

CFTC letter No. 02-103

August 21, 2002

Interpretation

Division of Clearing and Intermediary Oversight

Re: Section 4m(1) of the Act – Request for CPO Registration Relief
by “X” on behalf of Market Maker Member Firms that Trade
Security Futures Products.

Section 4m(1) of the Act – Request for CTA Registration Relief
by “X” on behalf of Traders associated with Market Maker
Member Firms who Provide Commodity Interest Trading Advice to the Firms.

Dear :

This is in response to your letter dated December 24, 2001 to the Division of Trading and Markets (“Division”) of the Commodity Futures Trading Commission (“Commission”), as supplemented by your letters dated January 3, 2002, January 31, 2002, and August 16, 2002, your e-mail sent April 3, 2002, and telephone conversations with Division staff.^[1] By your correspondence, on behalf of the “X”, you request relief from commodity pool operator (“CPO”) and commodity trading advisor (“CTA”) registration on behalf of certain “X” market maker member firms (“Market Makers”). Specifically, you request that the Division not recommend that the Commission commence enforcement action under Section 4m(1) of the Commodity Exchange Act (“Act”)^[2] against: (1) Market Makers whose members trade security futures products (“SFPs”) on a proprietary basis if they do not register as CPOs; and (2) individual traders trading SFPs on a proprietary basis on behalf of Market Makers if they do not register as CTAs.

Based upon the representations you have made to us, we understand the facts to be as follows: “X” has approximately 700 Market Makers, each of which is registered with the Securities and Exchange Commission (“SEC”) as a broker-dealer (“BD”). Market Makers typically are owned by more than one person, and the income from proprietary trades entered into by the individual traders of a Market Maker (“Traders”) is allocated among the Traders, owners and associated persons of the firm.^[3] As you know, it is the Division’s position that because this income will be pooled and allocated among these people, where a Market Maker trades commodity interests – such as SFPs – the Market Maker would be a commodity pool, its operator would be a CPO subject to registration as such under Section 4m(1) of the Act and its traders would be CTAs similarly subject to registration as such under Section 4m(1).^[4]

In support of your request for CPO registration relief for the Market Makers, you claim that it would be in the public interest for the Division to grant this relief because, among other reasons, a Market Maker is subject to: (1) the Securities Exchange Act of 1934 (“Exchange Act”) and thus the statutory

jurisdiction of the SEC; (2) the disciplinary jurisdiction of “X”;^[5] and (3) “X” membership requirements.^[6] In further support of your request, you represent that to qualify for relief from CPO registration, a Market Maker would have to meet, among others, the following criteria (“Market Maker Criteria”): (1) the firm is registered with the SEC as a BD; (2) the firm is a member in good standing of “X”; and (3) any person who participates in the profits and losses associated with the trading of SFPs by the Market Maker, including the firm’s operator, is not statutorily disqualified from registration under Section 8a(2) or (3) of the Act,^[7] and is (a) a “knowledgeable employee” of the firm^[8] or its immediate family member;^[9] (b) a retired knowledgeable employee of the firm or of another “X” member firm or its immediate family members; or (c) one of up to ten natural persons who do not meet the qualifications of (a) or (b) and is either (i) an officer, director, employee or principal of a registered BD, or (ii) a “qualified eligible person” under Commission Rule 4.7(a).^[11]

In support of your request for relief from CTA registration for the Traders, you claim, among other reasons, that each Trader: (1) is an associated person of a registered BD and, as such, is subject to and regulated by the Exchange Act and the SEC; (2) is supervised by its respective Market Maker for compliance with, for example, the Exchange Act and “X’s” Rules and Constitution; (3) must be approved as an individual member of “X”; and (4) is subject to the disciplinary jurisdiction of “X”.^[11] In further support of your request, you represent that to qualify for relief from CTA registration, each Trader would have to meet the following criteria (“Trader Criteria”): (1) the Trader is an associated person of a BD that meets the Market Maker Criteria and that is operating pursuant to the terms of this letter without CPO registration; (2) the Trader will provide commodity interest trading advice solely to the Market Maker and to persons associated with the Market Maker whose trading, in whole or in part, is for the benefit of the Market Maker; (3) the Trader does not hold itself out generally to the public as a CTA; and (4) the Trader is not subject to a statutory disqualification from registration under Section 8a (2) or (3) of the Act.

Based upon the foregoing, the Division believes that your request would not be contrary to the purposes and intent of the registration provisions of the Act and Part 3 of the Commission’s regulations issued thereunder. Accordingly, subject to the conditions set forth below, the Division will not recommend that the Commission commence enforcement action under Section 4m(1) against: (1) Market Makers who meet the Market Maker Criteria and trade SFPs for failure to register as a CPO under the Act; and (2) Traders who meet the Trader Criteria and provide commodity interest trading advice concerning SFPs for failure to register as a CTA under the Act.

These no-action positions are, however, subject to the condition that prior to entering into a transaction involving an SFP, each Market Maker who desires to claim the relief available under this letter must file a Claim of CPO and CTA Registration No-Action Position (“Claim”) with the Chicago Regional Office of the Commission (“CRO”) (Attn: Branch Chief, Division of Clearing and Intermediary Oversight).^[12] The Claim must: (1) be in writing; (2) provide the name, main business address and main business telephone number of the Market Maker and its operator;^[13] (3) provide the name and unique “X”

acronym of each of the Market Maker's Traders who desires to claim the relief available under this letter; (4) contain representations that the Market Maker: (i) meets the Market Maker Criteria and the Traders meet the Trader Criteria; (ii) will permit the Commission or its delegee to inspect the Market Maker's books and records to confirm that the Criteria are being met without the need for a formal Commission-issued order of investigation or judicial process;^[14] and (iii) will advise the Director of the Division in writing within thirty days after the Market Maker or any previously identified Trader becomes subject to a statutory disqualification under Section 8a(2) or (3) of the Act; and (5) be signed and dated by a duly authorized representative of the Market Maker. In addition, as a condition of these no-action positions, each Market Maker must annually file an updated claim with the CRO by January 15 of each year.

The positions taken in this letter do not excuse a Market Maker or a Trader from compliance with any other applicable requirements contained in the Act or the Commission's regulations issued thereunder. For example, each Market Maker and Trader remains subject to all antifraud provisions of the Act and the Commission's regulations, to the reporting requirements for traders set forth in Parts 15, 18 and 19 of the regulations and to all other applicable provisions of Part 4. Nor are these positions intended to limit or otherwise affect the Commission's authority, through a special call for information, a formal order of investigation or other process, to investigate the activities of a Market Maker or a Trader (including inspection of books and records) for compliance with the Act and regulations by the Market Makers and Traders.^[15] Moreover, these positions are applicable to the Market Makers and Traders solely in connection with their SFP activity.

This letter, and the no-action positions taken herein, are based upon the representations that you have made to the Division and they are subject to compliance with the conditions set forth above. Any different, changed, or omitted facts or conditions might render these positions void. You must notify the Division immediately in the event the operations or activities of the Market Makers and Traders with respect to SFPs change in any material way from those represented to the Division. Further, this letter solely represents the positions of the Division. It does not necessarily represent the positions of any other Division or Office of the Commission.

If you have any questions concerning this correspondence, please contact me or Barbara S. Gold, Associate Director, at (202) 418-5430.

Very truly yours,

Jane Kang Thorpe
Director

^[1] As of July 1, 2002, a reorganization of Commission staff became effective. The responsibility for

addressing requests for interpretative, no-action, and exemptive letters (including letters such as your May 17, 2002, letter) is now with the Division of Clearing and Intermediary Oversight. Accordingly, for purposes of this letter, the term “Division” includes the Division of Clearing and Intermediary Oversight and its predecessor, the Division of Trading and Markets, as the context requires.

[2] 7 U.S.C. § 6m(1) (2000).

[3] Note 2 of your December 24, 2001 letter explains “X” licensing and other requirements for Market Makers and note 3 defines the term “associated person.”

[4] Although certain of the Market Makers for whom “X” is requesting relief from CPO registration may function as both a market maker and a floor broker under limited circumstances (*e.g.*, where special permission to so act has been granted by a “X” floor official or when acting as a Designated Primary Market Maker), “X” is requesting relief solely with respect to the Market Makers’ proprietary trades, in SFPs.

[5] “X” has not applied to list SFPs. It is anticipated that the Market Makers will trade SFPs primarily on OneChicago, but they will be able to trade SFPs on any exchange that offers SFPs. In response to staff inquiries, you explained that it is your understanding that the Market Makers’ trading activities on other exchanges will be monitored by “X” to ensure compliance with, among other “X” requirements, “X” market making responsibilities.

[6] You also claim that to grant the requested relief would be consistent with the intent of the Commodity Futures Modernization Act of 2000 (“CFMA”) that futures commission merchants (“FCMs”) and BDs trading SFPs not be subject to duplicative regulation and you cite to CFMA §§ 251 (f), (g) and (h) to support your claim. However, the requested relief concerns relief from CPO registration for the operators of collective investment vehicles that trade commodity interests (*i.e.*, SFPs), and the attendant Part 4 obligations applicable to registered CPOs with respect to their pool participants. Thus, although the collective vehicles at issue are themselves BDs, it is their operators that are the subjects of the requested relief. Therefore, this is not a case of FCM/BD duplicative regulation.

[7] 7 U.S.C. § 12a(2) or (3) (2000).

[8] *See* Rule 3c-5(a)(4) under the Investment Company Act of 1940.

[9] For the purpose of this letter, “immediate family members” means children, parents, siblings and spouses, and family trusts for the benefit of one or more immediate family members.

[10] Commission rules cited to herein are found at 17 C.F.R. Ch. I (2002).

[11] *See* n.4, *supra*.

[12] You enclosed a draft Claim with your August 16, 2002 letter. However, for the purposes of this letter the Division has not reviewed or approved that draft Claim.

[13] For example, if the BD were organized as a limited partnership its operator would be the general partner thereof. If the BD were organized as a limited liability company, its operator would be the managing member or the manager thereof.

[14] As is stated more fully in the following paragraph, this condition is not intended to limit the Commission's general investigation authority.

[15] In this regard, by e-mail sent April 3, 2002, your colleague explained that all market maker firms are required to keep records pursuant to 17 C.F.R. §§ 240.17a-3, a-4 and a-5, including records of all trades, and that as part of these records, market maker firms keep a record of the trader who executed each trade. For the purpose of this letter, the Commission's inspection authority referred to above includes the right to inspect the books and records that a Market Maker who has claimed relief hereunder keeps pursuant to those rules.