



LEGAL ALERT

CFTC REAUTHORIZATION BILL PASSED

*Includes important changes to
regulation of energy trading and
retail currencies*

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On May 15, 2008, Congress passed the Food, Conservation and Energy Act (HR 2419 commonly referred to simply as the "Farm Bill") that both reauthorizes the Commodity Futures Trading Commission ("CFTC") and vests CFTC with broad new regulatory authority in the areas of electronic energy commodity contracts and retail over-the-counter foreign currency. The CFTC Reauthorization Act of 2008 (the "Act"), title XIII of the Farm Bill, passed both the Senate and the House by wide margins that will likely defeat a threatened Presidential veto.

Closing the Enron Loophole

The Act will close the so-called Enron loophole, codified in Section 2(h)(13) of the Commodity Exchange Act ("CEA"), which exempted electronic energy-commodity markets from the CEA (and CFTC oversight). The Act vests CFTC with broad authority to regulate such markets and imposes regulatory and oversight requirements on the electronic exchanges carrying such contracts akin to those currently required of Derivative Transaction Execution Facilities ("DTEFs") under Section 5a of the CEA. The Act further empowers CFTC with the authority to set position limits on energy commodities traded on such electronic markets to prevent excessive speculation and manipulation. Furthermore, the Act requires CFTC to review all electronically traded energy commodity contracts to determine whether such contracts are "significant" for price-discovery purposes. Contracts that are deemed "significant" by CFTC must be subject to strict oversight by the electronic market on which they trade. Such markets must also make large trader

reports to CFTC as is currently required of exchange traded commodity futures.

In determining whether a given contract is "significant," CFTC will look at both the volume of trading and the form of the contract. Contracts that are similar in nature to those already traded on Designated Contract Markets ("DCMs") such as the CME or NYMEX, so called "look-alikes" are also more likely to be classified "significant," because of the perceived increased risk of manipulation in the trading of such contracts.

Overhaul of Retail FX Regulation

The Act makes three substantial changes to CEA section 2(c)(2) which empowers the CFTC to regulate over-the-counter ("OTC") retail currency contracts.

First, the new provisions revise the list of qualifications for regulated entities permitted to act as counterparty to OTC currency contracts with retail clients (section 2(c)(B)(ii) of the CEA). The Act creates a new and separate category of CFTC registration for "retail foreign exchange dealers" ("REFD"s), which essentially codifies the membership category of Forex Dealer Member employed by National Futures Association for Futures Commission Merchants ("FCM"s) dealing in retail FX. Existing registered FCM's will continue to be permitted to deal OTC FX to the U.S. retail public provided they also transact a substantial volume of regulated exchange traded futures business (this category will likely pick up the majority of existing exchange member FCM's who deal in both classes of contracts). By framing the new REFD registration category for registrants

dealing solely in retail OTC FX, congress is likely paving the way for the CFTC to tailor more specific and detailed regulation specifically for this category of registrants.

Secondly, the Act will raise the minimum capital requirement in several stages over its first effective year to \$20 million. (NFA regulations presently specify base minimum capital of \$5,000,000 for Forex Dealer Member FCM's.) The capital requirement will increase in three stages from the date of the Act as follows: \$10,000,000 beginning 120 days after the date of enactment, \$15,000,000 beginning 240 days after the date of enactment, and \$20,000,000 beginning one year from the date of enactment. These new capital requirements will apply identically to *both* REFED's *and* FCM's with active futures business who also choose to deal retail OTC FX contracts. Again, the new specification of two separate categories of permitted registrant for retail OTC FX with identical minimum capital requirements argues for greater regulatory scrutiny on the RFED in the near term future.

Thirdly, the Act also closes the "Zelener loophole," so called for the 7th Circuit Court of Appeals decision in CFTC v. Zelener, which excluded certain over-the-counter spot currency contracts from CFTC jurisdiction under the CEA because, according to the court, they did not constitute "contracts of sale for future delivery." Under the Act, CFTC is given specific jurisdiction over all agreements, contracts, or transactions in foreign currency that are "offered to or entered into [with retail customers] on a *leveraged* or *margined* basis, or financed by the offeror, the counterparty, or a person acting in concert with the offeror or counterparty on a similar bases." The Act also codifies CFTC's definition of what

constitutes a "spot" contract by precluding from the Act only those retail OTC FX contracts that result in actual delivery in less than two days, or that create an enforceable delivery obligation between a seller and a buyer both of whom (a) have the ability to deliver and accept delivery, and (b) do so in connection with their line of business. The effectiveness of these new standards remains an open question given the distaste of many U.S. federal circuit courts for "intent-based" regulation.

In addition to the changes noted above, the new Act also affords CFTC additional tools for combating fraud and manipulation including increasing civil penalties and statutory disqualification. Please look for more complete discussions of these and other emerging regulatory changes on our website at www.dlkny.com.

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