The rationale of FINRA’s proposal to limit margin on spot FX contracts to 1.5% of account balance is seriously flawed and needs to be revaluated. The example analysis below clearly confirms there is no need to change the existing framework and demonstrates why this margin requirement amendment is not needed and in fact is harmful. The proposed changes would clearly result in the permanent closure of the retail FX market due to this restriction. Therefore this proposal is not considered beneficial nor wanted by the retail FX community. Please consider the impact of taking away the retail FX market from the ordinary investor and the lost livelihoods of many, including the brokers that will need to shut down.

FX is a spot market and the effective result of entering, say 1 std. contract, is that we committed to buy (in the example I will use) 100,000 units of one currency and we borrow an equivalent amount in another currency in order to buy the first currency. At its simplest, except for the broker spread, this is a balanced transaction. Said another way, this means I own 100,000 units of one currency and owe the equivalent in another. The key to this statement is that I already own a sovereign risk currency that will eventually be used for repayment of the other.

So the true risk lies in a potential decrease in value to the currency I have just purchased. As FINRA is well aware, the currency markets move very slowly and a daily change of 3-5% is highly significant and a change more than that would represent an extraordinary economic event that is a very rare occurrence indeed. Expressed in U.S. dollars, this is a change of 3-5 cents. To continue with this example, let’s say the USD was the borrowed side of the transaction and the USD had strengthened over the day by 5 cents and an amount of, say, $125,000 had increased to $130,000 due to the currency change. This means that if I now decided to close out the contract by selling the 100,000 units I presently owned of the other currency, I would be $5,000 short. If I had $10,000 in my account, I would not have been at margin risk and I could simply sit back and analyze why I had made such a lousy trade. (BTW that is a highly leveraged trade and is only used as an extreme example of when things could go really bad and is a leverage any educated FX trader would not take).

Let’s look at this example and relate it to the FINRA proposal and for simplification, I will consider trader #1 to be “ultra conservative”, who does not
wish to use margin at all. So to enter this exampled trade, the trader would have made sure there was $125,000 in their broker account, which effectively provides 200% coverage to the borrowed currency. This security coverage is provided by a sovereign risk currency and is therefore as good a risk as it gets. We’re not talking about bank stock or maybe an “Enron”, we’re talking sovereign risk. Now if the USD did go up 5 cents, well guess what, this trader has now into margin. But that’s OK because the trader still has $120,000 surplus and about $37,000 before there would be a margin call (see next paragraph). That 5 cent swing was a really bad day, but did the trader really need to have all of that extra $120,000 sitting there? Well one thing for sure was there was no danger of a margin call!

Now let’s look at trader #2, who actually is very aggressive and decides he is going to take a big chance with everything he has. He decides to margin to the limit every penny he has to get into this 100,000 unit buy contract. Under the new FINRA margin requirement, he now has to have $83,333 (125,000/1.5) on deposit with his broker to cover the borrowed USD. But an unfortunate thing happens; the USD appreciates by 5 cents! He now has gone into margin and has to come up with $5,000, which unfortunately he doesn’t have. So it seems that somewhere along the line this trader was put on notice that he was in margin default and the position would be liquidated. This is notwithstanding the trader still had 100,000 units of the other currency now worth $120,000 USD equivalent plus the $83,333 on deposit that provides 162% liquid coverage. So even though the trader’s analysis indicated the trade would come back, the decision to stay in the transaction was taken away from him because he was margined out, even though he had that $78,000 unproductively sitting there against a currency that at worst should only move $5,000 one way or the other.

If we compare this to a simple stock transaction, the conservative trader could use the $125,000 to purchase, say 1,250 shares @ $100. On a really bad day, these shares could go down maybe $20, for a loss on the day of $25,000. But that’s OK because there were no margin issues with this trader. But trader #2 decides because his broker will give him 2:1 margin coverage and he has a really hot tip, to use his $62,500 to buy this same stock for $125,000. Unfortunately this stock went down $25,000 and now the stock only provides 160% coverage and he has had a serious margin call.

Carrying our examples further if we go to day 2, for the FX trader, as we’re dealing with slow moving currencies carrying sovereign risk, perhaps the worst that could happen would be another 5 cent drop and please recognize this is 10 cents in 2 days, which is significant. Both the FX traders would still have oodles
of surplus, notwithstanding FX trader #2 would still have a margin call. But for the poor stock traders and because stocks have much higher risk than sovereign risk, this may be an Enron equivalent and it may go down $35 the second day. The first stock trader has lost a lot of money, but the second one is wiped out and still owes his broker $7,500. This represents 2 bad trading days in two totally different markets with vastly different outcomes. The market for the stock may also now be illiquid.

I hope these examples demonstrate that you simply can not compare these two markets the same way. FX leverage is applied to the value of the contract to the traders account balance, whereas the risk in the transaction actually lies in the exchange rate change. We’re really not comparing apples with apples here. Most FX traders do not leverage their accounts for exchange rate risk by more than 1-5% of their account balance. The high liquidity of the FX market means traders are protected to exit their trade positions.

The OTC FX broker model as it presently exists works just fine. NFA has implemented increased capital requirements, which helps protect traders by weeding out the undercapitalized and/or potentially unscrupulous firms. The brokers provide excellent education programs and are clear on margin and margin maintenance requirements. Demo accounts are freely available and encouraged and all clearly show the margin.

Constructive action would be to effect changes to have counts held in segregated accounts not exposed to broker creditors and to be covered by insurance. These would be real and meaningful ways to help the retail FX trader. There are thousands and thousands of retail FX traders who have made serious financial and time commitments to learn and trade the FX market. I feel I can safely say, there are none who would consider the FINRA proposal would be of benefit to them.

Please reconsider your proposal and thank you for your time.

Sincerely,

Arlene Isaacs