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SEC ALLOWS RULE PERMITTING BROKER-DEALERS TO ENGAGE IN RETAIL FOREX TRANSACTIONS TO EXPIRE

By Rita M. Molesworth and Michael A. DeNiro

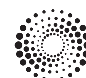
Rita M. Molesworth is a partner and Michael A. DeNiro is an associate in the Asset Management Group of Willkie Farr & Gallagher LLP in New York. They can be reached at rmolesworth@willkie.com and mdeniro@willkie.com, respectively. The views expressed in this article are solely the views of the authors and do not necessarily reflect the views of Willkie Farr & Gallagher LLP.

The Securities and Exchange Commission ("SEC") has allowed an agency rule to expire that permitted, prior to its expiration on July 31, 2016, registered broker-dealers, including any broker-dealer that is dually registered as a futures commission merchant ("FCM"), to engage in certain foreign exchange transactions with counterparties that are not eligible contract participants ("ECPs"). The Commodity Exchange Act ("CEA") now effectively prohibits registered broker-dealers from entering into such transactions with non-ECP counterparties (each, a "retail customer"). As a result, retail customers, including commodity pools that do not meet the definition of ECP, that wish to access the off-exchange foreign currency markets for speculative trading or hedging purposes may have to enter into alternative arrangements. Notably, the rule's expiration generally will not prevent broker-dealers from transacting in foreign currency for retail customers where any such transaction is intended to facilitate the purchase or sale of a security denominated in a foreign currency.

1. "Retail" Foreign Exchange, Dodd-Frank and ECPs

A. Over-The-Counter Foreign Currency Markets

Regulators have from time to time expressed concern over speculative trading by retail customers in the over-the-counter ("OTC") foreign currency markets, drawing attention to certain fraud risks and abusive sales practices.[1] For example, the Commodity Futures Trading Commission ("CFTC") has highlighted certain improper practices, such as solicitation fraud, lack of transparency with respect to pricing and the execution of transactions, failure to respond to customer complaints, and the targeting of elderly, low net worth or unsophisticated individuals.[2] During the 2000s, the CFTC also brought a number of enforcement actions against persons offering to enter into OTC foreign currency transactions with retail customers.[3] In line with these concerns, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") amended the CEA generally to require that



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certain off-exchange transactions in foreign currency be effected only pursuant to the rules of a federal regulatory agency, resulting in increased regulatory oversight of these markets.[4] Prior amendments to the CEA in 2000 and 2008, respectively, had a similar effect.

B. Restriction on Foreign Exchange Transactions with Retail Customers

Section 742 of Dodd-Frank amended the CEA to prohibit certain enumerated persons from entering into certain off-exchange transactions in foreign currency with retail customers,[5] other than pursuant to a rule or regulation permitting such transactions that has been promulgated by the relevant federal regulatory agency.[6] The CEA, as amended, further stipulates that any such rule or regulation must set forth appropriate requirements with respect to, among other things, disclosure, recordkeeping, capital, reporting and business conduct in respect of the covered transactions.[7] In addition, any such rule or regulation must treat in a similar manner both the retail foreign exchange transactions expressly described in Section 2(c)(2)(B)(i)(I) of the CEA and any agreements, contracts or transactions that are "functionally or economically similar" to such transactions. Following these amendments, the CFTC,[8] the Federal Deposit Insurance Corporation,[9] the Board of Governors of the Federal Reserve System,[10] the Office of the Comptroller of the Currency[11] and, as discussed below, the SEC, each adopted a rule permitting certain persons under their jurisdiction to engage in OTC foreign currency transactions with retail customers.

The list of persons enumerated in Section 2(c)(2)(B) of the CEA that generally may not offer to enter into, or enter into, off-exchange foreign currency transactions with retail customers, other than pursuant to an agency rule or regulation, includes broker-dealers registered with the SEC under Section 15(b) (except pursuant to paragraph 11 thereof) or Section 15C of the Securities Exchange Act of 1934 (the "Exchange Act") and associated persons of such broker-dealers, as well as certain other financial intermediaries such as U.S. financial institutions, FCMs and RFEDs (each such person, an "enumerated counterparty").[12]

C. Commodity Pools as ECPs post-Dodd-Frank

As discussed above, as of July 31, 2016 the CEA effectively prohibits broker-dealers from entering into certain off-exchange foreign currency transactions with retail customers. In general, broker-dealers must therefore determine whether any customer being offered, or seeking to enter into, a foreign exchange transaction qualifies as an ECP for the purpose of such transaction. ECP is defined in Section 1a(18) of the CEA and includes, generally, certain regulated entities such as financial institutions and insurance companies, operating companies that have assets exceeding specified thresholds and other "sophisticated" investors. A commodity pool is generally an ECP under Section 1a(18) provided it has more than $5 million in total assets and is formed and operated by a person subject to regulation under the CEA. However, Dodd-Frank amended the definition of ECP contained in the CEA to provide that, for the purpose of certain sections of the CEA that apply to OTC transactions in foreign currency, the definition of ECP does not include any commodity pool in which any participant investor is not itself an ECP.[13]

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Following amendments to the CEA as a result of the enactment of the Commodity Futures Modernization Act of 2000, a person that is not an ECP generally may not enter into OTC foreign exchange transactions unless its counterparty is an enumerated counterparty.[14] After Dodd-Frank, a commodity pool with one or more non-ECP participants is no longer deemed to be an ECP for the purpose of OTC foreign exchange transactions, as noted above (and subject to the exception discussed below). Therefore, any such commodity pool generally cannot enter into OTC foreign currency transactions unless, first, its counterparty is an enumerated counterparty and, second, such enumerated counterparty is permitted to engage in OTC foreign exchange transactions with retail customers pursuant to an agency rule.[15]

In 2012, the CFTC promulgated Rule 1.3(m) to effectuate the amendments to the CEA described above and to carve out from the regulatory definition of ECP (solely with respect to OTC foreign exchange transactions) any commodity pool that enters into such transactions if any direct participant in such commodity pool is not an ECP.[16] In the case of a commodity pool with participants that are themselves commodity pools, however, the CFTC determined to interpret the look-through provisions of CEA Section 1a(18) to avoid an "indefinite" look-through to all direct *and* indirect participants at all levels of the pool structure.[17] Specifically, pursuant to Rule 1.3(m)(5)(ii), the status of the participants in any commodity pool that invests in a transaction-level commodity pool (*i.e.*, the pool engaged in OTC foreign currency transactions) (a "higher-tier pool") generally can be disregarded for the purpose of determining whether all direct participants in the transaction-level commodity pool are ECPs. This limitation does not apply where either the transaction-level pool or any higher-tier pool (or any pool in which the transaction-level pool is invested) is structured in a manner that constitutes an attempt to evade the applicable restrictions on participation by non-ECPs in off-exchange transactions in foreign currency set forth in Subtitle A of Title VII of Dodd-Frank.

Rule 1.3(m) also provides that a commodity pool with one or more non-ECP participants *may* be deemed to be an ECP for the purpose of engaging in OTC foreign exchange transactions—notwithstanding the general rule discussed above—provided that such commodity pool meets certain criteria set forth in the rule.[18] First, the commodity pool must not be formed for the purpose of evading the provisions of the CEA or CFTC rules or regulations pertaining to "retail" foreign exchange transactions. Second, the commodity pool must have total assets exceeding $10 million. Finally, the commodity pool must be formed and operated by a registered CPO or a person exempt from registration as a CPO under CFTC Rule 4.13(a)(3). The CFTC incorporated this exception to the look-through provisions of CEA Section 1a(18) in part to relieve certain CPOs that were deemed to be "sophisticated, professional asset managers" from the "array of additional compliance costs" and limited access to swap dealer counterparties that may have resulted from a strict implementation of the look-through provisions of Section 1a(18).[19]

2. SEC Rule Permitting Broker-Dealers to Enter into "Retail" Foreign Exchange Transactions

A. Exchange Act Rule 15b12-1

In order to address the potential impact on

broker-dealers of Dodd-Frank's amendments to the CEA (as discussed above), the SEC adopted an interim rule in 2011 to permit broker-dealers (including any broker-dealer dually registered as an FCM) to enter into off-exchange transactions in foreign currency with retail customers until such time as the SEC could properly conduct an assessment of broker-dealer practices in the "retail" foreign exchange market.[20] The SEC subsequently adopted its interim rule as a final rule—Rule 15b12-1—on July 11, 2013, but included a sunset provision that would cause Rule 15b12-1 to expire and become no longer effective on July 31, 2016.[21]

Under Rule 15b12-1, a broker-dealer could engage in a "retail forex business" provided that such broker-dealer complied with the Exchange Act, the rules and regulations thereunder and the rules of any self-regulatory organization ("SRO") of which the broker-dealer is a member. "Retail forex business" was defined in the rule as engaging in any "retail forex transactions" with the intent to derive income from those transactions, either directly or indirectly. "Retail forex transaction" was defined, in turn, as any account, agreement, contract or transaction in foreign currency that is offered or 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; (ii) an option that is not executed or traded on a national securities exchange registered under Section 6(a) of the Exchange Act; or (iii) offered or entered into on a leveraged or margined basis.

Certain transactions were excluded from the definition of "retail forex transaction." Specifically, the rule excluded (i) spot transactions that result in actual delivery within two days, (ii) forward contracts that create an enforceable obligation to make or take delivery, provided that each counterparty has the ability to deliver and accept delivery in connection with its line of business, and (iii) options that are executed or traded on a registered exchange. Notably, however, the rule did not exclude so-called "rolling spot" transactions from the definition of "retail forex transaction." Such transactions, which in theory require actual delivery of the relevant currency within two days, but in practice permit the customer to roll over the contract indefinitely and avoid actual delivery until either the customer or the offeror of the contract closes out its position, were the subject of a well-known court case involving the CFTC.[22]

B. Conversion Trades

The impetus for the adoption of Rule 15b12-1 was, in part, concern expressed by market participants that, as a result of the Dodd-Frank amendments to the CEA, broker-dealers would no longer be able to enter into so-called conversion trades on behalf of their retail customers.[23] Conversion trades involve the purchase (or sale) of a foreign currency and are generally entered into to facilitate an investor's purchase (or sale) of a security that is listed for trading on a foreign exchange and denominated in a foreign currency. Because such trades do not have to be settled on a T+2 basis, market participants were concerned that they would fall within the scope of the CEA's prohibition with respect to OTC foreign exchange transactions with retail customers.

When it adopted its interim rule in 2011, the SEC provided some relief to broker-dealers from the uncertainty surrounding conversion trades entered into on behalf of retail customers, by effectively permitting such transactions under the

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framework of Rule 15b12-1. However, in 2012, the CFTC issued an interpretation establishing, in effect, that conversion trades are not "retail forex transactions" and, therefore, are not covered by Section 2(c)(2)(E) of the CEA.[24] According to the CFTC's interpretation, a conversion trade is generally any agreement, contract or transaction for the purchase or sale of an amount of a foreign currency equal to the price of a foreign security with respect to which (i) the security and the related currency transactions are executed contemporaneously in order to effect delivery by the relevant securities settlement deadline and (ii) actual delivery of the foreign security and foreign currency occurs by such deadline. As a result of the CFTC's interpretation, the impact of the Dodd-Frank amendments described herein on broker-dealers' activities in the foreign exchange markets was generally reduced.

3. SEC Allows Rule 15b12-1 to Expire

On May 26, 2016, the SEC published a notice in the *Federal Register* that it had determined to allow Rule 15b12-1 to expire and become no longer effective as of July 31, 2016.[25] As of that date, broker-dealers may no longer engage in OTC foreign exchange transactions with retail customers; this includes commodity pools that do not meet the definition of ECP on account of the participation, in any such commodity pool, of one or more investors that are not themselves ECPs, unless the exception under CFTC Rule 1.3(m), discussed above, applies. However, broker-dealers generally may continue to offer to enter into, and enter into, transactions that are not considered "retail" foreign exchange transactions under the CEA (*i.e.*, transactions that are not "retail forex transactions," as defined in expired Rule 15b12-1), regardless of whether any such broker-dealer's customer or counterparty is an ECP.[26] Notably, this means that broker-dealers may continue to enter into conversion trades on behalf of retail customers.

In its notice, the SEC did not elaborate on any specific reasons for permitting Rule 15b12-1 to expire. In its 2013 adopting release for the rule, the SEC discussed the risks to retail customers of trading in the foreign currency markets and the potential for abusive practices, which would be ameliorated in part through a complete prohibition with respect to broker-dealers.[27] In the same release, the SEC also conceded that OTC 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."[28] Further, the SEC acknowledged that certain inefficiencies could result from the expiration of Rule 15b12-1, including the potential costs that might be incurred by a retail customer in transferring its account to an FCM that is registered only with the CFTC.[29] Notwithstanding any disadvantages that may flow from the expiration of the rule, however, the SEC has made a determination that a complete prohibition is appropriate at this time. In light of that, retail customers that have not already found alternatives to utilizing a broker-dealer for speculative trading or hedging in foreign currency may need to enter into other arrangements, such as electing to trade with a registered FCM or RFED.

ENDNOTES:

[1]*See, e.g.*, FINRA Regulatory Notice 08-66,

"Retail Foreign Currency Exchange" (Nov. 2008) (noting that the retail foreign exchange market is "opaque, volatile and risky" and suggesting that investors could be drawn in by "aggressive, and sometimes misleading, advertising that minimizes risks and exaggerates potential returns").

[2]Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries, 75 Fed. Reg. 3282, 3286 (Jan. 20, 2010) (proposed rules). The CFTC formally adopted rules regulating the activities of FCMs and retail foreign exchange dealers ("RFEDs") in September 2010. *See* Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries, 75 Fed. Reg. 55409 (Sept. 10, 2010) (final rules).

[3]75 Fed. Reg. at 3286 n.44 (stating that, between December 2000 and September 2009, the CFTC filed 114 foreign exchange-related enforcement actions on behalf of over 26 thousand customers, many of which involved allegations of solicitation fraud).

[4]Prior to the enactment of Dodd-Frank, Congress had bestowed on the CFTC anti-fraud authority over certain off-exchange transactions in foreign currency offered to, or entered into with, non-ECPs, except where the counterparty of any such ECP fell within one of certain categories of persons enumerated in the CEA. *See* Commodity Futures Modernization Act of 2000, Pub. L. 106-554, 114 Stat. 2763.

[5]Specifically, the prohibition applies to any agreement, contract or transaction in foreign currency described in Section 2(c)(2)(B)(i)(I) of the CEA, which includes (i) a contract of sale of a commodity for future delivery (or an option on such a contract) and (ii) an option that is not traded or executed on a national securities exchange registered pursuant to Section 6(a) of the Exchange Act, and that is offered to, or entered into with, a person who is not an ECP.

[6]*See* Section 2(c)(2)(E) of the CEA (7 U.S.C. § 2(c)(2)(E)). The federal regulatory agencies that the CEA contemplates promulgating rules or regulations applicable to "retail" foreign exchange transactions are the CFTC, the SEC, the federal banking regulators, the National Credit Union Association and the Farm Credit Administration.

[7]*See* Section 2(c)(2)(E)(iii) of the CEA (7 U.S.C. § 2(c)(2)(E)(iii)).

[8]*See* Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries, 75 Fed. Reg. 55409 (Sept. 10, 2010).

[9]*See* Retail Foreign Exchange Transactions, 76 Fed. Reg. 40779 (July 12, 2011).

[10]*See* Retail Foreign Exchange Transactions, 78 Fed. Reg. 21019 (Apr. 9, 2013) (Regulation NN).

[11]*See* Retail Foreign Exchange Transactions, 76 Fed. Reg. 41375 (July 14, 2011) (covering national banks subject to regulation by the OCC).

[12]*See* Section 2(c)(2)(B)(i)(II)(aa)-(ff) (7 U.S.C. § 2(c)(2)(B)(i)(II)(aa)-(ff)).

[13]Dodd-Frank amended the CEA to provide that, for purposes of Section 2(c)(2)(B)(vi) and 2(c)(2)(C)(vii), the term ECP does not include a commodity pool with one or more investors that are not themselves ECPs. A commodity pool that is not an ECP in respect of OTC transactions in foreign currency may be an ECP for other purposes.

[14]*See* CFTC, Div. of Trading and Markets, Division of Trading and Markets Advisory Concerning Foreign Currency Trading by Retail Customers 1 (2002), *available at* http://www.cftc.gov/files/opa/opaforexupdateadvisory3-19-021.pdf ("The CFMA amended the [CEA] to clarify the jurisdiction of the [CFTC] in the area of foreign currency futures and options trading. Generally, offering foreign currency futures and options contracts to retail customers on an 'off-exchange' basis . . . is unlawful unless the counterparty is a regulated entity enumerated in Section 2(c)(2)(B)(ii) of the [CEA]."). This advisory was superseded by the CFTC's retail forex rule and is no longer effective.

[15]Under current CFTC rules, a non-ECP commodity pool may generally engage in "retail" foreign exchange transactions with a registered FCM or RFED, and its commodity pool operator ("CPO") will be subject to the CFTC's Part 5 rules pertaining to such transactions. In general,

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this may require the operator of the non-ECP commodity pool to register with the CFTC as a CPO under Part 5 of the CFTC's rules and comply with the CFTC's Part 4 rules pertaining to registered CPOs.

[16]*See* Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 Fed. Reg. 30596 (May 23, 2012) (joint SEC and CFTC rulemaking).

[17]*Id.* at 30650.

[18]*See* CFTC Rule 1.3(m)(8).

[19]77 Fed. Reg. at 30660.

[20]*See* Retail Foreign Exchange Transactions, 76 Fed. Reg. 41676 (July 15, 2011) (interim final temporary rule).

[21]*See* Retail Foreign Exchange Transactions, 78 Fed. Reg. 42439 (July 16, 2013) (final rule).

[22]*See* 76 Fed. Reg. at 41677; CFTC v. Zelener, 373 F.3d 861 (7th Cir. 2004), *reh'g denied*, 387 F.3d 624 (2004). In *Zelener*, the court of appeals ruled generally that the "rolling spot" transactions that were the subject of the case were not futures contracts subject to the jurisdiction of the CFTC.

[23]*See* 76 Fed. Reg. at 41677.

[24]*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).

[25]Retail Foreign Exchange Transactions, 81 Fed. Reg. 33374 (May 26, 2016) (notice of expiration of regulation).

[26]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.

[27]*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).

[28]*Id.*

[29]*See id.* at 42447-42449.

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