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COMMENT
CL-08895

From: Tammy Botsford <tbotsford@futuresindustry.org>
Sent: Monday, March 22, 2010 4:42 PM
To: secretary <secretary@CFTC.gov>
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Subject: Regulation of Retail Forex - FIA Comment Letter
Attach: FIA FINAL comment CFTC Retail Forex Transactions & Intermediaries.pdf

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Attached please find the Futures Industry Association's comment letter regarding proposed regulation of off-exchange retail foreign exchange transactions and intermediaries.

Please do not hesitate to contact me with any questions.

Tammy

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March 22, 2010

David Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Proposed Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries, 75 Fed. Reg. 3282 (Jan. 20, 2010)

Dear Mr. Stawick:

The Futures Industry Association[1] submits these comments on the Commodity Futures Trading Commission's Notice of Public Rulemaking entitled "Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries." FIA supports almost all aspects of the Commission's proposal, and strongly supports the overarching goal of the rulemaking: to protect customers and prevent fraud in the retail FX business.

Congress has made protecting customers one of the cornerstone purposes of the Commodity Exchange Act (CEA § 3(b)). FIA fully supports that statutory mandate and has itself proposed changes to the CEA that Congress has enacted to strengthen customer protection and fraud prevention in the retail FX business. We applaud the Commission for thoroughly implementing the new rulemaking powers granted in the Commodity Futures Trading Commission Reauthorization Act of 2008.

FIA does oppose three aspects of the Commission's proposals and offers one conceptual comment for Commission consideration. While our letter will focus on those areas of disagreement, we do not want that focus to be misread as a negative appraisal of the Commission's entire customer protection package. Nothing could be further from the truth. FIA believes that the overall strength of the Commission's proposed reforms, when implemented

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[1] For the record, FIA is a principal spokesman for the commodity futures and options industry. FIA's regular membership is comprised of approximately 30 of the largest futures commission merchants ("FCMs") in the United States. Among its associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of its membership, FIA estimates that its members effect more than eighty percent of all customer transactions executed on United States designated contract markets.

fully and enforced vigorously, should make it unnecessary to adopt the elements of the Commission's proposal which we question.

Where we disagree with the Commission's proposal, we believe customer protection actually would be better served by a different approach. FIA urges the Commission to reconsider its ten percent security deposit requirement because National Futures Association's current standards, when coupled with the rest of the Commission's new reforms, will better protect customer interests. FIA would ask the Commission to wait until its reforms have taken full effect before reconsidering whether any changes to NFA's security deposit levels are warranted. FIA also requests that the Commission modify one element of its mandated disclosures and clarify its proposal that all the introducing brokers (IBs) must be guaranteed by retail foreign exchange dealers (RFEDs) or futures commission merchants (FCMs).

I. THE TEN PERCENT SECURITY DEPOSIT SHOULD NOT BE ADOPTED

The Commission proposes a new security deposit requirement for retail FX trades. Proposed Regulation 5.9 would require each RFED or FCM that engages in retail FX transactions to collect from customers a security deposit equal to ten percent of the notional value of the retail FX transaction.[2] *See* Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries, 75 Fed. Reg. 3282, 3290-91 (Jan. 20, 2010). This rule effectively imposes a leverage limit of 10 to 1 on these transactions; for $100 of notional FX exposure, a customer must post $10.

This security deposit level would expose customers to greater potential losses than current law. National Futures Association rules, which the CFTC has reviewed and approved, allow for 100-1 leverage for major currencies and 25-1 leverage for other currencies.[3] NFA's original security deposit rule went into effect on December 1, 2003. It required customers to post a security deposit equal to two percent of the notional value of transactions in "major currencies" and four percent of the notional value of transactions in all other currencies.[4] In 2004, NFA amended this rule so that customers could post a security deposit of one percent of

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2 With respect to short options, Proposed Regulation 5.9 requires that the customer post a security deposit of ten percent of the notional value of short retail forex options in addition to the premium received. For long options, the customer must post the full premium received.

3 With respect to options transactions, the NFA's leverage rule is identical to Proposed Regulation 5.9.

4 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 were specified as "major currencies."

the notional value for transactions in "major currencies."[5] Originally, NFA instituted a security deposit requirement as a way to ensure that FX dealers did not offer customers so much leverage that the customer would have little chance to profit. NFA also wanted to ensure that its security deposit requirement would be in line with that allowed for retail FX customers of banks and other dealers in the international currency market. *See* National Futures Association, Letter to Jean A. Webb, Commodity Futures Trading Commission Re: National Futures Association: Proposed Amendments to NFA Bylaws 306 and 1301, NFA Compliance Rule 2-36 and Section 1 of NFA's Code of Arbitration, and Proposed Adoption of Sections 11 and 12 of NFA Financial Requirements and an Interpretive Notice entitled, "Forex Transactions with Forex Dealer Members" (Jun. 2, 2003).

FIA believes current NFA's security deposit requirements provide more customer protection than the Commission's proposal. Setting a security deposit level requires finding a balance point. On the one hand, the security deposit level should not be so low as to be rigged or inherently fraudulent -- whereby "super" leverage and normal price volatility will combine to make it virtually impossible for a customer to profit from trading. (Before NFA stepped in years ago, some retail FX firms did just that.) On the other hand, once a security deposit is set at a level that allows the customer a fair opportunity to profit, the level should not be set too high because it actually could lead to greater customer losses.

In our view, NFA's security deposit levels set an appropriate balance and should be retained, at least until the Commission has had an opportunity to observe how those levels will work within the new and extensive customer protection regime the Commission is proposing. The Commission's proposal to increase the NFA levels by either 400% or 1000% should be held in abeyance. As we will discuss, the Commission's levels may actually inadvertently harm customer interests. Moreover, at least on this record, the Commission's proposed security deposit level may not pass muster substantively or procedurally under the Administrative Procedure Act.

A. Proposed Regulation 5.9 could harm the interests of customers.

The CFTC's reason for proposing to replace the one or four percent NFA security deposit level with a ten percent security deposit is to protect the retail FX customers of RFEDs and FCMs. *See* 75 Fed. Reg. 3291. We share the Commission's concern for retail FX customers. In

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[5] The 2004 Amendment also exempted FX dealers who maintained adjusted net capital of at least twice the required amount from collecting security deposits. In 2008, the NFA changed the rule so that FX dealers who maintained adjusted net capital of at least 150% of the required amount could qualify for the exemption. In 2009, the NFA removed this exemption entirely, so all FX dealers subject to NFA rules had to collect security deposits.

our view, however, NFA's approach places less customer funds at risk and offers better customer protection.

The Commission argues that retail FX involves inherent risks to customers, and lists those risks -- the risk of a market loss,[6] the risk the stop-loss protections of the RFED or FCM will be breached, the risk of the bankruptcy of the RFED or FCM will cause it to be unable to pay customers that earn trading profits, and the risk customer's funds will be commingled with those of the RFED or FCM. For each risk, the CFTC claims that requiring the customer to put up more money to open a retail FX position offers better customer protection.

FIA disagrees. We believe putting less, not more, customer money at risk would protect customers. When comparing the CFTC's proposed required security deposit level to that the NFA now requires, the NFA security deposit levels better protect customers by putting less customer money at risk. NFA requires customers to put up \$1 or \$2.5 for every \$100 of exposure, while the CFTC would require \$10 for every \$100. FIA believes a reasonable customer would prefer to have \$1 or \$2.50 at risk, than \$10, for the same transaction. In that sense, the NFA security deposit rules would offer more protection for the interests of customers.

The Commission concedes that "usually" retail FX customer accounts are "closed out once the losses in an account exceed the initial investment." 75 Fed. Reg. at 3291. That is one element that distinguishes the retail FX business model from the exchange-traded model. Again, if the usual "close out" practice is followed, the CFTC's proposal would expose \$10 to loss, while NFA would expose \$1 or \$2.50. NFA's approach involves less risk for the customer.

The Commission argues that, if, for any reason, "the positions are not closed out at a zero balance, the customer could be liable for additional losses." *See* 75 Fed. Reg. at 3291. The CFTC is right that such additional losses are possible. But customers' interests are not helped by increasing the amount of the security deposit.

Consider this example. Assume a sharp market increase or decrease in price. In that situation, it is possible any retail FX customer could suffer serious losses (or reap corresponding profits) and those losses might eclipse the deficit balance safeguards the RFED or FCM has in place. In that case, the CFTC's larger (\$10/100) security deposit would expose more customer funds to loss than the NFA's lower amounts (\$1 or \$2.5/100). In other words, if a firm is going to put the brakes on a customer's losses just before or after the deficit balance level is reached, customers would be better served if the brakes are applied sooner, not later. Then even if the

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6 The Commission argues that "[t]he extreme volatility of the foreign exchange currency markets exposes retail FX customers to substantial risk." *See* 75 Fed. Reg. at 3291. The CFTC provides no data or study to show that FX markets are more volatile than other markets

brakes don't stop the losses immediately, they will have a better chance of stopping the losses sooner, resulting in less loss for the customer.

Of course, customers always could put up more money (or have less leverage) for their security deposit if they so desired. No RFED or FCM is going to turn down a customer that wants to trade on less leverage. But if customers have been trading on 100-1 or 25-1 leverage under the NFA rules and want to continue to do so, those customers will simply trade with banks or overseas firms where NFA-level, or much higher leverage, is available. Alternatively, customers could finance the required security deposit, which would not, as a matter of economics, change the leverage ratio at all.

The CFTC also argues that it wants higher customer security deposits "to provide some capital to cushion funds held by a failing firm," implying that putting more customer funds at risk is desirable because those monies can be used to cushion a failing RFED or FCM, which is accepting bi-lateral credit risk in these uncleared transactions. This rationale turns customer protection on its head. It is hardly customer protection to make "extra" customer funds available to help bail-out any RFEDs or FCMs that fail. In any event, Congress has already addressed the issue of minimum financial rules for RFEDs and FCMs with the statutory $20 million net capital standard. There is no evidence that this statutory minimum is inadequate.

Regulation 5.9 should be re-assessed. The CFTC should wait until its new anti-fraud and customer protection provisions take effect before considering whether to implement stricter security deposit requirements. If, after a trial period, the Commission still believes security deposit improvements are necessary, it could adopt them or ask NFA to do so. For now, however, this is a step the CFTC does not need to, and should not, take.

B. The CFTC provides no evidence to support its choice of a ten percent security deposit.

The Commission's methodology in choosing a ten percent security deposit requirement is, at best, unclear. The CFTC's proposal provided no data to justify its choice of a ten percent security deposit requirement. An agency's authority to promulgate rules is based, in part, on the premise that agencies have expertise in a given area. This expertise is the "lifeblood of the administrative process," but the CFTC should explain its reasoning so that the interested public can understand how the agency is exercising its expertise. *See Burlington Truck Lines v. United States* 371 U.S. 156, 168 (1963) (finding that the Interstate Commerce Commission improperly granted an "additional certificate of service" to prevent a union boycott of non-unionized stockholder carriers from disrupting shipping services in several regions).

The CFTC's rationale for requiring a ten percent security deposit, as stated in the Federal Register, is simply that ten percent falls between FINRA's proposed twenty-five percent

requirement and NFA's existing four percent (or one percent) requirement. *See* 75 Fed. Reg. at 3291. This rationale ignores the basic contradiction of FINRA's proposed level -- a proposal to protect customers will actually put more customer funds at risk -- which should disqualify it as an appropriate benchmark. *See* Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change to Adopt FINRA Rule 2380 To Limit the Leverage Ratio Offered by Broker-Dealers for Certain FX Transactions, 74 Fed. Reg. 32022, 32023 (Jul. 6, 2009).[7]

FINRA states that it wants to increase the amount of a customer's security deposit in order to limit the customer's losses. FINRA must have found the NFA standards to be inadequate. FINRA was wrong, as this example shows. First, assume an investor posts a $1 deposit on a notional FX position of $100. The trading increment (tick size) is 12.5 cents. If the market moves 5 ticks against the investor's position, 62.5 cents of the $1 deposit is depleted, which would be the same amount of loss if the investor posted a $25 security deposit, as FINRA would require. But, if the market moves 30 ticks against the investor's position, for a loss of $3.75, the investor would likely <u>not</u> lose more than $1 under the NFA rule because his position would have been closed out by the RFED or FCM as it approached deficit status (as the CFTC acknowledges). If the same investor posted a $25 security deposit under FINRA's rule, however, he would have lost the full $3.75. FINRA's proposal will therefore allow for greater losses for customers who enter into retail FX positions than NFA's rules. The CFTC should not rely on FINRA's proposal as a credible benchmark.

In contrast to its misplaced reliance on FINRA's rule, the CFTC does not explain its past role in the adoption of NFA's standards. Put simply, for almost seven years, the CFTC has been responsible for, and has even approved, the NFA security deposit requirements. Under Section 17(j) of the CEA, NFA submits its rules to the CFTC and may request CFTC approval (or the CFTC may review and approve those rules on its own motion). The record shows that on certain occasions the CFTC affirmatively approved NFA's security deposit rules. *See* National Futures Association, Notice 1-03-14, "New Forex Rules Will Become Effective December 1, 2003" (Oct. 2, 2003) ("The Commodity Futures Trading Commission (CFTC) has approved amendments to NFA Bylaws, Compliance Rules, Financial Requirements, and Code of Arbitration, and a new Interpretive Notice regarding off-exchange foreign currency futures and options transactions with retail customers."). By law, the CFTC only approves those NFA rules that the CFTC determines to be consistent with the customer protection and other provisions of Section 17 and not otherwise in violation of the Act.

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[7] This notice proposes a leverage limit of 1.5 to 1. FINRA amended this notice on November 12, 2009 to propose a 4 to 1 leverage limit, but did not change the rationale for having a leverage limit in the first place.

Having accepted NFA's leverage rules for many years, the CFTC now claims those rules are inadequate to protect customers. FIA respects the Commission's right to change its mind, but believes that the public is entitled to an explanation for this about-face. The Commission, however, has offered none. FIA believes NFA's security deposit levels actually better protect customers than the Commission's proposed levels and should be retained. We would be interested to learn why the Commission disagrees with that conclusion.

C. The Commission has not taken the least anticompetitive means of achieving the Act's objectives in violation of Section 15(b).

Section 15(b) of the Commodity Exchange Act requires the CFTC, when it adopts any rule, to "endeavor to take the least anti-competitive means of achieving the objectives" of the Act. The CFTC has not acknowledged that its proposal would make it prohibitively expensive and risky for customers to enter into retail FX transactions with RFEDs and FCMs, leaving banks with an effective monopoly on the retail FX business in the U.S. As shown above, the CFTC has available to it less anti-competitive, and more effective, means of protecting retail FX customers. If the CFTC adopts its proposed rule, it would contravene CEA § 15(b).

Section 15(b) of the Commodity Exchange Act requires the Commission to do two things when promulgating regulations. The Commission must: i) "take into consideration the public interest to be protected by the antitrust laws;" and ii) "endeavor to take the least anticompetitive means" to achieve the objectives of the CEA. See 7 U.S.C. § 19(b). The Commission has not explained either factor with respect to Proposed Regulation 5.9.[8] *See* 75 Fed. Reg. at 3295-3296. Therefore the public has no way of knowing whether the agency has discharged its legal duty. Without such an explanation, the CFTC denies the public meaningful opportunity to comment on the proposal.

II. THE DISCLOSURE REQUIREMENT IS UNPRECEDENTED AND COULD MISLEAD CUSTOMERS

The Commission proposes to require RFEDs, FCMs and IBs to "provide retail forex customers with a risk disclosure statement similar to that currently required by Regulation 1.55, but tailored to address the risks, conflicts of interest and unique characteristics of retail forex trading." *See* 75 Fed. Reg. at 3289. FIA supports the effective and accurate disclosure of risk to customers, but we question one element of the proposed retail FX disclosure. The proposal would require RFEDs and FCMs to disclose the number of non-discretionary retail FX accounts maintained by an RFED or FCM, and the percentage of such accounts that were profitable for each of the four most recent quarters. The CFTC grounds this proposal in its belief that the "vast

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[8] Indeed, the Commission does not address either factor with respect to any proposed regulation in the proposing release.

majority of retail customers who enter these transactions do so solely for speculative purposes, and that relatively few of these participants trade profitably." *See* 75 Fed. Reg. at 3289. Instead of presenting supporting data, however, the Commission states that even if it is mistaken, this disclosure will be helpful to customers. As proposed, we respectfully disagree because the proposal is unprecedented and could mislead customers in certain circumstances.

FIA agrees with the Commission that RFEDs and FCMs should provide potential customers with sufficient material information to allow them to make informed decisions about whether to enter the retail FX market. FIA also commends the Commission's effort to tailor disclosure obligations to the specific risks of the retail FX market. But the novel requirement mandating disclosure of the number of accounts that were profitable for each of the past four quarters lacks balance and will likely misinform customers.

Legitimate questions could be raised about the value of providing any past account performance data for retail FX. The CFTC's rules for disclosure of performance by trading professionals always contain the mandated warning that "past performance is not necessarily indicative of future results." The disclosure is required to caution prospective investors against over-reliance on past performance information because markets are dynamic and unlikely to be replicated in the future. This is especially true for FX markets because retail customer performance turns on each customer's trading ability. Customers, as a whole, have a broad range of experience and trading acumen. FIA therefore believes that the data on past profitability may well be particularly unreliable and unhelpful as predictors of future prospects.

In addition, some customers may well enter into retail FX contracts to hedge FX exposures; as a hedge, an unprofitable retail FX trade may well indicate a successful strategy. Disclosing the loss out of context could be misleading.

Furthermore, requiring disclosure of the number of "accounts that were profitable for ***each*** of the four most recent quarters" may mislead the very investors the CFTC seeks to inform. *See* 75 Fed. Reg. at 3289 (emphasis added). As written, this requirement could understate the number of truly profitable retail FX accounts. A customer could have a very profitable trading year or two (or more) but still have an unprofitable quarter or two. On an overall net basis, the customer could have a healthy profit. Yet, for the quarter or two where the customer's trading was not successful, the customer would be included in the calculation of those suffering losses.[9] This snapshot approach does not give a prospective customer an accurate description of the

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9 The proposal refers to "accounts that were profitable" rather than accounts that suffered losses. A dormant account will therefore be allocated to the unprofitable category. That disclosure would not give an investor an accurate picture.

trader's overall actual experience. In short, the proposal's mandatory past customer performance summary may actually misinform prospective customers about past performance.[10]

III. REQUIRING ALL INTRODUCING BROKERS TO BE GUARANTEED BY AN RFED OR FCM IS TOO RESTRICTIVE

The Commission proposes to require all IBs and all applicants for registration as IBs in connection with retail off-exchange FX transactions to enter into a guarantee agreement with an RFED or FCM. *See* 75 Fed. Reg. at 3287. As part of this effort, the Commission notes that it will prepare a new guarantee agreement providing that FCMs and RFEDs who guarantee performance by an IB are jointly and severally liable for all the IB's obligations under the CEA and CFTC regulations. This liability will extend to the solicitation of, and transactions involving, all retail FX customer accounts of the IB, as of the effective date of the guarantee agreement. *See id.* The Commission suggests that this requirement will prevent fraud by forcing RFEDs and FCMs to vet carefully the qualifications of persons who solicit business on their behalf and the practices those persons employ. *See id.* While the FIA supports this objective, it believes that the Commission may not have considered the ramifications of its proposal and respectfully requests that the Commission clarify the application of this rule.

The language of Proposed Regulation 1.10(j)(8) makes clear that an IB may not "simultaneously be a party to more than one guarantee agreement." *See* 75 Fed. Reg. at 3294. The Commission appears to be giving IBs a choice -- either surrender your independent IB status and agree to solicit business for a single RFED or FCM (in effect becoming a branch office of that enterprise) or retain your independence and solicit business for banks or overseas dealers. From the proposal, it is not clear whether the Commission intends to prohibit IBs that are guaranteed by an RFED or FCM from introducing retail FX business to banks or overseas dealers. FIA is not certain the Commission actually has the authority to prohibit IBs from soliciting customers for entities operating outside the CEA. In any event, FIA assumes the Commission intends that the RFED or FCM would be legally responsible for its guaranteed IBs' solicitations for the RFED or FCM alone, and not any of the IB's actions to find business for the bank or overseas competitors of the RFED or FCM. It would be grossly unfair, to say the least, to make the RFED or FCM responsible legally for the solicitations of IBs for their competitors. The Commission should clarify its intent in that regard.[11]

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[10] FIA also believes that the Commission should clarify that a single customer signature is all that is required for the mandatory risk disclosure. Requiring multiple signatures in different places in disclosure documents can lead to confusion and undue administrative costs.

[11] The need for an extra measure of clarity with the respect to the scope of an FCM's liability for its IBs is consistent with the Commission's history when it approved the FCM-IB guarantee agreement form in 1983. Then, the Commission adopted final rules containing the form language that purported to expand an FCM's

To the extent, the CFTC is proposing to preclude the operations of independent IBs, FIA urges the Commission to reconsider. The CFTC's proposed retail FX regulatory regime may be more than adequate to address the potential for fraud and sales practice abuses by IBs. The Commission's new rules should be implemented and tested in the market place before any applicable business model is banned. In fact, retaining the independent IB category may well help to protect customers because the CFTC's sales practice and antifraud rules are surely more stringent than those an independent IB would face if it only introduced business to banks and overseas dealers. Independent IBs also may perform a customer service by referring customers to one of several retail FX trading platforms depending on the needs of the customer. If all IBs must be guaranteed by a single RFED or FCM, and that RFED or FCM does not offer trading in a currency the customer wants to trade, the IB's ability to fulfill that customer's request would be comprised. Banning independent IBs would seem to be a harsh result that could lead to less customer choice and service, outcomes that do not appear to be consistent with the Commission's goals.

IV. "NON-ECP" CUSTOMERS ARE A DIVERSE CLASS

FIA understands the CFTC's regulatory scheme is intended to protect all retail customers, called non-Eligible Contract Participants. The ECP definition establishes high thresholds for determining who is a retail customer and who is not. As a result, the breadth of the non-ECP category is vast (and pending legislation may make scope of that category even broader). For example, an individual with $100,000 in assets is generally quite different in terms of investment sophistication and experience from an individual with $9.5 million in assets. Both individuals would be non-ECPs under the CEA, of course. But no one would expect both individuals to need generally the same types of protections from sales abuse and sharp practices.

FIA does not have a specific proposal in this regard. We would simply observe that as the CFTC finalizes its new regulations for protecting non-ECPs it should take into account the range of non-ECPs it is trying to protect and adjust its rules accordingly.

CONCLUSION

In 2008, Congress strengthened CFTC regulation of the retail FX business in an attempt to continue the pattern of improved business practices in this popular market. The CFTC has largely implemented its new authority with great skill. Its new regulations should add a substantial measure of additional protections for customers that enter into retail FX contracts with RFEDs or FCMs. FIA strongly supports those efforts, although it has taken issue with certain aspects of the Commission's proposals.

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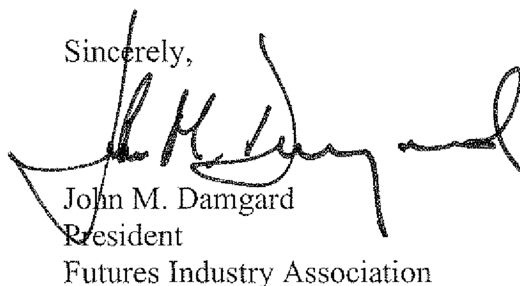
liability beyond financial obligations of its IBs. The Commission, however, never asked for comment on, or explained, this aspect of its IB regulations creating unnecessary confusion and legal uncertainty in this area.

In particular, FIA believes the CFTC should reconsider and at least defer action on its security deposit proposal. In our view, the current NFA standards, especially when buttressed by the Commission's new customer protection framework, will better serve the interests of customers than the proposed ten percent rule. At a minimum, we encourage the Commission to take the time to assess the effectiveness of the NFA security deposit levels in combination with the new retail FX safeguards the Commission will implement to protect the public.

Thank you for your consideration.

Sincerely,



John M. Damgard
President
Futures Industry Association

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

Division of Clearing and Intermediary Oversight

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