MEMORANDUM

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TO: James Brigagliano
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US Securities and Exchange Commission

FROM: P. Georgia Bullitt
Michael A. Piracci

DATE: June 17, 2011

SUBJECT: Pershing LLC – Proposed Relief regarding transactions in Retail Foreign Exchange

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On behalf of Pershing LLC, we respectfully request relief to allow broker-dealers to continue to transact in foreign exchange with retail investors in limited ways after July 16, 2011. The relief we are seeking relates to the following three types of transactions: (i) purchase by a broker-dealer of a foreign currency or exchange of a foreign currency for USD on behalf of a retail customer in connection with the purchase or sale of a security by the retail customer when the foreign currency settlement is greater than two days, (ii) conversion by a broker-dealer of a foreign currency into USD or of USD into the foreign currency in connection with a distribution or other payment received in respect of a customer's security when the foreign currency settlement is greater than two days, and (iii) maintaining on the books of the broker-dealer, after July 16, 2011, a foreign exchange transaction entered into by a broker-dealer with a retail customer, prior to July 16, 2011. The reason we are seeking the relief is that, after July 16, 2011, we believe that there would be uncertainty about the legality of a broker-dealer continuing to engage in these activities under the terms of The Dodd Frank Wall Street Reform and Consumer Protection Act of 2010 ("The Dodd Frank Act") due to the fact that the Securities and Exchange Commission (the "SEC") has not adopted rules governing transactions in foreign exchange by broker-dealers with retail investors.

We believe that this relief is important not only for Pershing and its correspondent brokers and customers but it is also consistent with the protection of U.S. investors and with the safe and sound operation of the U.S. securities markets. Failure by the SEC to grant relief may require broker-dealers to execute currency transactions at a separate, stand-alone entity or on a day or two prior to settlement of the accompanying securities transactions and to move existing foreign exchange positions with retail customers to a separate entity. These changes potentially subject retail customers to greater price risk, credit risk, operational risk and, -in the case of the transfer, potential adverse tax consequences.

Pershing seeks exemptive relief or, in the absence of exemptive relief, interpretive guidance and no-action relief for the following:

(i) A determination that physically-settled, foreign exchange transactions (each a "Securities Conversion Trade") effected by a broker-dealer solely to effect the purchase or sale of a security or in order to clear or settle such purchase or sale are not "foreign currency transactions" as defined in Section 2(c)(2) of the Commodity Exchange Act (the "CEA") even if the settlement period is longer than trade date+2 days ("T+2");

(ii) A determination that physically-settled foreign exchange conversions to change foreign currency payments made with respect to securities held for a customer, such as coupons, dividends and class action settlements, to the currency in which the account is

denominated (i.e., typically, USD), even if settled at a date later than T+2, are not "foreign currency transactions" as defined in Section 2(c)(2) of the CEA; and

(iii) A determination that foreign exchange transactions entered into by a broker-dealer with a person that is not an eligible contract participant ("ECP") prior to July 16, 2011 may continue to be held on the books of the broker-dealer until maturity of the transactions and would not be impacted by effectiveness of the provisions in Section 2(c)(2)(E) of the CEA (*i.e.*, requiring the SEC to adopt rules in order for broker-dealers to be able to offer or enter into any foreign currency agreement or transaction with a non-ECP).

Background

Section 2(c)(2)(B) of the CEA provides that only enumerated regulated entities are permitted to offer or enter into off-exchange, foreign currency transactions with persons that are not ECPs ("retail foreign exchange"). The enumerated entities include SEC-registered broker-dealers.[1] The legislative history indicates that Congress was focused on providing regulatory authorities with anti-fraud enforcement authority over retail foreign exchange as well as the ability to regulate cash-settled instruments used for speculation, such as rolling spot transactions.[2]

The Dodd Frank Act added Section 2(c)(2)(E) to the CEA. This section provides that a broker-dealer may not offer to or enter into with a non-ECP any agreement, contract, or transaction in foreign currency described in section 2(c)(2)(B)(i)(I) of the CEA except pursuant to a rule or regulation of the SEC "allowing the agreement, contract or transaction."

Section 2(c)(2)(B)(i)(I) of the CEA references "an agreement, contract, or transaction in foreign currency that—(I) is a contract of sale of a commodity for future delivery (or an option on such a contract)…" The scope of what constitutes a transaction that would be covered by this provision is not clear and has been the source of litigation.[3] The Section 2(c)(2)(B)(i)(I) definition could be read to be qualified by the expanded definition of "retail foreign exchange" contained in Section 2(c)(2)(C)(i) of the CEA, which reads as follows:

"(I) This subparagraph shall apply to any agreement, contract, or transaction in foreign currency that is offered to, or entered into with, a person that is not an eligible contract participant (except that this subparagraph shall not apply if the counterparty, or the person offering to be the counterparty, of the person that is not an eligible contract participant is a person described in any of item (aa), (bb), (ee), or (ff) of subparagraph (B)(i)(II)); and (bb) offered, or entered into, on a leveraged or margined basis or financed by the offeror, the counterparty, or a person acting in concert with the offeror or counterparty on a similar basis.

1 *See* Section 2(c)(2)(B)(i)(II)(bb) of the CEA.

2 *See* H.R. Rep. No. 110-627 at 978 (2008)(Conf. Rep.)(describing the purpose of section 2(c)(2)(C) of the CEA). As described by the Commodity Futures Trading Commission (the "CFTC"), the history of the regulation of retail foreign exchange is one focused on cash settled, leveraged, speculative transactions that were marketed to small unsophisticated investors and the subject of a large number of fraud cases. *See generally*, 75 Fed. Reg. 3282, 3283 - 3285 (Jan. 20, 2010), *see also* 75 Fed. Reg. at 3285 (noting that the Commodity Futures Trading Commission Reauthorization Act of 2008 ("CRA") charged the CFTC with "regulating speculative forms of retail forex trading" and excluding "true spot transactions that have a legitimate business purpose or that result in actual delivery").

3 See *CFTC v. Zelener*, 373 F.3d 861 (7th Cir. 2004), reh'g denied, 387 F.3d 624 (2004) and *CFTC v. Erskine*, 512 F.3d 309 (6th Cir. 2008).

(II) Subclause (I) of this clause shall not apply to –
(aa) a security that is not a security futures product; or
(bb) a contract of sale that –
(AA) results in actual delivery within 2 days;[4] or
(BB) creates an enforceable obligation to deliver between a seller and buyer that have the ability to deliver and accept delivery, respectively in connection with their line of business."

Under this reading, absent regulations or other guidance by the SEC, retail foreign exchange transactions that settle beyond T+ 2 (even if effected solely in order to purchase securities or to convert distributions) arguably could be deemed to be transactions covered by the provision of 2(c)(2)(E) of the CEA. As a result, questions may be raised regarding the legality or enforceability of the transactions absent relief. In addition, because the word "offered" in Section 2(c)(2)(B(i)(II) and 2(c)(2)(C)(i)(I) could be interpreted to refer to a position that continues to be carried by a broker-dealer with a customer after July 16, 2011, there is a risk that legacy positions entered into by broker-dealers with non-ECPs prior to July 16, 2011 would be deemed to be unauthorized as of that date unless moved to a regulated entity whose functional regulator has passed rules to conduct retail foreign exchange. Appropriately-regulated entities would include a futures commission merchant or retail foreign exchange dealer but only if the entity was not dually-registered as a broker-dealer or material associated person of a broker dealer.[5]

Analysis

A Securities Conversion Trade should not be deemed to be a retail foreign exchange transaction because it is not "entered into on a leveraged or margined basis or financed" by the broker-dealer. Based on a common sense reading of the term "financial leverage," this term assumes that there has been a borrowing in connection with which debt has been created. *See, e.g., Wikipedia,* "Financial leverage refers to the use of debt to acquire additional assets." The conversion trades effected by broker-dealers are not subject to margining and do not involve borrowing or lending in connection with purchase of the foreign currency. In connection with purchases of foreign securities by the broker-dealer on behalf of retail customers, the customer typically has money in its account at the broker-dealer on trade date to pay for the conversion or will deposit the payment amount with the broker-dealer prior to the settlement date.

Treatment of a Securities Conversion Trade as being outside the scope of Section 2(c)(2)(E) and, thus, authorized to continue to be conducted by a broker-dealer, absent additional rule making or pursuant to an exemption, is consistent with Congressional intent and should be approved for the following reasons:

- The primary reason that Congress added the retail foreign exchange provisions to the CEA in 2000 was to ensure that the CFTC or another functional regulator has anti-fraud authority over such transactions. The concern stemmed from an adverse court decision involving a retail FX options dealer. *See Dunn v. CFTC,* 519 U.S. 465. Congress

[4] Although the CEA refers to two days, we understand that this has been interpreted by the CFTC to mean "currency trading days."

[5] CEA Section 2(c)(2)(B)(i)(II)(cc) conditions the ability to use an FCM to offer or enter into retail foreign exchange transactions on the FCM not also being a broker-dealer registered with the SEC under Section 15(b) of the Securities Exchange Act of 1934. In its rules governing retail foreign exchange, the CFTC provided that a retail foreign exchange dealer could not be dually-registered as a broker-dealer. 17 C.F.R. Section 5.1(h)(1).

specifically stated that the purpose of the new law was "to clarify the jurisdiction of the [CFTC] over certain retail foreign exchange transactions and bucket shops that may not be otherwise regulated."[6]

- The SEC already has full anti-fraud authority in connection with Securities Conversion Trades since the transactions are "in connection with the purchase or sale of a security." *See* Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.

- The SEC also has general censure and anti-fraud authority to protect against bad acts by broker-dealers in connection with conversion trades and legacy foreign exchange transactions, under Section 15(b)(4) of the Securities Exchange Act of 1934.

- Broker-dealers are subject to comprehensive capital requirements, business conduct rules and regulatory standards.

- As a result, the intent of Congress for establishing that the retail foreign exchange transactions be conducted by a regulated entity would be met in connection with granting the relief requested.

The limited nature of the foreign exchange transactions that are subject to the requested relief mitigates against any risk to the investing public. Securities Conversion Trades, regular conversions and legacy transactions are not subject to the types of abuses that led to adoption of the provision in 2000 and passage of the CRA, including enhancements to the provision, in 2008.

As reflected in the legislative history leading up to the CRA, the enhanced provisions were intended to turn back a 7th Circuit decision in, *CFTC v. Zelener,* 373 F.3d 861 (7th Cir. 2004) holding that, even if a retail foreign exchange dealer had defrauded customers, the applicable regulator in that case – the CFTC-- had no jurisdiction to prosecute the actors involved because the foreign exchange contracts at issue (*i.e*., cash settled rolling spot transactions) were not "contracts of sale of FX for future delivery." The CFTC has noted that physically-settled conversion trades are materially different from those at issue in *Zelener* and are not subject to the same types of abuses as those discussed in the *Zelener* case.[7]

Authority for Relief

The SEC has authority to grant this relief under Sections 23 (a) and 36 of the Securities Exchange Act of 1934. Specifically, Section 23(a) provides that the SEC has the "power to make such rules and regulations as may be necessary or appropriate to implement" the Securities Exchange Act of 1934. The Securities Exchange Act of 1934 addresses activities of broker-dealers and securities

6 Commodity Futures Modernization Act of 2000, Pub. L. 106-554, appendix E, 114 Stat. 2763, Section 2(5).

7 *See* 75 Fed. Reg. at 3284. "Unlike true spot transactions where delivery is contemplated . . . [the Zelener transactions] were 'rolled over' at expiration . . . and carried forward indefinitely" and have been "the basis of many forex fraud cases brought by the Commission." The CFTC has also noted stated that the CRA was intended to "encompass transactions that do not result in actual delivery, or for which no legitimate business purpose exists for the customer to enter into the transaction." 75 Fed. Reg. at 3285.

trading markets, among other things. Since the relief requested implicates both, the SEC would be able to rely on this provision in crafting the requested relief.

Similarly, Section 36(a)(1) permits the SEC to "conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of [the Securities Exchange Act] or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors." Pursuant to this authority, the SEC may specify activities that a broker-dealer is authorized to conduct, provided that the activity is in the public interest. Granting relief in these circumstances is in the public interest because it avoids needless transfer of positions, facilitates investing in foreign securities without requiring investors to take on additional price, operational or credit risk and allows distribution payments to be carried in the currency of choice for the investor.

In addition to this statutory authority, it is inherent in the responsibility that Congress has given the SEC as a federal agency to administer and enforce the federal securities laws to provide interpretive relief under those laws. Courts have recognized this inherent power by giving "considerable weight" and recognizing a "principle of deference" with regard to agency interpretations of the statutes that it administers.[8]

Conclusion

Currency conversions are part of the basic securities activity conducted by broker-dealers. Such transactions are ancillary to the already regulated activities of broker-dealers and are necessary to provide brokerage services to retail customers.

The CEA's provisions regarding retail foreign exchange, including those added by The Dodd Frank Act, were not intended to regulate physically-settled conversions but, instead, were designed to ensure robust regulation of cash-settled, retail foreign exchange transactions that are speculative, leveraged or margined. As a definitional matter, the statute leaves open to interpretation the possibility that spot conversions settling beyond T+2 business days (or, even, T+2 calendar days) could be deemed to be unlawful unless conducted pursuant to regulations that the SEC has, to date, declined to adopt. While it is understandable that the SEC has determined not to adopt rules to allow broker-dealers to engage in speculative foreign exchange transactions with their retail clients, it would expose both broker-dealers and their retail customers to needless operational, price, credit and other risks if the SEC does not allow broker-dealers to engage in foreign exchange activity that is ancillary to the broker-dealer's ordinary securities execution, clearing, settlement and booking activity.

In recognition of the important ancilliary role played by retail foreign exchange transactions in connection with ordinary course securities brokerage, we respectfully ask the SEC to grant the relief requested. This relief is in the public interest and is consistent with the statutory framework articulated by Congress both in the Securities Exchange Act of 1934 and in the CEA.

cc: Jesse H. Lawrence
Pershing LLC

[8] *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844 (1984).