

December 9, 2008

Via Federal Express

Mr. David Stawick
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: National Futures Association: Forex Price Adjustments and Trade
Practices – Proposed Adoption of Compliance Rule 2-43*

Dear Mr. Stawick:

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") proposed Compliance Rule 2-43 regarding forex orders. This proposal was approved by NFA's Board of Directors ("Board") on November 20, 2008. NFA respectfully requests Commission review and approval of the proposed amendments.

PROPOSED AMENDMENTS
(additions are underscored)

**Part 2 - RULES GOVERNING THE BUSINESS CONDUCT OF MEMBERS
REGISTERED WITH THE COMMISSION**

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RULE 2-43. FOREX ORDERS.

(a) Price Adjustments

(1) A Forex Dealer Member may not cancel an executed customer order or adjust a customer account in a manner that would have the direct or indirect effect of changing the price of an executed order except when:

(i) the cancellation or adjustment is favorable to the customer and is done as part of a settlement of a customer complaint; or

(ii) if a Forex Dealer Member's platform exclusively uses straight-through processing such that the Forex Dealer Member automatically (without human intervention and without exception) enters into the identical but opposite transaction with another counterparty (creating an offsetting position in its own name) and that counterparty cancels or adjusts the price at which the position was executed.

(2) With regard to cancellations or adjustments made pursuant to section (a)(1)(ii), a Forex Dealer Member must:

(i) provide written notification to the customer within fifteen (15) minutes of the customer order having been executed that it is seeking to cancel the executed order or adjust the customer's account to reflect the adjusted price provided by the Forex Dealer Member's counterparty, as applicable, and the written notification must include documentation of the cancellation or adjustment from the Forex Dealer Member's counterparty; and

(ii) either cancel or adjust all executed customer orders executed during the same time period and in the same currency pair or option regardless of whether they were buy or sell orders.

(3) Notwithstanding section (a)(2)(ii), a Forex Dealer Member may choose to honor transactions in which customer orders resulted in profits for the customers but must do so with regard to all similarly situated customers.

(4) Cancellations and adjustments to executed customer orders must be reviewed and approved by a listed principal that is also an NFA Associate. Such review and approval must be documented by a written record, must include any supporting documentation, and must be provided to NFA in the manner requested by NFA.

(5) A customer order is considered executed upon the earlier of the customer receiving notification of the execution price from the Forex Dealer Member or when the position established by such order is identified in the customer's account, whether electronically or otherwise.

(6) If a Forex Dealer Member may cancel or adjust an executed order under the circumstances provided for in section (a)(1)(ii), the FDM must provide customers with written notice that the Forex Dealer Member may cancel or adjust executed customer orders based upon liquidity provider price changes prior to the time they first engage in forex transactions with the Forex Dealer Member. The notice may be included in a customer agreement.

(7) Any provision in a customer agreement or any contract between a Forex Dealer Member and a customer that reserves to the Forex Dealer Member the right to make price or equity adjustments to a customer account except as allowed by this Rule is prohibited.

(b) Offsetting Transactions

Forex Dealer Members may not carry offsetting positions in a customer account but must offset them on a first-in, first-out basis. At the customer's request, an FDM may offset same-size transactions even if there are older transactions of a different size but must offset the transaction against the oldest transaction of that size.

EXPLANATION OF PROPOSED AMENDMENTS

As part of NFA's ongoing oversight and review of the activities of Forex Dealer Members ("FDMs"), NFA became aware of two practices regarding customer orders that it believes must be addressed. One of these practices is FDMs adjusting the price of customer orders after they have been executed and confirmed. The other practice relates to a new strategy offered by FDMs involving the offsetting of transactions.

Compliance Rule 2-43(a): Price Adjustments

NFA staff has become concerned about FDMs changing prices on orders after they had been executed and reported to customers. When asked about these price adjustments, the FDMs told staff that they resulted from bad price feeds. In particular, these FDMs stated that the adjustments occurred when the liquidity provider banks or trading systems from which they received price feeds experienced internet issues, software glitches, systems failures, or market conditions that caused their price feeds to freeze or be otherwise impacted.

NFA's Executive Committee has discussed a number of proposals to deal with this issue, including disclosure, adopting interpretive notice language stating that an FDM violates just and equitable principles of trade if it adjusts prices only when doing so favors the FDM, and banning price adjustments altogether (except when done in the customer's favor to resolve a dispute). During this process, staff discussed each of these proposals with the FCM Advisory Committee and sought FDM comments on an earlier proposal that limited, but did not ban, price adjustments.

Four FDMs commented on that proposal, and all expressed concern that the proposal would not permit them to cancel or adjust trades when they traded on bad prices from a liquidity provider. FDMs that offset their retail customer trades argued that the inability to change prices would leave them exposed to significant risk where a bank cancels or adjusts a trade with the FDM since the FDM would not be allowed to cancel or adjust the corresponding trade with its customer. One FDM claimed that it offset its risk with some of the largest forex liquidity providers and that these banks would cancel or adjust transactions at least once a day due to "invalid" prices. This same FDM stated that sometimes the bank did not notify the FDM of the invalid price until hours after the fact.

The Executive Committee then asked staff to obtain further information on the frequency of and reasons for FDM price adjustments. In April 2008, NFA staff asked FDMs to file weekly reports with NFA providing details relating to any price adjustments, direct or indirect, occurring after May 1, 2008. NFA also performed on-site examinations of seventeen FDMs.

In reviewing the data submitted to NFA as well as from the on-site examinations, NFA found that—from May through September—thirteen FDMs adjusted prices after the fact. Only eight of the thirteen FDMs cited erroneous prices from their liquidity providers as a reason for adjusting prices. Even for these eight, the vast majority of price changes reported by seven of them had nothing to do with their liquidity providers.

Most of the adjustments were due to factors such as stale quotes generated by the FDM's own matching system, unfilled orders due to technical errors with the FDM's trading platform or the customer's front end system, erroneous prices being entered by the FDM's traders, and system connection issues arising from the FDM's use of two or more different trading platforms. For example, two of the largest FDMs reported a significant number of price changes that related to the firms' inability to integrate third party trading platforms. Accordingly, while some FDMs claim that they need the ability to make price adjustments so they can correct pricing errors beyond their control, the actual data submitted by the FDMs and collected during NFA's on-site examinations show that price adjustments are 2 ½ times more likely to result from problems associated with systems under an FDM's control.

In the Board's view, the issue is who should bear the burden of invalid prices: the FDM or the retail customer. For pricing errors that result from the failure of the FDM's own system, the FDM should clearly bear that burden. With regard to pricing errors outside the FDM's immediate control, such as an erroneous price from a liquidity provider, the answer is less clear. The Board has determined that an FDM should be allowed to change a price with a customer after the fact if the FDM's liquidity provider changes the price to the FDM after the FDM entered into an automatic offsetting position with the liquidity provider, the customer has been told in advance that this could occur, and the FDM promptly notifies the customer of the price change.

New Compliance Rule 2-43(a) would permit an FDM to adjust executed customer orders in very limited circumstances. Other than to settle customer complaints in favor of the customer, only FDMs that exclusively operate a "straight-through processing" model would be permitted to adjust executed customer orders. Under this business model, when a retail customer enters an order on the FDM's platform, the FDM automatically (without human intervention and without exception)

enters into the same transaction with another counterparty, creating an offsetting position in its own name. These FDMs would be permitted to adjust the price of executed customer orders if the liquidity provider with which it entered into the automatic offsetting position changes the price of an executed order with the FDM. Additionally, the FDM would be required to notify the customer within fifteen minutes of the customer order being executed that it intends to cancel or adjust the order. Notice must be timely because a customer's reliance on an executed order might influence its subsequent trading.

If FDMs adjust executed customer orders based on adjustments by liquidity providers, the FDM will be responsible for demonstrating that the liquidity provider adjusted the price. Accordingly, as part of the notice to customers the FDM must provide the customer with documentation of the price adjustment made by the liquidity provider. To ensure that FDMs do not selectively choose to adjust only those trades where the adjustment benefits the FDM, an FDM must either cancel or adjust all customer orders affected. Further, the cancellation or adjustment of executed customer orders must be reviewed and approved by a listed principal of the FDM who is also an associated person. Such review must be in writing and include the documentation from the liquidity provider and must be provided to NFA. Finally, any FDM that may elect to cancel or adjust executed customer orders based upon liquidity provider price changes must provide customers with written notice of that fact prior to the time they first engage in forex transactions.

Compliance Rule 2-43(b): Offsetting Transactions

The other trading practice NFA believes must be addressed involves a strategy that FDMs refer to as "hedging," where customers take long and short positions in the same currency pair in the same account. NFA is concerned that customers employing this strategy do not understand either the lack of economic benefit or the financial costs involved.

Ten of 17 FDMs surveyed offer the strategy to their customers, although for most it is a very small part of their business. Of these ten, six actively promote it on their web sites, while another one merely indicates that it is available.

Several of the FDMs told NFA that they had not offered the “hedging” strategy until their customers requested it. Although many of the FDMs admit that customers receive no financial benefit by carrying opposite positions, some FDMs believe that if they do not offer the strategy they will lose business to domestic and foreign firms that do.

NFA has two major concerns about this strategy. First, it essentially eliminates any opportunity to profit on the transaction. Second, it increases the customer’s financial costs in several ways. One way it increases costs is by doubling the expense of entering and exiting the transactions. In the on-exchange markets, a customer who carries opposite positions will normally pay twice the commissions. Similarly, a forex customer will pay the entire spread twice (buying at the high end of the spread and selling at the low end) rather than paying half on entry and half on exit. Additionally, the customer pays carrying charges that always exceed the funds it receives. In a normal transaction, a customer receives “interest” on the long position and pays “interest” on the short position. Since the two transactions are mirror images, you would expect the receipts and payments to zero out. In practice, however, the amount a customer receives on a long position is always less than the amount a customer pays on a short position. Since these transfers occur daily when the positions roll over, the loss increases continually over time.

The costs described above are integral to the strategy, but there is an additional cost that could occur in certain circumstances. FDMs typically determine the equity balance in the account by calculating the liquidation price of the individual positions using the bid rate for long positions and the offer rate for short positions. If the customer holds contemporaneous positions long enough, the carrying charges will bring the equity below the required security deposit. Furthermore, if the bid-ask spread on the currency pair widens, as may happen when volatility increases or the FDM anticipates major market events, the customer’s account equity may fall even faster. If the account falls below its security deposit requirement while the spread is wider than normal, the account could be liquidated at unfavorable prices even though the customer has no currency exposure risk.

The strategy also creates significant potential for abuse. An FDM could promote the strategy to unwitting customers with an eye to collecting the additional

spread and carrying costs. A knowledgeable customer could use it to launder money by using the carrying charge to take intentional losses. For a managed account, the practice could be used to disguise losses and inflate the manager's performance by, for example, directing the FDM to offset a winning position and then entering into a new transaction in the same direction while letting the losing position run.

NFA solicited comments on banning the practice, and two commenters agreed with the proposal, stating that the practice serves no economic purpose. A third supported the ban without discussing the reasons behind it. One commenter that operates an institutional forex platform as well as a retail one indicated that institutional investors never use this strategy. Most commenters stated that the practice results from customer demand and generally felt that NFA should not dictate what strategies customers choose to use. Some were also concerned that customers will simply take their business to foreign counterparties who can accommodate them.

A number of commenters argued that the practice provides a trading strategy benefit. Specifically, they argued that it allows customers to pursue both a long-term and a short-term trading strategy in the same currency. Some commenters also stated that the practice provides an economic benefit because it allows customers to maintain a directional position by lowering their margin requirements when the position goes against them. The proposed rule would not prohibit customers from pursuing long and short-term strategies in separately margined accounts, and it is not clear that the benefits of maintaining a directional position justify the costs.

Several commenters also recognize the financial costs of maintaining two positions but noted that these costs could be alleviated if FDMs treat them as a single position for calculating interest charges and allow customers to offset positions against each other when exiting both at the same time. In fact, at least one commenter seems to suggest that NFA should require this treatment. None of these FDMs have chosen to do so voluntarily, however. Furthermore, this approach would be equivalent to dictating how or how much Members can be compensated.

NFA believes that the potential for misuse outweighs any perceived benefits from allowing customers to carry long and short positions in the same currency in the same account. Therefore, Compliance Rule 2-43(b) bans the practice and

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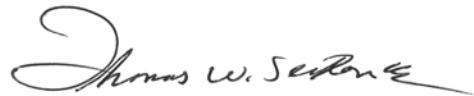
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requires FDMs to offset positions on a first-in, first-out basis (FIFO). It does, however, allow customers to direct the FDM to offset same-size transactions.

One commenter who supported Compliance Rule 2-43(b) said that NFA should provide sufficient lead time so that firms now offering the "hedging" strategy could change their systems. NFA agrees with this comment and will consider systems issues when setting an effective date.

NFA respectfully requests that the Commission review and approve proposed Compliance Rule 2-43 regarding forex orders.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Thomas W. Sexton", with a stylized flourish at the end.

Thomas W. Sexton
Vice President and General Counsel

* The proposed addition of NFA Compliance Rule 2-43(b) becomes effective May 15, 2009, and the proposed addition of NFA Compliance Rule 2-43 (a) becomes effective on June 12, 2009.

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