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Time Running Out on Retail Currency Business for SEC-Registered Broker-Dealers

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As things currently stand, on July 16, when the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act)[1] becomes effective, Securities and Exchange Commission (SEC)–registered broker-dealers (BDs) will no longer be able to enter into many types of foreign currency transactions for their retail customers. Although the law is not entirely clear, there is even a question as to whether BDs may purchase foreign currency for retail customers in connection with foreign securities trades if the settlement date for the currency transaction extends beyond two days.[2] The reason for these changes is that the Dodd-Frank Act included a requirement that the applicable functional regulator pass rules governing conduct of a regulated entity regarding retail forex in order for an entity to be able conduct such business. The Commodity Futures Trading Commission (CFTC),[3] the Federal Deposit Insurance Corporation (FDIC),[4] and the Office of the Comptroller of the Currency (OCC)[5] have passed rules, but the SEC has not.

The bad news for BDs does not end there. A provision in the Dodd-Frank Act disallows a BD from using its CFTC-registered futures commission merchant (FCM) to conduct such foreign currency transactions (even though a stand-alone FCM may legally carry out the trades), and the CFTC has provided in its rules that a BD may not solve its problem by registering as a retail foreign exchange dealer (Forex Dealer). Going forward, unless the SEC acts, the only types of entities that may solicit and effect foreign exchange transactions with customers that are not "eligible contract participants" (ECPs) are banks and stand-alone FCMs and Forex Dealers. Investment advisers that assist retail customers will also have to separately register as commodity trading advisers (CTAs) in order to advise on foreign exchange trades carried out at FCMs and Forex Dealers.

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1. Pub. L. No. 111-203 (2010).

2. As an example, if a customer places an order to purchase ordinary shares of British Petroleum, payment must be made in British pounds sterling. If the customer only has U.S. dollars in his or her account, the BD executing the transaction must purchase the pounds by settlement date to deliver in payment for the ordinary shares. Settlement of the stock purchase is typically T+3, or longer than the two business days referenced in the Commodity Exchange Act for "spot" currency transactions that are excluded from the requirement that a regulated entity act as counterparty. Whether the conversion may be legally carried out by a BD depends on whether the BD would be deemed to be "financing" the conversion or not.

3. *See* http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2010-21729a.pdf.

4. *See* 76 Fed. Reg. 28358 (May 17, 2011).

5. *See* 76 Fed. Reg. 22633 (Apr. 22, 2011).

The potential impact of these changes on existing transactions between retail customers and BDs leaves room for doubt regarding their ongoing validity. As a result, BDs and investment advisers that work with retail customers should evaluate their current foreign exchange business and evaluate how best to address the changes from a structural perspective, including possibly moving existing transactions to a bank affiliate or a stand-alone FCM or Forex Dealer.

Retail Forex Transactions

The Commodity Exchange Act (CEA) provides that only enumerated regulated entities are permitted to "solicit" or transact in off-exchange foreign currency transactions (forex transactions) for non-ECPs.[6] These regulated entities include U.S.-regulated banks, SEC-registered BDs, FCMs, and Forex Dealers. Covered forex transactions include forwards and options conducted in the over-the-counter market as well as off-exchange futures and leveraged transactions that do not result in actual delivery of currency. An ECP is defined in Section 1a(18) of the CEA, as amended by the Dodd-Frank Act, and includes, for purposes of transacting in foreign exchange, (i) a corporation, partnership, organization, trust, or other entity (other than a commodity pool) that has total assets exceeding $10 million; (ii) an individual that has in excess of $10 million "invested on a discretionary basis";[7] and (iii) a commodity pool that is formed and operated by a person regulated under the CEA (but only if all of the participants in the pool are ECPs).

Spot transactions are excluded from the scope of the regulation, as are physically settled transactions that are not "offered, or entered into, on a leveraged or margined basis, or financed by the offeror." Spot transactions are narrowly defined to include only physically settled transactions settling in two business days and transactions that create an enforceable obligation to deliver among persons that have the ability to do so in connection with a line of business.[8] Neither the SEC nor the CFTC has provided interpretive guidance on what it means for a transaction to be entered into on a leveraged or margined basis or to be financed by the offeror. Although it would be appear contrary to the common meaning of the term "financing," a currency conversion carried out by a BD in connection with a securities purchase for a retail customer could be interpreted to be a "financing" due to the settlement risk. As a result, to the extent that the statute was to be interpreted in this way, BDs would not be eligible to carry out those conversions for retail customers after July 16, absent SEC relief. While a BD could avoid this result by settling the foreign currency conversion T+2 (ahead of the T+3 settlement for the security), that approach would impose additional market risk on either the customer or BD, depending upon how the one-day pricing risk was allocated.

Broker-Dealers Offering Retail Forex

Although the CEA provides that enumerated regulated entities may act or offer to act as counterparty in retail forex transactions, the Dodd-Frank Act added Section 2(c)(2)(E)[9] to the CEA, which provides that an otherwise regulated entity, such as a bank or BD, for which there is a federal regulator, may not offer or enter into retail forex transactions unless offered pursuant to rules of the applicable federal regulator.[10]

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6. Section 2(c)(2)(B)(i)(II of the CEA

7. This provision is stricter than the current definition that counts as an ECP a natural person having more than $10 million in assets.

8. Section 2(c)(2)(B)(i)(II) of the CEA.

9. Section 742(c) of the Dodd-Frank Act.

10. Section 2(c)(2)(E)(ii)(I) of the CEA prohibits an otherwise regulated entity, such as a registered BD, from entering into a forex transaction described in 2(c)(2)(B)(i)(I) of the CEA, unless done pursuant to rules of a federal regulatory agency. The transaction described in section 2(c)(2)(B)(i)(I) of the CEA is a transaction in foreign currency that "is a contract of sale of a

The applicable regulator for BDs is the SEC. However, to date, the SEC has not published rules and the staff has informally suggested that the SEC is not likely to do so. As a result, as of July 16, 2011, BDs will no longer be able to effect transactions to purchase or sell currency for their retail customers, unless the currency transaction will be physically settled in two business days or otherwise falls outside the coverage of the CEA (e.g., because the transaction is not leveraged, margined, or financed). The CEA does not include exemptions for hedging or *de minimis* transactions.

The prohibition on soliciting and transacting in retail forex applies to every type of BD. As a result, clearing firms will not be able to facilitate retail forex trades for customers of their U.S. and foreign correspondents. A correspondent BD would not be allowed to handle execution of retail foreign exchange itself (e.g., through its institutional foreign exchange desk) unless the customers are ECPs. BDs that direct retail forex to another entity that is appropriately registered for the business (e.g., an FCM) would not be affected.

The CFTC's ability to fix this problem is limited. The CFTC is not allowed to regulate or have its rules apply to a BD. The CEA expressly provides that a BD may not qualify to carry out this activity by routing the business through an FCM that is part of the BD. In its forex rules, the CFTC has similarly provided that a BD may not address the problem by dually registering as a Forex Dealer.[11] As a result, unless the SEC acts, retail forex may *only* be conducted by a regulated entity that is outside of a BD.

BDs who currently conduct retail forex transactions for their customers should work with their customers to open separate accounts for the business at an FCM, bank, or Forex Dealer. In terms of legacy transactions, it is not clear whether or not they would continue to be enforceable and legal if carried by the BD. As a result, absent SEC relief, BDs may want to consider novating them to a properly regulated FCM, bank, or Forex Dealer.

Investment Advisers

Investment advisers are also impacted by these rules. Under the CEA and CFTC rules, a person who exercises discretionary authority over a retail forex account carried at an FCM or Forex Dealer must itself register as a CTA. The CEA excludes from this requirement other regulated entities that are permitted to act as counterparty to retail transactions, but does not exclude registered investment advisers. Since BDs will no longer be a type of authorized entity for such activity, financial advisers and other types of registered investment advisers (RIAs) will no longer be able to advise retail customers on foreign exchange transactions conducted through an FCM or Forex Dealer unless they are licensed as a CTA with the CFTC. To the extent that the retail foreign exchange transactions on which an adviser provides advice are executed through a bank, a discretionary adviser will not be required to register as a CTA.

Conclusion

Section 4(a) of the CEA provides that contracts executed in violation of the CEA are illegal. As a result—notwithstanding that many of the retail forex transactions carried out today may in fact be outside of the class of transactions regulated by the CEA, as may be much of the advice on forex that is provided to retail customers by investment advisers—given the lack of clarity and the fact that transactions conducted in violation of the CEA pose risks regarding the enforceability of trades, BDs and investment advisers

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commodity for future delivery (or an option on such a contract) or an option" not executed or traded on an exchange. The scope of what constitutes a transaction that would be covered by the provision is not clear and has been the source of prior litigation. *See CFTC v. Zelener*, 373 F.3d 861 (7th Cir. 2004), *reh'g denied*, 378 F.3d 624 (7th Cir.).

11. 17 C.F.R. § 5.1(h)(1).

should examine their retail foreign exchange activities and consider moving their affected business to an FCM, Forex Dealer, or a bank.

If you have any questions or would like more information on the issues discussed in this LawFlash, please contact any of the following Morgan Lewis attorneys:

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