

CFTC Authority Extended over Retail Forex and Energy Trading

May 29, 2008

What This Means

Recently, Congress enacted amendments to the Commodity Exchange Act (CEA) that grant the Commodity Futures Trading Commission (CFTC) extended authority to regulate over-the-counter foreign exchange (forex) trading with retail customers and trading in energy derivatives conducted over the counter and through electronic platforms. As a result of the new CEA provisions, certain futures market participants will have to register their retail forex business with the CFTC. Additionally, futures commission merchants (FCMs) and futures-introducing brokers involved in retail forex and energy trading will want to consider making changes to their compliance procedures and processes. The new provisions of the CEA are scheduled to become effective September 19, 2008.

Discussion and Analysis

Retail Forex

- **CFTC Authority over Retail Forex**

- The new provisions of the CEA provide that the CFTC generally has jurisdiction over retail forex transactions, including over-the-counter margined business. The CFTC's retail forex authority generally does not extend to regulated entities, such as banks, broker-dealers, insurance companies and designated holding companies, and certain of their regulated affiliates and subsidiaries.
- Excluded from the CFTC's retail forex jurisdiction are (1) spot contracts that result in actual delivery within 2 days, (2) contracts that create an enforceable obligation to deliver and accept delivery in connection with the parties' lines of business, and (3) securities (other than security futures).

- **Registration of Retail Forex Dealers**

- The CEA now includes a registration category for retail forex dealers and other persons that solicit orders, exercise discretionary trading authority, and operate commodity pools with respect to off-exchange retail foreign currency transactions.
- In effect, entities engaging in retail forex as an FCM or an affiliate of an FCM will be required to register with the NFA as a Retail Foreign Exchange Dealer (under regulations to be adopted by the CFTC). The registration requirement does not extend to otherwise-regulated entities, such as banks, broker-dealers, insurance companies and designated holding companies, and certain of their regulated affiliates and subsidiaries.

- The registration requirement will not apply to FCMs or affiliates of FCMs that are “substantially or primarily engaged in buying and or selling futures contracts on a designated contract market or a derivatives transaction execution facility.”
- **Increased Capital Requirements**
 - The CEA now includes a requirement that certain Retail Foreign Exchange Dealers engaging in retail forex business over the counter as counterparties maintain capital of \$20 million.
 - The capital requirements will be phased in such that entities will be required to have capital of \$10 million beginning 120 days after the enactment of the new requirements (September 19, 2008), \$15 million beginning 240 days after enactment (January 17, 2009), and \$20 million beginning 360 days after enactment (May 17, 2009).
- **Anti-Fraud Authority**
 - Retail forex transactions conducted by FCMs and Retail Foreign Exchange Dealers that are not otherwise-regulated entities (e.g., banks, broker-dealers, and insurance companies) will become subject to anti-fraud prohibitions and certain other provisions of the CEA.
 - With certain exceptions, fraudulent activities in retail forex business conducted by FCMs will be subject to CEA requirements regarding (1) principal-agent liability (Section 2(a)(1)(B)), (2) foreign markets (Section 4b), (3) fraud by commodity pool operators and commodity trading advisors (Section 4o), (4) aiding and abetting liability (Section 13(a)), and (5) controlling person liability (Section 13b).

Energy Trading

- **CFTC Enforcement Authority**

The amendments to the CEA clarify that the CFTC has authority to bring enforcement actions against participants in principal-to-principal over-the-counter transactions in exempt commodity transactions in energy.

- **Oversight Authority over Significant Price Discovery Contracts**

- The amended CEA provides the CFTC with oversight authority over Significant Price Discovery Contracts (SPDCs) that trade on Exempt Commercial Markets (ECMs), electronic trading facilities used for the trading of energy derivatives products.
- The CEA outlines criteria—such as price linkage, arbitrage, material price reference, and material liquidity—to be used in determining when an ECM contract should be considered an SPDC.
- The CFTC will have authority over certain aspects of SPDCs, including (1) large trader reporting, (2) position limits or accountability levels, (3) ability to require an ECM to exercise self-regulatory responsibility over SPDCs, and (4) emergency authority regarding SPDC transactions.
- The CFTC is directed to propose rules regarding the standards for SPDCs within 180 days of enactment (November 18, 2008) and to implement a final rule within 270 days of enactment (February 26, 2009). The CFTC is directed to identify significant price discovery contracts within 180 days after the effective date for the final rule.

Additional Provisions

- **Regulation of Futures Contracts and Trading on Exchanges**

- The definition of the term “trading facility” under Section 1a (33)(A) of the CEA now includes markets using automated trade matching and execution algorithms.
- A breach of any speculative limit rule will constitute a violation of the CEA, regardless of whether the rule has been approved by the CFTC or has been certified by a futures exchange.

- **Regulation of Security Futures**

- The CFTC and the SEC are directed to jointly adopt a risk-based portfolio margining regime for securities options and security futures by September 30, 2009.
- The CFTC and the SEC are directed to publish final rules establishing an exclusion for broad-based indices on foreign equities from the definition of a narrow-based securities index by June 30, 2009.

- **Increase in Penalties**

The amendments to the CEA double the civil and criminal penalties for manipulation or attempted manipulation and false reporting.

- **CFTC Reauthorization**

Funding for the CFTC was reauthorized through 2013.

How Morgan Lewis Can Help

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