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COMMENT
CL-08888

From:	Michael Stumm <stumm@oanda.com>
Sent:	Monday, March 22, 2010 4:11 PM
To:	secretary <secretary@CFTC.gov>
Cc:	Michael Borland <mborland@oanda.com>
Subject:	Regulation of Retail Forex
Attach:	CFTC letter v2.pdf

Dear Mr. Stawick,

please find attached our comments with respect to the proposed rule on **Regulation of Retail Forex (RIN 3038-AC61)**

We unsuccessfully tried to fax it to your (202) 418 5521 number, as it appears your fax machine/line is down.

Kind regards,

Michael Stumm
OANDA Corporation

OANDA

THE CURRENCY COMPANY

OANDA Corporation
140 Broadway
46th Floor
New York, NY 10005
Tel: +1 212 858 7690

March 22, 2010

Via E-mail: secretary@cftc.gov and Fax: (202) 418–5521

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

Re: Regulation of Retail Forex --- RIN 3038-AC61

Dear Mr. Stawick,

OANDA very much welcomes the Commission's proposed rules regarding the regulation of off-exchange retail foreign currency transactions ("forex"). We are particularly pleased with the removal of the so-called "Zelener" loophole, the anti-fraud measures, the introduction of additional transparency, the financial requirements, and the increased regulatory oversight of Introducing Brokers ("IBs"), Trading Advisors, and Pool Operators.

I would like to take this opportunity to address some of the more important aspects of the Commission's proposal. As co-founder and CEO of OANDA Corporation (an NFA-registered Forex Dealer Member and CFTC-registered FCM operating as a forex market maker since 2001), as Chairman of the National Futures Association (NFA) Forex Dealer Member Advisory Committee, and as a Professor at the University of Toronto, I believe my insight into the forex market and its operations qualifies me to comment on the proposed rules.

OANDA has always supported regulatory oversight of the industry and the protection of retail forex customers. As one of the world's leading FDMs and the most highly capitalized FDM registered with the NFA, OANDA agrees fully with the intent and objectives of the rules proposed by the Commission. However, OANDA has serious concerns with §5.9 limiting leverage to 10:1, and minor concerns with:

- §5.5(e) requiring the disclosure of the number of accounts and the percentage of those that were profitable / unprofitable;
- §5.16 prohibiting guarantees against customer loss; and
- §5.18(f) restricting requoting.

We outline our reasoning below.

§ 5.9 Security deposits for retail forex transactions.

OANDA strongly objects to the 10:1 leverage limit stipulated by the proposal on the grounds that:

a. it is not in the best interest of the retail trading public in that it increases client risks;
b. the choice of 10:1 appears to be arbitrary and unreasonable;
c. it is highly anti-competitive; and
d. it weakens the business environment in the U.S.

Choice of 10:1 increases the risks for retail trading clients

Restricting leverage to 10:1 actually increases the risks faced by the retail trading public in several ways. The most immediate impact is that clients will be forced to deposit a greater amount of funds with their FDM in order to trade at their accustomed levels, and arguably, FDMs provide less security on deposited funds than banks and savings institutions where funds are protected by FDIC insurance, and they provide less security than FCMs where client funds are segregated.

Under these proposed rules, a $1 million position, say, in USD/CAD at 10:1 leverage will require a deposit of $100,000. By way of contrast, under the current NFA limit of 100:1 this same position requires a deposit of only $10,000. In other words, with a leverage limit of 10:1, clients risk $100,000 of capital whereas they only risk $10,000 with a leverage limit of 100:1. (Note that all FDMs have implemented real-time margin checking with auto-liquidation, where the positions are closed automatically when margin capital becomes insufficient, thus limiting a client’s losses to the amount deposited.)

Secondly, lowering leverage to a maximum of 10:1 will lead to an increase in the number of margin calls clients will incur, resulting in greater loss of clients’ capital. To understand why lower leverage counter-intuitively increases (and not decreases) the number of margin calls incurred, one must understand that the vast majority of clients trade responsibly and do not typically trade close to their margin limit. At OANDA, for example, the average client trades using an average leverage of 4:1.

For these clients, having higher leverage available is important because it allows more leeway for those short periods when currency price movements are particularly volatile. Indeed, this is the primary defence used to manage the risk of short-term volatility triggering a margin call. With lower leverage restrictions, clients will be forced to trade closer to the margin limit because of the attendant higher capital requirements. As a result, they will be more susceptible to margin calls and find it more difficult to preserve their capital.

As an analogy, vehicle engines do not need to be very powerful to maintain 55 miles per hour driving on a highway, but more power is needed for short bursts to ensure sufficient acceleration to highway speeds without disrupting the overall flow of traffic. Similarly, higher leverage is needed during short periods of time to better deal with the short-term volatility that often follows an event such as an important news announcement.

We have statistically analysed the frequency of margin calls that occurred on OANDA FXTrade accounts over the last 5 years, and were able to substantiate that clients trading at 10:1 incurred margin calls 30% more frequently than clients trading at 20:1.

Finally, a 10:1 leverage limit may add further to the risks of those this proposed amendment seeks to protect, because many clients, for whom having a leverage larger than 10:1 is important, will likely take their business elsewhere and begin trading in a jurisdiction that offers higher leverage. For these clients, the danger, of course, is that they could very well be moving their business to a location with less stringent regulatory requirements, where they are far less protected.

The choice of a 10:1 leverage limit appears arbitrary and unreasonable

A significant issue with the proposed 10:1 leverage restriction is that the choice of 10:1 appears arbitrary. No scientific, economic, financial, or empirical reasoning behind the choice of 10:1 has been provided. The proposal states that the Commission selected 10:1 because FINRA was proposing 4:1, while the NFA recently reduced the maximum leverage to 100:1, and 10:1 falls somewhere between these two limits. However, FINRA's proposal for 4:1 was chosen just as arbitrarily. Moreover it would apply to firms that have significantly lower capital requirements. NFA's 100:1 restriction – in effect since November 2009 – at least has some empirical reasoning behind it. The NFA – rightly, in our view – observed that leverages as high as 200:1 or even 400:1 were not healthy to most trading clients, and hence they decided to bring it down to 100:1.

This raises the question of why 10:1 is a reasonable limit. Why is 20:1 or 30:1 or 50:1 or 100:1 unreasonable? It is notable that other very strong and conservative regulatory regimes allow FDMs to offer significantly more leverage than what the Commission is proposing. For example:

- in Great Britain, the FSA allows virtually unlimited leverage
- in Singapore, the MAS allows 50:1
- in Japan, the JFSA allows 50:1, with a further tightening to 25:1 next year

While some believe that the regulators in these jurisdictions will also further tighten leverage should the Commission adopt a limit of 10:1, I would argue that these jurisdictions fully understand the economic and business advantages of allowing higher leverage than the proposed U.S. limits. Further, I would suggest that with the potential inflow of capital and creation of jobs, it is unlikely that non-U.S. regulators will adopt 10:1 in order to maintain a competitive advantage.

There should be some (scientific, economic, financial, or empirical) reasoning behind any limit on leverage. In particular, we believe that a static, one-size-fits-all rule, as is currently being proposed, does not take real market conditions into account. Different currency pairs have different historical volatilities that can change significantly over time, and different currency pairs have different degrees of liquidity. Hence, we would argue that any rule on leverage should take these factors into account. In that sense, we believe that the Canadian regulators have taken a more sensible approach in limiting leverage, since the leverage limit they impose is a function of a currency's volatility. For example, the Canadian IIROC imposes a leverage limit of:

- 33:1 on EUR/USD and other major, highly liquid currency pairs, such as the USD/CAD;
- 25:1 on USD/JPY; and
- 10:1 on USD/SGD.

Canadian FDMs are also required to monitor volatility of each currency pair and automatically reduce leverage if volatility increases unexpectedly. At least this approach is rooted in some reasoning. (For the formal regulation 100.2(d), see http://iiroc.knotia.ca/Knowledge/View/Document.cfm?Ktype=445&linkType=toc&dbID=200706346&tocID=428)

In a further indication that the 10:1 leverage limit is arbitrary, the CFTC lists two reasons for limiting leverage to 10:1 in the new proposed rules:

1. to protect the clients from losing more than their account balance if their positions cannot be closed out in a timely fashion because of the "extreme volatility of the foreign exchange markets", and
2. to protect against counterparty risk should the FDM become insolvent.

These are worthy objectives. However, as reasons for limiting leverage, neither holds much merit in today's retail forex market. Reason (1) above does not take into account the fact that all NFA-regulated FDMs have implemented sophisticated technology to monitor margin-checking in real time, and to automatically liquidate client positions as soon as the account balance falls below margin requirements. This limits the losses a client can incur and is in direct contrast to how typical FCMs monitor margin requirements.

OANDA, for example, checks the margin of every account every second. This technology was tested several years ago when the price of Silver dropped by 15% within 30 minutes – one of the most extreme market moves imaginable. Yet even with such historic price movements, clients did not lose more than their account balances.

Moreover, Reason (1) above does not take into account the fact that:

- forex prices on the major pairs are, despite conventional thinking, actually far less volatile than equity prices or commodity futures prices;
- the forex market is open and active 24 hours a day (in contrast to the futures and equity markets); and
- the forex market is the most liquid market in the world, and is several orders of magnitude more liquid than both the futures and equity markets.

As for Reason (2) above: limiting leverage does not help protect against counterparty risk. This is better addressed by increasing capital requirements, and by protecting client funds by allowing them, for example, to reside in segregated accounts. Besides, counterparty risk has not played a factor in spite of the recent financial system turmoil --- we are unaware of there being even one case of an FDM regulated by the CFTC/NFA to have become insolvent, placing client funds at risk. In fact, the currently regulated FDMs are far better capitalized than most financial firms – especially when one considers the larger banks. The ratio of client deposits to FDM capital ranges from 1:1 to 5:1.

These facts indicate that the risks the CFTC are trying to address are significantly lower for OTC spot forex trading than for any other market. Despite this, the CFTC allows close to 50:1 leverage on, say, EUR/USD futures (a point we will address below). It is also important to point out that the FDMs themselves do not enter into leveraged positions (a la Lehman's), and hence, are themselves not exposed to the risks associated with leveraged trading.

The choice of a 10:1 leverage limit is anti-competitive

The arbitrary choice of 10:1 is anti-competitive along many dimensions.

1. It is anti-competitive vis a vis the banks that may offer 100:1 and higher. (Consider, for example, dbFX or CitiFX.)
2. It is anti-competitive vis a vis similar forex instruments that are traded over the Chicago Mercantile Exchange (CME) or the NASDAQ, which are also regulated by the CFTC. In some cases, these exchange-traded instruments can be traded with close to 50:1 or even 100:1 leverage. This level of leverage is permitted despite the fact that the OTC forex market is far more liquid and is active 24/5. Also, CME forex instruments, including futures and options, are primarily derivates based on the OTC spot forex underlyings, which are not derivatives.
3. It is anti-competitive vis a vis FDMs that operate out of other conservatively-regulated jurisdictions offering higher leverage. This will assuredly cause many international clients currently trading with U.S.-based FDMs that now have funds deposited with U.S. banks, to move their accounts and funds to other jurisdictions (for example to SaxoBank in Denmark).

The choice of a 10:1 leverage limit weakens the business environment in the U.S.

There is no question that the CFTC-regulated FDMs will lose a significant amount of business should the 10:1 limit become rule. Firstly, it will cause trading volume to decrease significantly. Secondly, existing clients of CFTC-regulated firms will flee to foreign firms (often to foreign subsidiaries of the same firms). For example, over 75% of OANDA's clients are non-U.S. persons. Currently, they deposit margin capital that is held in U.S. banks, and are protected by the regulations of the CFTC/NFA. However, if the 10:1 limit proposal is implemented, these clients will likely move their accounts offshore.

As a result, the U.S.-based FDMs will transact far lower trading volumes, resulting in lower revenues, together with the following attendant consequences:

1. the IRS will generate less tax revenue;
2. the FDMs will downsize, resulting in significant job losses; and
3. the fees paid to the NFA will be greatly reduced, making it more difficult for the NFA to enforce the rules and investigate unscrupulous actors in our industry.

Historical Perspective

A 10:1 leverage restriction for U.S.-based FDMs will definitely damage the industry in the U.S. and make it less competitive internationally, which in the end is disadvantageous for the trading public. I personally find this disappointing considering the huge positive transformation the forex industry has gone through over the last ten years. These changes were driven to a large extent by the offerings from the very forex dealers being negatively affected by the new rules.

This seems at odds with history as the United States has long been home to some of the world's most innovative companies. For their part, U.S. FDMs have played a key role in bringing innovation to the forex market. Consider:

- Ten years ago, forex trading was available only for corporates and well-to-to clients, where a credit line was necessary and the minimal trade size was $1 million. The forex dealers opened the forex market to new market segments making it accessible to all. Today, there is much flexibility in ticket sizes. OANDA takes this to the extreme, where tickets can be for any odd lot as low as $1. Other FDMs allow trading in sizes as low as $10,000 or $25,000.
- Ten years ago, the typical spread on EUR/USD was between 5 and 8 pips. Today it is below 1 pip. This is a massive reduction in the cost of trading, and today, forex is arguably the asset class that has the lowest cost of trading. (The reduction of cost to the trading public is similar to the dramatic reduction in price of computer hardware.)
- FDMs introduced margin-based trading to the forex market whereas previously it was all based on credit. This has been a key aspect in opening up the market to more participants.
- Reporting and account statistics are now updated in real time – something still not available with many of the forex banks.
- Forex trading has been brought to the Internet, making it accessible to all.
- The reliability and up-time of trading systems of the forex dealers is significantly better than those of the largest forex banks. This is primarily due to the fact that retail clients are far more demanding than institutional and professional clients.
- The quality of pricing has increased dramatically. Pricing from the major forex banks still include invalid spikes on a daily basis, something retail clients will not accept. Forex dealers have largely eliminated the spikes.
- There is now an unprecedented degree of transparency, with firms such as OANDA publishing their spreads, the order book, and their clients' positions.

I personally view this all as huge progress, but I am worried that a 10:1 leverage limit and its consequences will move this type of innovation offshore. There is clearly a demand for services offered by the forex dealers, as the number of live retail forex accounts has grown from zero, to hundreds of thousands over these last ten years.

§5.5(e) requiring the disclosure of the number of accounts and the percentage of those that were profitable / unprofitable

OANDA has always firmly believed in full transparency, and this rule is a step in the right direction. However, we have three concerns:

1. The metrics that must be published are not defined in sufficient detail, leaving too much open to interpretation, in turn making comparisons difficult.
2. The proposed metrics are misleading, considering that a significant portion of clients use forex trading for hedging purposes, where a trading loss is not a loss in the traditional sense.
3. This rule is also anti-competitive because it singles out forex dealers. Why does this rule not apply across all products?

§5.16 prohibiting guarantees against loss

Firms should be allowed to guarantee that clients do not lose more than their account balance. OANDA has provided this guarantee for quite some time, and is able to do this because of the technological advancements OANDA has pioneered. OANDA's systems check margin requirements for every account, every second, and can auto-liquidate positions if the account balance falls below margin requirements.

§5.18(f)(3) restricting requoting

OANDA understands and supports the objectives of this rule, but the rule does not take into account the spread volatility that occurs in the forex market. The rule, as stated, would be fine the vast majority of time, but during news announcements, spreads can increase dramatically, which might legitimately cause the new bid price to be higher and the new ask price to be lower. This could make it very difficult for FDMs to adhere to the rule without losing money on the transaction.

In closing, OANDA appreciates having been given the opportunity to comment on the Commission's new rules for forex trading. To be clear, OANDA is in favour of the intent and objectives of the proposed rules. We understand that there is much fraud in the industry which needs to be addressed. However, it is important to point out that the registered FDMs have not been implicated of fraud, and the proposed 10:1 limit does not address the fraud issue itself. We do believe that the rules proposed by the Commission – with the exception of the 10:1 leverage limit – will indeed help to reduce fraud. This is why OANDA supports the overall proposal, but respectfully asks that the Commission withdraw the limit of leverage to 10:1.

Sincerely,

Michael Stumm,
Chief Executive Officer