

Commodity Futures Archive - Selected materials, CFTC Interpretative Letter No. 92-16. (Implementation of Order Transmittal Procedure.), ¶25,386, Commodity Futures Trading Commission, (Sep. 23, 1992)

¶25,386. Commodity Futures Trading Commission. Division of Trading and Markets. September 23, 1992.
Correspondence in full text.

Interpretations: Orders: Transmittal Procedure: FCM's Foreign Affiliate.— A futures commission merchant and its foreign broker affiliate may implement an order transmittal procedure provided the brokers comply with all applicable CFTC rules, regulations and orders. The brokers may permit certain of their institutional customers in their respective omnibus accounts to transmit trading orders directly to the overseas executing broker rather than through the carrying broker, from time to time as market conditions may warrant.

See ¶12,011, "Liabilities—Prohibitions" division, Volume 1.

This is in response to your letter to the Division of Trading and Markets ("Division"), dated May 12, 1992, on behalf of X, a registered futures commission merchant ("FCM") and New York corporation, and its London-based affiliate, Y, a member of the U.K. Securities and Futures Authority ("SFA"),¹ each a subsidiary of the Industrial Bank of Japan. In your letter you request the Division to confirm that it will not recommend to the Commission that any enforcement action be taken against either X or Y in the circumstances described below.

X and Y each specialize in providing financial futures brokerage and execution services to institutional market participants, mainly banks, insurers, pension plans and financial institutions ("institutional customers") which use the U.S. and foreign financial futures markets for hedging and risk-management purposes. X's institutional customers are located in the U.S. and other countries. Y's institutional customers are located in England and other countries, but not in the U.S.

In your letter, you represent that as is customary, institutional customers' orders would normally be transmitted directly between X and Y for the benefit of their respective institutional customers in their respective omnibus accounts. Each carrying broker would in turn collect margins from its own customers and pay margins directly to the other executing broker. X as a U.S. FCM would comply with all applicable provisions of the Commodity Exchange Act ("Act") and Commission rules both with respect to Y's customer omnibus account carried on its books and X's customers omnibus account carried with Y, and Y as a foreign broker would comply with Commission rules applicable to foreign brokers in, for example, rules 15.05 and 21.03.

Mainly because of the time zone difference between London and New York but also to facilitate more efficient brokerage services to their respective institutional customers, X and Y however desire to permit certain of their institutional customers in their respective omnibus accounts to transmit trading orders directly to the overseas executing broker (*i.e.*, X or Y, as the case may be) rather than through the carrying broker, from time to time as market conditions may warrant. The firms wish to continue to do customer business through each other on an omnibus basis even though from time to time, each would like to permit the other to take orders directly from its customers.

For the purpose of X's U.S. institutional customers engaging in financial futures transactions on U.K. futures exchanges which are permitted to be traded by persons located in the U.S., such as certain contracts traded on the London International Financial Futures and Options Exchange, X maintains an account with Y through which all such transactions are carried on a non-disclosed omnibus basis, denominated as an X customer omnibus account. For purposes of such transactions, the U.S. institutional customers are treated as customers of X, the carrying broker, and would continue as such although they may have contacts with personnel at Y, the executing broker.

For the purpose of Y's U.K. and non-U.S. institutional customers engaging in financial futures transactions on U.S. contract markets, such as those traded on the Chicago Mercantile Exchange, Y would normally maintain an account with X through which all such transactions are carried on a non-disclosed omnibus basis, denominated as a Y Foreign Broker customer omnibus account. For such an omnibus account, Y would be considered to be a "foreign broker" and its institutional customers to be "foreign traders" under Commission rule 15.00. For purposes of such transactions, the U.K. and other non-U.S. institutional customers are treated as customers of Y, the carrying broker, and would continue as such although they may have contacts with personnel at X, the executing broker.

In order for X and Y to implement the order transmittal process specified above, you request that subject to the conditions specified herein, the Division issue a no-action letter to the effect that:

- (a) Y's institutional customers whose positions will continue to be carried in Y's foreign broker omnibus account with X be permitted to transmit orders directly to X for inclusion in Y's customer omnibus account without X

being required to treat such institutions as its “customers,” as that term is defined in Commission rule 1.3(k), or otherwise as separate accounts of X under Commission rule 1.37(a); and

- (b) X's institutional customers whose positions will continue to be carried in X's customer omnibus account with Y be permitted to transmit orders directly to Y for inclusion in X's customer omnibus account without Y being required to treat such institutions as its customers or otherwise as separate accounts of Y pursuant to Part 30 of the Commission's rules.

If X in directly accepting orders from foreign customers of Y were considered to have made such persons customers of X for all purposes, X could, among other things, be required to: (a) comply with Commission rule 1.37 related to identification of customers; (b) deliver the disclosures required by, for example, Commission rule 1.55; and (c) provide monthly and confirmation statements required by Commission rule 1.33.

Although X would be subject to the antifraud provision of section 4b of the Act and all rules relative to the supervision of orders, including Commission rule 166.3, X asks that customers of Y permitted to use this order transmittal procedure be treated as customers of Y rather than of X, whose regulatory obligations to its customers as a foreign broker are based, in the first instance, on foreign not U.S. requirements. To avoid confusion, Y and X will ensure that each such institutional customer understands its relationship to Y and to X and that Y and X will agree to be jointly and severally liable relative to any sales representations. X will not carry the accounts of individual customers but only the omnibus account of Y. Therefore, X will not separately account for such customers' funds as those of individual customers but will only separately account for and segregate the funds of Y's customer omnibus account. Y's customers thus will have no direct claims against X's accounts segregated for X's customers solely by virtue of the order transmittal procedure referred to herein, but only against Y under applicable law.

The case of Y accepting orders from U.S. customers of X related to non-U.S. transactions can be distinguished from that of X's acceptance of orders from customers of Y. In the former scenario, U.S. institutional customers would expect to deal with a firm which had qualified under rule 30.10 and could directly handle customer orders.² However, rule 30.10 only addresses Y's ability to directly carry the accounts of U.S. customers. Under the arrangement contemplated, X's institutional customers would be permitted to place orders not with their FCM who is responsible for ensuring credit and position limits for their accounts, but with an entity which is not a branch office of the FCM and, hence, itself is not subject to the Commission's financial integrity, segregation and other customer protection requirements. Nonetheless, this entity is accepting orders which bind an omnibus account containing the accounts of other U.S. customers at such FCM. Although the sales practice concerns related to such institutional customers may be addressed by the generally comparable regulatory regime in the U.K. coupled with the fact that customers of X will receive full customer protection in the U.S., there is concern that the order transmittal procedure be structured consistent with X being able to adequately supervise its financial condition.

To address the regulatory concerns expressed above, X and Y which are affiliated entities with a common parent, the Industrial Bank of Japan, represent that if the request herein is granted, they will implement the following internal controls. Y and X will execute two omnibus account agreements which will make explicit the internal control procedures relative to the operation of direct contacts between customers and existing brokers in the other jurisdiction. These procedures, which relate to authorization, identification, and supervision of orders, follow:

- (a) *Institutional Customers*—X and Y will each identify a limited number of banks, insurers, pension plan fiduciaries and financial institutions as the only traders who will be approved to transmit orders directly to Y for non-U.S. transactions, in the case of X, and to transmit orders directly to X for U.S. transactions, in the case of Y.
- (b) *Order Supervision*—Each carrying broker will designate supervisory personnel at the carrying firm to review orders added to its omnibus account which are entered through this procedure for compliance with order ticket review and other requirements.
- (c) *Credit Limits*—Neither executing broker will accept from any such customer an order which would cause the carrying broker's omnibus account to exceed any approved position or credit limits. Each carrying broker will ensure that it has procedures for review of its customers' positions on a daily basis and to adjust position and credit limits as appropriate. In the event a particular institutional customer who is the subject of this no action letter is approaching any such limits imposed by the carrying broker, the carrying broker will inform the executing broker.
- (d) *Order Confirmation and Customer Identification*—Upon receipt and execution of a customer's order for the omnibus account, the executing broker will confirm such receipt and execution in writing to the carrying broker, identifying the customer for whom the order has been entered in the carrying broker's omnibus

account. In particular, the executing broker will identify on the order ticket at the time it is created, the name of the carrying broker's customer placing the order for the omnibus account. The carrying broker will confirm the execution of such trade to its customers. In addition, each executing broker will maintain an audit trail which can be used to confirm all customer transactions for the omnibus account.

- (e) *Margin Collection*—X and Y will collect margin from each other with respect to omnibus accounts which each carries for the other and each will continue to collect margins from its own institutional customers with respect to positions entered under this arrangement. Y and X will incorporate into the omnibus agreements a provision which makes each firm directly liable to the other for margin payments related to the omnibus accounts. Margins will never be demanded nor collected by the executing broker directly from the carrying broker's institutional customer.
- (f) *Customer Documentation*—In addition to the usual account opening agreement, X and Y will each provide to their institutional customers who are the subject of this no action request, documentation which provides in substance that although they may transmit orders directly to X or Y, as the case may be, that (i) the orders are for their carrying broker's omnibus account with the executing broker; (ii) such customers are customers of the carrying broker and are not "customers" of the executing broker; and (iii) such customers agree to the limits imposed on the direct order transmittal procedure. Further, the contracts between X and Y and each of their institutional customers will specify any additional conditions applicable to the procedure, and X and Y will have agreements in place between themselves and documentation identifying whose orders may be accepted under these procedures and procedures for notifying each other of any special conditions between each firm and its institutional customers.

Based on the foregoing facts and representations as set forth above and subject to compliance with the conditions set forth herein as agreed, the Division will not recommend that the Commission take enforcement action against X and/or Y if they implement the order transmittal procedure described above. This no-action position is conditioned on compliance by X and Y with all applicable Commission rules, regulations and orders, including but not limited to, the antifraud provisions in section 4b of the Act and rule 30.9 of the Commission's regulations and the supervisory, requirements of Commission rule 166.3, either directly in the case of X, or indirectly, in the case of Y through compliance with comparable U.K. requirements. This position will become effective upon the confirmation of rule 30.10 relief as to Y by the Division.

The position adopted herein is based on the information provided to us. Any different, changed or omitted facts or conditions might require us to reach a different conclusion. This position is solely that of the Division of Trading and Markets and does not necessarily reflect the views of the Commission or its other offices or divisions.

Footnotes

- 1 Your letter states that you have been advised by X's Director of Compliance that Y has met with appropriate SFA officials and has (i) completed all necessary documents and undertakings which must be filed to qualify for registration exemption under Commodity Futures Trading Commission ("Commission") rule 30.10, 17 C.F.R. §30.10 (1992), as a member firm designated by the SFA; (ii) the appropriate designation of agent form has been executed and sent to the National Futures Association; and (iii) the SFA will shortly be filing Y's requisite undertakings with the Commission. This is being done pursuant to the Commission's Order dated May 15, 1989, granting rule 30.10 relief to member firms designated by the Association of Futures Brokers and Dealers and The Securities Association, which have since merged to form the SFA. *See* 54 *Fed. Reg.* 21604 (1989), and 56 *Fed. Reg.* 14017 (1991). On May 5, 1992, the Division received Y's application for relief under rule 30.10.
- 2 *Cf.* SEC rule 15a-6 which permits major U.S. institutional investors as defined in that rule to effect transactions through non-registered foreign broker-dealers so long as such transactions are effected through a registered broker-dealer and subject to the conditions specified. With respect to U.S. institutional investors who do not qualify as *major* U.S. institutional investors, an associated person of the broker-dealer must participate in all oral communications between the foreign broker-dealer and such investor. *See* 17 C.F.R. §240-15a(a)(3)(i).