

OCC and FDIC Adopt Rules Regarding Retail Forex Transactions

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The Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC and, together with OCC, the Bank Regulators) have recently issued final rules concerning off-exchange retail foreign exchange (forex) transactions and the entities that serve as counterparties to such transactions.¹ The final rules authorize entities that are subject to the jurisdiction of a Bank Regulator to engage in off-exchange forex transactions with retail customers.² With few modifications, the final rules adopt the Bank Regulators' proposed rules in this area. The final rules took effect on July 15, 2011.³

Under Section 2(c)(2) of the Commodity Exchange Act (CEA), as amended by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), only certain eligible counterparties may engage in off-exchange forex transactions with retail counterparties. Eligible counterparties include U.S. financial institutions, broker-dealers, futures commission merchants (FCMs), financial holding companies and retail foreign exchange dealers. Another provision of CEA Section 2(c)(2) prohibits an eligible counterparty for which there is a federal regulatory agency from entering into a retail forex transaction except pursuant to a rule or regulation of that federal regulatory agency.⁴ If the Bank Regulators had not adopted rules authorizing Covered Institutions to engage in retail forex business, CEA Section 2(c)(2), as amended by the Dodd-Frank Act, would have prohibited these institutions from entering into retail forex transactions as of July 16, 2011.

1 The FDIC adopted its rules on July 6, 2011. Retail Foreign Exchange Transactions, 76 Fed. Reg. 40779 (Jul. 12, 2011) (the FDIC Adopting Release). The OCC adopted its rules on July 7, 2011. Retail Foreign Exchange Transactions, 76 Fed. Reg. 41375 (Jul. 14, 2011) (the OCC Adopting Release).

On July 28, 2011, the Board of Governors of the Federal Reserve System (Board) proposed rules to permit Board-supervised banking institutions to engage in retail forex business. See Retail Foreign Exchange Transactions (Regulation NN), 76 Fed. Reg. 46652 (Aug. 3, 2011) (Board Proposal). The Board Proposal is similar to the final rules adopted by the OCC and the FDIC. The most significant difference between the Board Proposal and the OCC's and the FDIC's final rules is that the Board Proposal would not prohibit a bank from offsetting a retail forex customer's losses or margin call against other assets of the customer held by the bank other than money or property pledged as margin. In addition, the Board Proposal would not require the creation of a separate retail forex margin account. Comments on the Board Proposal are due on October 11, 2011.

2 See OCC Rule 48.1; FDIC Rule 349.1.

3 The rules adopted by the OCC are substantially similar to those adopted by the FDIC. One significant difference between the rules arises in the context of customer dispute resolution. The FDIC adopted a blanket prohibition on pre-dispute arbitration agreements with customers, while the OCC permits such agreements in limited circumstances. The OCC's rules also include a provision (Rule 48.17), that allows the OCC to modify its retail forex rules, consistent with safety and soundness and protection of retail forex customers. There is no equivalent FDIC provision. National banks and FDIC-supervised insured depository institutions would also have to comply with slightly different filing requirements to be granted permission to engage in retail forex business. The Bank Regulators' rules also differ modestly with respect to disclosure, reporting and trading and operational requirements.

4 The Commodity Futures Trading Commission (CFTC) has adopted rules that will allow CFTC-regulated eligible counterparties to engage in retail forex transactions. See 75 Fed. Reg. 55410 (Sep. 10, 2010). The Bank Regulators used the CFTC's rules as a model when crafting their retail forex regulations. The Securities and Exchange Commission also has adopted an interim final temporary rule to allow a registered broker-dealer to engage in a retail forex business until July 16, 2012, provided that the broker-dealer complies with the Exchange Act of 1934, the rules and regulations thereunder, and the rules of the self-regulatory organization(s) of which the broker-dealer is a member, insofar as they are applicable to retail forex transactions. The SEC has requested comments on the interim final rule. The comment period closes on September 13, 2011.

A retail forex transaction is one between an eligible counterparty and a retail customer.⁵ Generally, retail customers are:

- individuals with less than \$10 million in total assets, or less than \$5 million in total assets if entering into the transaction to manage risk, and who are not registered as futures or securities professionals;
- companies, other than financial institutions and investment companies, with less than \$10 million in total assets, or a net worth less than \$1 million if entering into the transaction in connection with the conduct of their business; and
- commodity pools that have less than \$5 million in total assets.⁶

Which institutions are covered by these rules?

The FDIC's rules apply to FDIC-supervised insured depository institutions (IDIs) which currently include state nonmember banks and, as of July 21, 2011, state savings associations. The OCC's rules apply to national banks, federal branches or agencies of foreign banks, and their operating subsidiaries (collectively, National Banks and, together with FDIC-supervised IDIs, Covered Institutions).⁷

Many provisions of the rules do not apply to transactions between a foreign branch of a Covered Institution and a non-U.S. customer.⁸ This carve-out, which was not included in the Bank Regulators' proposals, is intended to respond to industry concerns that such transactions may be subject to foreign regulatory requirements that may be inconsistent with the final rules.

What are the minimum requirements a Covered Institution must meet to be eligible to engage in forex transactions with retail customers?

The final rules require a Covered Institution to seek approval from the appropriate Bank Regulator before engaging in a retail forex business. For National Banks, this means obtaining a written supervisory non-objection from the OCC.⁹ Similarly, FDIC-supervised IDIs must provide the FDIC written notice and obtain the FDIC's written consent.¹⁰ The final rules also require Covered Institutions to provide substantial information about their proposed retail forex business to the appropriate Bank Regulator as a condition of receiving approval.¹¹

5 Retail forex transactions do not include "spot" forex transactions, forward contracts with commercial entities that create an enforceable delivery obligation, transactions executed on an exchange or identified banking products. OCC Rule 48.2; FDIC Rule 349.2. The Bank Regulators note that rolling spot forex transactions (Zelener contracts) are not excluded for the definition of retail forex transaction.

6 Section 741(b)(10) of the Dodd-Frank Act will change the criteria used to determine whether a commodity pool is a retail investor. Specifically, once the Dodd-Frank amended definition of "eligible contract participant" takes effect, a pool may need to look through to its individual investors to determine whether the pool is a retail customer in certain circumstances. According to the staff of the CFTC, this look-through may not apply when a pool is engaged in an FX transaction with a U.S. financial institution.

7 On July 21, 2011, the OCC became the federal banking agency for federal savings associations. Through informal conversations with OCC staff, we have learned that the OCC intends to issue an interim final rule for federal savings associations with respect to retail forex transactions.

The Board Proposal would apply to state member banks, uninsured state-licensed U.S. branches or agencies of foreign banks, financial holding companies, bank holding companies, agreement corporations and Edge Act corporations. See Board Proposed Rule 240.2(b).

8 OCC Rule 48.1(d); FDIC Rule 349.1(d). In particular, the disclosure, recordkeeping, capital, margin, reporting, business conduct and documentation standards contained in the final rules will not apply to such transactions.

9 See OCC Rule 48.4.

10 FDIC Rule 349.4(a).

11 As a prerequisite for obtaining a supervisory non-objection, a National Bank would need to demonstrate that it

Both sets of final rules require Covered Institutions that operate a retail forex business to comply with capital and operational standards.¹² A Covered Institution must have policies and rules in place to ensure fair settlement practices and to prevent unfair trade practices, such as front-running customer orders.¹³ The Bank Regulators note that this provision is designed to prevent Covered Institutions from unfairly taking advantage of information they gain from customer trades.¹⁴

Furthermore, a Covered Institution must keep full, complete and systematic records, together with all pertinent data and memoranda, of all transactions relating to its retail forex business.¹⁵ The final rules task a Covered Institution and its agents, officers and employees with supervising the Covered Institution's retail forex operations to ensure compliance.¹⁶

What regulations apply to a Covered Institution's forex dealings with retail customers?

Before opening an account that will engage in retail forex transactions, a Covered Institution must send the retail forex customer the risk disclosure statement provided in OCC Rule 48.6(d) or FDIC Rule 349.6(d), as appropriate.¹⁷ The Covered Institution also must disclose certain information about its retail forex business to prospective retail forex customers, including the percentage of profitable retail forex accounts for each of the past four quarters and information about the fees and other charges (including spreads) imposed by the Covered Institution on retail forex customers.¹⁸

Prior to entering into a forex transaction for the account of a retail customer, the final rules require a Covered Institution to receive an authorization from the customer. The authorization must specify the precise retail forex transaction to be effected, including the exact amount of the foreign currency to be

has appropriate policies, procedures and risk management systems in place for the operation of a retail forex business. The National Bank also would need to furnish certain information to OCC, including "know your customer" documentation, customer due diligence information and collateral haircuts for non-cash margin.

For FDIC-supervised IDIs, the required notice must include, among other things, a brief description of the FDIC-supervised IDI's proposed retail forex business and the manner in which it will be conducted, a copy of the institution's business plan, a description of the institution's target customers and related information, including credit evaluations, customer appropriateness, and "know your customer" documentation, and a resolution by the institution's board of directors that the proposed retail forex business is an appropriate activity for the institution.

Under the Board Proposal, the required notice would need to include, among other things, information concerning customer due diligence, including credit evaluations, customer appropriateness, and "know your customer" documentation, information concerning new product approvals, information addressing conflicts of interest, and a resolution by the institution's board of directors that the institution has established and implemented appropriate policies, risk management systems and controls for its retail forex business.

12 OCC Rule 48.8 (requiring a National Bank to be "well-capitalized" as defined by 12 CFR part 6); FDIC Rule 349.8 (requiring a FDIC-supervised IDI to be "well capitalized," as defined by 12 CFR part 325). The Board Proposal would require most Board-supervised banking institutions to be well capitalized, but agreement corporations and Edge Act corporations would need to maintain capital in compliance with applicable capital adequacy guidelines. Board Proposed Rule 240.8.

13 OCC Rule 48.13; FDIC Rule 349.13.

14 OCC Adopting Release at 41381; FDIC Adopting Release at 40786.

15 OCC Rule 48.7; FDIC Rule 349.7. Both of these rules have been reorganized and expanded to incorporate recordkeeping provisions from other proposed retail forex rules. The Bank Regulators also have clarified that a Covered Institution may accept phone orders from retail forex customers, provided such orders are recorded and customers are advised that they are speaking on a recorded line.

16 OCC Rule 48.14; FDIC Rule 349.14.

17 Although not identical, these substantially similar disclosures are intended to apprise the potential customer of the risks involved in retail forex transactions.

18 OCC Rule 48.6(e) and (f); FDIC Rule 349.6(e) and (f). In addition to the regulations imposed by the final rules, the preamble to each rule notes that Covered Institutions would be expected to continue to meet the expectations of the 1994 Interagency Statement on Retail Sales of Nondeposit Investment Products to the extent such expectations do not conflict with the final rules.

purchased or sold.¹⁹ As proposed, these rules would have required written authorization, but the final rules permit telephone authorization, provided the Covered Institution records the authorization.²⁰

The final rules also impose new requirements on Covered Institutions when entering into a forex transaction with a retail customer. For example, a Covered Institution must observe execution standards for customers that prohibit certain trade practices, including, among others, changing prices after confirmation and providing a retail forex customer with a new bid price that is higher (or lower) than previously provided without providing a new ask price that is similarly higher (or lower) as well.²¹

The final rules require a Covered Institution to collect margin when entering into a forex transaction for a retail customer. The amount of margin collected is 2 percent of the notional value of the transaction for major currency pairs and 5 percent of the notional value for all other currency pairs.²² The final rules permit a wide variety of assets to be posted as margin, including cash, U.S. government obligations, commercial paper, corporate bonds and interests in money market mutual funds.²³ Covered Institutions must maintain customer margin in an account that is separate from the retail forex customer's other accounts at the institution (a so-called "separate account").²⁴ This rule permits Covered Institutions to place margin collected from retail forex customers into an omnibus account as long as the institution keeps records of each retail forex customer's margin balance.²⁵

Margin calls must occur at least daily and the final rules prohibit a Covered Institution from offsetting a retail forex customer's losses on retail forex transactions against any funds or other assets of the customer, other than money or property pledged as margin.²⁶ The final rules also require a Covered Institution to close out offsetting long and short positions in a retail forex account, but customers may direct how such offsets should occur.²⁷ If the customer does not provide instructions, however, the Covered Institution must apply any offsetting purchase or sale to the oldest portion of the previously held short or long position. In this respect, the final rules are more flexible than the proposed rules, which would not have allowed a customer to provide specific instructions for offsets.

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- 19 OCC Rule 48.12; FDIC Rule 349.12. In the case of an option, the authorization also must specify the identity of the foreign currency or contract underlying the option.
- 20 OCC Rule 48.7(g) specifies that a National Bank must create and maintain audio recordings of oral orders and oral offset instruction. The FDIC's rules do not specifically mention oral authorization, but the FDIC Adopting Release advises such authorization is permissible at 40786.
- 21 OCC Rule 48.13(e); FDIC Rule 349.13(e). The Bank Regulators note that these execution requirements do not prevent a Covered Institution from changing bid or ask prices of a retail forex transaction to respond to market events. Neither would these rules prohibit a Covered Institution from rejecting an order and advising customers they may submit a new order.
- 22 OCC Rule 48.9(a); FDIC Rule 349.9(a). Major currencies are the U.S. dollar, Canadian dollar, Euro, U.K. pound, Japanese yen, Swiss franc, Australian dollar, New Zealand dollar, Swedish kronor, Danish kroner and Norwegian krone. Because major currencies can change over time, the Bank Regulators, like the CFTC, do not define the term "major currency" in their rules. The Bank Regulators note that Covered Institutions would need to obtain an interpretive letter from their appropriate Bank Regulator prior to treating any other currency as a major currency. Notably, the Board Proposal would identify major currencies and would grant the Board discretion to designate other currencies as major currencies. See Board Proposed Rule 240.8(c).
- 23 OCC Rule 48.9(b); FDIC Rule 349.9(b).
- 24 The Board Proposal would not require Board-supervised banking institutions to create a separate margin account.
- 25 The Bank Regulators interpret the term "separate account" differently in their final rules than they had proposed. For example, the FDIC's proposal stated that FDIC-supervised IDs would need to hold each retail forex customer's retail forex transaction margin in a "separate account that contains only that customer's retail forex margin." Retail Foreign Exchange Transactions, 76 Fed. Reg. 28358, 28362 (May 17, 2011).
- 26 OCC Rule 48.9(d) and (e); FDIC Rule 349.9(d) and (e). No similar prohibition exists in the Board Proposal. However, the Board Proposal would require additional disclosure if a Board-supervised banking institution retains the right to set off obligations of the retail forex customer against the customer's other assets held by the institution. Board Proposed Rule 240.6(g).
- 27 OCC Rule 48.5(c); FDIC Rule 349.5(c). Notably, although the FDIC and OCC discuss this rule using nearly identical language, the OCC's final rules appear to allow a National Bank to determine whether to offer customers the option of controlling offsets at all. The Board Proposal follows the FDIC model. Board Proposed Rule 240.5(c).

The final rules further require Covered Institutions to provide a monthly account statement to each retail forex customer. In addition, the Covered Institution must send a confirmation statement for each retail forex transaction executed by the customer within one business day of execution.²⁸

The final rules prohibit a Covered Institution from making certain representations or engaging in certain activities with respect to its retail forex business. For example, neither a Covered Institution nor its affiliated parties may engage in fraudulent conduct in connection with retail forex transactions. A Covered Institution also may not act as a counterparty to a retail forex transaction if the institution or its affiliate exercises discretion over the customer's retail forex account.²⁹ Neither a Covered Institution nor its affiliates are permitted to represent that the federal government or any federal agency has sponsored, recommended or approved retail forex products and no Covered Institution may represent that it will guarantee a retail customer against loss on forex transactions, limit losses on such transactions or not call for required margin.³⁰

A Covered Institution must give a retail forex customer at least 30-days notice before transferring the customer's account. The notice must inform the customer of its right to direct the Covered Institution to liquidate the positions in the account or transfer the account to another retail forex counterparty of the customer's selection.³¹ The final rules also restrict a Covered Institution's ability to enter into pre-dispute mandatory arbitration agreements with customers. The FDIC's rules prohibit this practice completely, while the OCC's rules permit it under certain circumstances.³²

When must a Covered Institution with an existing retail forex business comply with the final rules?

The final rules allow a Covered Institution engaged in retail forex business as of July 15, 2011, to continue its business as long as it notifies the appropriate Bank Regulator within 30 days. The Covered Institution then has six months (or a longer period as provided by its Bank Regulator) to bring its operations into compliance with the rules.³³ During that time, the Covered Institution is deemed to be operating its retail forex business pursuant to a rule or regulation of a federal regulatory agency as required by the amended CEA.³⁴

28 OCC Rule 48.10; FDIC Rule 349.10. If the retail forex transaction is executed by a pooled investment vehicle, the monthly statement and all confirmations would need to be delivered to the operator of the vehicle. Similarly, if a retail forex account is controlled by a person other than the retail forex customer, the Covered Institution would be required to provide the account controller monthly statements and confirmations.

29 OCC Rule 48.3; FDIC Rule 349.3.

30 OCC Rule 48.11; FDIC Rule 349.11.

31 OCC Rule 48.15; FDIC Rule 349.15.

32 OCC Rule 48.16; FDIC Rule 349.16. The Board Proposal, like the FDIC's final rules, would bar such agreements. Board Proposed Rule 240.16.

33 OCC Rule 48.4(c); FDIC Rule 349.4(c) and FDIC Adopting Release at 40782. The FDIC's final rule does not specify that the FDIC-supervised IDI must give notice to the FDIC within 30 days. Instead, the FDIC provides this guidance in the preamble.

34 OCC Rule 48.4(d); FDIC Rule 349.4(d).