

## CLIENT MEMORANDUM

# SEC Will Allow Retail Foreign Exchange Rule to Expire on July 31, 2016

June 9, 2016

## AUTHORS

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The Securities and Exchange Commission has given notice that it intends to allow Rule 15b12-1 to expire on July 31, 2016, in accordance with that rule's sunset provision.<sup>1</sup> Rule 15b12-1 permits registered broker-dealers, including any broker-dealer that is dually registered with the Commodity Futures Trading Commission as a futures commission merchant ("FCM"), to engage in certain over-the-counter foreign exchange transactions with counterparties that are not eligible contract participants ("ECPs").<sup>2</sup> When Rule 15b12-1 expires, the Commodity Exchange Act ("CEA") will effectively prohibit broker-dealers from entering into such transactions with non-ECP counterparties.

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<sup>1</sup> Retail Foreign Exchange Transactions, 81 Fed. Reg. 33374 (May 26, 2016).

<sup>2</sup> An ECP, as defined in CEA Section 1(a)(18), generally includes certain regulated persons or entities acting for their own account and that meet certain asset-based tests, as well as individuals with an aggregate amount invested, on a discretionary basis, in excess of \$10 million (or \$5 million if such individual enters into an agreement, contract or transaction in order to manage the risk associated with an asset owned or a liability incurred, or reasonably likely to be owned or incurred, by such individual).

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### Background

Section 2(c) of the CEA generally prohibits certain persons, including any person registered with the SEC as a broker-dealer and any person that is dually registered as a broker-dealer and an FCM, from entering into foreign exchange transactions with persons that are not ECPs, except pursuant to a rule or regulation of a relevant federal regulatory agency. This requirement was added to the CEA in 2010 by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The SEC adopted an interim rule in 2011 to permit broker-dealers (including broker-dealer/FCMs) to enter into foreign exchange transactions with non-ECP counterparties until such time as the SEC could properly conduct an assessment of broker-dealer practices in the retail foreign exchange market.<sup>3</sup> The SEC subsequently adopted Rule 15b12-1 as a final rule, but included a sunset provision that would cause the rule to expire and become no longer effective on July 31, 2016.<sup>4</sup>

Under Rule 15b12-1, a broker-dealer generally may engage in retail forex transactions provided that such broker-dealer complies with the Securities Exchange Act of 1934 (“Exchange Act”), the rules and regulations thereunder and the rules of any self-regulatory organization (“SRO”) of which the broker-dealer is a member. For purposes of the rule, a “retail forex transaction” is, generally, any account, agreement, contract or transaction in foreign currency that is entered into by a broker-dealer with any person that is not an ECP and that is (i) a contract of sale of a commodity for future delivery or an option on such contract or (ii) an option that is not executed or traded on a national securities exchange registered under Section 6(a) of the Exchange Act.

Certain transactions are excluded from the definition of “retail forex transaction.” Specifically, the rule excludes (i) spot transactions that result in actual delivery within two days, (ii) forward contracts that create an enforceable obligation to make or take delivery<sup>5</sup> and (iii) options that are executed or traded on a registered exchange. In addition, the CFTC issued an interpretation in 2012 that conversion trades are not “retail forex transactions.”<sup>6</sup> A conversion trade is generally a transaction in a foreign currency that facilitates a retail investor’s purchase or sale of a security that is listed on a foreign exchange and denominated in a foreign currency.

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<sup>3</sup> See Retail Foreign Exchange Transactions, 76 Fed. Reg. 41676 (July 15, 2011).

<sup>4</sup> See Retail Foreign Exchange Transactions, 78 Fed. Reg. 42439 (July 16, 2013).

<sup>5</sup> Additionally, the seller and buyer must have the ability to deliver and accept delivery, respectively, in connection with their line of business.

<sup>6</sup> See Further Definition of “Swap,” “Security-Based Swap” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48208, 48257 (Aug. 13, 2012) (stating that “Securities Conversion Transactions” will be deemed to be bona fide spot foreign exchange transactions).

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## SEC Will Allow Retail Foreign Exchange Rule to Expire on July 31, 2016

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### SEC Notice of Expiration of Rule 15b12-1

As stated above, the SEC has determined to allow Rule 15b12-1 to expire and become no longer effective as of July 31, 2016. On that date, broker-dealers (including broker-dealer/FCMs) will no longer be able to engage in certain foreign exchange transactions with non-ECP customers. However, they will be able to enter into transactions that are not considered retail forex transactions under the CEA and, also, conversion trades, regardless of whether the counterparty is an ECP.<sup>7</sup>

In its notice, the SEC does not discuss the reasons for permitting Rule 15b12-1 to expire. The SEC has previously highlighted the risks to retail investors of investing in foreign exchange markets and the potential for abusive practices.<sup>8</sup> The SEC has also observed that retail foreign exchange transactions that are entered into for hedging purposes or to gain direct exposure to foreign currency markets “may be appropriate for retail investors through broker-dealers with the protections available to investors under existing [SEC] and SRO oversight.”<sup>9</sup> Finally, the SEC has noted that costs may result from the expiration of Rule 15b12-1, including those that might be incurred by a retail customer in transferring its account to an FCM that is registered only with the CFTC.<sup>10</sup>

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<sup>7</sup> Broker-dealers who enter into such transactions with retail customers would still be subject to the Exchange Act’s anti-fraud provisions and Rule 10b-5.

<sup>8</sup> See 78 Fed. Reg. at 42443 (noting certain “key risks” including the lack of a central marketplace for retail forex, uncertainty about transaction costs, and the possibility for investors to lose more than their original investment).

<sup>9</sup> *Id.*

<sup>10</sup> See *id.* at 42447-42449.