MEMORANDUM

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FINRA

FROM: Securities Industry and Financial Markets Association (SIFMA)
International Swaps and Derivatives Association (ISDA)

DATE: February 23, 2012

SUBJECT: Retail Foreign Exchange Transactions

The Securities Industry and Financial Markets Association ("SIFMA") and the International Swaps and Derivatives Association ("ISDA") (the "Associations")[1] are writing as a follow-up to our meetings in December 2011 regarding Retail Forex.[2] The Associations appreciate your consideration of our views regarding regulation of the Retail Forex business conducted by our member firms.

Retail Forex conducted by a broker-dealer is subject to regulation by the Securities and Exchange Commission (the "SEC") and has been since 2000.[3] Over the years, the SEC has looked to the Financial Industry Regulatory Association ("FINRA") to develop guidance with respect to this business as conducted by broker-dealers.[4] We understand that the SEC intends to continue to delegate its regulatory authority over the Retail Forex business conducted by broker-dealers to FINRA. We believe this is an appropriate and good approach to regulating Retail Forex and recognizes the connection of the business to that of the securities business conducted

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association ("GFMA"). For more information, visit www.sifma.org. ISDA's members comprise a broad range of OTC derivatives market participants, including banks, asset managers, commodities firms, exchanges and clearinghouses. ISDA, with seven offices nationally and globally, commits to building robust, stable financial markets and a strong financial regulatory framework. For more information, visit www.isda.org.

[2] Retail Forex is subject to regulation under Sections 2(c)(2)(B), 2(c)(2)(C) and 2(c)(2)(E) of the Commodity Exchange Act (the "CEA") and covers over-the-counter ("OTC") foreign exchange transactions conducted with persons who are not eligible contract participants ("ECPs") as defined in the CEA. Section 2(c)(2)(C)(i)(I) excludes (i) transactions offered or entered into by one of the counterparties in Section 2(c)(2)(B) if the transaction is not leveraged, margined or financed by the counterparty; (ii) physically settled spot transactions that settle within T+2; and (iii) transactions that create an obligation to deliver between a seller and buyer each of whom has the ability to deliver and accept delivery in connection with their line of business.

[3] *See* Sections 2(c)(2)(B) and 2(c)(2)(E) of the CEA.

[4] *See, e.g.*, FINRA Regulatory Notice 08-66 (Nov. 3, 2008).

by broker-dealers. We understand that this delegation of authority would apply only to Retail Forex and not to other foreign exchange or other non-securities businesses conducted by broker-dealers.

Retail Forex is an important adjunct to the securities brokerage business our members conduct as members of FINRA. Most of our members provide full-service execution as well as separate advisory services to clients in connection with investing in foreign exchange. Although a few firms may also provide clients with the ability to enter orders electronically, the electronic access is used by firms primarily for conversions only and, in the case of the few firms offering broader electronic execution capability for clients, the clients typically are permissioned to use the service and work with registered financial professionals who apply suitability obligations to the business. Execution is generally performed through intermediation by a financial adviser with an institutional desk within the broker-dealer. The financial adviser typically has access to a large number of third-party quotes as well as those of the firm's own institutional, foreign exchange desk and can assist the client in evaluating pricing. The business includes three primary types of transactions: (i) conversion trades, in which currency is purchased or sold in conjunction with a securities trade;[5] (ii) hedging trades, in which a Retail Forex transaction is entered into to hedge currency risk inherent in a portfolio or specific security or other asset; and (iii) exposure trades, in which foreign exchange provides a client with a means of investing in or selling short a particular market or currency. Member firms may be stand-alone broker-dealers or dually registered as broker-dealers with the SEC and as futures commission merchants with the Commodity Futures Trading Commission (the "CFTC").

The Retail Forex business that the members of the Associations conduct generally is different from the remote-access, platform-based model offered by many Futures Commission Merchants ("FCMs"), retail foreign exchange dealers ("RFEDs") and banks to retail clients. Under that model, clients enter orders without intermediation by or assistance or advice from a financial adviser, and the firms rely on risk warnings rather than suitability judgments, in part because they have very little interaction with the clients and do not assist clients with investing in foreign exchange or other financial products. The regulations promulgated by the CFTC and banking regulators are addressed to this platform-based business and not to the full-service brokerage model followed by most of our members.

The Associations believe that the most appropriate way for FINRA to regulate the full-service Retail Forex business conducted by our members and other broker-dealers like our members is to leverage the existing regulatory framework that is applicable to broker-dealers with respect to their securities-related business. Because full-service broker-dealers must "know their clients," they are able to (i) conduct the type of credit review that is necessary to support a good faith margining standard, (ii) make the type of suitability determination necessary to allow

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[5] As described above, spot transactions and unlevered transactions are exempt from regulation as Retail Forex under Section 2(c)(2)(C)(i)(I) of the CEA. The CEA defines "spot" as transactions that settle physically within two days. Since conversion trades are carried out in conjunction with purchases and sales of securities, they typically settle at the same time as the securities transaction – which is usually three days or more. In addition, because the CEA does not include a definition of what constitutes a "leveraged" transaction, the industry treats conversion trades as Retail Forex for policy reasons in an abundance of caution since the transactions involve delayed settlement beyond the spot definition of two days.

a client to enter into a speculative transaction and (iii) report in a detailed and comprehensive fashion to the client on its Retail Forex holdings in light of the total portfolio mix. The margining scheme, performance risk disclosure requirements and futures-style reporting required by the CFTC and the banking regulators in their regulations are designed for a different business and different concerns from those presented by the full-service business our members conduct.

In addition, the Associations believe that it is important for regulations governing this full-service brokerage model to acknowledge the broad range of clients that are considered "retail." Because Congress was concerned about bucket shops and bad actors pooling client monies to avoid the Retail Forex regulations, it drafted the definition of ECP in a way that could, if interpreted broadly by the CFTC, as currently proposed, include a number of large institutional investors as "retail." The Associations refer to these large institutional investors as "professional clients." In recognition of this concern, the Associations ask that FINRA adopt a two-tiered approach to regulation for the full-service brokerage model that allows for less regulation when transacting with sophisticated institutional or individual investors. This two-tiered approach is designed primarily to provide for less onerous regulations with respect to sophisticated clients that, in large part, would otherwise qualify as ECPs in connection with transactions other than foreign exchange. Most professional clients would be institutions that failed to satisfy the ECP test for commodity pools in Section 1a(18)(A)(iv) of the CEA because not all of their investors are ECPs. In defining what type of client would qualify as a "professional client," FINRA could look to its institutional account standard[6] to delineate between different types of non-ECPs. Another definition that FINRA could use would be the qualified purchaser[7] standard established by Congress in the Investment Company Act as a measure of sophistication sufficient to invest in privately offered fund products. Although use of a qualified purchaser standard would include individuals who were not ECPs for purposes of transacting in other types of swaps under the CEA, given the sophistication of these investors, the Associations believe that treating these clients as "professional clients" would be appropriate.[8]

As you requested, the Associations have provided recommendations below regarding how the Associations think FINRA rules should appropriately be applied to our members' full-service Retail Forex business; what issues would be presented if FINRA were to elect to apply the CFTC's Retail Forex rules to a platform-based Retail Forex business; what provisions in the banking rules may be useful to consider when adopting regulations in the areas and what

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[6] FINRA Rule 4512 defines an "institutional account" as (1) a bank, savings and loan association, insurance company or registered investment company; (2) an investment adviser registered either with the SEC under Section 203 of the Investment Advisers Act of 1940, as amended (the "Advisers Act") or with a state securities commission (or any agency or office performing like functions); or (3) any other person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million. Although many of these entities are ECPs, because the definition of ECP as it applies to commodity pools, as currently proposed by the CFTC, would exclude funds from the definition of ECP unless all of their investors are ECPs, there could be a number of hedge funds and other commodity pools that have over $50 million in assets but are not ECPs.

[7] *See* Section 2a(51) of the Investment Company Act of 1940 (the "Investment Company Act"), as amended. The definition includes natural persons having at least $5 million in investable assets.

[8] To the extent that FINRA were to adopt a "qualified purchaser" standard rather than an institutional account standard, clients having from $5 million to $10 million in assets would not qualify as ECPs.

additional points should be addressed in FINRA rules. The Associations appreciate your consideration.

1. What modifications should be made to existing FINRA rules governing securities brokerage to accommodate the broker-intermediated Retail Forex business conducted by full-service broker-dealers?

The Associations request that FINRA clarify that conversion transactions are outside the scope of FINRA regulation. The Associations believe that this treatment is consistent with the recognition in the CEA that Retail Forex would not include transactions that are subject to physical settlement and not leveraged, margined or financed by the dealer.

Margin

As an initial matter, it is important that FINRA exclude from margin requirements altogether conversion and spot transactions (both of which are physically settled) as well as "covered" transactions (*e.g.*, a short currency call where 100% of the currency to be delivered upon exercise is deposited as collateral in the account). These clarifications would mirror the provisions applicable to securities transactions conducted in a cash account.

Second, with respect to forwards, short options and other Retail Forex transactions involving an extension of credit, the Associations believe that the existing "good faith" approach that the Board of Governors of the Federal Reserve ("Federal Reserve") adopted under Regulation T ("Reg. T") for foreign exchange generally is appropriate and best tailored for the broker-intermediated Retail Forex business. The Reg. T provision would be supplemented by the provisions in FINRA Rule 4210(e). This approach has worked well in the broker-intermediated foreign exchange market (both institutional and retail), and the Associations recommend that it be adopted without modification for the broker-intermediated Retail Forex business.

Day Trading Margin Requirement

The Associations do not believe that the day trading provisions of Rule 4210 should apply at all to Retail Forex. Those rules define day trading as the purchase or sale of the same security on the same day.[9] In the case of OTC transactions in Retail Forex, off-setting transactions entered into on the same day would have different purposes, credit profiles and risk and thus would not be "the same" transaction. For example, a client may execute several different hedges in a single day, each hedging a specific asset or income flow unrelated to the others.

Even if FINRA does believe that the day trading definition should apply to OTC foreign exchange transactions; conversions, spot transactions and other cash account transactions should be exempted, as they would be in the case of securities trades eligible for the cash account, as well as all types of foreign exchange transactions with professional clients. With respect to margin account trades, the Associations do not believe that the day trading provisions in Rule

[9] *See* FINRA Rule 4210(f)(8)(B)(i).

4210 are appropriate. The rules are difficult for the clients to understand and impose a significant operational burden on broker-dealers. The rules are also designed primarily for traders in the equity markets and do not take into account trade practices in the foreign exchange market.

Suitability

The Associations believe that it is appropriate to apply the same suitability standards that are applied to the securities business to Retail Forex. In that regard, the Associations believe that a recommendation should be a triggering event for the suitability obligations to apply. In applying new FINRA Rule 2111 (effective July 9, 2012) to Retail Forex, FINRA should make clear that the institutional-investor exemption contained in FINRA Rule 2111(b) or a similar standard, such as the qualified purchaser standard, discussed above, would apply in case of Retail Forex to allow a broker-dealer to rely on larger, sophisticated clients to make their own suitability determinations. Broker-dealers would be allowed to leverage the procedures that they have in place to address suitability obligations in the securities context for Retail Forex, and the rules and interpretive guidance should be applied by FINRA in a consistent manner across asset classes.

In the context of correspondent clearing, firms should be allowed to contract among themselves regarding which firm would be responsible for suitability. In this context, it would be usual for the executing broker (rather than the clearing broker) to take full responsibility for carrying out the suitability obligations and for the supervision of account activity consistent with FINRA Rule 4311.

Similarly, in the context of prime brokerage, the rule should recognize a division of responsibility between the prime broker and the executing broker. Although the division of duties may be negotiated between the parties, because of the greater client knowledge of the prime broker, in this area our members' experience is that parties typically designate the prime broker as being responsible for suitability obligations.

Know-Your-Customer ("KYC")

With regard to the application of KYC rules, the Associations urge FINRA to apply FINRA Rule 2090 (effective July 9, 2012) to the Retail Forex activities of a broker-dealer conducting a broker-intermediated business to the same degree as the rule applies to clients of broker-dealers transacting in securities. Although the CFTC KYC Rules require that different information be collected than the FINRA Rules do (*e.g.*, NFA Rules require collection of information regarding the client's estimated annual income and net worth whereas FINRA Rule 2111 requires a broker-dealer to collect information regarding a client's financial situation and needs), the general coverage and approach of the two rules are similar. In the Associations' view, it would create additional burdens on both clients and broker-dealers to have to comply with both rules and the Associations do not see any added benefit to be gained by imposing both rules. The Associations recommend that FINRA apply the same approach it applies to broker-dealers with respect to their securities business to the Retail Forex business conducted by broker-dealers.

Best Execution

The Associations do not believe that the best execution standard applied in Rule 5310 is the appropriate standard to apply to Retail Forex. Instead, the Associations believe that FINRA should apply a fair dealing standard and base compliance on the types of considerations that are relevant to determining whether execution has been conducted in the best interest of the client in the context of a widely disbursed, OTC market. These considerations would include evaluation of credit quality of the counterparty, the timing of the transaction, the volatility of the currency, the size of the trade, the availability of quotes, the integrity of the brokers providing quotes and the general market conditions at the time. As the CFTC recognized in the case of swaps,[10] it does not make sense in a market where transactions are individually negotiated to apply the same principles of best execution that apply to a commoditized product, such as a publicly traded equity – even when the swap is executed on a crossing platform or exchange. The Associations believe that the arguments are even stronger in the case of Retail Forex, where the individualized transactions are conducted in an OTC market. While the Associations believe that it is appropriate and consistent with established duties of a broker to its clients for a broker-dealer, in the context of a full-service Retail Forex business, to seek to achieve favorable execution for client orders, the Associations do not think that this standard should be equated with the best execution standards (including the pre- and post-execution reviews) applied to publicly traded equities under FINRA Rule 5310.

In the context of a platform-based Retail Forex business (as opposed to the full-service model conducted by the majority of SIFMA and ISDA members), the Associations believe that the CFTC's pricing standards are appropriate. In this situation, it is important to regulate the quote provider since that will be the client's only source of pricing because clients do not have access to other market quotes or to the assistance of a financial adviser intermediary. The Associations think that the CFTC's approach of requiring the platform provider to provide pricing that is "reasonably related to current market prices" is appropriate and fair. The Associations would endorse building this standard into FINRA's rules for Retail Forex conducted using a platform-based model but not for Retail Forex conducted by broker-dealers under the full-service model.

Exercise of Discretion and Discretionary Accounts

To the extent that a broker-dealer exercises full investment discretion over a client's account and the account contains securities, interpretive guidance from the SEC suggests that the broker-dealer is subject to registration as an investment adviser with the SEC or the applicable state.[11] As a registered adviser, all fiduciary activities (including those relating to foreign

[10] See Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties; Final Rules (Jan. 11, 2012), p. 6, available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister011112e.pdf; see also Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties; Proposed Rule (Dec. 22, 2010), 75 F.R. 80638, 80662.

[11] *See* Proposed Interpretative Rule under the Advisers Act Affecting Broker-Dealers, Advisers Act Release No. 2652 (Sept. 24, 2007).

exchange) would be subject to regulation by the SEC under the Advisers Act or the state under applicable state law but not by FINRA. As a result, as is the case today, a registered investment adviser must comply with conflict of interest provisions under Section 206 of the Advisers Act when transacting directly or through an affiliate with a client whose account is managed with discretion by the broker-dealer. This delegation of authority to the SEC and to the states to regulate advisory activity and related trading activity involving securities and Retail Forex should be referenced in the Retail Forex rules and govern discretionary trading of Retail Forex for clients of full-service broker-dealers in lieu of the CFTC rules (which prohibit trading between a managed account and an affiliate of the adviser – even with client consent).

To the extent that a broker-dealer provides investment advice only with respect to Retail Forex that is booked at the broker-dealer, that activity would not be subject to SEC or CFTC regulation or regulation by the states. However, the SEC would have the ability to bring enforcement actions against the adviser under Section 206 of the Advisers Act. As a result, trading by the discretionary adviser for an advised account with an affiliate should be subject to the same type of trade-by-trade consent procedures applied by the SEC to trades by advisers with affiliates for managed accounts in securities pursuant to Section 206(3) of the Advisers Act. Again, in the Associations' view, regulation of this activity by the SEC rather than imposition of the CFTC's rule regarding discretion is the appropriate approach to follow.

NASD Rule 3260 governs the obligations of members having discretionary authority over client accounts. Among other things, Rule 3260 allows members to exercise time or price discretion given by a client during a normal trading session, provided that the discretion is only valid during that session or, if given after the session, then during the next normal trading session. The Associations believe that these rules are appropriate for a broker-dealer conducting a full-service Retail Forex business.

Marketing and Advertising

FINRA has proposed a new rule to replace NASD Rules 2210 and 2211 and NYSE Rule 472, which are currently in effect. The proposed rule would replace the current categories of communications with three broad categories: retail communication, correspondence and institutional communication. The Associations support application of this proposed rule to Retail Forex, including application of the institutional communication carve-out from the filing requirements.

Trade Reporting

The Associations understand that FINRA has a legitimate need to receive and review market-based information in order to oversee the market and ensure compliance by broker-dealers with applicable regulations. However, the Associations believe that FINRA should take steps in adopting requirements in this area to ensure that (i) any trade reporting system adopted be as economical as possible and leverage existing reporting systems to the greatest extent possible so as to avoid duplicative reporting; and (ii) spot foreign exchange and conversion trades be exempted from reporting requirements since those transactions are conducted solely to facilitate securities trades or for commercial purposes (i.e., to pay for a shipment of foreign

goods) and not for speculation and, thus, are outside the regulatory purview of the SEC and FINRA.

The Associations believe that FINRA may be able to achieve economies of scale by leveraging National Futures Association's ("NFA's") reporting system for Retail Forex. Although NFA uses the system for end-of-day reporting, the Associations believe that it could efficiently be adopted for use on a weekly basis rather than a daily reporting basis. The Associations recommend that FINRA adopt a weekly reporting system rather than a daily system.

The Associations do not believe that use of FINRA's Trade Reporting and Compliance Engine ("TRACE") and the TRACE rules would be appropriate in the context of Retail Forex. Although TRACE has produced some market-related benefits, it has been difficult to administer and costly to implement. The Associations urge FINRA to seek to find a more efficient and cost-effective solution for trade reporting regarding Retail Forex that will still satisfy the very real need that FINRA has to monitor the market.

Client Account Statements

The Associations would support application of FINRA's existing and proposed revised rule governing client account statements to Retail Forex.[12] The Associations also believe that broker-dealers should be allowed to deliver statements regarding Retail Forex to clients electronically, consistent with the SEC's requirements on the use of electronic media by broker-dealers.

Confirmations

The Associations believe that it is appropriate to apply the same confirmation requirements set out in Rule 10b-10 of the Securities Exchange Act of 1934 (the "Exchange Act") for securities to Retail Forex. Rule 10b-10 requires broker-dealers to provide a confirmation, which may be provided electronically, at or before the completion of each transaction, disclosing certain basic terms of the transaction (*e.g.* price, quantity, currency, date). As is the case for confirmations for fixed income transactions, the Associations do not believe it is appropriate to disclose the spread or mark up associated with principal transactions in Retail Forex on the confirmation. The Associations also believe that FINRA should make clear that, at least in the case of professional clients, third-party electronic matching confirmation services would meet the requirement to provide confirmations for forex transactions.

[12] FINRA has had pending since 2009 proposed Rule 2231, which would replace NASD Rule 2340 and NYSE Rule 409, governing client account statements. Among other changes, the rule would require that members deliver account statements to clients monthly except under limited circumstances where there was no account activity and the client had access to the account both via the Internet and via telephone. The account statements must describe the securities positions, cash balances and any purchase, sale, transfer or distribution activity in the account since the prior statement and advise clients to report any discrepancies in their account and confirm in writing any oral communications made during the month. As SIFMA has commented previously to FINRA, we believe that it should be adequate that the client has access to his or her account either via the Internet or via telephone connections in order for the exception to monthly reporting to apply.

Supervision

In connection with adoption by the SEC of a permanent rule authorizing broker-dealers to carry out a Retail Forex business, the Associations believe it is appropriate to apply NASD Rule 3010 (or a successor rule) to Retail Forex going forward. FINRA Regulatory Notice 08-66 currently requires member firms engaging in Retail Forex activities to ensure that their anti-money laundering program addresses the risks associated with the business and includes procedures for monitoring, detecting, and reporting suspicious transactions associated with their Retail Forex activities, but it does not apply FINRA's supervisory rule to Retail Forex in any other respect. We believe that the appropriate supervisory standard to apply to the Retail Forex business in connection with de novo adoption of regulations by FINRA is the FINRA standard that is currently applicable to the securities business conducted by broker-dealers and not the CFTC's standard (which is similar but tailored for FCMs and not broker-dealers). We agree that, going forward, it is reasonable to apply securities-based rules to broker-dealers requiring adoption of written supervisory procedures reasonably designed to ensure compliance with applicable laws, rules and regulations in connection with conduct of their Retail Forex business. As discussed in current Regulatory Notice 08-66, we also believe that it is appropriate for broker-dealers to be required to conduct due diligence on solicitors that introduce Retail Forex clients to their firms.

Capital and Customer Protection

The Associations believe that current FINRA Rule 4210 and Rules 15c3-1 and 15c3-3 under the Exchange Act regarding net capital requirements for broker-dealers applicable to Retail Forex activities, as currently in effect, are appropriate without modification. Under Rule 15c3-1 of the Exchange Act, broker-dealers must treat the unsecured portion (but <u>*not*</u> the secured portion) of the receivable from a client on a Retail Forex transaction as a non-allowable asset for purposes of net capital calculation. To the extent that the client's obligation is secured by allowable assets (generally, freely saleable securities collateral or a U.S. dollar balance), the broker-dealer may treat such secured portion as an allowable asset for purposes of the net capital calculation. That treatment is conservative as well as well tailored for the business of the broker-dealer. Additionally, under the current securities regime, SEC Rule 15c3-3 under the Exchange Act requires broker-dealers to maintain margin posted for securities and to segregate when margin posted by clients is in excess of 140% of the mark-to-market position of the broker-dealer. The Associations believe that the current SEC customer protection rule is appropriate for Retail Forex.

Recordkeeping

Under the Exchange Act Rules 17a-3 and 17a-4, broker-dealers are required to make, keep current, and preserve records regarding the broker-dealer's securities business. A broker-dealer must preserve its records for at least three years and make the records readily accessible for the first two years. Under FINRA Rule 4513, broker-dealers must also maintain a record of all written client complaints for a period of four years. The Associations support application of these rules to Retail Forex and believe that it would be beneficial for broker-dealers to comply

with the same set of recordkeeping rules for both their securities-related business and their Retail Forex business.

Bulk Transfer

FINRA typically requires client consent for bulk transfers but allows for the use of negative consent in limited circumstances. The Associations believe these principles apply equally to Retail Forex accounts for full-service broker-dealers.

Arbitration

The Associations urge FINRA to apply its existing pre-dispute arbitration requirements to Retail Forex clients of broker-dealers. FINRA Rule 2268 requires a broker-dealer to highlight all pre-dispute arbitration disclosures in any client agreement and include prescribed language in outline form before any pre-dispute arbitration clause. A broker-dealer must also highlight statements in the agreement noting that the agreement contains a pre-dispute arbitration clause and where the clause is located. The Associations do not support imposition of the arbitration requirements by the CFTC or the banking regulators. To adopt a separate set of arbitration rules for Retail Forex activities would create additional burdens on both clients and broker-dealers. It would be confusing for a client that transacts both securities and Retail Forex with a broker-dealer to have a different dispute mechanism with its broker-dealer depending upon the product.

2. If FINRA were to adopt the CFTC's Retail Forex rules and apply them to broker-dealers that conduct a platform-based Retail Forex business, what modifications should be made to the rules?

As mentioned above, the Associations believe that the regulations promulgated by the CFTC are addressed to the platform-based Retail Forex business and not to the full-service brokerage model followed by our members. The CFTC regulations are designed for a different business and different concerns from those presented by the full-service business that most of our members conduct. The Associations have provided our recommendations below regarding which of the CFTC's Retail Forex rules should be applied to the platform-based Retail Forex business.

Margin

As discussed above, the Associations believe that the "good faith" approach applied by Reg. T is appropriate for the broker-intermediated, full-service Retail Forex business and should be applied to that business by FINRA. The Associations also believe, however, that the futures-style margining system and margin levels (2% for major currencies and 5% for other currencies) that have been applied to FCMs, RFEDs and banks are appropriate for the platform-based, true retail business conducted by those entities. The CFTC's strategy-based margining approach assumes that the dealer is not positioned to take into account the credit profile of each client, as a broker-dealer is required to do under a good faith margining approach. The Associations support adoption of a different margining approach for full-service Retail Forex and for the platform-based business.

Custody and Use of Collateral

The CFTC rules require the dealer to hold assets equal to the total net credit balance of property deposited with the firm by Retail Forex clients, adjusted to reflect unrealized profits and losses. Custody of these balances must be at a "qualifying institution," which includes a broker-dealer or a bank. Assets may be invested in accordance with CFTC Rule 1.25 but may not otherwise be rehypothecated or used in the dealer's business. The Associations do not believe these rules are appropriate for broker-dealers or are consistent with those in effect for the securities business operated by broker-dealers. Under the current securities regime, SEC Rule 15c3-3 under the Exchange Act requires broker-dealers to maintain margin posted for securities and to segregate when margin posted by clients is in excess of 140% of the mark-to-market position of the broker-dealer. The Associations believe that the current SEC custody protection rule is appropriate for Retail Forex and that the CFTC rules should not be adopted by FINRA.

Confirmations

CFTC rules require daily confirmations that are similar to those required for listed futures. The Associations believe that this style of confirmation will be potentially confusing to broker-dealer clients and recommend that broker-dealers be allowed to provide clients with the same style of confirmation for Retail Forex as they do for securities.

Account Statements

The Associations do not believe that FINRA should adopt the CFTC's rules with respect to client reporting but should, instead, rely on existing requirements under FINRA and SEC rules. CFTC rules require broker-dealers to provide monthly account statements that include much but not all of the same information as is required for securities statements. The Associations believe that clients should receive a uniform style of statement for all assets carried at their broker-dealer to allow them to better understand their portfolio and to see positions carried as hedges.

Trade Reporting

NFA currently requires daily end-of-day reporting for all Retail Forex activities. The reports are submitted through NFA's Forex Transaction Reporting Execution Surveillance System ("FORTRESS"). NFA has been collecting such information from forex dealer members since July 2010. The Associations would support adoption of FORTRESS or a similar system for use by broker-dealers under a reporting regime that allows for weekly reporting.

Discretionary Trading

The Associations do not believe that the CFTC's rules with respect to discretionary trading are appropriate for the Retail Forex business conducted by broker-dealers. In the Associations' view, it is important that broker-dealers that are dually registered as investment advisers be allowed to act as discretionary advisers with respect to Retail Forex. With respect to

the regulation of such activity, the Associations believe that it is best left to the SEC and the individual states, as provided under the Advisers Act and applicable SEC interpretations. Consistent with Section 206(3) of the Advisers Act, which applies to trading by an investment adviser for a client in securities, an SEC-registered investment adviser should be authorized to enter transactions in Retail Forex for the client's account with its own trading desk or that of an affiliate subject to receipt of trade-by-trade consent from the client.

Know-Your-Customer

The CFTC KYC rules are similar to FINRA's rules in approach but require collection of different information as well as impose different implementation and recordkeeping requirements (e.g., under the CFTC's rules, a Retail Forex dealer may still do business with a client that refuses to provide certain identifying information but must retain a record of the refusal). The Associations do not believe that imposition of the CFTC rules is necessary or appropriate given the comprehensive KYC rules already in place at broker-dealers. The Associations recommend that FINRA not apply these rules.

Employee Registration and Training

The Associations do not support application of CFTC and NFA registration requirements to broker-dealer employees. Instead, the Associations believe that existing employee registration and training requirements for registered representatives of broker-dealers transacting in securities should be maintained with regard to Retail Forex activities. The Associations also believe that continuing education requirements applicable to securities activities should apply to Retail Forex activities as well. To the extent that FINRA is concerned that full-service brokerage personnel may not have sufficient expertise with respect to Retail Forex, it may want to consider adding Retail Forex related questions to the existing Series 7 and 24 examinations.

Performance-Related Disclosure

The Associations recommend that FINRA not adopt the performance-related disclosure rules adopted by the CFTC. These rules require that forex dealers provide both at account opening and at any time during the account relationship, upon request of a client, a description of whether Retail Forex accounts carried by the dealer are profitable (aggregating performance across accounts but without disclosing the identity of the account holder). This requirement is contrary to FINRA guidance (NASD Rule 2210) that prior performance reflecting profitable trading is misleading. Moreover, given that the individuals managing the trading of the various accounts are different, showing aggregate combined performance is misleading and runs a risk that performance by some highly skilled clients will mask poor performance by others. This risk is particularly acute if some of the country's largest hedge funds will be considered non-ECPs for purposes of conducting foreign exchange. Assuming that foreign exchange experts, whether institutional investors or individuals (*e.g.* money managers or finance professors trading in their own name) will generally have better performance than non-expert foreign exchange investors, new clients could falsely assume that Retail Forex is a suitable and profitable activity for them based on these profitability analyses of investors who are foreign exchange experts. In all

likelihood, it may be difficult for an individual investor to achieve the same profitability as a foreign exchange expert.

Performance disclosure is confusing to investors because different Retail Forex products will result in different performance records. Similarly, the value of hedging transactions will not be appropriately reflected in the performance report unless the hedge is of another asset in the client Retail Forex account.

In sum, the Associations recommend that FINRA not apply this requirement to broker-dealers conducting a full-service Retail Forex business. Clients already receive periodic and year-end statements that reflect performance of their own accounts. The Associations also do not believe that the requirement addresses the primary concern underlying the rule – which was to help clients identify false and misleading marketing conducted with respect to Retail Forex. The Associations believe that this concern is best addressed by subjecting marketing to review by firm supervisors, as the FINRA rules require, as well as to examination by regulatory authorities, as is the case with marketing material relating to securities.

Limits on Price Adjustments

The Associations recommend that FINRA not limit a broker-dealer's ability to make adjustments to the price of transactions as contemplated by the CFTC rules. To the extent that FINRA wishes to impose some constraints, the Associations believe that an appropriate approach might be that recommended by the Federal Reserve in its proposed rules, which allows for price adjustments with client consent.

Under the CFTC Rule, a regulated entity generally may not adjust or alter prices for a Retail Forex transaction except to settle a client complaint, when "straight-through-processing" is utilized or when a price is more favorable to the client. Although the Associations agree with the underlying concern about adjustments, the Associations also believe that there are times when there are bona fide errors that should be corrected. By adopting either the current approach followed by FINRA in this area under just and equitable principles of trade or the Federal Reserve's approach of allowing adjustments with client consent, FINRA would ensure that firms and clients could accurately and appropriately record trades and correct legitimate errors.

Offset Positions

Under the CFTC rules, a regulated entity must offset positions on a first-in, first-out basis, although a client may direct the dealer to offset the oldest transaction of the same size, even if there are older transactions of a different size. Currently, broker-dealers do not offset positions for OTC Retail Forex activity unless they were specifically requested to do so by clients or a position is entered into specifically to close out an existing position. The brokerage approach more accurately reflects the intent of the client by allowing off-setting positions to stay intact if, for example, they are part of an arbitrage strategy or maintained as hedges for two different securities positions or two different asset classes. Although the Associations understand the CFTC's desire to reduce systemic risk and to address a problematic Retail Forex strategy that certain bucket shops had been promoting involving offsetting positions, the

Associations do not believe that the mandatory offset rule is an appropriate way to address these concerns, as it may adversely impact clients and their intended hedging and investment strategies.

Risk Disclosure

Under the CFTC rules (as well as the Retail Forex rules of the banking regulators), the dealer must provide prescribed risk disclosure to Retail Forex clients. The Associations agree that this disclosure is generally appropriate, but the Associations would recommend that FINRA allow professional clients to waive receipt of the disclosure.

Price Disclosure

The CFTC rules require disclosure of the bid and ask price at order entry. The Associations believe that for Retail Forex clients other than professional clients it is appropriate that the client be provided with the bid and ask price at order entry. The CFTC requirement is intended to provide Retail Forex clients with an understanding of how much the market must move in order for the client's transaction to be profitable. For professional clients, however, this is unnecessary as these types of institutional clients are not necessarily entering into these transactions for purposes of making a profit on the forex transaction, but rather as part of a larger investment strategy. Moreover, professional clients are well aware of the current pricing in the forex market. Accordingly, professional clients are concerned solely with the pricing of the side of the transaction they are entering into, *i.e.*, the bid or the ask, but not both.

The CFTC rules and some of the banking regulators' rules require disclosure of fees, charges, commissions and spreads on monthly statements. The Associations believe it is appropriate to disclose fees, charges and commissions at both order entry and on the monthly statements. Similar to FINRA's and the SEC's rules with respect to fixed income securities, however, the Associations do not believe it is appropriate to require specific disclosure of the spread or of any mark up either on the monthly statements or on the confirmations. Non-professional Retail Forex clients will be aware of a broker-dealer's spread implicitly through disclosure of the bid and asked prices in connection with receipt of the order for the Retail Forex transaction, similar to fixed income transactions.

Trading Platforms

The CFTC rules (as well as similar banking regulators' rules) require that there be procedures in place that are reasonably designed to ensure the integrity of trades placed on trading platforms used by clients, including proprietary trading platforms as well as platforms on a white label or sponsored basis. Trading platforms must be designed to provide bids and offers that are reasonably related to current market prices. The Associations believe that CFTC's trading platforms rules are appropriate for Retail Forex and should be adopted by FINRA.

Supervision

The CFTC and NFA rules require completion and retention of a self-audit questionnaire annually and also require a qualified independent outside party to conduct an annual review of the trading platform. The Associations support adoption of these procedures, but believe that the requirement to have independent third parties conduct annual reviews of trading platforms provided exclusively to high-net-worth or ultra-high-net-worth clients is not necessary or appropriate for the platform-based Retail Forex business.

Anti-fraud Rules

The CFTC and NFA rules prohibit fraudulent activities, creation of false reports and the providing of false information to NFA. The Associations believe that adoption of similar rules by FINRA is appropriate for the Retail Forex business.

Prohibition Against Guarantees

The CFTC rules prohibit any representation to a Retail Forex client regarding a guarantee against loss. The CFTC rules also prohibit any representation that the CFTC or any other governmental agency has sponsored, recommended or approved the Retail Forex business. The Associations support adoption of similar rules by FINRA for the Retail Forex business conducted by broker-dealers.

Directions from Trader

The CFTC rules require that specific authorization be obtained from a client or authorized trader before execution of a Retail Forex transaction and that a record of such authorization be maintained. The Associations do not believe it is necessary for FINRA to adopt this rule because FINRA has incorporated NYSE Rule 408, which requires firms to obtain prior written authorization from a client in order to exercise any discretionary power in a client's account. The Associations believe that FINRA's requirements are comprehensive and consistent with existing requirements for a broker-dealer's securities business.

Capital

The CFTC's net capital rules require a minimum of $20 million and do not allow assets held by an affiliate (unless approved by NFA) as current assets. The Associations believe that the Exchange Act Rule 15c3-1, which is already applicable to Retail Forex, and not the CFTC net capital rule, is appropriate and should be applied to broker-dealers with respect to their Retail Forex business.

Recordkeeping

The Associations do not believe that FINRA should adopt the CFTC's recordkeeping rules. The CFTC requires the maintenance of daily net capital computations and the calculation of profitable and non-profitable accounts. The Associations believe that these rules are

burdensome to broker-dealers and provide no added value to clients. FINRA's and the SEC's existing recordkeeping requirements are comprehensive and consistent with existing requirements for a broker-dealer's securities business.

Bulk Transfer

The CFTC rules are similar to FINRA's rules in approach. Given that broker-dealers are already set up to comply with FINRA rules, the Associations believe that it would be more appropriate to apply those rules for the Retail Forex accounts in the same manner as the securities accounts.

Arbitration

CFTC rules, like the FINRA rules, require disclosures regarding pre-dispute arbitration but also impose additional requirements, such as a requirement that the dealer not condition provision of Retail Forex services on the client signing an arbitration agreement. The Associations believe that dispute resolution should be uniform across product classes, and the Associations recommend that FINRA not adopt the CFTC's requirements but, instead, allow broker-dealers to comply with existing FINRA rules with respect to their Retail Forex business.

3. Are there provisions in the bank regulators' proposed or final regulations that FINRA should consider adopting?

Yes. Proposed Regulation NN, proposed by the Federal Reserve on July 28, 2011, includes the following provisions, which the Associations believe would be useful to include in FINRA regulations of broker-dealers with respect to retail foreign exchange:

(a) Regulation NN provides for a notice requirement rather than a registration requirement. This is consistent with FINRA's existing approach under Rule 1017 but, as proposed by the Federal Reserve, provides for a more tailored and streamlined process. Under Rule 240.4, a subject institution must provide the Federal Reserve with prior written notice of its intent to conduct the activity. The notice becomes effective in 60 days provided the Federal Reserve does not request additional information. The information to be provided consists of (i) KYC and credit check information, (ii) margin haircuts, (iii) new product approvals, (iv) conflicts of interest and (v) a board resolution stating that the institution has established compliance policies and risk procedures governing the business.

(b) Under Rule 240.5 of Regulation NN, a regulated entity may offset Retail Forex transactions in accordance with client instructions rather than having to close out offsetting transactions regardless of client intention, as required by the CFTC's rules.

(c) The Associations also agree, as the Federal Reserve concluded in its proposed rules, that firms should not be required to use a separate margin account that holds only client Retail Forex margin and positions but, instead, should allow the transactions to be booked in a securities or other account.

(d) As provided in Regulation NN, and unlike the Office of the Comptroller of the Currency and Federal Deposit Insurance Corporation rules, the FINRA rules should allow the member forex dealer to apply a Retail Forex client's losses against assets or liabilities of the Retail Forex client and, thereby, exercise set-off rights.

4. Would broker-dealers elect not to do Retail Forex in a broker-dealer if the regulation included (as they necessarily would) some type of trade reporting?

The Associations' members have consulted with senior business colleagues and confirmed the importance of being able to conduct a Retail Forex business in the broker-dealer. Our members' business groups understand FINRA's need to receive trade data in order to monitor and surveil the market and business conduct but urges FINRA to be mindful of costs in developing its rules and procedures in this area. These groups suggested that FINRA coordinate with NFA to see if FINRA may be able to leverage the FORTRESS reporting system that NFA developed for FINRA members. The Associations also recommend that FINRA adopt a weekly reporting system rather than a daily trade reporting system. Conversions and spot transactions should be exempt from trade reporting.

Regardless of the trade reporting regime that is ultimately adopted by FINRA, firms will need some period of time (ideally, one year) to build infrastructure and come into compliance with the new requirements. In the interim, FINRA could request trade information as needed from the firms.

5. What certification requirements should broker-dealers use to confirm that clients should transact in foreign exchange under the Retail Forex rules rather than under the swap rules and what are the consequences of a client moving from non-ECP to ECP status?

FINRA should allow broker-dealers to monitor the status of their clients as non-ECPs once a year by relying on an affirmative initial certificate and subsequent annual updates through the use of negative consent letters. Although a client may migrate to ECP status during the course of a year, the Associations believe that it is appropriate to allow them to continue transacting on the same Retail Forex platform in connection with which they will receive enhanced protections. The Associations do not believe that it was the intent of Congress to force individual investor clients to move between Retail Forex and institutional foreign exchange platforms as the individual's ECP status changes. With individuals, this is particularly likely to occur since the definition of ECP applicable to individuals is dependent upon the value of their respective investment portfolios.

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The Associations thank you for the consideration of our views and thoughts and welcome the opportunity to discuss these matters further. If you have additional questions, please do not hesitate to contact P. Georgia Bullitt at 212-309-6683 (gbullitt@morganlewis.com) or Michael A. Piracci at 212-309-6385 (mpiracci@morganlewis.com) at Morgan, Lewis & Bockius LLP if you have any questions regarding this memorandum or need any additional information.

Sincerely yours,

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