DechertOnPoint

August 2008 / Issue 14

A legal update from Dechert's Financial Services Group

CFTC Reauthorization Act of 2008 Enacted Into Law

The CFTC Reauthorization Act of 2008 ("CFTC Reauthorization Act" or "Act") was enacted as Title XIII of the Food, Conservation, and Energy Act of 2008 ("Farm Bill") on June 18, 2008.[1] The CFTC Reauthorization Act amends the Commodity Exchange Act ("CEA"),[2] reauthorizing the Commodity Futures Trading Commission ("CFTC") through the year 2013 and substantially enhancing the CFTC's authority in several areas. The Act substantially augments and clarifies the CEA's provisions regarding CFTC authority over foreign currency ("forex") transactions, closes the so-called "Enron Loophole" by increasing CFTC regulatory oversight over exempt commercial markets ("ECMs"), increases criminal and civil penalties for market manipulation, and effects other modifications to the CEA.

The key provisions of the CFTC Reauthorization Act are explained in more detail below.

Clarification of CFTC Authority Over Off-Exchange Retail Foreign Currency Transactions

The CFTC's authority over foreign currency transactions, long a subject of debate and conflicting judicial decisions, was significantly clarified in 2000 with the passage of the Commodity Futures Modernization Act ("CFMA").[3] Section 2(c) of the CEA, as adopted as part of the CFMA, established that the CEA applies to, and that the CFTC has authority to regulate, foreign currency futures contracts trading involving retail customers, unless the contracts are offered by one of the qualifying entities specified in Section 2(c)(2)(B)(ii) of the CEA (*e.g.,* financial institutions and registered broker-dealers or Futures Commission Merchants ("FCMs")). However, in June 2004, the United States Court of Appeals for the Seventh Circuit held that the CFTC did not have the jurisdiction to bring enforcement actions relating to trading in off-exchange foreign currency contracts, finding the contracts to be spot contracts rather than foreign currency futures contracts subject to regulation under Section 2(c) of the CEA because the contracts

1 Food, Conservation, and Energy Act of 2008, Pub. L. No. 110-246 (2008). Congress initially passed the Farm Bill over a Presidential veto on May 22, 2008, but one of the bill's titles had been left out of the copy presented for the President's review. *See* Food, Conservation, and Energy Act of 2008, H.R. 2419, Pub. L. No. 110-234 (2008), *repealed by* Food, Conservation, and Energy Act of 2008, Pub. L. No. 110-246. To avoid Constitutional challenges to the validity of the first bill, Congress presented a full version of the Farm Bill to the President and then voted on June 18, 2008 to override the President's second veto of the Farm Bill. *See* Press Release, U.S. House of Representatives Committee on Agriculture, Congress Overrides Presidential Farm Bill Veto (June 18, 2008).

2 7 U.S.C. §§ 1-27f (2000). The CEA contains a "sunset provision," which requires that Congress periodically review and reauthorize the CFTC. Congress had most recently renewed the CFTC's mandate by adopting the Commodity Futures Modernization Act of 2000.

3 Pub. L. No. 106-554 (2000).

Dechert LLP

did not guarantee a right of offset.[4] Critics, including the CFTC and the National Futures Association, argued that this created a potential gap in consumer protection.[5]

The CFTC Reauthorization Act amends Section 2(c)(2) of the CEA to clarify that CFTC regulatory authority applies to off-exchange retail forex transactions that are: (i) offered to retail customers (*i.e.,* non-eligible contract participants); and (ii) offered or entered into on a leveraged or margined basis, or financed by the offeror, the counterparty, or a person acting in concert with them, on a similar basis, unless offered by a qualifying entity specified in Section 2(c)(2)(B)(ii). The Act also creates a new registration category of permitted counterparties to forex transactions under Section 2(c)(2), known as "retail foreign exchange dealers" ("RFEDs"). An RFED that solicits orders must register with the CFTC as an RFED and maintain $20 million minimum adjusted net capital. The Act also provides the CFTC with expanded authority over foreign currency trading industry participants other than the counterparty to the transaction, including commodity trading advisors and commodity pool operators.

The amendment also strengthens the qualifications and minimum capital requirements for FCMs as qualifying offerors. In order to be a qualifying person for a retail forex transaction, an FCM must be primarily or substantially engaged in the buying or selling of futures contracts on a designated contract market ("DCM") or derivatives transaction execution facility ("DTEF")[6] (or be an affiliate of such an FCM) and must maintain $20 million minimum adjusted net capital.

In addition, the amendment provides the CFTC with general rulemaking authority to effectuate any of the provisions or accomplish any of the purposes of the amendments to Section 2(c)(2).

Expanded Oversight of Significant Price Discovery Contracts

Exempt Commercial Markets

In 2000, the CFMA established a multi-tiered regulatory framework for futures markets under which the level of regulation is tailored to the type of market, the commodity traded, and the participants permitted to transact in that market. Among the new exemptions from futures exchange regulation, the CFMA added Section 2(h)(3) of the CEA to create a broad exemption for ECMs, a type of electronic trading facility for trading in exempt commodities, including energy contracts, by eligible commercial entities.[7] This exemption, the so-called "Enron Loophole," became a focal point for criticism, cited as contributing to price distortions in energy transactions. In October 2007, the CFTC submitted to Congress a report recommending that Congress increase the CFTC's oversight jurisdiction of trading activity on those ECMs that serve a significant price discovery function. These ECMs include, for example, the Intercontinental Exchange (ICE), which the CFTC cited as serving the same price discovery function as the New York Merchantile Exchange (NYMEX), which is a DCM.

Amendments to Section 2(h) of the CEA Relating to ECMs

The CFTC Reauthorization Act adds Section 2(h)(7) to the CEA, creating heightened CFTC regulatory authority over trading in "significant price discovery contracts" (*i.e.*, contracts in exempt commodities that would be exempt from CFTC oversight under Section 2(h)(3) but that perform significant price discovery functions). As a result, two types of transactions may be executed on ECMs: transactions in contracts not deemed to perform significant price discovery functions, which are subject to limited CFTC oversight pursuant to Section 2(h)(3); and transactions in the new significant price discovery contracts, which are subject to a relatively higher level of CFTC oversight pursuant to Section 2(h)(7).

---

4 *See CFTC v. Zelner*, 373 F.3d 861 (June 30, 2004).

5 *See, e.g.,* Written Testimony of Walter Lukken, Acting Chairman, CFTC, before the Subcommittee on General Farm Commodities and Risk Management, Committee on Agriculture, U.S. House of Representatives (Oct. 24, 2007) (available on the CFTC website at www.cftc.gov).

6 DCMs and DTEFs are regulated trading platforms. A DTEF is subject to a greater level of CFTC regulatory authority than an ECM but a lower level of regulation than a DCM.

7 Pursuant to Section 2(h)(3) of the CEA, to qualify for the ECM exemption from futures exchange regulation, transactions must be executed on electronic trading facilities on which multiple persons have the ability to trade contracts by accepting bids and offers from multiple other participants, the contracts traded must be "exempt commodities," and the ECM must limit access to "eligible commercial entities" (*i.e.*, certain highly qualified eligible contract participants as defined in Section 1a(11) of the CEA).

New Section 2(h)(7) requires that the CFTC evaluate all contracts in exempt commodities traded on an ECM pursuant to Section 2(h)(3) on at least an annual basis to determine whether those contracts serve a significant price discovery function. New Section 2(h)(7) also provides criteria that the CFTC must use to determine whether a contract traded on an ECM performs a significant price discovery function and requires the CFTC to monitor trading in significant price discovery contracts. The criteria indicative of a significant price discovery function include:

(i) whether there is a price linkage to contracts traded on DCMs or DTEFs or an already-identified significant price discovery contract;

(ii) whether the price for a contract is sufficiently related to a contract traded on a DCM or DTEF or a significant price discovery contract to permit arbitrage;

(iii) whether the price for the contract is used as a material price reference to price transactions in the underlying commodity;

(iv) whether trading volume is sufficient to have a material effect on other contracts; and

(v) any other material factors.

In addition, new Section 2(h)(7) provides that the ECMs on which designated significant price discovery contracts are traded must comply with nine "core principles," including: (i) significant price discovery contracts may not be readily susceptible to manipulation; (ii) the ECM must monitor trading in significant price discovery contracts to protect against manipulation; (iii) the ECM must adopt rules to enable itself to obtain information and provide it to the CFTC upon request; (iv) the ECM must adopt speculative position limits; (v) the ECM must adopt emergency authority rules; (vi) the ECM must publish daily price and volume trading data; (vii) the ECM must monitor and enforce any of its applicable trading rules; (viii) the ECM must establish and enforce rules to minimize and resolve conflicts of interest; and (ix) the ECM must avoid adopting rules that unreasonably restrain trade or impose an anticompetitive burden on trading.

In addition, the CFTC Reauthorization Act amends Sections 4g(a) and 4i of the CEA to require that large traders keep books and records of, and report their positions in, significant price discovery contracts as required by the CFTC.

Other Amendments to the CEA

Expansion of Anti Fraud Authority over Principal-to-Principal Futures Transactions. Prior to the new legislation, Section 4b of the CEA, the core CEA anti-fraud provision, had in some circumstances been construed to bar fraud only in futures transactions conducted on an agency basis by a broker or other intermediary. The CFTC Reauthorization Act amends Section 4b of the CEA to clarify that the CEA gives the CFTC authority to bring fraud actions in off-exchange "principal-to-principal" futures transactions, including exempt commodity transactions in energy contracts under Section 2(h) of the CEA and transactions on DTEFs. The CFTC Reauthorization Act also adds a new provision establishing that Section 4b of the CEA applies to all covered forex transactions as if such forex transactions were transactions in future contracts.

Modification of Criminal and Civil Penalties. The CFTC Reauthorization Act amends the CEA to increase both the civil and criminal penalties available for certain violations of the CEA such as manipulation, attempted manipulation, and false reporting. The maximum civil penalty for the specified violations is raised to $1 million, and the maximum criminal penalty for specified violations is raised to ten years' imprisonment.

Required CFTC and SEC Rulemaking on Portfolio Margining and Security Index Issues. The CFTC Reauthorization Act also modifies the CEA to require that the CFTC and the U.S. Securities and Exchange Commission ("SEC") take certain actions:

- The CFTC and the SEC must use their existing authorities to permit risk-based portfolio margining for security options and security futures products by September 30, 2009.

- The CFTC and SEC must permit the trading of futures on broad-based indexes on foreign equities by adopting rules to exclude them from the definition of "narrow-based security index" as appropriate by June 30, 2009.[8] Pursuant to provisions adopted as part of the CFMA, the CFTC and SEC have joint authority over "narrow-based security indexes." Currently, indexes composed of foreign securities generally are viewed as falling within the definition of "narrow-based" security index and not satisfying the statutory non-narrow-based security index definition. Futures on foreign

[8] *See* Section 3(a)(55) of the Securities Exchange Act of 1934 and Section 1a(25) of the CEA.

narrow-based security indexes may not be offered or sold to customers in the United States until the CFTC and SEC adopt rules governing the offer and sale, and the agencies have not adopted rules for foreign security indexes because of "divergent views."[9] This mandate under the CFTC Reauthorization Act would facilitate trading in futures on certain foreign indexes by requiring the agencies to resolve the issues necessary to exclude broad-based indexes on foreign equities from the definitions of narrow-based security index as appropriate, deeming such indexes "broad-based" and within the sole jurisdiction of the CFTC.

Significant Technical Amendments. The CFTC Reauthorization Act's technical amendments modify:

- Section 1(a)(33) of the CEA, the definition of "trading facility" under the CEA, to expressly include markets which utilize automated trade matching and execution algorithms;
- Section 4a(e) of the CEA to provide that it is a violation of the CEA, for which the CFTC may bring an enforcement action, for any person to violate a speculative position limit rule that has been certified by a registered entity pursuant to Section 5c(c)(1) (in addition to those limits set by the CFTC); and
- Section 14(d) of the CEA to provide that a reparations award received through the CFTC's reparations process is directly enforceable in federal district court, as if the award were a local judgment registered for enforcement in another district pursuant to 28 U.S.C. 1963.

■ ■ ■

This update was authored by Susan C. Ervin (+1 202 261 3325; susan.ervin@dechert.com); Philip T. Hinkle (+1 202 261 3460; philip.hinkle@dechert.com); Brendan C. Fox (+1 202 261 3381; brendan.fox@dechert.com) and Alan Rosenblat (+1 202 261 3332; alan.rosenblat@dechert.com).

[9] *See* Testimony of Patrick J. McCarty, General Counsel, CFTC, before the Committee on Banking, Housing and Urban Affairs, U.S. Senate (Sept. 8, 2005).

Practice group contacts

For more information, please contact the authors, one of the attorneys listed, or any Dechert attorney with whom you regularly work. Visit us at www.dechert.com/financialservices.

Margaret A. Bancroft
New York
+1 212 698 3590
margaret.bancroft@dechert.com

Sander M. Bieber
Washington, D.C.
+1 202 261 3308
sander.bieber@dechert.com

Stephen H. Bier
New York
+1 212 698 3889
stephen.bier@dechert.com

Daphne T. Chisolm
Charlotte
+1 704 339 3153
daphne.chisolm@dechert.com

Christopher D. Christian
Boston
+1 617 728 7173
christopher.christian@dechert.com

Elliott R. Curzon
Washington, D.C.
+1 202 261 3341
elliott.curzon@dechert.com

Douglas P. Dick
Washington, D.C.
+1 202 261 3305
douglas.dick@dechert.com

William K. Dodds
New York
+1 212 698 3557
william.dodds@dechert.com

Ruth S. Epstein
Washington, D.C.
+1 202 261 3322
ruth.epstein@dechert.com

Susan C. Ervin
Washington, D.C.
+1 202 261 3325
susan.ervin@dechert.com

Joseph R. Fleming
Boston
+1 617 728 7161
joseph.fleming@dechert.com

Brendan C. Fox
Washington, D.C.
+1 202 261 3381
brendan.fox@dechert.com

Wendy Robbins Fox
Washington, D.C.
+1 202 261 3390
wendy.fox@dechert.com

David M. Geffen
Boston
+1 617 728 7112
david.geffen@dechert.com

David J. Harris
Washington, D.C.
+1 202 261 3385
david.harris@dechert.com

Robert W. Helm
Washington, D.C.
+1 202 261 3356
robert.helm@dechert.com

Jane A. Kanter
Washington, D.C.
+1 202 261 3302
jane.kanter@dechert.com

Geoffrey R.T. Kenyon
Boston
+1 617 728 7126
geoffrey.kenyon@dechert.com

George J. Mazin
New York
+1 212 698 3570
george.mazin@dechert.com

Jack W. Murphy
Washington, D.C.
+1 202 261 3303
jack.murphy@dechert.com

John V. O'Hanlon
Boston
+1 617 728 7111
john.ohanlon@dechert.com

Jeffrey S. Puretz
Washington, D.C.
+1 202 261 3358
jeffrey.puretz@dechert.com

Jon S. Rand
New York
+1 212 698 3634
jon.rand@dechert.com

Robert A. Robertson
Newport Beach
+1 949 442 6037
robert.robertson@dechert.com

Keith T. Robinson
Hong Kong
+1 852 3518 4705
keith.robinson@dechert.com

Alan Rosenblat
Washington, D.C.
+1 202 261 3332
alan.rosenblat@dechert.com

Kevin P. Scanlan
New York
+1 212 649 8716
kevin.scanlan@dechert.com

Frederick H. Sherley
Charlotte
+1 704 339 3100
frederick.sherley@dechert.com

Patrick W. D. Turley
Washington, D.C.
+1 202 261 3364
patrick.turley@dechert.com

Brian S. Vargo
Philadelphia
+1 215 994 2880
brian.vargo@dechert.com

David A. Vaughan
Washington, D.C.
+1 202 261 3355
david.vaughan@dechert.com

Anthony H. Zacharski
Hartford
+1 860 524 3937
anthony.zacharski@dechert.com

Dechert LLP

www.dechert.com

U.S. Austin • Boston • Charlotte • Hartford • Newport Beach • New York • Philadelphia Princeton • San Francisco • Silicon Valley • Washington, D.C. • **EUROPE** Brussels London • Luxembourg • Munich • Paris • **ASIA** Hong Kong