

## Financial Services and Products ADVISORY

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### New U.S. Registration Requirement for Foreign Boards of Trade

#### Introduction

Congress, in a surprise move, has imposed a registration provision on non-U.S. futures markets (“foreign boards of trade”) with direct market access from the United States. As expected, the U.S. financial reform legislation (“Dodd-Frank Act” or the “Act”) applies new regulatory requirements to contracts traded on foreign boards of trade (FBOT) that are directly linked to contracts traded in U.S. markets.<sup>1</sup> However, the final version of the bill as enacted into law also includes the requirement that all FBOTs that provide for direct market access from the United States register with the Commodity Futures Trading Commission (CFTC).<sup>2</sup> The full extent and impact of this requirement on FBOTs can only be assessed following promulgation of implementing rules by the CFTC.

#### New Registration Requirements for Foreign Boards of Trade

The final version of the Dodd-Frank Act provides that the CFTC *may* adopt regulations requiring FBOTs that provide members located in the United States direct market access<sup>3</sup> to its electronic trading and order matching systems to register with the CFTC. The registration provision of the Dodd-Frank Act is general in nature and merely provides that the CFTC must take into consideration:

- (1) whether any FBOT is “subject to comparable, comprehensive supervision and regulation by the appropriate governmental authorities” in its home country; and

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<sup>1</sup> On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform Act and Consumer Protection Act (the “Dodd-Frank Reform Act”) to strengthen financial regulatory oversight, enhance transparency and provide for greater consumer protection. Title VII of the Dodd-Frank Reform Act, entitled “Wall Street Transparency and Accountability Act of 2010,” establishes a new regulatory framework for over-the-counter derivatives transactions and provides for enhanced regulation of exchange-traded derivatives. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 113, 124 Stat. 1398-1402 (2010) (to be codified at 12 U.S.C. § 5323) *available at* <http://www.alston.com/files/docs/hr1473.pdf>.

<sup>2</sup> Although a registration provision was included in the House of Representatives version of the bill that was passed December 11, 2009, a registration requirement was not included in the Senate version of the bill that was passed May 20, 2010. Compare H.R. 4173, § 3115, passed in the House by a 223-202 margin December 11, 2009, *available at* [http://frwebgate.access.gpo.gov/cgi-in/getdoc.cgi?dbname=111\\_cong\\_bills&docid=f:h4173ih.txt.pdf](http://frwebgate.access.gpo.gov/cgi-in/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173ih.txt.pdf) with S. 3217, § 738, passed in the Senate by a vote of 60-40 May 20, 2010, *available at* [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111\\_cong\\_bills&docid=f:s3217as.txt.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:s3217as.txt.pdf).

<sup>3</sup> See Dodd-Frank Reform Act § 738(a) (stating that “Direct Access” refers to “an explicit grant of authority by a foreign board of trade to an identified member or other participant located in the United States to enter trades directly into the trade matching system of the foreign board of trade”).

(2) whether there are any previous CFTC findings that subject the FBOT to “comparable comprehensive supervision and regulation by the appropriate government authorities” in its home country.<sup>4</sup>

### Current CFTC Practice: Request for No-Action Relief and CFTC Scope of Review

Presently, U.S. members or participants of an FBOT are granted direct market access to FBOTs through a no-action process.<sup>5</sup> Generally, FBOTs request no-action relief to permit:

- members situated in the United States to trade for their own accounts through the trading system;
- members registered with the CFTC as futures commission merchants (FCMs) or who are exempt from registration to submit orders and trade for U.S. customers through the trading system;<sup>6</sup> and
- members who are registered as FCMs or who are exempt from registration to accept orders from U.S. customers through automated order routing systems for submission to the trading system.<sup>7</sup>
- The grant of no-action relief generally includes a number of conditions, including the requirement that the FBOT report its volume on a quarterly basis and that the FBOT’s home regulator affirm on an annual basis that the FBOT remains in good standing.<sup>8</sup> To date, approximately 20 FBOTs have been granted no-action by the CFTC.<sup>9</sup>

### Changes Under Dodd-Frank

The registration provision of Dodd-Frank will likely result in transforming the current no-action process into a formal CFTC registration procedure. Although the Act leaves it within the CFTC’s discretion

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<sup>4</sup> See Dodd-Frank Reform Act § 738(a).

<sup>5</sup> On November 2, 2006, the CFTC issued a policy statement entitled “*Boards of Trade Located Outside of the United States and No-Action Relief From the Requirement To Become a Designated Contract Market or Derivatives Transaction Execution Facility*” (the “2006 CFTC Statement of Policy”), which affirmed the use of a no-action process. A no-action letter is a “written statement by the staff of a Division of the Commission or its Office of the General Counsel that such staff will not recommend that the Commission commence enforcement action for failure to comply with a specific provision of the Act or Commission regulations. It binds only the staff of the Division that issued it (or the Office of the General Counsel, as the case may be) with respect to the specific fact situation and persons addressed by the letter, and third parties may not rely upon it.” See CFTC Staff Letters available at <http://www.cftc.gov/LawRegulation/CFTCStaffLetters/index.htm>.

<sup>6</sup> See CFTC Regulation 30.10 (permitting certain persons and foreign persons to file a petition for exemption from registering with the CFTC as an FCM).

<sup>7</sup> In addition, some “foreign boards of trade also request relief to permit members who are registered with the Commission as commodity pool operators (CPO) or commodity trading advisors (CTA), or are exempt from such registration pursuant to CFTC Regulation 4.13 or CFTC Regulation 4.14, to submit orders for execution on behalf of U.S. pools they operate or U.S. customer accounts for which they have discretionary authority, respectively, provided that an FCM or Regulation 30.10 firm acts as clearing firm and guarantees without limitation all such trades of the CPO or CTA effected through submission of orders on the trading system.” See Access to Foreign Markets from the U.S., available at <http://www.cftc.gov/international/foreignmarketsandproducts/foreignmkt.html>.

<sup>8</sup> *Id.*

<sup>9</sup> See Foreign Boards of Trade Receiving Staff No Action Letters Permitting Direct Access from the U.S., available at <http://services.cftc.gov/sirt/sirt.aspx?Topic=ForeignTerminalRelief>.

whether to adopt FBOT registration requirements, it is unlikely that the CFTC will continue to use a no-action process in light of the explicit grant of authority to affirmatively register FBOTs.

The issue therefore, is two-fold—whether the procedures and the substance of any new registration requirement will establish a higher barrier to entry for FBOTs than the current no-action process. Presently, in making a determination whether to grant no-action relief, the CFTC considers whether the foreign exchange is a *bona fide* FBOT. In making that determination, the CFTC considers whether the FBOT possesses the attributes of an established, organized exchange; adheres to appropriate rules prohibiting abusive trading practices; has been authorized by a regulatory process that examines customer and market protections; and is subject to continued oversight by a regulator that has power to intervene in the market and share information with the CFTC.<sup>10</sup> The uncertainty facing FBOTs is whether the CFTC will interpret its current practice as meeting the legislative intent of the new registration provision.

### Effect for FBOTs with Existing No-Actions

The effect of the new registration provision may be tempered for FBOTs that have already been granted no-action relief. Congress has provided that in connection with the registration of FBOTs, the CFTC must consider an FBOT's past demonstration of the comparability of its home regulatory framework. Based upon this provision, it is reasonable to assume that FBOTs that have already been granted no-action relief will be grandfathered into registered status or, at a minimum, that the registration procedures for such FBOTs will be highly streamlined.

### Regulation of Linked Contracts

Separate from the new registration process, special requirements will apply with respect to the contacts of an FBOT with direct market access to the United States that are linked to contacts traded on a U.S. market. Section 738(a) of the Act prohibits the CFTC from permitting an FBOT to provide customers in the United States direct market access to a linked contract<sup>11</sup> unless the FBOT meets the following requirements:

- (1) the FBOT must make publicly available the daily trading information relating to the linked contract that is comparable to the daily trading information published by the U.S. registered entity; and
- (2) either the FBOT or its home regulator:
  - (a) adopts position limits<sup>12</sup> for the linked contract that are comparable to those which apply to the U.S. contract;

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<sup>10</sup> *Id.*

<sup>11</sup> See Dodd-Frank Reform Act § 738(a) (“an agreement, contract, or transaction that settles against any price (including the daily or final settlement price) of [any contract] listed for trading on a registered entity”).

<sup>12</sup> See *id.* § 738(a) (noting that such position limits include “related hedge exemption provisions for the agreement, contract, or transaction that are comparable to the position limits (including related hedge exemption provisions)”).

- (b) has the authority to require or direct market participants to limit, reduce or liquidate any position of the FBOT (or its home regulator);<sup>13</sup>
- (c) agrees to promptly notify the CFTC of specified changes or events;<sup>14</sup> and
- (d) provides information to the CFTC for inclusion in the CFTC's *Commitment of Traders Reports*.<sup>15</sup>

## Aggregate Position Limits

In addition to the new registration provision, the Dodd-Frank Act, for the first time, will include, under an aggregate speculative position limit, contracts traded on an FBOT with direct market access that are economically linked to contracts traded on a U.S. market. Section 737(a) of the Dodd-Frank Act requires that the CFTC set aggregate speculative position limits on exempt and agricultural commodities in economically linked futures contracts, swaps, over-the-counter derivatives and contracts traded on a FBOT with direct market access.<sup>16</sup> The CFTC must establish such limits for exempt commodities within 180 days, and for agricultural commodities, within 270 days, of enactment.<sup>17</sup>

Also noteworthy for FBOTs and their continued ability to offer direct market access to their U.S. members, Section 719 of the Dodd-Frank Reform Act requires the CFTC to conduct a study of the aggregate position limits with respect to the movement of transactions from exchanges in the United States to trading venues outside the United States.<sup>18</sup> In addition, the Dodd-Frank Act requires the chairman of the CFTC to prepare and submit to Congress biennial reports on the "growth or decline

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<sup>13</sup> *Id.* As "determine[d] to be necessary to prevent or reduce the threat of price manipulation, excessive speculation, price distortion, or disruption of delivery or the cash settlement process."

<sup>14</sup> *Id.* (Including any change relating to (i) the information that the FBOT will make publicly available; (ii) the position limits that the FBOT or its home regulator will adopt and enforce; (iii) the position reductions required to prevent manipulation, excessive speculation, price distortion or disruption of delivery or the cash settlement process; and (iv) any other area of interest expressed by the Commission to the FBOT or its home regulator).

<sup>15</sup> *Id.* (Including information relating to (i) large trader positions in the agreement, contract or transaction that is comparable to the large trader position information collected by the CFTC for any contract against which the agreement, contract or transaction traded on the FBOT settles, as well as (ii) such information as is necessary to publish reports on aggregate trader positions for the agreement, contract or transaction traded on the foreign board of trade that is comparable to such reports on aggregate trader positions for any contract against which the agreement, contract or transaction traded on the FBOT settles).

<sup>16</sup> See Dodd-Frank Reform Act § 737(a).

<sup>17</sup> *Id.* (Providing that the CFTC "shall by rule, regulation, or order establish limits on the amount of positions, as appropriate, other than bona fide hedge positions, that may be held by any person with respect to contracts of sale for future delivery or with respect to options on the contracts or commodities traded on or subject to the rules of a designated contract market"). See also Proposed Rule Withdrawal Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations 75 Fed. Reg. 50950 (Aug. 18, 2010) available at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2010-20428a.pdf> (withdrawing the CFTC's January 26, 2010, rule proposal to implement position limits for futures and option contracts based on a limited set of exempt commodities, namely certain energy commodities (the "Energy Proposal"). In "light of the broadened scope and new requirements of the CEA, as amended by the Dodd-Frank Act, and amended section 4a(a) of the Act in particular, the Commission has determined to withdraw the pending Energy Proposal as it plans to issue a notice of rulemaking proposing position limits and exemptions therefrom for regulated exempt commodity derivatives, including energy derivatives, as directed by the Dodd-Frank Act."

<sup>18</sup> See Dodd-Frank Reform Act § 719.

of the derivatives markets in the United States and abroad, which shall include assessments of the causes of any such growth or decline, the effectiveness of regulatory regimes in managing systemic risk, a comparison of the costs of compliance at the time of the report for market participants subject to regulation by the United States with the costs of compliance in December 2008 for the market participants, and the quality of the available data.”<sup>19</sup>

## Conclusion

The Dodd-Frank Act provides for a number of new requirements that will apply to FBOs that offer direct market access to their U.S. members. These include a new registration procedure and the imposition of speculative position limits for contracts linked to those trading on a U.S. market. The full extent of the scope and effect of these requirements cannot be fully assessed until the CFTC adopts implementing rules. For this reason, FBOs should closely monitor the CFTC’s regulatory process during the coming months.

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<sup>19</sup> *Id.* § 719(a)(4) (stating that “[i]n preparing the report, the Chairman shall solicit the views of, consult with, and address the concerns raised by, market participants, regulators, legislators, and other interested parties”).

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