

## Regulatory Roundup

In the wake of the recent financial crisis, the United States and the European Union are instituting major regulatory changes which will impact currency traders and fund managers. In the U.S., the Commodities Futures Trading Commission (“CFTC”) recently promulgated new rules regarding over-the-counter retail foreign currency trading (“forex”). Also, in October, the CFTC proposed another set of rules codifying more transparent registration requirements for certain Commodity Pool Operators (“CPOs”). On the other side of the Atlantic, the European Union is working on the Alternative Investment Fund Managers Directive. In November the European Parliament will vote on this Directive, which proposes changes in the regulation of private equity and hedge funds. Since currency funds are classified as hedge funds in Germany, this piece of legislation is of significant interest for currency fund managers operating in Germany.

### United States

The CFTC’s new rules governing retail forex trading went into effect on October 18, 2010. These new rules are significant because they are amongst the first to be promulgated pursuant to the Dodd-Frank Act. While the majority of these rules are aimed at entities that serve as counterparties to retail forex transactions, a number of provisions concern CPOs operating in the forex industry. Such relevant changes include the following:

- Rule 4.7: Allows for CPOs to gain exemption from certain requirements with respect to offerings to qualified eligible persons. For a qualified eligible person the minimum security deposit for the transaction must be included in the calculation of the portfolio agreement.
- Rule 4.13: In order for a CPO to claim an exemption from registration under this provision, the aggregate initial margin, premiums, and required minimum security deposit for retail forex cannot be larger than 5% of the liquidation value of the pool’s portfolio.
- Rules 4.24 and 4.34: CPOs must provide customers a risk disclosure statement which states that under the Bankruptcy Code forex transactions may not be given the same preferential treatment as commodity customer claims.
- Rule 5.3: People who operate or solicit funds or property for a pooled investment vehicle including forex pools must register as CPOs. Associated persons of such CPOs must also register as associated persons.
- Rule 5.9: The minimum leverage for retail forex transactions is 2% of the notional value for major currencies pairs and 5% the notional value for minor currency pairs. If the amount deposited does not meet this requirement, the counterparty must liquidate the customer’s position. The CFTC originally proposed setting the minimum leverage at 10%; however, they decided to lower the requirement in the final rules after receiving a lot of negative comments suggesting that such a high leverage requirement would force industry to move offshore.
- Rule 5.13: Counterparties must furnish to each customer a monthly statement (this can be submitted electronically with the CPOs’ consent).
- Rules 5.15 and 5.16: CPOs, principals, and those who solicit for them, cannot represent that the CFTC or federal government has sponsored, recommended or approved them in any way.

The new CFTC rules are aimed at preventing fraud in retail foreign currency trading. Currency fund managers should note that the CFTC has recently brought a number of enforcement actions against CPOs and fund managers. For example, in July the CFTC brought an action against a registered CPO for making false statements to customers and in required CFTC regulatory filings. Other recent actions center around ponzi schemes, defrauding customers, and failing to register as a CPO.

Additionally, on September 8, 2010, the CFTC proposed to change the regulatory structure pertaining to certain CPOs whose units of participation are listed and traded on a national securities exchange. The proposed changes would relieve these CPOs from certain disclosure, reporting and recordkeeping requirements. Such CPOs would still need to provide the same disclosure information, make the same periodic reports, and keep the same books and records they are already maintaining. However, they would be relieved from: (1) Obtaining a signed acknowledgment of receipt of the disclosure document if the disclosure is already available on the CPO's website (2) delivering monthly account statements if the required information is available on the CPO's website and (3) keeping all required books and records at the CPO's main business address. Such relief is based on substituted compliance with corresponding federal securities law. Previously the commission had issued such relief on a case-by-case basis. Additionally, the changes would require certain independent directors or trustees of actively managed commodity pools to register.

The new CFTC forex rules which went into affect on October 18, 2010 and the proposed CFTC rules related to CPOs are microcosms of the shift the financial markets are experiencing leading to more stringent specific regulation. In the wake of the financial crisis the government will likely continue to take a hands-on approach to regulation, an approach that is likely going to permeate through many financial centers around the world.

### **Germany**

Another important upcoming regulatory change concerning currency fund managers is the Directive on Alternative Investment Fund Managers (AIFMD) which was proposed in 2009. Since 2009, member states of the European Union ("EU") have been negotiating the controversial provisions, and in mid-October, 2010, a common text was adopted. The main obstacle to adopting this text has been debates regarding how to treat hedge funds domiciled outside of the EU. On November 11<sup>th</sup> the European Parliament will be voting on the final text, and if it passes, member states will have two years to incorporate the rules into their national laws.

The Directive is aimed at providing regulation of private equity and hedge funds, as there is currently no EU supervision of these sectors. Subsequently, the Directive will create a pan-European watchdog with greater oversight powers. Through this watchdog, the directive aims to establish a harmonized framework for monitoring and supervising the risks that alternative investment fund managers pose to their investors, counterparties, other market participants, and the stability of the entire financial system. Another one of the law's main goals is to promote transparency by extending the range of information private equity advisers and hedge funds must distribute. As a result such companies will have to indicate what financial products and markets they are investing in. They will also have a duty to disclose

to investors and regulators their investment strategy and the amount of leverage they are using to implement it. Additionally, private equity and hedge funds will be banned from short-selling. These requirements are aimed at safeguarding investors' money and preventing fraudulent investment schemes. Other specific requirements include that each fund has an independent valuator, a minimum capital requirement of 125,000 Euros, and unspecified leverage requirements to be promulgated in the final directive.

The main compromise in the common text is the marketing of non-EU funds within the EU. Such funds will be given a "passport" enabling it to be marketed throughout the EU, rather than having to gain permission in each individual country. The requirements for receiving this passport are that the country in which the fund is domiciled must (1) have high enough standards for anti-money laundering (2) grant reciprocal access to the marketing of EU funds in its territory (3) have agreements with EU member states where marketing covers the exchange of information relating to taxation and monitoring, and (4) recognize and enforces judgments in the EU on AIMFD issues.

The AIFMD has raised concern among currency fund managers operating in Germany, because such funds are categorized as hedge funds under German law. They are concerned with how the AIMFD will change the regulation of hedge funds in Germany. Currently, major requirements for hedge funds in Germany include the following:

- Hedge funds must obtain a written license from the national regulator.
- Hedge funds can only market and distribute through a private placement. Therefore, they must follow the rules applicable to prospectuses, which includes containing a list of the fund rules and a warning about the total possible loss. This rule applies to foreign funds as well.
- Hedge funds are subject to minimum capital requirements, but advisers are not. Such capital requirements are expected to provide a safety-net against existing obligations when asset values decline sharply.
- There is no minimum leverage requirement. The Ministry of Finance, however, can restrict leverage in short-selling transactions through an executive order intended to prevent abuse and protect capital market integrity.
- Relative lack of restrictions in Germany for retail investors in hedge funds. There is no minimum requirement to invest in hedge funds in Germany.

The main way in which the EU directive will change the regulation of hedge funds in Germany is with regards to transparency and disclosure requirements. German law does not currently require fund managers to disclose leverage and investment strategies to clients, and prefers to leave it up to the investors to make individual arrangement with fund managers. Additionally, the EU "passport" regime will allow investors to bypass the current private placement regime in Germany. Instead, investors can gain access to the entire EU market, rather than complying with each individual countries requirements. Although the German regulators favor a higher standard for the passport regime, this will be a favorable development for currency fund managers outside the EU looking to enter the German market. Also, additional costs will be incurred as fund managers will need to comply with the German regulators and the pan-European watchdog.

While many have speculated that the financial crisis is ending, an inevitable result is more stringent government intervention in the financial markets. The failure of the global financial system was likely perceived by the government as a failure on self-regulation. In the U.S. the Dodd-Frank Act will greatly impact the financial sector and continue the trend to increased government regulation which will likely trickle to European financial sectors.