

Skadden

Skadden, Arps, Slate, Meagher & Flom LLP
& Affiliates

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Mark D. Young
Washington, D.C.
202.371.7680
mark.d.young@skadden.com

Maureen A. Donley
Washington, D.C.
202.371.7570
maureen.donley@skadden.com

Timothy S. Kearns
Washington, D.C.
202.371.7244
timothy.kearns@skadden.com

* * *

This memorandum is provided by Skadden, Arps, Slate, Meagher & Flom LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum is considered advertising under applicable state laws.

1440 New York Avenue, NW,
Washington, D.C. 20005
Telephone: 202.371.7000

Four Times Square, New York, NY 10036
Telephone: 212.735.3000

WWW.SKADDEN.COM

CFTC Adopts Final Rules Governing Foreign Board of Trade Registration

Foreign exchanges that allow direct access to their markets by U.S. market participants have been operating for many years under no-action letter relief granted by the staff of the U.S. Commodity Futures Trading Commission (CFTC or Commission). In Section 738 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), Congress amended Section 4(b) of the Commodity Exchange Act (CEA) to authorize the CFTC to adopt rules requiring registration of foreign markets in lieu of the no-action process.

On December 5, the CFTC exercised this authority and unanimously voted to adopt final rules imposing formal registration and other requirements on foreign exchanges, known as foreign boards of trade (FBOTs), that allow persons in the United States to directly access the FBOT's electronic trading and order matching systems for futures, options on futures and CFTC-regulated swaps. *See* 76 Fed. Reg. 80674 (Dec. 22, 2011). These rules will replace the CFTC's informal no-action process for FBOTs and will require FBOTs operating under these no-action letters to apply for registration. The final rules will become effective February 21, 2012.

Why did the CFTC abandon the no-action process?

In the preamble to the final rules, the CFTC acknowledges that the no-action process has served a "useful purpose," with the CFTC staff issuing 24 no-action letters to FBOTs offering direct access. 76 Fed. Reg. at 80675. However, the CFTC states that its no-action process is "better suited for discrete, unique factual circumstances" that are not addressed in the CEA or the CFTC's regulations. *See id.* In circumstances where the CFTC is granting the same relief on a repeated basis, the CFTC concludes that the relief should be addressed by a generally applicable regulation.

The CFTC identifies greater transparency, standardization and consistency with international regulation of FBOTs as benefits of the new regulation. *See id.* The CFTC also notes that because letters under the no-action process were issued by CFTC staff and not the Commission itself, a regulatory regime administered by the Commission will offer greater legal certainty for registering FBOTs. *See id.*

How does an FBOT register with the CFTC?

Any FBOT¹ that seeks to permit direct access² to its system to U.S. persons will be required to register by electronically filing a Form FBOT and Supplement S-1 with the

1 The final rules define an FBOT to include "any board of trade, exchange or market located outside the United States ..." Rule 48.2(a).

2 The CFTC defines "direct access" as an explicit grant of authority by the FBOT to one of its members or participants located in the United States to enter trades directly into its trade matching system. Rule 48.2(c). *See also* CEA section 4(b)(1)(A). This access is limited, however, to U.S. members and participants that are trading for their own proprietary account, registered futures commission merchants (FCMs) submitting customer orders for execution, or commodity pool operators (CPOs) or commodity trading advisors (CTAs) (or those exempt from CPO/CTA registration) submitting orders on behalf of a U.S. pool or the account of a U.S. customer for whom the member has discretionary authority. Rule 48.4(b). An FCM must act as the clearing firm for all CPO/CTA trades executed through direct access. Rule 48.4(b)(3).

CFTC. Rule 48.3. Form FBOT requires the FBOT to designate a clearing organization that will clear trades executed on the FBOT's trading system. FBOTs currently operating under no-action relief also must apply to register within 180 days of the effective date of the rules. Currently operating FBOTs that had previously sought no-action relief through electronic filings and FBOTs with pending no-action requests may use a more limited application process. Rule 48.6(b)-(c).

Items the CFTC will consider in reviewing an FBOT application include whether the FBOT is eligible to be registered, whether the FBOT and its clearing organization meet the other registration requirements (discussed below), and whether the FBOT and its clearing organization are subject to comprehensive supervision and regulation in their respective home countries that are comparable to the analogous U.S. regulations for such entities. Rule 48.5(d)(1)-(4). The comparable supervision and regulation determination will be informed by a principles-based review of the foreign country's support and enforcement of regulatory objectives equivalent to those supported by the CFTC for derivatives clearing organizations (DCOs), designated contract markets (DCMs) and consideration of the CFTC's prior findings with respect to the home country. Rule 48.5(d)(3) and (5).

What makes an FBOT eligible to register?

Not all FBOTs will be eligible to register. To be eligible, an FBOT will need to possess the attributes of an organized exchange, adhere to rules prohibiting abusive trading practices, enforce rules to maintain market and financial integrity, be authorized through a regulatory process that examines customer and market protections, and be subject to oversight by a foreign regulator that can intervene in the FBOT and share information with the CFTC. Rules 48.2(b), 48.4. The CFTC intends FBOT registration to be available only to those foreign entities that are regulated in a manner analogous to U.S. DCMs. 76 Fed. Reg. at 80686.

What are the other requirements for registration?

To register, an FBOT (and its clearing organization) will need to meet criteria in the same seven categories the CFTC employs under its no-action regime: (1) membership criteria, (2) the trading system, (3) terms and conditions of the contracts to be available by direct access, (4) settlement and clearing, (5) the applicable regulatory regimes, (6) rules and rule enforcement, and (7) information sharing. These criteria are discussed in turn below.

Membership Criteria

Members of the FBOT and its clearing organization will need to be "fit and proper" and meet both financial and professional standards. Rule 48.7(a)(1). The FBOT and its clearing organization will need to enforce provisions minimizing and resolving conflicts of interest and disclosure of nonpublic information obtained as a result of a member's participation on governing boards or committees. Rule 48.7(a)(2)-(3).

The Automated Trading System

The FBOT's trading system will need to comply with the Principles for the Oversight of Screen-Based Trading Systems for Derivative Products developed by the International Organization of Securities Commissions (IOSCO). Rule 48.7(b)(1). The trading system must fairly match trades, demonstrate reliability and provide secure access. Rules 48.7(b)(2), 48.7(b)(5), 48.7(b)(6). The audit trail will be required to capture and maintain all relevant data with adequate backup to prevent a loss of data. Rules 48.7(b)(3), 48.7(b)(5), 48.7(b)(8). The FBOT also must make adequate provisions for emergency operations and disaster recovery. Rule 48.7(b)(7).

Terms and Conditions of Contracts Made Available Through Direct Access

The final rules will limit direct access to those futures, option or swap contracts that the FBOT identifies in its application or in subsequent written requests. Rule 48.7(b)(9). Rule 48.10(a). To make additional contracts available through direct access, the FBOT must file a written request with the CFTC. Rule 48.10(a). Ten business days after the FBOT receives a receipt from the CFTC, the FBOT may make the contracts available for trading by direct access, unless the CFTC directs otherwise. Rule 48.10(a). Option contracts on or linked to previously approved contracts can be subject to fewer filing requirements, with options on contracts already listed for trading on a registered entity requiring only FBOT certification before the contract is listed. Rule 48.10(b).

The contracts an FBOT proposes to offer for trading by direct access must meet a number of criteria. The contracts must be futures, option or swap contracts that would be eligible to trade on a DCM and must not prohibit trading by U.S. persons. Rule 48.7(c)(1). If the contract to be offered is either linked or has some other relationship with a contract listed for trading on a registered entity, the application must specifically identify this relationship. Rule 48.7(c)(3).

Foreign futures and option contracts on broad-based security indexes will also have to be certified by the Commission in the manner outlined in Part 30. Rule 48.7(c)(2). This will require the FBOT to provide additional information specifically relating to the contract, including selection criteria for the underlying securities and the methods of computation of the index. 17 C.F.R. 30.13(a)(2). The CFTC would then need to issue a letter certifying that the contract may be offered directly to participants in the United States. *See* 17 C.F.R. 30.13(d).

Settlement and Clearing

All contracts that an FBOT makes available for trading by direct access in the United States will be subject to a clearing requirement. Rule 48.7(c)(1)(ii). Several commenters objected that this clearing requirement was more rigorous than requirements for swap execution facilities, but the CFTC noted that the FBOT registration provision is only intended to be coextensive with its current no-action authority, which is limited to entities that are comparable to DCMs. 76 Fed. Reg. at 80686. An FBOT must certify that its clearing organization is in good regulatory standing in its home country and either observes the current Recommendations for Central Counterparties jointly issued by the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of IOSCO (Recommendations for Central Counterparties) or is a registered DCO. Rule 48.8(d).

Governing Regulatory Regimes

The FBOT's application must detail the home country regulatory regime governing the FBOT and its clearing organization. For any FBOT seeking to register, the foreign regulatory regime governing the FBOT and clearing organization must employ a regime and regulatory objectives that are comparable to the CFTC's supervision and regulation with respect to DCMs, DCOs and contracts traded on DCMs. Rule 48.7(e)(1). The regime would be required to have standards for continuous regulatory monitoring, market integrity, customer protection and regulatory intervention as needed. Rules 48.7(e)(2), 48.7(e)(4). The regulatory authority monitoring the FBOT or clearing organization must be empowered to provide the CFTC with information sufficient to evaluate the FBOT's eligibility. Rule 48.7(e)(3).

FBOT and Clearing Organization Rules and Enforcement

The FBOT and its clearing organization must implement and enforce rules designed to ensure compliance with the CFTC's rules governing FBOTs, such as prosecuting disciplinary actions imposing

sanctions. Rules 48.7(f)(1), 48.7(f)(3). The CFTC also will consider whether the FBOT and its clearing organization are adequately staffed and maintain an adequate audit trail to detect trading and market abuses. Rules 48.7(f)(5), 48.7(f)(7). The FBOT is charged with enforcing rules regarding trading system access, fraud, abusive market practices, market manipulation, price disruption and other market disruptions and ensuring a competitive, open, and efficient market and mechanism for executing transactions. Rules 48.7(f)(6), 48.7(f)(8)-(10).

Information Sharing

The FBOT will have to execute the International Information Sharing Memorandum of Understanding and Agreement. Rule 48.7(g)(3). The regulatory authorities monitoring the FBOT and clearing organization must sign the IOSCO Multilateral Memorandum of Understanding and the Declaration on Cooperation and Supervision of International Futures Exchanges and Clearing Organizations or make other commitments to share the information anticipated by the International Information Sharing Memorandum of Understanding and Agreement. Rule 48.7(g)(1)-(2).

What conditions must be complied with upon registration?

While reserving the right to impose other conditions, the CFTC conditions an FBOT's continued registration upon satisfying registration requirements, being subject to a satisfactory regulatory regime, maintaining adequate information sharing agreements and limiting direct access.

Jurisdictional Requirements

FBOT registration is conditioned on the FBOT requiring that each member or other participant that is granted direct access in the U.S file a written representation with the FBOT stating that the participant agrees to submit to CFTC jurisdiction as long as the participant is permitted direct access and committing to provide prompt access to the CFTC, the Department of Justice and potentially the National Futures Association with access to its books and records. Rule 48.8(a)(5)(i) and (iii). In a change from its proposed rules, FBOT participants will not be required to appoint a service of process in the United States, although the FBOT and its clearing organization will be required to appoint an agent of process in the United States. Rule 48.8(a)(5)(ii).

Conditions Applicable to Swap Trading

FBOTs will be required to ensure that all trade data, including price and volume, is reported to a CFTC-registered swap data repository (SDR) (once SDRs are registered) or to have an information sharing arrangement with the CFTC. Rule 48.8(a)(9).

Information Submissions

FBOTs must maintain and update data on contracts on a quarterly basis. Rule 48.8(b). This data must include various trade volume data, such as volume originating from direct access and total trade volume on the system worldwide. Rule 48.8(b)(1)(i). The FBOT is required to provide written notice of any changes to the information it provides. Rule 48.8(b)(1)(ii)(A)-(C). The CFTC also must be notified of conditions that could affect the financial or operational viability of the FBOT or its clearing organization. Rule 48.8(b)(1)(ii)(D).

Annual Certifications

The FBOT and clearing organization (or their respective regulatory authorities) must provide the CFTC with annual certifications that include:

- confirmation from the home country's regulatory authority that the FBOT or clearing organization (if not registered as a DCO) retains its authorization and is in good standing;
- for clearing organizations not registered as DCOs, a recertification of its observance of the Recommendations for Central Counterparties;
- a certification that affiliates are required to comply with the rules of the FBOT and clearing organization and the members or participants to whom the affiliates are associated remain responsible for their affiliates' compliance;
- a description of any previously undisclosed material changes at the FBOT or clearing organization;
- a description of significant disciplinary or enforcement actions instituted by or against the FBOT, clearing organization or its respective senior officers; and
- a description of any previously undisclosed material regulatory changes that affect the FBOT or clearing organization. Rule 48.8(b)(1)(iii).

Does the CFTC add additional restrictions on FBOTs with linked contracts?

Yes, the CFTC requires that FBOTs trading linked contracts must meet several thresholds that are not generally applied to all FBOTs. Among other things, the FBOT must publicly disseminate daily trading information regarding the linked contract that is comparable to the information disseminated about the underlying contract. The FBOT (or its regulator) must also adopt position limits (with appropriate hedge exemptions) for the linked contracts that are comparable to the limits for the underlying contract and give the CFTC large trader and aggregate trader position information. The FBOT or its regulator must be empowered to liquidate or reduce participants' positions as needed. Rule 48.8(c).

How may the CFTC revoke FBOT registration?

The CFTC may request from FBOTs written demonstrations of continued compliance with the registration requirements and conditions. Rule 48.9(c). The CFTC may revoke an FBOT's registration, after notice and an opportunity to respond, if: (1) the FBOT fails to comply with the registration requirements or conditions; (2) the registration statement is untrue or materially misleading; (3) the regulatory regime governing the FBOT materially changes such that it no longer satisfies the registration requirements or conditions for registration applicable to that regime; or (4) the FBOT or clearing organization is no longer authorized, licensed or registered as a regulated market, exchange or clearing organization or otherwise ceases to operate as an FBOT or clearing organization. 48.9(a)-(b). If the CFTC finds a failure to comply, it may revoke the FBOT's registration after allowing for an opportunity to respond. Rule 48.9(a)(1)-(2). If an FBOT's registration is revoked, it may not reapply for registration for 360 days after revocation. Rule 48.9(a)(3).