



## U.S. COMMODITY FUTURES TRADING COMMISSION

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### **DIVISION OF TRADING AND MARKETS ADVISORY CONCERNING FOREIGN CURRENCY TRADING BY RETAIL CUSTOMERS**

In December 2000, the Commodity Futures Modernization Act of 2000 ("CFMA")<sup>1</sup> was enacted into law. The CFMA amended the Commodity Exchange Act ("Act")<sup>2</sup> to clarify the jurisdiction of the Commodity Futures Trading Commission ("Commission") in the area of foreign currency futures and options trading.<sup>3</sup> Generally, offering foreign currency futures and options contracts to retail customers<sup>4</sup> on an "off-exchange" basis, i.e., where the contracts are not executed or traded on an organized exchange,<sup>5</sup> is unlawful unless the counterparty is a regulated entity enumerated in Section 2(c)(2)(B)(ii) of the Act. The counterparties enumerated include registered futures commission merchants ("FCMs") and certain affiliated persons of registered FCMs.<sup>6</sup>

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<sup>1</sup> Pub. L. No. 106-554, 114 Stat. 2763 (2000) (codified in scattered sections of 7 U.S.C.).

<sup>2</sup> 7 U.S.C. § 1 *et seq.* (2000).

<sup>3</sup> The Commission issued an advisory on this subject in February 2001, which may be viewed on the Commission's web site at:  
<http://www.cftc.gov/opa/press01/opaadv06-01.htm>.

<sup>4</sup> As used in this advisory, the term "retail customer" refers to any person other than a person that comes within the definition of an "eligible contract participant" pursuant to Section 1a(12) of the Act. For example, an individual whose total assets do not exceed \$10 million is a retail customer.

<sup>5</sup> Section 1a(27) of the Act.

<sup>6</sup> The other enumerated counterparties are: (1) financial institutions; (2) registered broker-dealers; (3) associated persons of registered broker-dealers; (4) insurance companies or regulated affiliates thereof; (5) financial holding companies; and (6) investment bank holding companies. Section 2(c)(2)(B)(ii) of the Act.

Since enactment of the CFMA, the Division has received numerous inquiries regarding off-exchange foreign currency futures and options trading by retail customers. The Division is issuing this advisory so as to provide further guidance concerning unregistered entities and intermediaries involved in such trading.

#### *The Introduction of Retail Customers to Registered FCMs*

Generally, a person employed by an FCM to solicit or to accept customer orders must register as an associated person ("AP") of the FCM and a separate entity that introduces customers to an FCM must register as an introducing broker ("IB"). The Division has stated, however, that entities that introduce retail customers solely to trade off-exchange foreign currency futures and options with registered FCMs that act solely as counterparties, are not required to register under the Act as IBs, but may do so voluntarily.<sup>7</sup> Persons employed by an FCM acting as a counterparty must register as APs.

The Division has noted that where an entity is purportedly introducing retail customers to a registered FCM, but does so in a manner that has the indicia of such entity being the counterparty to retail customers, the entity must, itself, be one of the enumerated counterparties under the Act.<sup>8</sup> Some activities that would suggest that an "introducing" entity is acting as the counterparty would include: (1) promotional materials of the introducing entity, and customer agreements between the introducing entity and the retail customer, failing to identify or make clear the role of the registered FCM as counterparty; (2) the introducing entity receiving funds from retail customers in its own name; (3) the introducing entity acting as a conduit to return funds due to retail customers from the registered FCM; and (4) the introducing entity failing to

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<sup>7</sup> CFTC Staff Interpretative Letter No. 01-83, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,688 (November 2, 2001).

If an entity is introducing customers to a registered FCM that is also offering trading in futures or options contracts that are executed or traded on an organized exchange, such entity must register with the Commission as an IB or FCM.

<sup>8</sup> CFTC Staff Interpretative Letter No. 02-05 (January 8, 2002), <http://www.cftc.gov/tm/letters/02letters/tm02-05.htm>.

open and carry each retail customer's account with the carrying FCM on a fully-disclosed basis. An introducing entity operating in such a manner may not rely upon the registration status of the FCM with which it is dealing to meet the requirement under the Act that the counterparty to a retail customer be one of the regulated entities listed under Section 2(c)(2)(B)(ii) of the Act. Accordingly, if the introducing entity is not itself one of the enumerated counterparties under the Act, it would be in violation of Section 4(a) of the Act and the registered FCM with which the introducing entity is dealing may be liable for aiding and abetting a violation of the Act.<sup>9</sup>

#### *Managing Retail Off-Exchange Foreign Currency Accounts*

Generally, a person exercising trading authority over a customer's futures or options account is a commodity trading advisor ("CTA") and must register as such under the Act. However, the Division has noted that a person that manages the funds of retail customers held by an enumerated entity under the Act, solely to trade in off-exchange foreign currency futures and options contracts, would not be required to register with the Commission as a CTA, but may do so voluntarily.<sup>10</sup>

The person exercising trading authority over a retail customer's account may not receive funds in its name for purposes of trading in off-exchange futures and options contracts. Moreover, the funds of the retail customers must be held by an enumerated counterparty under the Act. If the counterparty to the retail customer is not one of those enumerated under the Act, the transaction is unlawful under Section 4(a) of the Act and, in addition to the counterparty being liable for violating the Act, the person managing the funds of the retail customer may be liable for aiding and abetting a violation of the Act.

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<sup>9</sup> See Section 13(a) of the Act.

<sup>10</sup> CFTC Staff Interpretative Letter No. 01-91 (December 12, 2001), <http://www.cftc.gov/tm/letters/01letters/tm01-91.htm>.

If a person exercises trading authority over a customer's account for anything other than the trading of off-exchange foreign currency, such as trading futures contracts that are executed or traded on an organized exchange, the person, absent an exemption, must be registered with the Commission as a CTA.

*Operating Pools Trading Exclusively in Off-Exchange Foreign Currency*

A commodity pool is generally defined as an "investment trust, syndicate or similar form of enterprise operated for the purpose of trading commodity interests."<sup>11</sup> Generally, a person who operates a commodity pool is a commodity pool operator ("CPO") and must register with the Commission as such. The Division has stated, however, that a person operating a pool that limits its trading solely to off-exchange foreign currency futures and options contracts, with an entity enumerated under Section 2(c)(2)(B)(ii) of the Act acting as the counterparty, is not required to register as a CPO, but may do so voluntarily.<sup>12</sup> While the person operating such a pool may not be required to register as a CPO, the pool must enter into off-exchange foreign currency futures and options transactions with one of the counterparties enumerated under the Act. If the counterparty is not one of those enumerated under the Act, the transaction is unlawful under Section 4(a) of the Act and the operator of the pool may be liable for aiding and abetting a violation of the Act.<sup>13</sup>

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Although entities introducing retail customers to, managing retail customer funds held at, and operating pools trading with, a registered FCM, in the ways discussed above, may not be

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<sup>11</sup> See Commission Rule 4.10(d)(1), 17 C.F.R. § 4.10(d)(1) (2001).

<sup>12</sup> CFTC Staff Interpretative Letter No. 02-04 (January 8, 2002)  
<http://www.cftc.gov/tm/letters/02letters/tm02-04.htm>.

If the activities of such a pool include trading for anything other than off-exchange foreign currency, such as trading futures contracts executed or conducted on an organized exchange, the person operating the pool, absent an exemption, must register with the Commission as a CPO.

<sup>13</sup> A commodity pool that has total assets exceeding \$5 million and is formed and operated by a registered CPO, or by a foreign person performing a similar function subject as such to foreign regulation, is an "eligible contract participant." Section 1a(12)(A)(iv) of the Act. Accordingly, such a pool would not be considered a retail customer and would not be limited to entering into off-exchange foreign currency futures and options transactions with counterparties enumerated under Section 2(c)(2)(B)(ii) of the Act.

required to register with the Commission, they remain subject to all relevant antifraud provisions of the Act and the Commission's rules thereunder. Moreover, in the event that such an entity violates the antifraud provisions of the Act or the rules thereunder, the registered FCM with which the entity is doing business may also be liable for aiding and abetting such violations.

### *Trading Platforms*

It has come to the attention of the Division that there are some entities offering trading platforms through which customers may trade directly with one another. These platforms are sometimes referred to as matching systems. Under Section 2(c)(2)(B) of the Act, one of the regulated financial entities enumerated under the Act must act as the counterparty in off-exchange foreign currency futures and options transactions with retail customers. To the extent that retail customers, trading through one of these matching systems, become counterparties to one another, that would fail to meet the requirement that the counterparty to a retail customer be one of the entities enumerated under the Act and, therefore, such transactions would violate Section 4(a) of the Act. The fact that a firm operating such a trading platform is registered as an FCM, or is one of the other counterparties enumerated under the Act, would not be sufficient to meet the requirement under the Act that the counterparty to a retail customer be one of the regulated entities listed under Section 2(c)(2)(B)(ii) of the Act. To the extent that any firms are operating such a trading platform, they should cease doing so immediately. Of course, this would not prevent the Commission from taking appropriate action with respect to previous conduct.

This advisory represents the position of the Division only and does not necessarily represent the views of the Commission or any other division or office of the Commission. For further information regarding this advisory, contact Lawrence B. Patent, Associate Chief Counsel, or Michael A. Piracci, Staff Attorney, at (202) 418-5430.