



## Legislative Update – Recent Amendments to the Commodity Exchange Act

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The Securities and Futures Regulation Group

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In June 2008, Congress passed the 2008 Farm Bill, which included a title reauthorizing the Commodity Futures Trading Commission (CFTC) until 2013 (Reauthorization Act).<sup>1</sup> The legislation amends the Commodity Exchange Act (CEA) by (1) providing additional oversight of Exempt Commercial Markets (ECMs), (2) enhancing CFTC authority over retail forex trading, (3) directing regulatory bodies to create a clearer framework for securities futures products, and (4) providing tougher penalties for violations of the CEA.

Compared to the Commodity Futures Modernization Act of 2000 (CFMA),<sup>2</sup> which made sweeping changes to derivatives market regulation, the Reauthorization Act is more patchwork in nature. It adds new regulatory muscle to the CFTC by closing certain loopholes and enhancing penalties for violations, but it does not fundamentally change the operation of the derivatives market.

### Regulation of Exempt Commercial Markets

Exempt Commercial Markets (“ECMs”) are electronic markets that are open only to sophisticated “eligible commercial entities” that trade exempt commodities for their own accounts as principals.<sup>3</sup> These markets operated without substantial CFTC regulation after a CFTC rule change that was later codified in the CFMA. Some referred to this exemption as the “Enron Loophole,” because Enron was one of the major forces that lobbied for its inclusion. This exemption, contained in 7 U.S.C. § 2(h)(3), exempts principal-to-principal transactions between eligible commercial entities on an all-electronic trading facility from regulation. The only regulations that applied to ECMs were the CEA’s general statutory prohibitions against fraud and price manipulation.

The collapse of Amaranth Advisors, L.L.C. in 2006 exposed potential weaknesses in the regulatory scheme. Amaranth was a hedge fund that took a highly speculative position on natural gas contracts on the Intercontinental Exchange (an ECM) that proved to be a losing bet, leading to a loss of \$6 billion and the collapse of the fund itself. Amaranth’s implosion was the catalyst for the inclusion of enhanced ECM regulation in the Reauthorization Act.

The Reauthorization Act expands the CFTC’s authority over contracts traded on an ECM that the CFTC determines to be “significant price discovery contracts” (SPDCs).<sup>4</sup> In making that determination, the CFTC is to consider:

1. Price Linkage. The extent to which the contract uses or relies on prices of some other contract that is traded on a regulated market to value, transfer, settle, or close out a position;
2. Arbitrage. The extent to which the price is sufficiently related to the price of a contract on a regulated market such that market participants can effectively arbitrage between the markets;
3. Material price reference. The extent to which, on a frequent and recurring basis, bids, offers or transactions in a commodity are based on or determined by referencing the contract being traded on the ECM;
4. Material liquidity. The extent to which the volume of contracts involving the commodity that are traded on the ECM has an effect on contracts or other agreements on another ECM or on a regulated market; and
5. Other material factors.

The Reauthorization Act requires an ECM on which SPDCs are traded to comply with new “core principles” with respect to those contracts. An ECM is expected to implement self-regulatory functions, such as only listing SPDCs that are not readily susceptible to manipulation, monitoring trading to prevent manipulation, publishing daily price and volume information about its SPDCs, and adopting rules for the exercise of emergency authority to, for example, liquidate open positions or suspend trading. An ECM must also establish position limits or accountability levels. In addition, large trader positions of an SPDC must now be reported to the CFTC in the same way that large positions on a regulated market are reported.<sup>5</sup>

### Enhanced CFTC Authority Over Retail Forex Trading

The CFMA granted the CFTC jurisdiction over certain transactions in currency futures and options that involved retail participants. However, in 2004, the Seventh Circuit held in *CFTC v. Zelenor* that certain OTC foreign currency contracts did not fall under the CFTC’s jurisdiction because they were “rolling spot” sales and not futures contracts.<sup>6</sup>

In the Reauthorization Act, Congress clarified which foreign currency contracts should be subject to the CFTC’s jurisdiction. Any agreement, contract or transaction in foreign currency that is offered on a leveraged or margined

basis to someone who is not an eligible contract participant is now subject to CFTC antifraud provisions as if the foreign currency contracts were futures contracts.<sup>7</sup> This includes “rolling spot” and other products that look like futures.<sup>8</sup> However, the CFTC does not have jurisdiction over retail forex transactions that are entered into by a financial institution, a registered broker-dealer, an insurance company, a financial holding company or an investment bank holding company. Nor does the CFTC have jurisdiction over transactions that (1) result in actual delivery of the foreign currency in two days or less, or (2) create an enforceable obligation to deliver between a buyer and a seller who can effectuate such delivery in their line of business.

The Reauthorization Act allows futures commission merchants (FCMs) and their affiliates to trade foreign currency contracts with retail customers only if they are primarily or substantially engaged in the buying or selling of futures contracts on a regulated futures exchange. This requirement is designed to prevent the creation of “shell FCMs” that are developed to offer foreign currency trading to retail customers, but that do not participate in regular futures market activities.<sup>9</sup> In addition, Congress created a new registration category for retail forex dealers in the Reauthorization Act. The Act requires that these dealers, as well as FCMs and their affiliates, must maintain \$20 million in net capital in order to be a valid counterparty for OTC forex transactions.<sup>10</sup>

Finally, the Act requires any individual or firm that deals in foreign currency products with someone who is not an eligible contract participant by soliciting or accepting orders, exercising discretionary trading authority, or operating a commodity pool, to register with the CFTC in the appropriate category.<sup>11</sup>

### **Portfolio Margining for Security Futures Products**

Before passage of the CFMA in 2000, it was unlawful to trade security futures contracts<sup>12</sup> in the United States. The CFMA authorized the trading of security futures contracts, but imposed a number of restrictions on such trading. One restriction is that the margin level for security futures cannot be lower than the margin level for comparable security options, which generally use strategy-based margin requirements. In contrast, futures customer accounts normally use a form of risk-based portfolio margining. The full expansion of portfolio margining to customer accounts for security futures has been stymied by differences between the CFTC and the Securities and

Exchange Commission (SEC) over how futures in a securities portfolio margin account should be treated. The SEC would like such an account to be a single securities account, while the CFTC prefers separate futures and securities accounts with margin reconciliation between the two. The Reauthorization Act directs the CFTC and the SEC to take action by September 30, 2009 to permit risk-based portfolio margining for both security futures and security options,<sup>13</sup> although it does not indicate which approach the two agencies should follow.

### **Tougher Penalties for Violations of the CEA**

The Reauthorization Act raises the maximum penalties applicable to fraudulent actions, especially those involving market manipulation. The maximum criminal penalty for manipulation, falsification, false reporting and other crimes is raised from five years to ten years, and the maximum civil penalty for an individual is raised from \$500,000 to \$1,000,000. Maximum penalties for market manipulation are raised from the higher of \$100,000 or triple the person's monetary gain to the higher of \$1,000,000 or triple the person's monetary gain, whether the penalty is assessed by the CFTC or by a court that is imposing an injunction or restraining order. The Reauthorization Act also raises penalties from \$500,000 to \$1,000,000 for registered entities that break or do not enforce rules regarding market manipulation, and increases the criminal penalty for officers who do not comply with CFTC cease and desist orders involving market manipulation from a misdemeanor to a felony.<sup>14</sup>

## Endnotes

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<sup>1</sup> CFTC Reauthorization Act of 2008, Pub. L. No. 110-246, 122 Stat. 1651 (2008).

<sup>2</sup> Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763, 2763A-378 (2001).

<sup>3</sup> See 7 U.S.C. § 2(h)(3)–(5) (2006). An exempt commodity is any commodity other than an agricultural or financial commodity, such as metals or energy. 7 U.S.C. § 1a(13)–(14) (2006).

<sup>4</sup> CFTC Reauthorization Act of 2008 § 13201 (to be codified at 7 U.S.C. § 2(h)(7)).

<sup>5</sup> *Id.* at § 13202; 7 U.S.C. § 6g(a) (2006); 7 U.S.C. § 6i (2006).

<sup>6</sup> *CFTC v. Zelener*, 373 F.3d 861, 862 (7th Cir. 2004). The transactions at issue in *Zelener* involved retail customers who could buy or sell any currency from a firm, with settlement of the transaction within 48 hours. Rather than settling, however, the customers could roll the transaction forward, essentially giving the customer an open position in foreign currency.

<sup>7</sup> CFTC Reauthorization Act of 2008 § 13101.

<sup>8</sup> H.R. Rep. No. 110-627, at 984 (2008) (Conf. Rep.).

<sup>9</sup> See *id.* at 980.

<sup>10</sup> CFTC Reauthorization Act of 2008 § 13101.

<sup>11</sup> *Id.*

<sup>12</sup> Security futures contracts are defined as futures on single stocks or on a narrow-based security index, or options on such futures. CEA §§ 1a(31)–(32).

<sup>13</sup> CFTC Reauthorization Act of 2008 § 13106.

<sup>14</sup> CFTC Reauthorization Act of 2008 § 13103.

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