

CFTC Reauthorization of 2008 & Beyond

Earlier this year, the CFTC Reauthorization Act of 2008 was enacted into law as part of the Food, Conservation, and Energy Act of 2008. The Act is also known as the Farm Bill and has made substantial contributions to modifying the Commodity Exchange Act (“CEA”), particularly affecting the Commodity Futures Trading Commission’s (“CFTC”) authority over off-exchange retail foreign currency transactions.

The CFTC has been attempting to close what is known in the industry as the *Zelener loophole* following the 2004 decision from the Seventh Circuit Court of Appeals. In the United States the CFTC has jurisdiction over futures contracts. In *Zelener*, the Court held that spot forex transactions are not deemed to be futures contracts thereby taking away CFTC’s jurisdiction under the CEA. Another setback to CFTC was made in January 2008, when the U.S. Court of Appeals for the Sixth Circuit in *CFTC vs. Erskine* reaffirmed the principals held in the *Zelener* decision.

These two decisions temporarily diminished CFTC’s authority to bring enforcement actions against retail forex against unscrupulous operators within the forex industry until the enactment of the CFTC Reauthorization Act of 2008. The Act amended section 2(c)(2) of CEA by clarifying that CFTC regulatory authority applies to off-exchange retail forex transactions. This clarification is an important stepping stone, allowing CFTC to bring enforcement actions for fraud under the CEA.

The Act also created a new registration category of permitted counterparties to forex transactions: “retail foreign exchange dealers” (“RFEDs”). For firms that register as RFEDS a new adjusted net capital requirement of \$20 million was set forth by the Act. According to a recent proposal from the National Futures Association (“NFA”) the increase will be phased -in through \$5 million increments.

The first increase will take place October 31, 2008, which is an extension of the original CFTC deadline of September 19, 2008. After the first phase-in period, RFEDs will be required to maintain at least \$10 million in adjusted net capital. The second increase will take place on January 17, 2009, which will bring the requirement to \$15 million. The third and final phase-in will be on May 16, 2009 and will bring the adjusted net capital requirement for RFEDS to \$20 million. The NFA has also proposed that firms offering greater than 100:1 leverage maintain at least 150% of the adjusted net capital requirement.

One of the most important achievements of the CFTC Reauthorization Act is requiring registration for those who solicit orders, exercise discretionary trading authority, and operate commodity pools with respect to off-exchange retail foreign currency transactions. Unfair solicitation practices by unregistered solicitors and trading advisors has cast a bad light onto the growing industry in the past several years. These also significantly burdened RFEDs with policing activities of their own unregistered solicitors. As such, this registration requirement has been highly supported by RFEDs in order to eliminate unlawful solicitation practices. While it has been several months since the law was enacted, the registration requirement for solicitors is one of the most highly awaited laws to be drafted by regulators.

The Act provides that the registration requirements are to go into effect on September 19, 2008 with a caveat that this date may be extended until such later time that the CFTC establishes. According to the NFA, in their discussion with CFTC staff, it is unlikely the new registration requirements will go into effect by September 19, 2008. There is, however, consensus among the regulators that solicitor registration is a top priority and efforts are being made to enforce this requirement by year's end.

To many, it is unknown that the CFTC Reauthorization was three years overdue by US Congress though its long awaited enactment has brought substantial changes to the off-exchange forex industry. The increase in the adjusted net capital requirements has caused an initial consolidation of the industry which is now approximately two dozen RFEDs strong. Although some RFEDs do not believe that a \$20 million adjusted net capital requirement is warranted to operate a firm, the industry has overwhelmingly welcomed the solicitor registration requirement. Since the CFTC Reauthorization, there have been a number of new regulatory proposals by the NFA that stemmed from the Act. The industry is also waiting for CFTC to draft new regulations for the establishment of the new registration category.

The Reauthorization Act of 2008 was much unnoticed by the financial sector media. In a recent Lexis Nexis search for the past year there are just a handful of articles that touch upon this legislation. Nevertheless, the long overdue law is now looked upon by some RFEDs as a catalyst for sensible regulation and the end of fraudulent sales and marketing practices by unregistered solicitors.