June 18, 2014

<u>Via Federal Express</u>

Ms. Melissa D. Jurgens
Secretary
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: National Futures Association: Electronic Funding Mechanisms – Adoption of the Interpretive Notice to NFA Compliance Rules 2-4 and 2-36: Prohibition on the Use of Certain Electronic Funding Mechanisms*

Dear Ms. Jurgens:

Pursuant to Section 17(j) of the Commodity Exchange Act, as amended, National Futures Association ("NFA") hereby submits to the Commodity Futures Trading Commission ("CFTC" or "Commission") the proposed adoption of the Interpretive Notice to NFA Compliance Rules 2-4 and 2-36: Prohibition on the Use of Certain Electronic Funding Mechanisms. NFA's Board of Directors ("Board") approved the proposal on May 15, 2014, and NFA respectfully requests Commission review and approval of the proposal.

PROPOSED AMENDMENTS
(additions are <u>underscored</u>)

INTERPRETIVE NOTICES

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<u>Interpretive Notice to NFA COMPLIANCE RULES 2-4 AND 2-36: PROHIBITION ON THE USE OF CERTAIN ELECTRONIC FUNDING MECHANISMS</u>

<u>NFA Compliance Rule 2-4 requires Members and Associates to observe high standards of commercial honor and just and equitable principles of trade in the conduct of their commodity futures business. Similarly, NFA Compliance Rule</u>

2-36(c) requires Forex Dealer Members (FDM) and their Associates to observe high standards of commercial honor and just and equitable principles of trade in the conduct of their forex business.

NFA's Board of Directors (Board) recently reviewed information regarding the use of credit cards[1] by FDM retail customers to fund their forex trading accounts, which indicates that retail forex customers overwhelmingly fund their trading accounts using a credit card. For the reasons described below, the Board believes that permitting customers to invest in the forex or futures markets using a credit card is inconsistent with a Member's obligation to observe high standards of commercial honor and just and equitable principles of trade.

Credit cards, by their very nature, permit easy access to borrowed funds. Given the highly volatile nature of the forex and futures markets, the substantial risk of loss, and the possibility that a total loss may occur in a very short period of time, the Board has concluded that Members should be prohibited from permitting customers to use credit cards to fund forex or futures accounts.

The Board also recognizes that the retail forex and futures businesses are largely Internet based, electronic payments are the acceptable payment method for most Internet based businesses, and that certain electronic funding methods may provide some convenience to customers. Therefore, the Board is not prohibiting all forms of electronic payment mechanisms.

Specifically, the Board believes that certain electronic funding mechanisms are acceptable and appear consistent with a Member's obligation to observe high standards of commercial honor and just and equitable principles of trade. Those electronic funding mechanisms, however, must be tied to a customer's bank account at a financial institution. In particular, the Board is aware that with an electronic payment made through a debit card, the funds are drawn directly from the customer's bank account and therefore this payment method functions in a manner very similar to a check drawn on a customer's account. The Board also understands that certain other electronic payment facilitators may draw funds directly from a customer's bank account.

[1] For purposes of this Interpretive Notice, the term credit card also includes other electronic payment facilitators (e.g., Paypal) that commonly draw funds from a customer's credit card.

The key factor differentiating a credit card payment from an electronic funding method that is directly tied to the customer's account at a financial institution is that with the latter method, the customer has funds on hand and those funds are immediately transferred from the customer's bank account to the FDM or FCM, which significantly reduces the likelihood that the customer is borrowing funds to invest. The Board also believes, however, that in order to accept an electronic funding method such as a debit card, the Member must be able to distinguish, prior to accepting funds, between a debit card or other electronic funding method that draws money from the customer's checking or savings account at a financial institution and a traditional credit card, and be able to reject the credit card before accepting funds. For example, in processing electronic payments, Members may utilize a third-party provider that uses technology to differentiate between a credit or debit card transaction.

As always, any FCM or FDM offering this type of funding mechanism should make sure that adequate risk disclosure is provided to a customer in light of the customer's financial circumstances.

EXPLANATION OF PROPOSED AMENDMENTS

The Board adopted the Interpretive Notice to NFA Compliance Rules 2-4 and 2-36, which prohibits Members from allowing customers to fund futures or forex accounts with a credit card or other electronic methods tied to a credit card. The Board approved this prohibition based on an extensive study and analysis done at the direction of NFA's Compliance and Risk Committee (CRC). As discussed below, the CRC's study and analysis found significant customer protection concerns with credit card funding in the retail forex area, and therefore the Board determined the only appropriate action was to adopt this prohibition. This prohibition is entirely consistent with NFA's longstanding position that it is a violation of NFA Compliance Rule 2-4, and inconsistent with just and equitable principles of trade, for Members and Associates to encourage customers to borrow money to invest.[2]

While reviewing business practices of NFA's Forex Dealer Members (FDM), the CRC became aware that many FDMs offer their retail forex customers the ability to fund their accounts directly using a credit card or via an online payment facilitator (e.g., PayPal) that is commonly tied to a credit card (Payment Facilitator(s) – Credit). The CRC had several concerns with this practice, including that retail

[2] See *In the Matter of First Investors Group of Palm Beaches, et. al.,* NFA Case No. 95-BCC-011 (November 12, 1999).

customers may be using credit cards to open accounts with funds that are borrowed and, therefore, not risk capital. The CRC's concern had significant merit since staff's 2012 review of several FDM websites showed that they promoted credit funding as the "quickest," "easiest," and "fastest" method of investing, and none indicated that retail customers should not be using credit cards to borrow funds to invest.

Given its concern, the CRC began considering whether it would be appropriate for NFA to prohibit its Members from allowing customers to fund their accounts (both forex and futures) via a credit card or a Payment Facilitator – Credit. The CRC obtained the feedback of NFA's FCM, IB, CPO/CTA Advisory Committees, each of which fully supported a ban of this practice for both futures and forex. Given the importance of this issue, the CRC did not obtain the views of NFA's FDM Advisory Committee—which had recently lost most of its representatives due to FDM withdrawals and consolidations—but rather obtained the FDMs' views by issuing a Notice to all FDMs requesting their views. The CRC also met with affected members of the FDM community to further discuss their comments.

Specifically, NFA received comments from five of NFA's 17 FDMs (one of which was filed by a law firm on behalf of the FDM), the Financial Services Roundtable (FSR)[3] and a retail forex customer. All but one FDM strongly opposed a ban against FDMs accepting credit cards from customers to fund forex trading accounts. Despite the fact that credit card funding was not "an insignificant portion" of its business, this FDM did not object to the proposed ban but requested a 60-day implementation period in order to make operational changes to reject credit card transactions while permitting debit card transactions and to educate clients about the ban.

As previously noted, the comments received from the other four FDMs opposed the ban, and contained many of the same themes, including:

- Banks that issue credit cards consider a customer's credit worthiness in determining the customer's credit limit, which is a built in risk safeguard;

- Credit card funding is one of the fastest, most convenient, and lowest cost funding vehicles;

[3] The FSR's letter claims banning credit cards and the use of credit cards through payment facilitators (e.g. Paypal) is a significant regulatory action that has far reaching implications. The FSR urged NFA to consider viable alternatives and seek comments from those outside the forex industry.

- NFA has other rules that ensure that customers do not invest funds in excess of risk capital (Rule 2-36 "know your customer," risk disclosure requirements, and guidance requiring FCMs to prominently disclose that customers should only fund with risk capital);

- Forex customers must react to market changes during non-banking hours and credit cards are the only funding method to do so, while checks or wire transfers often take too long to be credited to prevent a margin close-out;

- Credit cards are more economical since FDMs do not charge a fee to use them while banks charge fees for wire transfers and use of ACH;

- Funds deposited by traditional methods may ultimately be drawn from credit sources;

- The ban is overly broad since alternative payment facilitators (e.g., PayPal, MoneyBookers and Google Checkout) may be funded through a bank account or other debit sources; and

- FDMs have other procedures in place to ensure that customers only use risk capital even if the source is a credit card.

To further support their position, several commenters noted that foreign jurisdictions permit credit card funding—the U.K., Japan, Canada, and Australia—where retail forex "trading is available on a 24-hour basis." Additionally, at least one commenter noted that credit cards are permitted in numerous other industries in which "customer funds are put at risk with far fewer safeguards than retail forex trading." As an example, this commenter offered that the New York State Lottery provides customers the option of signing up for subscriptions to certain lottery games using credit cards, and the Nassau County, New York OTB permits individuals to make deposits via credit card to their permanent wagering account.

The FDMs opposing a ban on funding via a credit card recommended that NFA address this issue short of imposing a prohibition. For example, these FDMs believe that NFA should do one or more of the following—prohibit heavy promotion of credit card funding, require account withdrawals to go back to the original funding credit card, establish a monthly deposit cap for credit card funding, enhance disclosures regarding risk capital usage, issue prominent warnings regarding credit card usage to underscore the risks of using this funding means if a customer does not have sufficient bank funds to cover the deposit, and recommending that customers pay off credit card balances monthly by the due date.

The CRC also directed staff to conduct a detailed analysis of FDM account funding practices, customer income levels, and customer account funding origins. The analysis covered approximately 15,500 accounts held at seven FDMs—all of which were registered as retail foreign exchange dealers (RFED)—during 2012. Based on the results of this analysis, the CRC, as well as the Board, found that this practice raised significant customer protection concerns and the only appropriate response was to prohibit Members from allowing customers to fund accounts using a credit card or Payment Facilitator – Credit. Specifically, the analysis revealed:

- Credit card funding restrictions varied among the FDMs. Several permitted the use of a credit card up to $10,000 per transaction. One firm based its restriction on a customer's income level and a permitted customer with a net income between $0-$19,000 to fund an account with as much as $1,000 through a credit card;

- The average life of a retail forex trading account at an RFED was 4 months regardless of the amount of the initial deposit;

- For the 4th quarter 2013, 72% of the accounts analyzed were unprofitable;

- 78% of all accounts were initially funded via credit card/debit card/online payment facilitator;

- Almost 50% of all account holders reported a net income of $50,000 or less; and

- Deposits made by credit card/debit card/PayPal were markedly lower than deposits made by wires or checks. For example, for customers with a net income less than $50,000, the average deposit via credit card/debit card/PayPal was approximately $1,050 whereas for checks or wires it was approximately $6,650. This difference was also prevalent at other net income levels, including above $100,000 where the average deposit via credit card/debit card/PayPal was approximately $2,450 whereas for checks or wires it was approximately $28,000.

Given the prevalence of credit card usage by customers to initially fund retail forex accounts and the fact that such a large percentage of those customers have a relatively low income level ($50,000 or less), NFA reviewed whether the FDMs provide specific risk disclosures regarding the implications of funding via a credit card or Payment Facilitator-Credit. NFA learned that none of the FDMs warned customers that they should not use a credit card or Payment Facilitator – Credit to borrow money to invest in retail forex.

Many FDMs had represented to NFA that customers need to use credit cards in order to quickly add funds in order to avoid forced liquidation of their positions. NFA's analysis, however, revealed that very few positions overall are auto-liquidated, customers generally add funds to their account using the same method as their initial funding method, and positions in accounts funded through a credit card are not less likely to be auto-liquidated. In fact, those accounts funded through a credit card actually had positions auto-liquidated more frequently than those accounts funded through traditional methods, although still at a relatively low percentage.

Average Percent of Open Positions Auto-Liquidated

	Initial Funding Source	
Initial Account Size	**Credit/Debit/Paypal**	**Wires, Checks, etc.**
$0-$250	3.6%	2.3%
$251-$500	2.2%	1.2%
$501-$1,000	2.0%	1.8%
$1,001-$5,000	2.7%	1.1%
$5,001-$10,000	4.2%	0.8%
$10,001+	2.7%	1.2%

The Board concluded that the data was very disturbing from a customer protection perspective because it revealed that lower income individuals predominantly use credit cards or Payment Facilitator – Credit to fund their accounts and the majority of these individuals lost their funds trading forex. Although the Board acknowledged the possibility that all lower income individuals may pay off their credit card balances each month and not be borrowing funds beyond the payment due date to invest, the Board also believes that this possibility is simply implausible given the low income levels.

NFA Compliance Rule 2-4 requires Members and their Associates to observe high standards of commercial honor and just and equitable principles of trade in the conduct of their commodity futures business. Similarly, NFA Compliance Rule

2-36(c) requires Members and their Associates to observe high standards of commercial honor and just and equitable principles of trade in the conduct of their forex business.

In considering this issue, the Board noted that permitting customers to utilize funding mechanisms that by their very nature permit retail customers to borrow funds to invest in markets where the risk of loss can be substantial and a total loss may occur simply is not consistent with a Member's obligation to observe high standards of commercial honor and just and equitable principles of trade. Given NFA's analysis of the FDMs' customers' usage of credit cards and Payment Facilitator – Credit, and the fact that credit cards and Payment Facilitators – Credit readily allow individuals to borrow funds to purchase goods and services, the Board concluded that without adequate mechanisms in place to ensure that customers are not borrowing funds to invest in the highly volatile futures and forex markets, Members should not be permitted to allow their customers to invest via electronic funding mechanisms.

The Interpretive Notice adopted by the Board does not ban forms of electronic funding mechanisms that are tied to a customer's bank account at a financial institution, such as a debit card or a PayPal account tied to a bank account. These funding mechanism are acceptable and appear consistent with a Member's obligation to observe high standards of commercial honor and just and equitable principles of trade because customers by using electronic funding mechanisms directly tied to an account at a financial institution have funds on hand that are immediately transferred from the customer's bank account to the FDM or FCM, which significantly reduces the likelihood that funds are being borrowed to invest.

However, in order for a Member to allow customers to use electronic funding mechanisms, the Member must be able to distinguish between those electronic funding mechanisms tied to a credit card and those tied to a bank account and reject the ones tied to a credit card. One FDM indicated that it currently uses a third-party provider to process credit and debit card transactions when they are initiated by the customer. Accordingly, the third-party provider uses a programming code, which allows its front-end processer to identify whether a card is a credit or debit card based on the digits listed on the card. This front-end processing system has the ability to identify the card as a debit card even if the customer elected to process the card as a credit transaction.[4] In other words, the system programming can distinguish between a debit

[4] Many debit cards permit the user to elect to process the transaction as a "debit" or a "credit." When the user selects credit, the transaction amount is still deducted from

card issued by a bank with monies drawn from a checking or savings account, or a traditional credit card. The third party provider is able to automatically reject transactions that are credit card transactions.

Under the Interpretive Notice, if an FCM or FDM Member offers customers the ability to use an electronic funding mechanism, then the FCM or FDM must utilize a processing system or some other electronic mechanism that can ensure the funding device is a debit card or some other payment facilitator that is tied directly to the customer's bank account at a financial institution. Moreover, if FCMs and FDMs offer this type of funding mechanism, then they should also ensure that adequate risk disclosure is provided to customers in light of the customers' financial circumstances.

NFA strongly believes that the Interpretive Notice to NFA Compliance Rules 2-4 and 2-36, which prohibits Members from allowing customers to fund futures or forex accounts with a credit card or other electronic methods tied to a credit card is a necessary customer protection measure. NFA respectfully requests that the Commission review and approve the proposed adoption of the Interpretive Notice to NFA Compliance Rules 2-4 and 2-36: Prohibition on the Use of Certain Electronic Funding Mechanisms.

Respectfully submitted,

Thomas W. Sexton

Thomas W. Sexton
Senior Vice President and
General Counsel

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the user's checking or savings account. The primary difference is that by selecting "credit" the user receives some of the protections provided by a credit transaction.

* The proposed adoption of the interpretive notice will become effective on January 31, 2015.