

From: Nancy Paschen <NPaschen@NFA.Futures.Org>
Sent: Monday, March 22, 2010 1:04 PM
To: secretary <secretary@CFTC.gov>; Penner, William <WPenner@CFTC.gov>
Subject: Comment Letter
Attach: 2010 0322.pdf

Good afternoon,

Attached is a Comment Letter regarding Regulation of Retail Forex.

Nancy Paschen



March 22, 2010

Via E-mail: secretary@cftc.gov

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

Re: Regulation of Retail Forex

Dear Mr. Stawick:

National Futures Association ("NFA") appreciates the opportunity to comment on the Commission's proposed rules regarding the regulation of off-exchange retail foreign currency transactions ("forex"). NFA applauds the Commission for proposing these rules, which will both provide important protections to retail customers and bring greater regulatory certainty to the retail forex industry. Below NFA addresses a few of the more important aspects of the Commission's proposed rulemaking in areas relating to security deposits, trading practices, and the mandated registration requirements.

Security Deposits

The Commission proposes that retail foreign exchange dealers ("RFEDs") and certain futures commission merchants ("FCMs") acting as forex counterparties collect and maintain security deposits equal to ten percent of the notional value of each forex transaction with a retail customer.¹ As you are aware, NFA initially adopted its

¹ In proposing its security deposit level, the Commission notes NFA's current leverage limitations and that FINRA has proposed to limit the maximum leverage limitation on certain retail forex transactions offered by broker-dealers to 4 to 1. NFA notes that FINRA may have a greater interest in addressing the financial integrity protection objective solely through a security deposit requirement and, therefore, set a higher percentage since FINRA broker-dealers engaging in retail forex are not subject to a \$20 million minimum net capital requirement. Moreover, NFA also notes that FINRA's percentage level may be higher since FINRA has not sought to address the



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own security deposit requirements for forex transactions in 2003 when the Forex Dealer Member ("FDM") minimum net capital requirement was \$250,000. NFA Financial Requirements Section 12 mandates that NFA's Forex Dealer Members collect 1% of the notional value of transactions in ten different major currencies² and 4% of the notional value of transactions in other currencies.

In adopting our requirements, we were guided by two public policy objectives—the financial integrity of FDMs and the protection of retail customers who engage in these principal-to-principal transactions. Satisfaction of these two objectives led us to establish security deposit percentages that were approximately in line with the then existing margin requirements for exchange-traded foreign currency futures at the Chicago Mercantile Exchange ("CME"). NFA's security deposit requirements, like the SPAN margin levels set by CME, recognize that currencies can have differing risk and levels of volatility. Because of these factors, NFA established the security deposit requirement for transactions in the major currencies at a lower percentage than transactions in more exotic currencies.

Over the years, NFA has found that our security deposit requirements have served our two public policy objectives well. As to financial integrity, NFA's security deposit requirements help protect, in part, forex counterparties from absorbing losses of defaulting customers which, if significant, could affect the counterparty's capital and put the funds of other customers at risk. Although the prevention of counterparty default is always of paramount concern, the lack of bankruptcy protections afforded to forex customer funds significantly heightens this concern.

customer protection objective separately by adopting the extensive risk disclosures requirements already in place by NFA and the new customer performance disclosures proposed by the Commission.

² Major currencies that qualify for the 1% security deposit are the British pound, the Swiss franc, the Canadian dollar, the Japanese yen, the Euro, the Australian dollar, the New Zealand dollar, the Swedish krona, the Norwegian krone, and the Danish krone.



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To date, we are not aware of any situations in which an FDM's capital has been impaired due to its failure to collect customer debits. Of course, we also recognize that forex counterparties generally use real-time systems for collecting security deposits so that as a position moves against a customer the counterparty draws on reserves from the customer's account to maintain the security deposit level of 1% or 4%, as applicable. Additionally, as the Commission recognizes, under current auto-liquidation practices forex counterparties usually close out customer positions before an account's losses exceed its initial investment. These auto-liquidation practices, implemented by most firms, distinguish the retail OTC forex from exchange traded futures. Our experience indicates, however, that not all FDMs have implemented these close-out practices and, therefore, a forex counterparty's financial protection remains an appropriate public policy rationale for a security deposit requirement.

As noted above, NFA's second public policy objective relates to customer protection and sales practices. We agree with the Commission that at certain leverage ratios even minor fluctuations in volatile currency markets can result in customers having their positions liquidated with significant trading losses resulting—much faster than retail customers may realize. Of course, the Commission's proposed Rule 5.18(i) relating to the quarterly disclosure of customer account performance also serves as a tool to satisfy this customer protection objective, and ensures that retail customers have a full understanding of the attendant risks and leverage involved in these transactions so that they may make an informed decision. This is particularly important in these counterparty transactions where an RFED or FCM is on the opposite side of the transaction, which differs from an exchange traded transaction in which an FCM acts only as an intermediary. NFA encourages the Commission to consider the impact of this disclosure, if adopted, in formulating its security deposit requirements.

Although, for the reason explained below, NFA has not changed the percentages in our security deposit requirements, we have amended Financial Requirements Section 12 in an effort to bolster this second public policy objective. Specifically, in February 2009, NFA eliminated a prior exemption for certain highly capitalized FDMs from collecting security deposits. At that time, eight of NFA's 21 FDMs had an exemption from collecting minimum security deposits. Of these eight, one offered leverage of 700:1, four offered leverage of 400:1, two offered leverage of 200:1, and one offered leverage of 50:1. One of the firms without the exemption also offered leverage of 50:1. Based on our experience, a proportionately greater number of the



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firms that offered higher leverage had also been the subjects of NFA complaints, while neither of the firms that offered 50:1 leverage had ever been the subject of an NFA or CFTC enforcement action. These statistics not only indicate that higher leverage ratios can lead to abuses but also indicate that FDMs can compete while offering leverage of 100:1 or less. In eliminating this exemption, NFA was cognizant of the importance of balancing customer protection with both domestic and foreign competitive concerns,³ particularly when regulations in this area could easily drive U.S. customers overseas to less regulated trading venues.

NFA acknowledges that the Commission in proposing its security deposit requirements relied upon the same two public policy objectives as NFA. Therefore, we encourage the Commission to follow two basic guidelines in adopting final requirements in this area that we also found beneficial.

First, since the foreign currency market is not static, NFA recommends that the Commission reject a one-size-fits-all approach to establishing security deposit requirements. Based upon currency risk and volatility factors, NFA believes that security deposit requirements should recognize differences between certain currencies. Therefore, NFA recommends that the Commission adopt an approach similar to NFA's current requirements that applies a different percentage to separate currency categories or groupings based on currency risk and volatility factors.⁴ We also believe that setting a different percentage amount for each individual currency may be an alternative but is obviously more complicated to administer.

³ NFA notes that a major U.S. bank offers retail forex trading with security deposit amounts ranging from 2% to 8% depending on the currency.

⁴ NFA notes that the Investment Industry Regulatory Organization of Canada ("IIROC") takes a similar approach in setting forex margins. Specifically, the IIROC total margin requirement includes three components—a spot risk margin requirement, a term risk margin requirement, and a margin surcharge mechanism which adjusts the margin rate for a specific currency if the volatility of the currency exceeds a predetermined historic volatility threshold. Current margin rates are EUR/USD: 3%; USD/CAD: 3%; USD/GPD: 3.4%; USD/JPY: 3%; and CAD/SGD: 10%.



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Second, whoever sets the security deposit percentage levels—the CFTC or an SRO—should recognize that the requirements must be flexible, and continually evaluated and adjusted, if necessary. For example, pursuant to NFA Financial Requirements Section 12, NFA's Executive Committee has the authority to adjust NFA's security deposit requirements under extraordinary market conditions. Even absent extraordinary market conditions, however, NFA believes that security deposit requirements should be periodically reviewed and adjusted, if necessary.

To that end, NFA regularly compares our security deposit percentages to the CME's margin requirements, and we review our requirements in light of the prevailing practices in the forex market. As NFA noted in our February 23, 2009 submission letter to the CFTC regarding the amendments to Financial Requirements Section 12's security deposit requirements, CME margins are higher than they were at the time Section 12 was adopted. Specifically, as of December 24, 2008, margins for the major currencies averaged 5.6% and ranged from 3.5% to 8.2%. Margins for the other currencies averaged 8.1% and ranged from 3.2% to 12.5%. A more recent analysis shows that margins for the major currencies averaged 3.4% and ranged from 2.3% to 5.4%. Margins for the other currencies averaged 5.7% and ranged from 3.0% to 8.1%.⁵ Given the 2008 data, NFA recognized in early 2009 that NFA Financial Requirements Section 12's security deposit percentages could be adjusted upward but we resisted proposing these changes pending the Commission's proposed security deposit rules.

NFA appreciates the Commission's efforts in balancing various competing interests and regulatory objectives in establishing security deposit requirements. NFA encourages the Commission to recognize the different market risks and volatility posed by different currencies and adopt requirements reflective of those differences as exchanges routinely do in establishing their margin levels. Additionally, regardless of who sets the security deposit requirements and the percentage amount(s), NFA urges the Commission to endorse or adopt some mechanism to allow for periodic review and adjustment of the requirements if necessary.

⁵ An analysis of listed currency contracts on NASDAQ OMX, formerly the Philadelphia Board of Trade, reveals an average margin of 1.3%, ranging from .99% to 1.47%, for major currencies and a margin of 6.27% for the Mexican Peso.



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Trading Practices

The Commission's proposed Rule 5.18(f)(3) requires that if a forex counterparty provides a new bid price that is higher or lower it must also provide a new ask price that is equally higher or lower. NFA fully supports this proposed rule but urges the Commission to clarify the proposal to ensure that all requote practices are objective and evenhanded and that a counterparty that requotes customers must do so regardless of the direction in which the market has moved and have in place symmetrical tolerance thresholds for quoting. Additionally, NFA recommends that the Commission also require counterparties to disclose to customers how orders that reach the platform at a price no longer available are handled. At this time, NFA also encourages the Commission to carefully consider any comments it might receive from forex counterparties regarding the proposed trading practices requirements to ensure that they are appropriately crafted to meet both regulatory objectives and forex business practices.

Registration

For many years, NFA advocated that persons introducing forex accounts, managing forex accounts, or operating pools trading forex should have to register with the Commission. Requiring forex intermediaries to register with the Commission as introducing brokers ("IBs"), commodity trading advisors ("CTAs"), or commodity pool operators ("CPOs"), as applicable, is an extremely important customer protection feature. NFA also believes that the following technical amendments will provide greater clarity in the forex registration area.

The Commission's proposed rules provide that either an RFED or an FCM that is primarily and substantially engaged in traditional futures activity may act as a forex counterparty. The proposal requires any IB introducing retail forex accounts to an RFED or FCM that is primarily and substantially engaged in traditional futures activity to be guaranteed by that RFED or FCM. NFA believes that the Commission intends to require a forex IB guaranteed by an RFED to open and carry customer accounts exclusively with that RFED. As drafted, the proposed rules do not make this clear. NFA recognizes that in August 2007 the Commission's Division of Clearing and Intermediary Oversight issued an advisory that, among other things, indicated that Rule 1.57 encompasses forex transactions, but at that time the RFED counterparty category had



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not been created and, therefore, the advisory only refers to guarantor FCMs. Moreover, Commission Rule 1.57(a)(1) would appear to impose this exclusivity requirement on IBs as to FCM guarantors, but not RFEDs. NFA recommends that Rule 1.57 be amended to reference both FCMs and RFEDs, or alternatively a new rule adopted to provide the required clarity.

NFA also believes that there are additional issues relating to an RFED's guarantee of forex IBs that require more clarity. Pursuant to the proposed rules, if a firm engages in retail forex and conducts a minimal amount of on-exchange business that is not enough to meet the "primarily and substantially engaged" criteria, it must also be registered as an FCM to engage in on-exchange futures. Further, an RFED is prohibited from entering into a guarantee agreement with an IB that conducts on-exchange futures business because an RFED alone cannot engage in exchange-traded futures business. Therefore, as written, the proposal creates some uncertainty regarding who an RFED that is also registered as an FCM ("RFED/FCM") may guarantee. For example, if an IB only conducts on-exchange futures activities, may an RFED/FCM guarantee the IB pursuant to its FCM registration? Additionally, if an IB is a "dual-purpose IB" that conducts both forex and on-exchange futures business may the RFED/FCM guarantee the IB? Finally, if an IB only conducts on-exchange futures business as an IB but is also registered as a CPO or CTA for purposes of managing forex accounts or operating forex pools, may an RFED/FCM guarantee the IB? NFA believes that RFED/FCMs should be permitted to guarantee IBs under the three circumstances described and requests that the Commission's final rules address these registration permutations.⁶

Lastly, NFA strongly encourages the Commission to provide firms with adequate time to register or comply once its rules become final and effective. Time will be necessary for not only new entrants but also current registrants if the Commission's rules are adopted as proposed. For example, NFA currently has over 100 independent introducing brokers ("IBI") Members that engage in retail forex activities. Many of these

⁶ NFA recognizes that the Commission's final rules could permit guaranteed and non-guaranteed IBs to introduce forex accounts, possibly satisfying its customer protection objectives by requiring non-guaranteed forex IBs to maintain a higher capital requirement than independent IBs dealing in exchange-traded products. Even in such a case, these questions must be addressed with regard to guaranteed IBs.



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firms are also engaged in exchange-traded futures activities. As noted above, the Commission's proposed rules require any IB that introduces retail forex accounts to an RFED or FCM that is primarily and substantially engaged in exchange-traded futures activity to be guaranteed by that RFED or FCM. Therefore, NFA's current IBs may have to significantly alter their business. For example, if an IB currently introduces its retail forex accounts to an RFED or FCM-only firm that is primarily and substantially engaged in exchange-traded futures activity, then the IB must—(1) become a guaranteed IB of that RFED or FCM; (2) cease engaging in retail forex activities and remain independent; or (3) find another RFED or FCM-only firm that will guarantee it.

Conclusion

NFA commends the Commission and its staff for putting forth proposed retail forex requirements that will provide greater protection to forex customers and regulatory certainty to firms engaging in retail forex transactions. As always, NFA stands ready to assist the Commission in this endeavor. If you have any questions concerning this letter, please do not hesitate to contact me at (312) 781-1413 or tsexton@nfa.futures.org.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "T. Sexton", is written over a large, faint, circular watermark or background graphic.

Thomas W. Sexton
Senior Vice President and
General Counsel

cc: William Penner (wpenner@cftc.gov)

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