

**CFTC Letter No. 02-05**  
**January 8, 2002**  
**Interpretation**  
**Division of Trading and Markets**

Re: "X" & "Y" Licensees

Dear:

This is in response to your letter dated April 16, 2001, to "A" of the Division of Enforcement of the Commodity Futures Trading Commission ("Commission"), which was forwarded to the Division of Trading and Markets (the "Division") for reply, as supplemented by your letter dated November 26, 2001, and telephone conversations with Commission staff. By your correspondence, you request, on behalf of "X" and its "Y" licensees, that the Commission interpret the "Y" licensees to be affiliates of "X" or, in the alternative, permit the "Y" licensees to register as introducing brokers ("IBs").

*The Commodity Futures Modernization Act of 2000*

As you are aware, the Commodity Futures Modernization Act of 2000 ("CFMA")<sup>[1]</sup> amended the Commodity Exchange Act (the "Act")<sup>[2]</sup> to clarify the application of the Act and the Commission's jurisdiction in the area of foreign currency trading.<sup>[3]</sup> Generally, offering foreign currency futures and options contracts, other than those that are executed or traded on an organized exchange<sup>[4]</sup> ("off-exchange"), to retail customers<sup>[5]</sup> is unlawful unless the counterparty is a regulated entity enumerated in the Act. The counterparties enumerated include registered futures commission merchants ("FCMs") and certain affiliated persons of registered FCMs.<sup>[6]</sup>

*The Activities of "X"*

"X" offers trading in foreign currency, primarily over the Internet, and you have indicated that most of "X's" customers would be retail customers under the Act. You represented that "X" acts as a counterparty to retail customers "in almost all of its trading activities."<sup>[7]</sup> Effective October 14, 2001, "X" became registered as an FCM, and thus qualifies as one of the enumerated counterparties under the Act.

"X's" trading platform, for foreign currency trading over the Internet, is a software program called "Y". "X", in addition to utilizing "Y" on its own website, licenses its "Y" software to licensees. These licensees market the platform under their own brand names and set up their own structure for charging customer commissions. According to your representations, as part of the licensing agreement, licensees must agree that customer funds traded over the "X" "Y" system be "placed in accounts with "X" . . . so

that "X" has control over the disbursement of these customer funds on the customer's instructions." Additionally, you have represented that "X" monitors the web sites of licensees "to assure compliance with [the] contractual requirements" of the licensing agreements.

### *Affiliated Persons*

One of the enumerated counterparties under Section 2(c)(2)(B)(ii)(III) of the Act is "an affiliated person of a [registered FCM], concerning the financial or securities activities of which the registered [FCM] makes and keeps records under . . . section 4f(c)(2)(B) of this Act."<sup>[8]</sup> Section 4f(c)(2)(B) of the Act requires FCMs to keep records that describe the futures and financial activities, including the sources of capital and funding, of its affiliated persons whose business activities "are reasonably likely to have a material impact on the financial or operational condition of the" FCM.<sup>[9]</sup> Section 4f(c)(1)(i) of the Act defines the term "affiliated person" as "any person directly or indirectly controlling, controlled by, or under common control with a[n FCM], as the Commission, by rule or regulation, may determine will effectuate the purposes of this subsection."<sup>[10]</sup>

You ask that "Y" licensees be viewed as affiliates of "X", so as to qualify as one of the enumerated counterparties for retail foreign currency trading under the Act. You argue that, although "X" has no ownership interest in any of the "Y" licensees, it sufficiently controls their activities through the licensing agreement so that the "Y" licensees should be considered to be affiliates of "X".

You state in your letter that Section 4f(c) of the Act does not explicitly require that the affiliated person be owned by, or under common ownership with, an FCM. You also note that the Act confers on the Commission the authority to determine what denotes someone as an affiliated person of an FCM. The release adopting Commission Rules 1.14 and 1.15 refers to a holding company system and, in fact, the release is entitled "Risk Assessment for Holding Company Systems."<sup>[11]</sup> In the release, the Commission referred to "holding company structures" and a system involving "parent" companies.<sup>[12]</sup> Black's Law Dictionary states that a "holding company usually owns a controlling interest in the companies whose stock it holds."<sup>[13]</sup>

Although "X" may have influence over the activities of "Y" licensees with respect to their use of "X's" "Y" trading platform, "X" does not have any ownership interest in the "Y" licensees. The licensing arrangement is certainly not comparable to a holding company system. Therefore, the Division does not agree with your assertion that the "Y" licensees are affiliated persons of "X". Accordingly, "Y" licensees would not constitute enumerated counterparties for retail foreign currency transactions under the Act.

### *"Y" Licensees as Introducing Brokers*

In your letter, you requested that the Commission recognize "Y" licensees as affiliates of "X" or, in the alternative, permit them to register as IBs. You indicated that the "Y" licensees would be unable to meet

the minimum financial requirements for registering as an FCM, but could meet the lower requirements for registering as an IB. <sup>[14]</sup>

The "Y" licensees operate under their own names, offering the currency trading services to customers as their own, through web sites on the Internet. <sup>[15]</sup> Additionally, the Customer Agreement with the "Y" licensee does not make clear the role of "X" in customer trades, and does not even contain a reference to "X". <sup>[16]</sup> In fact, the agreement indicates that the "Y" licensee may be the counterparty to a trade. <sup>[17]</sup> Further, while "X" maintains control over customer funds once they are deposited into "X's" customer account, when the customer opens an account, or adds funds to an existing account, through a "Y" licensee, the funds are made payable to the "Y" licensee which then forwards the money to "X's" customer account. When "X" receives the funds, it then credits the customer's individual account. Requests for withdrawals from a customer's account are made to the "Y" licensee.

The terms of the customer agreement between the "Y" licensees and the customers and the manner in which the "Y" licensees are operated, in particular the fact that the "Y" licensees operate under their own names without any reference to "X's" role in the transactions and receive customer monies in the name of the "Y" licensees, have the indicia of the "Y" licensees being the counterparties to these retail customers. Accordingly, the "Y" licensees, to continue operating as they are currently, must be one of the enumerated counterparties under Section 2(c)(2)(B)(ii) of the Act. A registered IB is not one of the enumerated counterparties that may lawfully offer this type of off-exchange foreign currency trading to retail customers and, therefore, registration as an IB would not permit the "Y" licensees to continue operating as they are now.

If the "Y" licensees wish to continue any role with "X" in connection with off-exchange foreign currency futures or options transactions, without becoming registered, they must: (1) never act as a counterparty to the retail customers; (2) amend the "Y" licensee customer agreements and their web sites to reflect "X's" role in the retail foreign currency transactions; and (3) not receive funds from customers in their own name, nor act as a conduit for funds due to customers from "X". <sup>[18]</sup>

Although "Y" licensees, if they comply with the conditions listed above, may not be required to register, "X" and the "Y" licensees would remain subject to all of the relevant antifraud provisions of the Act and the Commission's regulations issued thereunder. Moreover, if a "Y" licensee violates the antifraud provisions of the Act or the rules thereunder, "X", as well as the "Y" licensee, may be liable for such violations.

### *The "Z"*

"X", through the "Z", provides a platform through which customers may trade directly with one another. You indicated your belief that "X" is the counterparty to these "Z" transactions "since it guarantees the integrity of the trades and allows the trading customers to liquidate their positions as they wish with "X" as their direct counterparty." Although "X" may be acting as the counterparty to some of these

transactions, there are some transactions in which "X" is not acting as the counterparty. 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 the subject off-exchange foreign currency transactions with retail customers. To the extent that retail customers, trading through "Z", become counterparties to one another, that would fail to meet the requirement that the counterparty to a retail customer must be one of the entities enumerated under Section 2(c)(2)(B)(ii) of the Act and, therefore, be a violation of Section 4(a) of the Act. With regard to "X's" operation of the "Z", its registration as an FCM is not sufficient to meet the requirement under the Act that the counterparty to a retail customer be one of the regulated financial entities listed under Section 2(c)(2)(B) of the Act. To the extent that "X" is continuing to operate the "Z", it should cease doing so immediately, and permit only those transactions necessary to liquidate any open positions being held by customers on the "Z".<sup>[19]</sup>

The positions taken herein are based upon the representations that have been made to us. Any different, changed, or omitted facts or conditions might require us to reach a different conclusion. Further, this letter 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.

If you have any questions concerning this correspondence, please contact Michael A. Piracci, an attorney on my staff, at (202) 418-5430.

Very truly yours,  
Lawrence B. Patent  
Associate Chief Counsel

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<sup>[1]</sup> Appendix E of Pub. L. No. 106-554, 114 Stat. 2763 (2000).

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

<sup>[3]</sup> *See* 7 U.S.C. § 2(c)(2)(B)(ii).

<sup>[4]</sup> 7 U.S.C. § 1a(27).

<sup>[5]</sup> As used in this letter, 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. 7 U.S.C. § 1a(12).

<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 affiliates thereof; (5) financial holding companies; and (6) investment bank holding companies. 7 U.S.C. § 2(c)(2)(B)(ii).

- [7] You represent that less than one percent of "X" customers trade directly with one another through the "Z". The "Z" is further discussed below.
- [8] 7 U.S.C. § 2(c)(2)(B)(ii)(III).
- [9] 7 U.S.C. § 6f(c)(2)(B).
- [10] 7 U.S.C. § 6f(c)(1)(i). The Commission implemented Section 4f(c) of the Act in Commission Rules 1.14 and 1.15. Commission rules referred to herein are found at 17 C.F.R. Ch. 1 (2001).
- [11] See 59 Fed. Reg. 66674 (December 28, 1994). Section 4f(c) of the Act was added by Section 229 of the Futures Trading Practices Act of 1992, which is also entitled "Risk Assessment for Holding Company Systems." Pub. L. No. 102-546, 106 Stat. 3590 (1992); see also H.R. Rep. No. 102-978 at 32-34, 73-75 (1992).
- [12] *Id.* at 66678.
- [13] *Black's Law Dictionary* 504 (Abridged 6th Edition 1991).
- [14] See 17 C.F.R. § 1.17.
- [15] "Y" License Agreement ¶ 1.1.
- [16] The Customer Agreement with the "Y" licensee is actually the same agreement "X" uses with its direct customers, except all references to "X" have been changed to the name of the "Y" licensee.
- [17] Customer Agreement ¶ 25.
- [18] See CFTC Staff Interpretative Letter No. 01-83, (November 2, 2001) <http://www.cftc.gov/tm/letters/01letters/tm01-83.htm>.
- [19] In your letter dated April 16, 2001, and in conversations with Commission staff, you indicated that if operating the "Z" is perceived to be "inappropriate for the activities of a[n FCM], "X" is prepared to discontinue [its operation of the "Z"] immediately, upon reasonable notice to its customers."