S. traders against international competition, and another commenter stated that the margin requirements would disadvantage small traders. One commenter stated that the margin requirements effectively create a fee for trading. One commenter suggested increased disclosure and access to information in place of margin requirements.

Disclosure

With respect to disclosure, one commenter agreed that risk disclosure should be provided to customers but made clarification comments to the proposed language. In particular, this commenter recommended that the mandatory disclosure include a statement regarding a bank's rights as an unsecured creditor and its ability to obtain adjudicative relief. In addition, this commenter asked for clarification regarding the requirement that a bank disclose fees, charges, commissions and spreads as a numerical disclosure. This commenter also said that it believed that it is unnecessary to obtain a separate customer signature for the risk disclosure. Another commenter agreed that risk disclosure statements are necessary, but believes that the statutory warning should serve as a model or safe-harbor, giving banks the ability to customize their policies to their customers.

Reporting Requirements

In terms of reporting, one commenter stated that it is unnecessary to mandate delivery of monthly customer statements when customers may obtain current account information on line. This commenter also recommended that the regulation be clarified to permit electronic delivery of confirmations and account information consistent with the CFTC's existing rules. Another commenter agreed that the customer reporting requirements are important but that some customers may feel inundated by the reporting required under the proposed rule. This commenter recommends modifying the rule to allow customers to opt out of monthly statements if the bank has 24-hour online access available updated instantly. A third commenter asked whether monthly statements are required for inactive accounts that were never closed, or for those transactions with only a one-month option, which make monthly statements redundant. This commenter also sought clarification on the requirement that a confirmation provide the amount of "mark-up."

Business Conduct Standards

Several commenters made comments regarding requirements for business conduct. In terms of trade authorization, three commenters recommended the flexibility to accept oral trade orders from customers. One commenter agrees that in most circumstances, when offsetting long and short positions, older positions should be closed out first. However, there are bona fide circumstances where first-in first-out should not be mandated. Accordingly, this commenter recommended that a customer's instructions, if any, should trump the general rule. One commenter sought clarification regarding the restriction on new bid/offer spreads. One commenter recommended that the front-running restriction apply only when the bank agent executing the orders has knowledge of unexecuted trades and that traditional firewalls should otherwise be sufficient. In terms of policies and procedures regarding accounts of affiliated persons of other retail forex counterparties, one commenter stated that it should be able to rely on the customer's representations and that these policies and procedures should apply to persons in the retail forex line of business as opposed to banks generally.

Finally, two commenters urged interagency cooperation to create an even regulatory playing field. One commenter urged each of the FDIC and OCC to define its scope of authority.

VI. SUMMARY OF THE FINAL RULE

As with the proposed rule, the Final Rule does not apply to forex transactions involving ECPs, a term from the CEA that defines sophisticated investors.

For forex transactions with customers that do not meet the ECP definition, that is, retail customers, the Final Rule imposes certain requirements for futures, options, and other forex transactions entered into on a leveraged or margined basis, or financed by a bank. The final rule, like the proposed rule, will not apply to: (1) spot transactions involving actual delivery of currency within 2 days; or (2) forward contracts that create an enforceable obligation with a retail customer who has the ability to delivery or accept delivery in connection with its line of business.

Based on the comments received, the Final Rule differs from the proposed rule in the following areas:

- Extraterritoriality: In response to a commenter, the final rule excludes transactions between a foreign branch of an FDIC-supervised IDI and a non-U.S. retail forex customer from all of the rule's requirements except for the requirement to obtain FDIC approval prior to engage in such transactions. The final rule also requires that the exempted transactions comply with applicable foreign law of the jurisdiction in which the foreign branch is located. OCC staff indicated that the OCC final retail forex rule will contain a similar exclusion.
- Exemptive authority. The FDIC would retain the authority to exempt transactions that fall within the retail forex transactions definition, but are not functionally or economically similar to futures or options.
- Identified banking products: The Final Rule clarifies that the rule does not apply to identified banking products, such as, deposit accounts holding foreign currencies.
- Telephonic orders: The Final Rule allows oral transaction orders provided they are recorded.
- Order of applying close-out of positions: The Final Rule tracks the proposed rule requirement that an FDIC-supervised IDI close-out positions by offset against the oldest positions first, but adds a provision to allow a different ordering of close-out based on a customer's explicit instructions.

VI. CONCLUSION

Based on the comments received, the staff is recommending that the limited changes to the Proposed Rule described above be implemented in the Final Rule. Accordingly, staff recommends that the Board of Directors adopt and authorize publication in the Federal Register the attached Final Rule. This Final Rule would become effective July 15, 2011.