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Says Goodbye to OTC Gold Trading

On July 21, 2010, President Obama signed into law the “Dodd-Frank Wall Street Reform Act” (the “Dodd-Frank Act” or “Act”). The Dodd-Frank Act most likely will bring about sweeping regulatory changes within the financial services industry. However, at over 2,300 pages in length, few people have read this legislation in its entirety. Of those individuals who have read the Act, few can comprehend the implications of such sweeping reform.

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The impact of the Act on commodity futures, over-the-counter retail foreign currency (“OTC forex”), and over-the-counter retail precious metals (“OTC metals”) transactions has been largely ignored by the media to date. Although the Dodd-Frank Act has been championed as a victory for consumer protection and rigid Wall Street reform, there is little actual clarity with respect to its practical implications. Since being signed into law, FCMs, IBs, CPOs, and CTAs have reached out to us regarding the vast amount of regulatory uncertainty now present in the financial industry. To assist commodities firms in complying with and understanding the Dodd-Frank Act, we have attempted to identify several of its most sweeping provisions. Our thoughts do not constitute legal advice and should not be relied upon in particular circumstances. We recommend that you contact competent counsel or a legal professional before taking any action in this complex area.

That being said, based on the current language of the Act, the following four areas are likely to have the most significant implications for commodity futures, OTC forex, and OTC precious metals market participants:

Elimination of OTC Forex

Effective 90 days from its inception, the Dodd-Frank Act bans most retail OTC forex transactions. Section 742(c) of the Act states as follows:

> *"…A person* [which includes companies] *shall not offer to, or enter into with, a person that is not an eligible contract participant, any agreement, contract, or transaction in foreign currency except pursuant to a rule or regulation of a Federal regulatory agency allowing the agreement, contract, or transaction under such terms and conditions as the Federal regulatory agency shall prescribe…"*

This provision will not come into effect, however, if the CFTC or another eligible federal body issues guidelines relating to the regulation of foreign currency within 90 days of its enactment. Registrants and the public are currently being encouraged by the CFTC to provide insight into how the Act should be enforced. *See* CFTC Rulemakings regarding OTC Derivatives located at the following website address [1], under Section XX – Foreign Currency (Retail Off Exchange). As this provision is potentially devastating to the forex industry, affected readers are encouraged to voice their opinions to the CFTC directly. To do so commentary should be forwarded to via email to:

Secretary@cftc.gov

Attn: David A. Stawick, Secretary

Commodity Futures Trading Commission

Three Lafayette Center

1155 21st Street, NW

Washington, DC 20581

It is essential that OTC forex participants seek professional help to discuss possible operational and regulatory contingency plans.

Elimination of OTC Metals

As for OTC precious metals such as gold or silver, Section 742(a) of the Act prohibits any person [which again includes companies]from entering into, or offering to enter into, a transaction in any commodity with a person that is not an eligible contract participant or an eligible commercial entity, on a leveraged or margined basis. This provision intends to expand the narrow so called "*Zelener* fix" in the Farm Bill previously ratified by congress in 2008. The Farm Bill empowered the CFTC to pursue anti-fraud actions involving rolling spot transactions and/or other leveraged forex transactions without the need to prove that they are futures contracts. The Dodd-Frank Act now expands this authority to include virtually all retail cash commodity market products that involve leverage or margin – in other words OTC precious metals.

The prohibition of Section 742(a) does not apply, however, if such a transaction results in actual delivery within 28 days, or creates an enforceable obligation to deliver between a seller and a buyer that have the ability to deliver, and accept delivery of, the commodity in connection with their lines of business. This may be problematic as in most spot metals trading virtually all contracts fail to meet these requirements. As a result, although the courts' interpretation of Section 742(a) is unknown, Section 742(a) is likely to have a significantly negative impact on the OTC cash precious metals industry. Here too, it is essential that those who offer to be a counterparty to OTC metals transactions seek professional help to discuss possible operational and regulatory contingency plans.

Small Pool Exemption Eliminated

Pursuant to Section 403 of Act, the ***"private adviser"*** **exemption, namely** Section 203(b)(3) **of** the Investment Advisers Act of 1940 ("Advisers Act"), *will be eliminated within one year of the Act's effective date (July 21, 2011)*. Historically, many unregistered U.S. fund managers had relied on this exemption to avoid registration where they:

(1) had fewer than 15 clients in the past 12 months;

(2) do not hold themselves out generally to the public as investment **adviser**s; and

(3) do not act as investment **adviser**s to a registered investment company or business development company.

At present, **adviser**s can treat the unregistered funds that they advise, rather than the investors in those funds, as their clients for purposes **of** this exemption. A common practice has thus evolved whereby certain advisers manage up to 14 unregistered funds without having to register under the **Adviser**s Act. Accordingly, the removal of this exemption represents a significant shift in the regulatory landscape, as this practice will no longer be allowable in approximately one year.

Also an important consideration, the Dodd-Frank Act mandates new federal registration and regulation thresholds based on the amount of assets a manager has under management ("AUM"). Although not yet underway, it is possible that various states may enact legislation designed to create a similar registration framework for managers whose AUM fall beneath the new federal levels.

Accredited Investor Qualifications

Section 413(a) of the Act alters the financial qualifications of who can be considered an accredited investor, and thus a qualified as eligible participant ("QEP"). Specifically, the revised accredited investor standard includes only the following types of individuals:

1. A natural person whose individual net worth, or joint net worth with spouse, is at least $1,000,000, *excluding the value of such investor's primary residence*;
2. A natural person who had individual income in excess of $200,000 in each of the two most recent years or joint income with spouse in excess of $300,000 in each of those years and a reasonable expectation of reaching the same income level in the current year; or
3. A director, executive officer, or general partner of the issuer of the securities being offered or sold, or a director, executive officer, or general partner of a general partner of that issuer.

Based on this language, it is important to note that the revised accredited investor standard only applies to new investors and does not cover existing investors. However, additional subscriptions from existing investors are generally treated as requiring confirmation of continuing investor eligibility.

On July 27th, 2010, the SEC provided additional clarity regarding the valuation of an individual's primary residence when calculating net worth. In particular, the SEC has interpreted this provision as follows:

> "Section 413(a) of the Dodd-Frank Act does not define the term "value," nor does it address the treatment of mortgage and other indebtedness secured by the residence for purposes of the net worth calculation…Pending implementation of the changes to the Commission's rules required by the Act, the related amount of indebtedness secured by the primary residence up to its fair market value may also be excluded. Indebtedness secured by the residence in excess of the value of the home should be considered a liability and deducted from the investor's net worth."

Seek Guidance Now

As is evident from reading the provisions detailed above, President Obama's sweeping reform is far from simple. At the present date, the Dodd-Frank Act offers up more questions than it provides answers. One thing is certain though; in time there will be significant implications for the financial industry as a whole. In order to properly evaluate how the Dodd-Frank Act may affect your CFTC and/or NFA regulated business, it would be prudent to contact a regulatory professional like Turnkey Trading Partners immediately. Likewise, savvy derivatives industry business owners would be well served to consider operational contingency plans and alternatives sooner rather than later. To assist in determining if your firm might be affected by the Dodd-Frank Act, TTP has put together a free evaluation worksheet which is available upon request. To receive this worksheet simply complete the web form available here [2].

James Bibbings and Nicole Kuchera

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Non-Exclusive Chart Article

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