

CFTC letter No. 03-29
July 16, 2003
Exemption
Division of Clearing and Intermediary Oversight

July 16, 2003

Re: Request for Exemption from Rule 155.4(a)

Dear :

This is in response to your letter dated January 17, 2003, to the Division of Trading and Markets of the Commodity Futures Trading Commission (Commission), as supplemented by telephone conversations with staff of the Commission's Division of Market Oversight.^[1] By your correspondence, you request, on behalf of yourself and "X", a registered introducing broker (IB), that the Commission grant an exemption from Rule 155.4(a)^[2], which generally requires that each IB establish and enforce internal controls to ensure, to the extent possible, that each order received from a customer that is executable at or near the market price is transmitted to the futures commission merchant (FCM) carrying the account of the customer before any order in the same commodity for any proprietary account or any other account in which an affiliated person has an interest.

Based upon your representations, we understand the facts to be as follows. You primarily trade S&P 500 futures contracts for your own account and your non-discretionary customer accounts on the Chicago Mercantile Exchange. You are requesting an exemption from Commission Rule 155.4(a) in order to place customer and proprietary account orders contemporaneously. You represent that all such bunched orders will be allocated using the "Y" average price system (APS). You believe that relief would enhance order entry efficiency by which both customer and proprietary accounts would equally benefit and that by using the APS, no customer or proprietary account would gain an economic advantage or receive preferential treatment.^[3]

As the Commission has stated, the Part 155 Rules are intended to prevent FCMs and IBs and their affiliated persons from using their knowledge of customer orders to the customer's disadvantage and have helped the Commission to deter such practices as, among others, "front-running," and "trading ahead."^[4] Rule 155.4(a)(1) requires that IBs establish and enforce internal controls to insure that IBs and their employees do not take advantage of their relationship with customers by using their knowledge of customer orders to trade ahead of or against the interests of such customers for their own benefit or that of their preferred customers.

The Commission has determined to deny your request. Rule 155.4 was patterned after Rule 155.3,^[5] which requires that FCMs establish and enforce internal controls "to insure that FCMs and their

employees do not take advantage of their relationship with customers by using their knowledge of customer orders to trade ahead of or against the interests of such customers for their own benefit or that of their preferred customers.”^[6] Rule 155.4 was designed “to ensure that the ‘customer first’ principle, which applies to orders given to an FCM, is extended to an introducing broker as well.”^[7] The Commission promulgated Rule 155.4 to deter IBs and their affiliated persons from using their knowledge of customer orders to the customer’s disadvantage. The Commission has stated that Rules 155.3 and 155.4 deter fraudulent practices such as “front running” and “bucketing.”^[8] Following the success of Rules 155.3 and 155.4, the Commission recently expanded Rule 155’s requirements to certain parties trading on derivatives transaction execution facilities.^[9]

In addition, when the Commission recently expanded its rules concerning bunching of discretionary orders by third-party account managers, it specifically declined to extend the rule’s coverage to IBs.^[10] Thus, even though “X” uses the APS, it does not obviate the customer first principle of Rule 155. Therefore, following the Commission’s objectives in creating Rule 155 and in light of the important customer protection issues at stake, the Commission does not find that it is appropriate to grant an exemption from Rule 155.4(a).

If you would like to discuss this matter further, please feel free to contact Lawrence B. Patent, Deputy Director, or Trabue Bland, attorney, both in the Commission’s Division of Clearing and Intermediary Oversight, at (202) 418-5439 or (202) 418-5466, respectively.

Very truly yours,

Jean A. Webb
Secretary of the Commission

^[1] Your letter was addressed to the Director, Division of Trading and Markets. The Commission reorganized last year and the functions formerly performed by the Division of Trading and Markets, which has been eliminated, are now performed by two new Divisions, the Division of Clearing and Intermediary Oversight and the Division of Market Oversight. Rule 155.10 gives the Commission the authority to grant an exemption from Part 155. This authority has not been specifically delegated to any staff unit, and, consequently, the Commission, rather than any staff unit, is responding to your request.

^[2] 17 CFR 155.4(a) (2003).

^[3] The Chicago Mercantile Exchange only allows bunched orders for non-discretionary accounts when the underlying order is a stop or a stop/limit order. CME Rule 572.

[4] 66 Fed. Reg. 53510, 53513-53514 (October 23, 2001).

[5] 17 CFR 155.3 (2003).

[6] 41 Fed. Reg. 56134, 56139 n. 18 (December 23, 1976).

[7] 48 Fed. Reg. 14933, 14954 (April 6, 1983).

[8] 66 Fed. Reg. 53510, 53513-53514 (October 23, 2001).

[9] *Id.*

[10] 68 Fed. Reg. 34790 (June 11, 2003). In adopting the rule change, the Commission required third-party account managers to adopt a standard that allocations be fair and equitable and make certain information available to customers concerning trading. As IBs were not included in the definition of “account manager,” these requirements are not applicable to IBs.