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Sent: Monday, March 22, 2010 10:52 PM
To: secretary <secretary@CFTC.gov>
Subject: RIN 3038-AC61 (Comment Letter)
Attach: Mallon P.C. Final Forex Comment (03-22-10).pdf

Please see our attached comment.

Many thanks,

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March 22, 2010

VIA ELECTRONIC MAIL
AND COURIER

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

Re: Request for Comment on Proposed Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries

Dear Mr. Stawick:

This letter is in response to the request of the Commodity Futures Trading Commission (the "Commission") in RIN 3038–AC61 (the "Release")[1] for comment on certain proposed regulations (the "Proposed Regulations") under the Commodity Exchange Act ("CEA")[2] as amended by the CFTC Reauthorization Act of 2008 (the "CRA").[3] The Proposed Regulations as drafted would establish requirements for, among other things, registration, disclosure, recordkeeping, financial reporting, minimum capital, and other operational standards with respect to retail off-exchange foreign currency ("forex") transactions.

Mallon P.C. is a law firm which represents a substantial number of clients who are domestic forex market participants and who would be directly affected by the Proposed Regulations. We appreciate the opportunity to comment on the Proposed Regulations, especially considering that the regulations, if adopted as proposed, would significantly affect the business of many of our clients. While we have discussed these views with our clients, and they share many of the same views, the comments expressed in this letter are our own.

Overview of Proposed Retail Forex Regulations

The Proposed Regulations would, among other things, (i) require certain retail forex market participants to register with the Commission, (ii) require counterparties dealing in retail forex to increase the security deposit for forex transactions, (iii) establish certain net capital levels for forex counterparties, and (iv) require introducing brokers to retail forex transactions to operate pursuant to a guarantee agreement with only one forex counterparty.

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[1] Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries, Commodity Exchange Act Release RIN 3038–AC61, 75 Fed. Reg. 3281 (proposed January 20, 2010) (to be codified at 17 C.F.R. pts. 1, 3, 4, 5, 10, 140, 145, 147, 160, and 166).

[2] Commodity Exchange Act of 1936, 7 U.S.C. § 1 et. seq.

[3] Food, Conservation, and Energy Act of 2008, Pub. L. 110-246, 122 Stat. 1651, 2189-2204 (2008).

The landscape in which the Proposed Regulations were developed is important. Prior to the CRA, the Commission did not have an explicit grant of jurisdiction over the off-exchange spot forex markets[4] and there was, accordingly, little regulatory oversight of certain market participants. Without a mandate to require registration of such market participants, run-of-the-mill common law fraud proliferated[5] as regulators were impotent to stop these scams. While state laws were able to address many of these cases after the fact, the Commission sought to regulate the industry as a proactive means to prevent fraud. At the same time, many legitimate domestic forex businesses sought ways to distinguish themselves from the fraudulent players in the industry by *voluntarily registering* with the Commission as commodity pool operators ("CPOs"), commodity trading advisers ("CTAs"), introducing brokers ("IBs") and futures commission merchants ("FCMs").[6] These businesses, like many of the firms and individuals who have responded to the Commission's request for comments, fully appreciate the important role that regulatory bodies play in "cleaning up" the industry and making sure that bad actors do not continue to tarnish the names of hard working individuals who have helped to create a competitive and robust industry in the United States.

We agree with many of the Proposed Regulations and believe they serve important investor protection functions, however we are concerned that some of the Proposed Regulations will not protect investors and will have a deleterious effect on the United States forex industry. It is within this context, and with the goal of helping to create a considered regulatory regime that emphasizes both investor protection and the continued economic viability of the domestic retail forex industry, we make the following comments.

Registration of Forex Market Participants

Registration of Forex CPOs, CTAs and IBs

The Proposed Regulations require persons to register with the Commission as forex CPOs, forex CTAs, and forex IBs, as appropriate.[7] The Proposed Regulations also create a new registration category for retail foreign exchange dealers ("RFEDs") and require RFEDs to register as such with the Commission.[8] Certain employees of the foregoing registrants would be required to register with the Commission as associated persons ("APs"), as appropriate.[9] The registered firms and APs would also be required to become members of a registered futures association.[10] In addition to registration, Proposed Regulation 5.4 would require certain disclosure, recordkeeping and reporting requirements for forex CPOs and CTAs.

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[4] See generally Release at 325 (citing to, most importantly, *Zelener* and *Erskine*).
[5] See Release at 3286, n. 44 (Between December 2000 and September 2009, 114 forex-related enforcement actions were brought by the Commission on behalf of more than 26,000 customers).
[6] These terms are defined in Section 1a of the CEA. With respect to groups who engage in only forex transactions, such firms will be defined under Proposed Regulation 5.1, which makes reference back to Section 1a of the CEA.
[7] Proposed Regulation 5.3(a)(2), Proposed Regulation 5.3(a)(3), and Proposed Regulation 5.3(a)(5).
[8] Proposed Regulation 5.1(h)(1) and Proposed Regulation 5.3(a)(6).
[9] See, e.g., Proposed Regulation 5.3(a)(1)(ii) and 5.3(a)(2)(ii).
[10] Proposed Regulation 5.22.

We broadly believe that requiring forex CPOs, CTAs, and IBs to register with the Commission is reasonable.[11] It is clear that the standards to operate as a Commission registered firm and National Futures Association ("NFA") Member Firm are high. In order to complete registration, each firm needs to designate at least one person as an AP/Principal, and that person needs to meet certain proficiency requirements,[12] background checks, and other investigations into the person's fitness to provide services to customers.[13] Once registered, forex CPOs and CTAs are generally required to have their disclosure documents reviewed by the NFA prior to soliciting customers.[14] These measures provide both the Commission and the NFA with ample opportunity to review firms and individual applicants. Once registered, Member Firms will be required to implement recordkeeping and compliance programs under both Commission regulations and NFA Rules.[15] In addition to self-examination and compliance mandates, NFA Member Firms are subject to routine audit and the NFA has made it clear that it intends to heavily monitor Member Firms involved in the retail forex industry.[16] It is our belief the foregoing measures are sufficient to achieve the goal of investor protection while remaining within with the Commission's statutory duty to utilize the least anti-competitive means possible.

Lower Leverage Requirement

The heavily criticized Proposed Regulation 5.9 requires RFEDs and FCMs engaging in retail forex transactions to collect from the retail customer a security deposit of ten percent of the notional value of the transaction. The regulation would also require the RFED or FCM to collect an additional security deposit or liquidate the position if the account value drops below the 10:1.[17] The Release cites a number of reasons for limiting leverage including: (i) extreme volatility of the forex markets; (ii) potential customer liability for losses if positions are not closed out; (iii) counterparty risk; and, (iv) current and proposed margin requirements by other regulatory bodies, including FINRA.[18] It is unknown if the Commission spoke with any industry participants such as FCMs or forex customers when considering this provision.

We strongly oppose Proposed Regulation 5.9. We believe that reducing leverage for retail forex transactions to 10:1 will not serve to protect customers and will likely, instead, harm the domestic forex industry. Many of the reasons cited by the Commission for the reduction of leverage are simply ill-founded and have previously been examined by the NFA.[19] We believe that the Commission should not pass the proposed regulation as written because the NFA's current leverage requirement adequately

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[11] With respect to the new RFED designation and registration requirement, we do not have any specific opinions and understand the reasoning behind the new designation.
[12] See NFA Rule 401(a) (requiring the Series 3 Exam for a variety of members), as well as NFA Bylaw 301 (requiring the Series 34 exam for Member Firm APs engaged in the off-exchange retail forex markets).
[13] Fingerprint cards are submitted by all APs to the NFA and are run through an electronic FBI database. Form 7-R and Form 8-R require firm and AP applicants, respectively, to provide background information on prior regulatory issues which may indicate unfitness. The NFA may, in certain instances, contact other regulatory bodies regarding the fitness of an applicant.
[14] This process will usually take several weeks of discussion between the firm and the NFA and is usually facilitated by the Member Firm's attorney. Forex IBs face different requirements as detailed later in this comment.
[15] See generally Regulation 4.23, Regulation 4.33 and NFA Rule 2-9 (requiring yearly self-examination).
[16] Unofficial discussion by NFA panelists on March 2, 2010 at the CPO/CTA Regulatory Seminar in Chicago.
[17] Proposed Regulation 5.9(b).
[18] See Release at 3290-3291.
[19] See generally February 23, 2009 NFA letter to the Commission regarding Forex Security Deposits.

protects investors and it is clear that there are serious anti-competition issues with the proposed regulation.

NFA Section 12 Provides Greater Leverage

Proposed Regulation 5.9 was promulgated notwithstanding that the NFA just recently implemented a rule, approved by the Commission on November 30, 2009, requiring leverage for Forex Dealer Members ("FDMs") of 100:1 for major currencies and 25:1 for non-major currencies.[20] In proposing the rule change (in which the NFA actually *increased* the leverage allowances), the NFA took a considered approach to the issue. The NFA (i) researched then current FCM and FDM practices with respect to leverage, (ii) researched the practices of other industry groups, (iii) solicited comments from FDMs on proposed rules, (iv) discussed the issue with an FDM advisory committee, and (v) independently investigated the issue.[21] In proposing the leverage rule, the NFA stated that it "believes that the amendments [100:1 and 25:1 leverage] are the best way to address NFA's customer protection concerns with certain FDMs' use of leverage."[22] The NFA further stated that:

> Based on our experience with FDM practices, including that most FDMs use systems that liquidate customer positions before they reach a negative balance, *NFA believes that the 1% and 4% security deposit requirement amounts remain sufficient at this time to protect against financial harm to FDMs and their customers* even though they are significantly lower than margin requirements for on-exchange equivalents.[23] [emphasis added]

We strongly agree with the NFA's current leverage requirements. We believe that the NFA took the appropriate time and care necessary to properly research this issue and that significant deference should be given to the NFA's margin requirements for Commission registrants.

Unprecedented Industry Resistance to Lower Leverage

As of March 22, 2010, the Commission published on its website almost 9,000 comments. These comments were prepared and submitted by all types of participants within the retail forex industry including: forex investors, market participants such as forex CPOs, forex CTAs, forex IBs, FCMs, FDMs, and two newly formed coalitions - the Forex Exchange Dealers Coalition and the IB Coalition. The comments were overwhelmingly against leverage reduction and a majority have cited a number of reasons including: (i) liberty/freedom to contract; (ii) job loss from trading going overseas;[24] and, (iii) lack of protections to domestic investors in offshore jurisdictions.

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[20] Id.
[21] Id.
[22] Id.
[23] When the NFA wrote the referenced letter, FDMs were only required to maintain minimum capital of $250,000 which is significantly less than the current NFA requirement of $20 million (or more under certain circumstances) minimum net capital.
[24] We believe that one of the more appropriate comments in this respect came from Utah Senator Orrin Hatch, letter dated March 2, 2010, who stated, "If all developed-country regulators adopted common leverage requirements, the U.S. industry might be able to remain competitive under such a rule, but absent such standardization, the United States is at risk of losing jobs from this proposed regulation."

We share the views expressed in many of the comments, especially with respect to the viability of the forex industry in the United States if lower leverage is required. As many comments noted, if lower leverage is instituted, customers will simply move their accounts to offshore brokers who provide leverage of 200:1 or more. It is common knowledge that these offshore brokers can be unreputable and may actually provide investors with fewer safeguards than domestic brokers who are (and will continue to be) subject to oversight by both the Commission and the NFA.

Net Capital Requirements

Proposed Regulation 5.7 requires each FCM engaged in retail forex transactions and each RFED to maintain a certain minimum net capital. The net capital requirement would require firms to maintain the greater of: $20 million; $20 million plus 5% of the total retail forex obligation in excess of $10 million; any amount required under Commission Regulation 1.17; or amounts required by a self regulatory organization of which the FCM or RFED is a member.[25] The purpose of these requirements is to protect retail customers in the absence of bankruptcy protection for segregated funds by making sure that FCMs and RFEDs will be able to remain solvent.[26]

We believe that absent bankruptcy protection for segregated funds, high net capital requirements are the best way to protect the assets of retail investors. We do note, however, that high net capital requirements limit the groups who are able to participate as principals in these markets.

Introducing Broker Guarantee Agreement

Proposed Regulation 1.10 requires forex IBs to enter into a guarantee agreement with a RFED or FCM in connection with retail off-exchange forex transactions.[27] The Commission will prepare a new Part C guarantee agreement to the Form 1-FR-IB which, according to the Release, will make FCMs and RFEDs jointly and severally liable for all obligations of the IB with respect to the solicitation of, and transactions involving, all retail forex customer accounts of the IB entered into on or after the effective date of the guarantee agreement. The Commission believes that the guarantee requirement serves the public's interest by creating a marketplace where improper practices by IBs are discouraged while still permitting FCMs and RFEDs to make use of outside salespeople.

We strongly disagree with Proposed Regulation 1.10. We believe it will effectively eliminate almost all forex IBs and put a number of honest and ethical forex IBs out of business. While it would be true that RFEDs and FCMs would still be able to utilize outside sales agents, in practice RFEDs or FCMs are not going to take on the risk of guaranteeing forex IBs.

We also cannot support this proposal because we believe that there is strong oversight of forex IBs and that registration will further weed out unscrupulous players. As we discussed above, the

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[25] See Release at 3315.

[26] See Release at 3290 ("The Commission recognizes that the retail forex obligation is not an equivalent substitute for the segregated funds regime, which cannot be replicated in the context of off-exchange retail forex trading. Unlike segregation of customer funds deposited for futures trading, such amounts would not be provided any preferential treatment to unsecured creditors in a bankruptcy, and would not be held in separately titled accounts under the CEA.").

[27] See Release at 3287.

NFA is tasked with significant oversight responsibilities and does not take this mandate lightly. While a forex CPO or CTA may be able to become initially registered within a matter of weeks (assuming the firm and principals have clean regulatory histories), a forex IB application may take three to six months or longer to be approved. Also, unlike forex CPOs and CTAs, the NFA requires forex IBs to have robust Anti-Money Laundering procedures, Business Continuity Plans and other compliance policies and procedures in place prior to registration. During the IB registration process the NFA examiners thoroughly review an applicant's background and operating procedures. Additionally, the NFA requires independent IBs to maintain a $45,000 net capital requirement and to submit financial information on a semi-annual basis.[28] In our opinion this existing regulatory framework of review procedures and net capital rules is more than sufficient to ensure investor protection.

Furthermore, we concur with a number of commenters who have noted that there are fairness concerns *vis-a-vis* introducing brokers to on-exchange traders. We believe that the Commission can achieve its goal of investor protection through less anti-competitive means.

Grandfathering Provision Should be Added

In the event the Commission adopts the proposed regulation as drafted, we believe the Commission should provide a grandfathering provision for current forex IBs who would be put out of business if the proposed regulation was passed as currently written. Additionally, the Commission should clarify the manner in which independent IBs are treated if they make introductions to both exchange traded futures products in addition to retail forex.

Other Issues

Technical Revisions

The Proposed Regulations include a number of revisions to current Commission regulations which are necessary from a technical perspective to ensure the new regulations are properly implemented within the Commission's statutory framework. We agree that technical adjustments to current rules are necessary and applaud the Commission for trying to streamline regulation as much as possible.[29] Certain technical aspects of the rules, however, should be revised with appropriate industry input.[30] Additionally, any adopted leverage regulation will likely necessitate a change to certain provisions which currently reference the NFA leverage rule.[31]

Disclosure Document Risk Statements

Proposed Regulations 4.24 and 4.34 provide certain risk disclosure statements which must be included at the beginning of forex CPO and CTA disclosure documents. We completely understand the purpose of this requirement and we also understand that this practice would mirror the current requirements for CPOs and CTAs. However, we do not believe that consumers actually read long

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[28] See NFA Financial Requirements, Section 5.
[29] See, especially, Release discussion with respect to Proposed Section 5.
[30] See, especially, comment letters from Global Futures & Forex, Ltd., dated March 9, 2010, and Rosenthal Collins Groups, LLC, dated March 8, 2010.
[31] See, e.g., proposed changes to Regulation 4.7(a)(1)(v)(B), Regulation 4.12(b)(i)(C), and Regulation 4.13(a)(3)(ii).

paragraphs of legal disclaimers in large capital letters. In the future, the Commission should consider a succinct bullet point list. We believe that consumers are more likely to read and understand information in such format.

Regulation 5.5(e)

Proposed Regulation 5.5 would require FCMs, RFEDs and forex IBs to provide retail forex customers with a risk disclosure statement similar to the statement currently required for customers engaging in on-exchange trading. Proposed Regulation 5.5(e) would additionally require these firms to disclose additional information which is not required to be disclosed for on-exchange trading.[32] We believe that Proposed Regulation 5.5(e) should not be deleted because it would not further any true investor protection and would likely be anti-competitive.

Conclusion

The proposed rules seek to develop a comprehensive regulatory structure for the off-exchange retail forex industry. We have provided the Commission with these comments in the hope of helping to create a robust but appropriate regulatory environment while preserving the industry's ability to succeed in a global forex marketplace. We appreciate the opportunity to comment on the Release. If you have any questions regarding this letter, please contact the undersigned at 415-868-5345.

Very truly yours,

Mallon P.C.

Mallon P.C.
Bart Mallon

[32] Proposed Regulation 5.5(e) generally requires that the risk disclosure statement include (i) the number of non-discretionary retail forex accounts maintained by an RFED or FCM, (ii) the percentage of such accounts that were profitable for each of the four most recent quarters, and (iii) a statement that past performance is not necessarily indicative of future results.