From: Alexis Hall <ahall@ruddylaw.com>
Sent: Friday, March 19, 2010 3:35 PM
To: secretary <secretary@CFTC.gov>
Subject: Regulation of Retail Forex
Attach: PFGBEST Comment Letter.pdf

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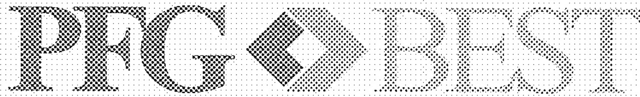

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March 18, 2010

Via FedEx and E-mail (secretary@cftc.gov)

Mr. David Stawick, Secretary
Commodity Futures Trading Commission
1155 21st Street, NW
Washington, DC 20581

Re: RIN 3038-AC61

Dear Mr. Stawick:

These comments are submitted on behalf of Peregrine Financial Group, Inc. d/b/a PFGBEST. PFGBEST is one of the largest non-clearing U.S. Futures Commission Merchants (FCMs), incorporated in 1990. Our firm offers futures, forex and options as well as full service brokerage, trader education and direct online trading, with customers, affiliates and brokerage offices in more than 80 countries. Our Commodity Futures Trading Commission ("CFTC") ranking has grown from the 30th largest (in terms of customer assets) to number 11 (excluding banks) in the past three years. Currently, PFGBEST customer assets in some 60,000 accounts total approximately $400 million, plus $50 million accounted for in separate forex accounts. Allow me to also note that I serve on the FCM Advisory Committee of the National Futures Association ("NFA").

PFGBEST strongly endorses the investor protection regulatory initiatives of the CFTC. To this end, we support most components of the rule proposed on January 20, 2010 by the CFTC "Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries."[1] However we are opposed to (i) the requirement that Introducing Brokers (IBs) and Futures Commission Merchants ("FCMs") or Registered Forex Exchange Dealers ("RFEDs") enter into guarantee agreements; (ii) mandatory quarterly disclosures; (iii) net capital add-on; and (iv) the requirement that each RFED and FCM that engages in retail forex transactions collect a security deposit equal to ten percent (10%) of the notional value of the transaction.

I. Guarantee Agreement Requirement

The CFTC's proposed rule requires all IBs to enter into a guarantee agreement with either an RFED or an FCM. Although the CFTC believes that this requirement will aid in the prevention of fraudulent solicitation and sales practices in the forex industry, this proposed rule will not achieve the CFTC's intended objectives.

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[1] *Federal Register* Vol. 75, No. 12, pp. 3282-3330.

We recognize that essential differences between trading futures contracts and trading forex contracts exist. Despite these differences, trading forex contracts involves no greater risk of fraudulent solicitation and sales practices than trading futures contracts. Thus, with respect to regulations designed to prevent fraudulent solicitation and sales practices, IBs in the forex industry should not be subjected to greater requirements than IBs in the futures trading industry. As such, we believe that the proposal to require guarantee agreements between IBs and FCMs or RFEDs (a) is inconsistent with the intent of Congress and (b) fails to accomplish the CFTC's stated goal.

A. The Guarantee Agreement Requirement is Inconsistent with Legislative History

As previously set forth, trading forex contracts involves no greater risk of fraudulent solicitation or sales practices than trading futures contracts. Thus, the legislative history surrounding the Futures Trading Act of 1982, which required the registration of IBs in the futures trading industry, provides valuable insight with respect to IBs in the forex industry.

Prior to the establishment of the IB registration category, small firms registered as "agents" of FCMs. The CFTC sought to hold FCMs liable for the acts of agents by requiring agents to register as associated persons of the FCMs. Congress recognized that agents, for the most part, were independent firms. As such, FCMs could not exercise the same control over agents as they could over their own employees. Thus, Congress rejected the notion that FCMs should be liable for the acts of these agents and instead established the IB registration category. Congress determined that registrants in this newly created registration category should be held accountable for their own conduct. Consequently, it established a minimum net capital requirement for IBs "to guarantee the accountability and responsible conduct of introducing brokers."[2] IBs that maintained such minimum net capital were classified as independent.

Congress held that in lieu of maintaining the required minimum net capital, an IB could become a guaranteed IB by entering into a guarantee agreement with an FCM. Pursuant to a guarantee agreement, an FCM is expressly responsible for the IB's obligations under the Commodity Exchange Act ("CEA"). The legislative history of the Futures Act of 1982 makes clear that Congress never intended guarantee agreements to be executed in conjunction with the maintenance of the required minimum net capital.

Through the proposed rules, the CFTC now seeks to hold FCMs and RFED's liable for the conduct of IBs regardless of whether the IB is independent or guaranteed. The CFTC has not established any basis for subjecting IBs in the forex industry to greater requirements than IBs in the futures industry. Without such basis, the CFTC cannot now obtain what Congress has already denied.

[2] *Federal Register* Vol. 48, No. 150, p. 35248.

B. Requirement of a Guarantee Agreement is Unnecessary to Further the CFTC's Goals

By requiring IBs and FCMs/RFEDs to enter into guarantee agreements, the CFTC believes that FCMs/RFEDs will be forced to more carefully vet the persons who solicit business on their behalf. The proposed rule, however, requires that all IBs in the forex industry register with the CFTC. Since the CFTC's paramount obligation is to assure, to the extent reasonably possible, the fitness of every registrant[3], IBs will have already been carefully vetted during the registration process. Any additional vetting arising from the existence of a guarantee agreement will be superfluous.

Furthermore, guarantee agreements were originally designed to ensure that wrongdoing could not occur without accountability. The registration and minimum net capital requirements placed the once unaccountable IBs in a position to be held accountable for their own actions. Consequently, it is no longer necessary to hold another party liable for the actions of IBs.

As evinced by the history of guaranteed and independent IBs in the futures trading industry, it is clear that requiring guarantee agreements is not necessary to further the CFTC's goal to prevent fraudulent solicitation and sales practices in the forex trading industry. Like the futures trading industry, the registration requirement along with the minimum net capital requirement is sufficient to establish proper accountability for the actions of IBs.

II. Risk Disclosures

Proposed Regulation 5.5 requires RFEDs, FCMs and IBs to provide retail forex customers a risk disclosure statement which is similar to that currently required to be provided to futures customers under Regulation 1.55. However, in addition to the disclosures required under Regulation 1.55, forex dealers will also be required to disclose its total number on non-discretionary accounts and the percentage of such accounts that were profitable for each of the four most recent quarters.

In order for a regulation to avoid being deemed arbitrary and capricious under the Administrative Procedure Act, it must be shown that the CFTC has "examine[d] the relevant data and articulate[d] a satisfactory explanation for its action including a rational connection between the facts and the choice made."[4] The CFTC presents no explanation or data demonstrating the need for disclosure of the percentage of profitable accounts maintained by forex dealers, when no such disclosure is necessary on the futures side. In fact, nothing indicates that forex transactions are any less profitable than futures transactions. Accordingly, requiring forex dealers to make such disclosures appears arbitrary and capricious.

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[3] *Federal Register* Vol. 48, No. 150, p. 35249.

[4] *Motor Vehicle Manufacturers Ass'n v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 27 (1983).

Additionally, Section 15(b) of the CEA requires the CFTC to use the least anticompetitive means in achieving the objectives of the CEA. Imposing unwarranted greater requirements on forex dealers gives FCMs, which do not deal in forex, an unfair competitive advantage.

Alternatively, and congruous with our peers operating exclusively in the commodity futures industry, we propose that FCMs and RFEDs should be left with the discretion to determine on a case-by-case basis which customers require some additional risk disclosure, and supplement disclosures as is necessary in particular instances.[5]

III. Net Capital Requirement

We appreciate that customers in the forex market rely on the dealer's financial stability and creditworthiness; and therefore support the Commission's initiative for higher minimum net capital requirements that, at some level, increases with customer liabilities. However, in our view, and without offering up any concrete proposals, any regulatory framework needs to address the true economic requirements of trade practices, including the practice of straight-through-processing.[6] It will make for bad public policy to implement unnecessarily stringent capital requirements and instead any rule must strike a balance to ensure net capital standards are equitable and not unduly burdensome. If not, we fear that the mantra offered up by many of our peers may hold true – this business will move offshore without regard for any sort of regulation, and opening up a greater possibility of fraud.

IV. Security Deposits for Retail Forex Transactions

Proposed Regulation 5.9 would require each RFED and each FCM that engages in retail forex transactions to collect a security deposit equal to ten percent (10%) of the notional value of the transaction. In proposing this rule, the CFTC is attempting to reduce forex customers' exposure to risk. For the reasons set forth below, we believe that the proposed rule regarding leverage will not meet all of the CFTC's stated purposes.

A. Purpose of Margin

Proposed Regulation 5.9 is based on a misunderstanding surrounding the role of margin in the commodities industry. Despite the CFTC's current proposal to use margin as a means to protect customers from risk, it has long been held that margin has a special status under the commodities laws because it is a protection for the FCM and not the customer. In *Levi-Zeligman*

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[5] NFA Compliance Rule 2-30; NFA Interpretive Notice 9013.

[6] The NFA in its current capital requirements recognizes the straight-through-processing that a lesser capital requirement should be imposed on parties offering a trade via straight through processing. *See* NFA Financial Requirements Section 11 (a).

v. Merrill Lynch[7], the CFTC stated that "[t]he purpose and law surrounding margin is clear . . . Futures Commission Merchants are closely protected by margins and liquidation because without that protection, they would be exposed to overwhelming risk." Thus, the CFTC, itself, recognizes that margin is a mechanism designed to protect the FCM and not the customer. The courts have consistently held that margin rules are not customer protection rules.[8]

Additionally, conditions in the forex arena can change very rapidly and if the authority to set margin is taken away from FCMs, they will be deprived of their ability to protect themselves from market volatility. In fact, the CFTC has stated

> [p]articularly in those market situations where a prompt response is required, a futures commission merchant is free to exercise its power to demand the deposit of additional funds by its customer and to liquidate an account without hesitation if the demand is not met. The exercise of these powers is available as a matter of business judgment, a judgment not curtailed by fear of subsequent claims of constructive fraud which have no basis.[9]

Thus, it is clear that an FCM should be able to set its own margin requirements as it deems fit and not be required to impose arbitrary and obstructive margin requirements on its traders.

B. Historical Customer Protection Mechanisms

By asserting that there is an increased need for customer protection from risk, the CFTC is removing the long held view that traders are responsible for determining their own risk tolerance. Forex FCMs are required to provide forex customers with the same risk disclosure statements as other commodity or futures FCMs provide to their traders and should be held to the same standard of self-determination for risk tolerance. Since the CFTC has not established any foundation for applying different standards in the forex industry, the CFTC should treat forex customers the same as other commodity traders. By imposing a blanket margin requirement of 10%, the CFTC is removing the ability of customers to set their own leverage limit, and hence establish their own risk exposure. In the commodities world, risk tolerance is determined on a case by case, individual basis by the customer, not by establishing standards that reduce universal risk; to do so reminds one of the suitability standards found in the securities world, which have been categorically refused in the commodities world and, at times, by the CFTC itself.

In 1978 the CFTC first announced that it would not adopt a suitability rule because to do so would merely codify principles already implicit in the antifraud provisions of the CEA and CFTC Rules.[10] Instead, it adopted a requirement that risk disclosure statements be given to

[7] *Levi-Ziligman v. Merrill Lynch Futures, Inc..*, Comm. Fut. L. Rep. (CCH) ¶25,767 (C.F.T.C. 1993).
[8] *ADM Investor Services, Inc. v. Collins*, 515 F.3d 753 (7th Cir. 2008).
[9] *Baker v. Edward D. Jones & Co.*, Comm. Fut. L. Rep. (CCH) ¶21,167 at 24,772 (C.F.T.C. 1981).
[10] Proposed Standards of Conduct for Commodity Trading Professionals for the Protection of Customers, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,474 at 21,928 (Sept. 6, 1977).

customers so as to warn them of the risk of commodity trading and the need to determine for themselves if they are suitable for the contemplated transaction (i.e. whether or not they can "afford to lose" the funds invested). The practice of providing risk disclosure statements has been upheld by the CFTC since 1978 and is effectively in use across the commodities and futures industry as the appropriate treatment of the issue. In addition, due to the nature of commodities and futures trading and the unique elements of each relationship between a trader and the traded commodity or his trading style, the CFTC has been unable to formulate meaningful standards of a universal suitability application. This means that in the world of commodities, it is not possible to establish a standard whereby all traders are uniformly judged according to whether or not they can afford to lose their investment.

C. Proposed Regulation 5.9 Will Likely Increase Risk to Forex Customers

Upon adoption of proposed Regulation 5.9, retail forex dealers registered in the United States will no longer be able to compete with foreign based retail forex dealers, who routinely offer forex trading to customers at leverage levels of 200:1 or greater. Consequently, U.S. registered dealers will be forced out of the forex business, and U.S. customers will be forced deal with foreign based, unregulated retail forex dealers. Thus, instead of reducing U.S. customers' exposure to risk, the proposed requirement increases it.

The NFA has recently adopted leverage restrictions of 100:1 on major currencies and 25:1 on non-major currencies. We believe that these restrictions will enable U.S. registered retail forex dealers to effectively compete with foreign based forex dealers.

The most significant threat to a forex customer is not risk; it is the element of fraud that has been allowed to fester due to inadequate regulatory oversight of industry professionals. The CFTC very effectively addresses this element of the industry in the other proposed rules found in RIN 3038-AC61. By requiring intermediaries to register, increasing net capital requirements, and properly defining forex transactions so that nefarious individuals are prohibited from operating outside the regulatory structure, the CFTC is effectively working to protect investors from fraud. Altering margin requirements serves no purpose in the fight against fraud and may in fact promote fraud if it serves to drive business away from U.S. regulatory jurisdiction and to other regulatory or non-regulatory environments that do not share the same vigilance towards customer protection.

As previously expressed, PFGBEST strongly endorses the regulatory initiatives of the CFTC that focus on investor protection. For the reasons stated above, we do, however, oppose the proposed requirement that that IBs and FCMs and RFEDs enter into guarantee agreements and the proposed Regulations 1.10, 5.5, 5.7, and 5.9.

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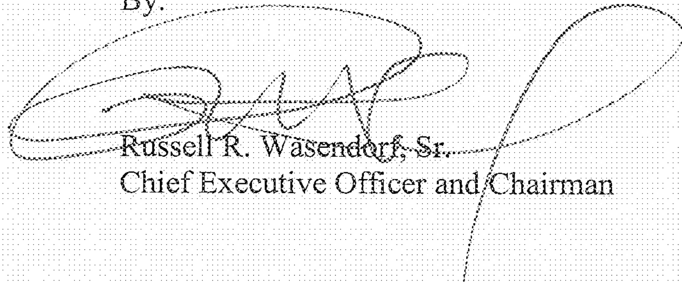
Thank you for your time and consideration of our points. Please do not hesitate to contact us if you wish to further discuss our views.

Sincerely,

PFGBEST
By:



Russell R. Wasendorf, Sr.
Chief Executive Officer and Chairman

cc: Attached List

cc: Hon. Gary Gensler, Chairman
Hon. Michael Dunn, Commissioner
Hon. Jill E. Sommers, Commissioner
Hon. Bart Chilton, Commissioner
Hon. Scott D. O'Malia, Commissioner

Division of Clearing and Intermediary Oversight
Ananda Radhakrishnan, Director

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Dan Berkovitz, General Counsel

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