

February 23, 2009

Via Federal Express

Mr. David A. 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 Security Deposits - Proposed
Amendments to NFA Financial Requirements Section 12 and Interpretive
Notice Regarding Forex Transactions*

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 amendments to NFA Financial Requirements Section 12 and the Interpretive Notice regarding Forex Transactions. This proposal was approved by NFA's Board of Directors ("Board") on February 19, 2009. NFA respectfully requests Commission review and approval of the proposed amendments.

PROPOSED AMENDMENTS
(additions are underscored and deletions are ~~stricken through~~)

FINANCIAL REQUIREMENTS

* * *

**SECTION 12. SECURITY DEPOSITS FOR FOREX TRANSACTIONS WITH
FOREX DEALER MEMBERS.**

(a) ~~Except as provided in (b) below, e~~Each Forex Dealer Member shall collect and maintain the following minimum security deposit for each forex transaction between the Forex Dealer Member and a person that is not an eligible contract participant as defined in Section 1a(12) of the Act:

* * *

~~(b)~~ A Forex Dealer Member that consistently maintains adjusted net capital of at least 150% of the greater of the amount required by Section 11(a)(i) or (ii) of these Financial Requirements is exempt from ~~(a)~~ above.

~~(e)~~ The Executive Committee may temporarily increase these requirements under extraordinary market conditions.

~~(d)~~(c) For purposes of this rule:

(1) "Forex" has the same meaning as in Bylaw 1507(b); and

(2) "Forex Dealer Member" has the same meaning as in Bylaw 306.

~~(e)~~(d) In addition to cash, a Forex Dealer Member ~~required to collect and maintain a minimum security deposit under (a) above~~ may accept those instruments described in CFTC Rule 1.25 as collateral for customers' security deposit obligations. The collateral must be in the FDM's possession and control and is subject to the haircuts in CFTC Rule 1.17.

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INTERPRETIVE NOTICES

* * *

FOREX TRANSACTIONS

* * *

C. OTHER REQUIREMENTS

* * *

4 Financial Requirements Section 12

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~~This requirement does not apply to any Forex Dealer Member that consistently maintains adjusted net capital equal to or in excess of 150% of the~~

~~greater of the amount required by Section 11(a)(i) or (ii) of the Financial Requirements. A Forex Dealer Member claiming the exemption must file advance written notice with NFA. If a firm that claims the exemption falls below 150% of its capital requirement under Section 11(a)(i) and (ii), it must immediately notify NFA. If the firm does not come back into compliance within 48 hours, it must collect the required security deposits on all customer positions and may not claim the exemption for six months. A firm that claims the exemption but falls below the required capital amount three times within 90 days may not claim the exemption for six months.¹⁸~~

¹⁸~~For this purpose, underages within the same U.S. calendar day are one occurrence.~~

EXPLANATION OF PROPOSED AMENDMENTS

NFA Financial Requirements Section 12 requires Forex Dealer Members ("FDMs") to collect a security deposit of 1% of the notional value for specified currencies (called major currencies in the rest of this discussion) and 4% of the notional value for all other currencies.¹ The rule also provides an exemption from collecting these amounts if an FDM maintains 150% of its capital requirement.

When NFA adopted Section 12 in 2003, it required a security deposit of 2% for major currencies and 4% for all other currencies. This was consistent with the margin requirements on the CME's IMM at the time, which averaged 2% for major currencies and 3.9% for other currencies.

Before the rule became effective, NFA met with a number of FDMs that were concerned with the 2% requirement for the major currencies. These FDMs represented that the industry standard was 1% and that NFA's requirement put them at a competitive disadvantage. NFA agreed to re-examine the security deposit requirement and issued an interim no-action position, allowing firms to charge 1% for the major currencies while NFA studied the matter. After evaluating its experience with the 1% level, NFA amended Section 12 to lower the requirement for the major

¹ The currencies that qualify for the 1% security deposit are 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.

currencies to 1%, and it adopted the exemption mentioned above, except that firms were required to maintain twice their capital requirement to qualify.

When NFA adopted the exemption, the minimum capital requirement for FDMs was \$250,000. Given the substantial increase in the minimum capital requirement, in August 2008 NFA lowered the exemption threshold from 200% to 150% of an FDM's capital requirement.² The Board understood, however, that staff was continuing to study the security deposit requirement and ultimately would recommend a different approach.

Staff's research focused on two areas. First, staff examined IMM margins to see how they compare with the security deposits required by Section 12. Second, staff also examined the actual leverage amounts offered by individual FDMs .

Current IMM margins are substantially higher than they were at the time Section 12 was adopted. As of December 24, 2008, margins for the major currencies averaged 5.6% and ranged from 3.5% to 8.2%. Margins for the other currencies traded on the IMM averaged 8.1% and ranged from 3.2% to 12.5%.

As with exchange margin, the primary purpose of the security deposit is to protect the FDM from absorbing the losses of defaulting customers which, if significant enough, could affect the FDM's capital and put the funds of its other customers at risk. 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.

On the other hand, NFA is concerned that higher leverage amounts can deplete a customer's account balance — and result in forced liquidation — much faster than retail customers realize. Of 21 FDMs, eight have the exemption from collecting minimum security deposits. Of these eight, one offers leverage of 700:1, four offer leverage of 400:1, two offer leverage of 200:1, and one offers leverage of 50:1. One of the firms without the exemption also offers leverage of 50:1. A proportionately greater number of the firms that offer higher leverage have also been the subjects of NFA

² The FDM capital requirement was \$5 million in August and will increase to \$20 million by May 2009.

complaints, while neither of the firms that offer 50:1 leverage has ever been the subject of an NFA or CFTC enforcement action.³

These statistics indicate that FDMs can compete while offering leverage of 100:1 or less and that higher amounts can lead to abuses. The amendments leave the minimum security deposit amount at 1% and 4% and eliminate the exemption. Under the amendments, no FDM would be allowed to offer more than 100:1 leverage on the major currencies or more than 25:1 leverage on other currencies. This would bring the operation of the forex requirement more in line with on-exchange margins, which are not affected by the firm's capitalization, while the required amounts would still allow FDMs to offer significantly higher leverage than is currently available for IMM contracts.

NFA's FCM Advisory Committee supported these amendments. NFA also sent the amendments to the FDMs for their comments and received eight responses. One FDM with a large customer base fully supported this proposal, noting that it uses 50:1 leverage for the major currencies and has resisted customer requests for higher leverage because these levels force liquidation too quickly and frequently to be in a customers' best interests. Another FDM supported eliminating the exemption but suggested that the requirement be changed to allow FDMs to offer 200:1 leverage in order to compete internationally. Five other letters also claimed that restricting them to 100:1 leverage would put them at a competitive disadvantage internationally. While these letters opposed the proposal, several of them stated that the international average is 200:1 and this level would be an acceptable compromise. The other FDM opposed the proposal because it limits an FDM's ability to use increased leverage as an incentive to place close-in stop orders.⁴

Commenters proposed several other alternatives besides increasing the allowable leverage to 200:1. One suggested providing exemptions for FDMs with effective risk management systems. Another commenter — whose preferred result is to increase the leverage to 200:1 — proposed, alternatively, that the rule only apply to U.S. customers. The ability to make these distinctions, however, may be problematic since one commenter stated that even the disparity between the allowable leverage for major and minor currencies creates programming inefficiencies.

³ Of the 20 FDMs, eight have been named in ten complaints issued by the Business Conduct Committee in connection with their forex business. Seven of those complaints were against five FDMs that offer more than 100:1 leverage (including two firms with two complaints each).

⁴ This firm offers as much as 700:1 leverage.

Mr. David A. Stawick

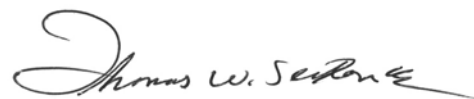
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Finally, three letters took issue with comparing OTC security deposits with exchange margins. These letters suggested three factors that give FDMs more control over the risk in customer transactions than FCMs have over on-exchange transactions: FDM systems generally automatically liquidate positions before the account goes into deficit; the OTC forex markets operate continuously, with no gap between closing prices and the next day's opening prices; and market-making gives firms more control over prices.

After reviewing the comments, NFA believes that the amendments are the best way to address NFA's customer protection concerns with certain FDMs' use of leverage. As noted above, the amendments already take the difference between on-exchange and off-exchange markets into account and allow higher leverage for OTC trades than is currently available for exchange transactions. Regarding the competition issue, two FDMs voluntarily use 50:1 leverage and those without exemptions manage with 100:1 leverage, indicating that firms can engage in the retail forex business and attract customers at these levels. Furthermore, the FDM that uses higher leverage to encourage close-in stop orders actually exemplifies one of the problems NFA is trying to address — that higher leverage can deplete the account balance and result in forced liquidation much faster than customers may realize.

NFA respectfully requests that the Commission review and approve the amendments to NFA Financial Requirements Section 12 and the Interpretive Notice regarding Forex Transactions.

Respectfully submitted,



Thomas W. Sexton
Vice President and General Counsel

* The proposed amendments to NFA Financial Requirements Section 12 and the Interpretive Notice regarding Forex Transactions become effective November 30, 2009.