

CFTC Issues Final Retail Forex Rules

September 1, 2010

On August 30, the Commodity Futures Trading Commission (CFTC) announced the issuance of its long-anticipated final rules for off-exchange foreign currency transactions (forex) with retail customers.¹ The rules implement the CFTC Reauthorization Act of 2008 (the CRA),² which for the first time gave the CFTC complete rulemaking authority over forex transactions between certain counterparties and retail customers.³ The rules are also the first final rules published by the CFTC to implement part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which required that the CFTC issue rules regarding retail forex within 90 days.⁴ The rules apply to retail forex transactions that are offered or entered into by entities that are solely registered with the CFTC under the Commodity Exchange Act (the CEA). The rules become effective on October 18, 2010.

The CFTC rules provide a comprehensive regulatory scheme for forex transactions between futures commission merchants (FCMs) or retail foreign exchange dealers (RFEDs) as counterparty to retail customers. Many of the requirements will be familiar to forex dealer members of National Futures Association (NFA) as they are analogous to many of NFA's current forex rules, which have been in place for a number of years. For example, an FCM or an RFED acting as counterparty to retail forex transactions will continue to be required to maintain at least \$20 million in adjusted net capital.

There are, however, some significant differences of which forex dealers should be aware. Additionally, those intermediaries that were not previously required to register with the CFTC or become NFA members because they were not acting as counterparty to retail forex transactions (for example, persons managing forex accounts or operating funds trading forex), will now find themselves subject to registration and the comprehensive regulatory oversight of the CFTC and NFA.

¹ A copy of the press release announcing the final rules may be found on the CFTC's website at <http://www.cftc.gov/PressRoom/PressReleases/pr5883-10.html>. The final rules may be found on CFTC's website at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister083010.pdf>.

² Food, Conservation, and Energy Act of 2008, Pub. L. 110-246, 122 Stat. 1651, 2189-2204 (2008).

³ Retail customers are those that are not eligible contract participants as defined in Section 1a(18) of the CEA. The recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (2010), adopted significant changes to the eligible contract participant definition. With regard to individuals the new definition was revised to provide that the person must have \$10 million "invested on a discretionary basis" rather than total assets. With regard to a commodity pool trading forex the definition was revised to require not only the pool to meet the financial and regulatory requirements (total assets exceeding \$5 million and operated by a person regulated under the CEA, or the foreign equivalent), but all the participants in the pool must themselves also be eligible contract participants.

⁴ Pub. L. No. 111-203 (2010).

Security Deposits

Current NFA rules require forex dealers to collect and maintain 1% of the notional value of retail transactions for 10 different major currencies and 4% of the notional value for all other currencies.⁵ The final CFTC rules continue to permit NFA to determine the amount of security deposits that must be collected and maintained by RFEDs and FCMs, but within certain parameters. Specifically, the CFTC requires security deposits of at least 2% for major currencies and 5% for all other currencies. The CFTC has left it to NFA to determine what currencies are “major currencies.”

The CFTC had initially proposed that FCMs and REFEDs collect and maintain security deposits equal to 10% of the notional value of each forex transaction, regardless of the currency. This proposed requirement garnered the greatest number of comments, the vast majority of which were opposed to the security deposit, considering it to be too high. In issuing the final rules, the CFTC acknowledged the opposition to its initial proposal and noted that the proposal was “conservative and was proposed in an effort to maximize customer protection.” CFTC indicates that it expects the final rule to provide a mechanism for setting security deposit levels based on and able to adapt to market conditions. The final rules require NFA to annually review its designation of “major currencies” and security deposit requirements. Similarly, the CFTC will periodically review its parameters and adjust them as necessary in light of market conditions.

Registration

The final rules provide for the registration of certain counterparties to retail forex transactions as FCMs or RFEDs.⁶ Additionally, persons introducing forex accounts, managing forex accounts, or operating pools trading forex will be required to register as introducing brokers (IBs), commodity trading advisors (CTAs), or commodity pool operators (CPOs), respectively, and to become members of NFA. A firm must register in the appropriate capacity by October 18, 2010, or it will be forced to cease conducting forex business until it obtains the necessary registrations, approvals, and designations, including registration of certain employees as associated persons (APs). A person seeking to register as an AP of a firm dealing in retail forex who was not registered as an AP on May 22, 2008, will be required to take and pass the National Commodity Futures Examination (Series 3) and the Retail Off-Exchange Forex Examination (Series 34).⁷

In the proposed rules published in January 2010, the CFTC had proposed that any IB introducing retail forex accounts to an RFED or FCM be guaranteed by that FCM or RFED.⁸ This would have meant that the FCM or RFED would be liable for any violations by the IB.⁹ The CFTC indicated that it received comments that this requirement was anticompetitive, could lead to less choice for customers, and

⁵ NFA Financial Requirements Section 12. The 10 major currencies that qualify for the 1% security deposit are the British pound, Swiss franc, Canadian dollar, Japanese yen, Euro, Australian dollar, New Zealand dollar, Swedish krona, Norwegian krone, and the Danish krone.

⁶ Although the CEA provides that affiliates of FCMs who maintain adjusted net capital of at least \$20 million and for whom the FCM makes and keeps risk assessment records may act as a counterparty in retail forex transactions, the CFTC rules require such affiliates to register as RFEDs.

⁷ NFA has announced that it will begin accepting registration applications for forex firms and individuals on September 2 (<http://www.nfa.futures.org/news/newsNotice.asp?ArticleID=3640>) and has prepared an overview of the registration process (<http://www.nfa.futures.org/NFA-registration/forex-registration-overview.HTML>).

⁸ 75 Fed. Reg. at 3325.

⁹ NFA Compliance Rule 2-23.

unnecessary. In the final rules, the CFTC has eliminated the requirement that IBs be guaranteed. Accordingly, an IB introducing retail forex accounts will be permitted to be independent if it satisfies the minimum net capital requirements, as is the case with an IB introducing on-exchange futures and options accounts.¹⁰

Disclosure

The final rules also provide that prior to their opening a forex account, customers must receive a risk disclosure statement. The statement is similar to that required under CFTC Rule 1.55 for the trading of on-exchange futures, but has been adapted to address risks unique to forex trading. The final rules continue to require that as part of the risk disclosure statement customers be provided with the number of nondiscretionary forex accounts maintained by the RFED or FCM and the percentage of such accounts that were profitable for the most recent four quarters. Additionally, upon request by an existing or prospective customer, an RFED or FCM must provide this information for each quarter for the most recent five years.

In proposing this requirement, the CFTC stated that it was appropriate to require this information because retail forex transactions serve no price discovery and the CFTC believes that the majority of retail customers enter into these transactions for speculative purposes and relatively few actually profit from them.¹¹ The CFTC noted that it received comments expressing concerns that this requirement was anticompetitive and that it was unfair because it was not required for on-exchange futures trading. In the final release, the CFTC, however, reiterated its position that differences between on-exchange futures and retail forex, such as the inherent conflict in forex dealers acting as counterparty to the customer, make this disclosure appropriate. The final rules clarify that an account that breaks even is to be considered “not profitable” and that only customer accounts are to be included in this disclosure.

Trading and Operational Standards

The final rules impose certain trading and operational standards, some of which are the same as those currently required by NFA. For example, FCMs and RFEDs must maintain information regarding customer orders and account information, including the date and time an order is placed and executed and the net value of open positions and cash held in a customer’s account. Additionally, an executed transaction may not be adjusted unless done so in accordance with NFA’s rules.¹²

The final rules also require that an FCM’s or RFED’s requote practices must provide for quoting regardless of the direction in which the market has moved and have in place symmetrical tolerance thresholds for quoting. In the final release, the CFTC indicates that this requires that quoted prices maintain the same spread between the bid and asked prices as the original quote regardless of market movement.

¹⁰ The current minimum net capital requirement for IBs is \$45,000. *See* CFTC Rule 1.17; NFA Financial Requirements Section 5.

¹¹ 75 Fed. Reg. 3282, 3289 (Jan. 20, 2010).

¹² NFA Compliance Rule 2-43(a) provides that an executed order may only be adjusted if it is favorable to the customer or if the counterparty exclusively uses straight-through processing, provides written notification to the customer within 15 minutes of the order having been executed that it is seeking to cancel or adjust the order, and makes the same cancellation or adjustment of all executed customer orders during the same time period in the same currency.

The CFTC also imposes on all retail forex intermediaries a requirement to provide the Division of Enforcement with a record of any communication received concerning a possible violation of the retail forex requirements of the Commodity Exchange Act (the CEA) or CFTC rules within 30 days of receiving such communication, unless the communication involves possible fraud, in which case it must be provided to the Division of Enforcement within three business days.

Otherwise Regulated Entities

As noted above, the CFTC Rules apply only to those entities that are solely registered with the CFTC. The CEA, provides that only certain regulated entities are permitted to act as counterparty to retail customers for forex transactions. These include, among others, U.S. banks, registered broker-dealers, FCMs, and RFEDs. The CFTC's jurisdiction in this area is generally limited to FCMs and RFEDs that are not also an otherwise regulated entity listed under the CEA.¹³ Accordingly, if a firm is registered as an FCM with the CFTC and as a broker-dealer with the Securities and Exchange Commission (the SEC), the CFTC does not have jurisdiction over the firm's retail forex transactions.

Such an entity, however, may be prohibited from offering retail forex trading in the future. Dodd-Frank added Section 2(c)(2)(E)¹⁴ to the CEA, which provides that the regulated entities enumerated in the CEA may not offer retail forex transactions unless offered pursuant to rules of a federal regulatory agency that permit such transactions. In questions and answers accompanying the final rules, the CFTC notes that unless the entity's federal regulator prepares rules regarding retail forex transactions, the regulated entity is prohibited from entering into such transactions.¹⁵ To date the SEC has not proposed rules regarding retail forex transactions. Moreover, retail forex rules do not appear on the list of regulatory topics under Dodd-Frank for which the SEC is currently soliciting public comments.¹⁶

Entities that have previously been acting as counterparties for retail forex pursuant to their status as an otherwise regulated entity, such as an SEC registered broker-dealer, should consider whether they will be permitted to continue to act in such a capacity. Entities that have been, or may be considering, conducting retail forex activities, such as offering a forex fund or managing forex trading for retail customers, should consider whether they must now register with the CFTC and comply with the CFTC and NFA requirements. Finally, firms that have until now been subject only to NFA's forex rules should review their policies and procedures to ensure they will be in compliance with the additional CFTC requirements. Morgan Lewis is available to assist firms in reviewing the new requirements, determining what

¹³ Section 2(c)(2)(B)(II) of the CEA.

¹⁴ Section 742(c) of Dodd-Frank.

¹⁵ The questions and answers may be found on the CFTC's website at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/forexfinalrule_qa.pdf.

Although the CFTC appears to suggest that all retail forex transactions offered by otherwise regulated entities may only be entered into pursuant to rules promulgated by a federal regulator, the language of the statute is not so clear. Specifically, section 2(c)(2)(E)(ii)(I) of the CEA prohibits an otherwise regulated entity from entering into a forex transaction described in 2(c)(2)(B)(i)(I), unless done pursuant to rules of a federal regulatory agency. The transaction described in section 2(c)(2)(B)(i)(I) of the CEA is a transaction in foreign currency that "is a contract of sale of a commodity for future delivery (or an option on such a contract) or an option" not executed or traded on an exchange. Accordingly, it is not clear that there must first be in place SEC rules allowing a registered broker-dealer to offer transactions in foreign currency other than futures, options on futures, or options, such as transactions like those offered by the forex dealer in *CFTC v. Zelener*, 373 F.3d 861 (7th Cir.), *rehearing denied*, 378 F.3d 624 (7th Cir. 2004).

¹⁶ The list of regulatory topics may be found on the SEC's website at <http://www.sec.gov/spotlight/regreformcomments.shtml>.

registration and regulatory requirements are applicable to their activities, and deciding how best to meet these requirements.

If you have any questions or would like more information on the issues discussed in this LawFlash, please contact the author, **Michael A. Piracci** (212.309.6385; mpiracci@morganlewis.com), or either of the following Morgan Lewis attorneys:

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