

CFTC letter No. 04-15

March 22, 2004

Interpretation

Division of Clearing and Intermediary Oversight

Re: Section 1a(23) and Regulation 1.3(mm) -- Request for Interpretation in Connection with the Definition of an Introducing Broker

Dear :

This is in response to your letter dated October 24, 2003, to the Division of Clearing and Intermediary Oversight ("Division") of the Commodity Futures Trading Commission ("Commission"), as supplemented by telephone conversations with Commission staff. By your correspondence, you request that the Division concur with your assessment that "X", would not be an Introducing Broker ("IB") under the Commodity Exchange Act ("Act"),^[1] with regard to providing its customers a software program with the ability to access the order-entry system of the futures commission merchant ("FCM") of their choice.

Facts

Based upon your representations, we understand the relevant facts to be as follows. "X" is a registered broker dealer that controls rights to a trading and order management software program called "Y", that allows institutional customers to gather and analyze market data. The software assists "X's" customers in trading decisions, but does not provide express "buy" or "sell" signals.

You represented that "X" plans on licensing "Y" to institutional customers to permit these customers to access the order-entry system of the FCM of their choice.^[2] "X" will not license "Y" to individuals. You represented that "X's" customers that would use "Y" would select their own FCMs and negotiate any and all fees between themselves and the FCM. The "Y" software would reside on the customers' computers and "X" would have no network connection to "Y". Customers will use the "Y" software to periodically generate a report of the number of contracts that are executed using the "Y" software and submit these reports to "X", who will, in turn, use these reports to calculate how much money is due to "X" by the FCM, which will be based on the number of contracts executed with "Y", not the dollar amount of the contracts or the FCM's commission. "X" will not recommend, propose, or encourage customers to use any particular FCM, even in response to a customer inquiry, nor will it solicit customers for an FCM in any other manner. The customer will inform "X" of the FCM with which it has an account and "X" will work with the FCM to develop the required technology to provide the customer access to the FCM's order-entry system.^[3] When the technology has been implemented, the customer

will be able to directly access its selected FCM's order-entry system through the "Y" screen, without opening a new application. The customer will log into the FCM's system and enter its trade in the FCM's system as it normally would, except that it would be trading through the "Y" screen. As a result, the customer will log-on and place orders with the FCM directly through the "Y" screen. In a browser-based system, the mouse-click will result in a separate browser window being automatically launched to provide the customer access to the FCM's order-entry system. By providing a method of entering trades without opening a separate application, "X" is providing technology that facilitates order-entry in a more efficient manner.

You have represented that this software will be available to all of "X's" customers and that "X" is not involved in any way with the selection of an FCM for any customer. "X" does not receive any form of payment from its customers for the use of the "Y" software, except in the event that a customer's usage does not generate fees from the FCM that exceed a certain minimum amount that may be negotiated with the customer, in which case the customer will be liable for the difference between the fees generated and the minimum amount.^[4] "X" does not have a right or ability to view a customer's orders, positions or the types of contracts traded or the time or prices of these trades. The orders go directly from the customer's computer terminal to the FCM's computer (without passing through "X's" computers). "X's" customers who request the "Y" software do not pay "X" any more for its data services than those customers who do not request the integration tool. "X" receives a transmission fee from the FCM. The fee is based on the number of contracts executed using the "Y" software and is not associated in any way with fees the customer might pay to the FCM for executing the trade.

Analysis

Section 1a(23) of the Act defines an introducing broker ("IB") as:

[A]ny person (except an individual . . . registered as an associated person of a futures commission merchant) engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market or derivatives transaction execution facility who does not accept any money, securities, or property (or extend credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom.

Rule 1.3(mm)^[5] similarly defines an IB, in relevant part, as:

Any person who, for compensation or profit, whether direct or indirect, is engaged in soliciting or in accepting orders (other than in a clerical capacity) for the purchase or sale of any commodity for future delivery on or subject to the rules of a contract market who does not accept any money, securities, or property (or extend credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom.

The Futures Trading Act of 1982,^[6] amended the Act to require persons known as "agents" of FCMs to

register as IBs, so as to "resolve[] any existing uncertainty as to the status of [these] agents."^[7] In creating the separate IB registration category, Congress intended to "protect the public" from the "sales abuses" of such agents for which FCMs "frequently disavow[ed] any responsibility."^[8]

In establishing the rules relating to IBs and their registration, the Commission noted that the intent of the Futures Trading Act of 1982 was "to require those persons who performed the type of activities traditionally engaged in by agents to register with the Commission as an [IB]."^[9] The Commission indicated that "[h]istorically, agents . . . carried all of their accounts on a fully-disclosed basis with an FCM which provided 'back office' services for those accounts."^[1] The Commission further stated that "the phrase 'soliciting or accepting orders,' . . . must be construed to encompass not just the literal solicitation or acceptance of customers' orders, but also the solicitation of customers . . . for referral to an FCM for the institution of a trading relationship and the execution of those orders."^[1]

"X's" central business activities are the collection and distribution of data services and it is not involved with the intermediation of trading on the futures markets. "X" does not solicit customers or orders for an FCM or the trading of futures contracts. Customers indicate to "X" the FCM with which they have an existing relationship or with whom they wish to trade. Even in response to a customer inquiry, "X" does not recommend, propose, or encourage that customers use any particular FCM, or place any orders for futures contracts. The fees paid to "X" by the FCM and are not associated with the fees paid to the FCM for the placement of customer orders—the fee is paid by the FCM based on the number of contracts executed with the FCM, not based on the FCM's commission or the price of the contract traded. Because "X" is collecting a fee based on the number of contracts executed with FCMs, using "Y", and to which customers wish to establish a link, "X's" net income may be affected by its providing this additional service. "X", however, is not accepting customer orders, since it has no involvement with the placing of the customers orders and does not recommend a particular trade or an FCM, even if asked to do so by the customer. "X" is simply providing technology that connects the customer to its FCM's order entry system. The customer is submitting its order to the FCM and not to "X". The Division concurs with your assessment that "X" is not an IB and, therefore, is not required to register as such.^[12]

The position taken herein is based upon the representations that have been made to the Division. Any different, changed, or omitted facts or conditions might require the Division to reach a different conclusion. You must notify the Division immediately in the event the operations or activities of "X" change in any material way from those represented to us. Further, this letter represents the position of this 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 Peter B. Sanchez, an attorney on my staff, at (202) 418-5437.

Very truly yours,

James L. Carley
Director

^[1] 7 U.S.C. § 1 *et seq.* (2000).^[2]

² You state that “institutional customer” “mean[s] a corporation, partnership, limited liability company or Massachusetts or similar business trust that was not formed for the specific purpose of using “Y” and is engaged in the business of investing in, owning, holding or trading securities, futures contracts and other financial instruments, either for its own account or for the account of others.”

^[3] You represent that the “Y” will use the “Z”, and that “X” has successfully tested “Y’s” ability to transmit a customer’s order information to five different FCMs. You represent that “Z” is a standardized protocol used to transmit financial data and that it is widely-used in the financial services industry. ^[4]

⁴ You represent that, in lieu of compensation from the FCM based on the number of contracts, a customer may instead choose a simple license fee that does not depend on the amount of contracts executed using the “Y” system. “X” may, separately, contract with customers to provide software technical support or data feeds from third party providers, but such technical support will not involve buy/sell recommendations and customers who obtain data feeds directly from unaffiliated third-party providers, instead of “X”, will receive equal treatment.

^[5] 17 C.F.R. § 1.3(mm). Commission rules referred to herein are found at 17 C.F.R. Ch.1 (2003).

^[6] Pub. L. No. 97-444, 96 Stat. 2294 (1983).^[7]

⁷ H.R. Rep. No. 97-565, pt. 1, at 49 (1982).^[8]

⁸ Id. ^[9]

⁹ 48 Fed. Reg. 35248, 35250 (August 3, 1983), *quoting* 48 Fed. Reg. 14933, 14935 (April 6, 1983).^[11]

¹⁰ Id. ^[1]

¹¹ Id.

^[12] The Staff has only once previously opined as to the registration requirements under the Act as they relate to data service providers, such as “X”, that provide technology to facilitate the order entry process

and do not engage in activities that would otherwise require registration. *See* CFTC Staff Letter 02-91, July 30, 2002. In that instance, however, the entity did not receive a per-contract compensation from the FCMs. If in the future the Commission determines that such entities must be registered under the Act, “X” may have to comply with the applicable registration requirements at that time.