

**CFTC Letter No. 97-38****May 28, 1997****Division of Trading & Markets**

Re: Section 4m(1) of the Act -- Request for Relief from CPO and CTA Regulation for a Limited Liability Company Registered as a Broker-Dealer and Acting as a Market-Maker on the Chicago Board Options Exchange

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Dear :

This is in response to your letter dated February 5, 1997 to the Division of Trading and Markets (the "Division") of the Commodity Futures Trading Commission (the "Commission"), as supplemented by your facsimile transmissions dated February 20, March 5 and April 22, 1997 and by telephone conversations with Division staff. By your correspondence, you request on behalf of W confirmation that W is not a commodity pool within the meaning of Commission Rule 4.10(d) (1).<sup>1</sup> In the alternative, you ask that the Division not recommend that the Commission take any enforcement action for failure to comply with Section 4m(1) of the Commodity Exchange Act<sup>2</sup> (the Act ) if the Management Committee of W does not register as a commodity pool operator ( CPO ) and the W traders do not register as commodity trading advisors ( CTAs ).

Based on the representations made in your correspondence, we understand the relevant facts to be as follows. W is a Delaware limited liability company that specializes in option trading on organized exchanges. It is registered as a broker-dealer with the Securities and Exchange Commission ( SEC ), and is a member of the Chicago Board Options Exchange ( CBOE ). Various of the traders who work for W are registered with CBOE as market-makers, holding market-maker appointments for options on the Standard & Poor s 500 Stock Price Index ( S&P 500 ) and/or the Standard & Poor s 100 Stock Price Index. To manage the risks associated with its traders CBOE market-making activities, W trades other options on CBOE, or the S&P 500 futures contract on the Chicago Mercantile Exchange ( CME )(or less frequently, options on S&P 500 futures contracts). In addition to their market-making activities, W traders take other, more speculative positions in options on S&P 500 futures traded on the CME. Although you represent that W trades commodity interests predominantly for purposes of managing the risks of its CBOE market-making activities, you indicate that there is no restriction on the amount of other, speculative trading in options on S&P 500 futures contracts in which W may engage.

The members of W are either: (1) persons who trade on a full-time basis for W ( W Traders ); (2)

persons who were principals of predecessor entities of W<sup>3</sup>, or (3) senior quantitative analysis, information technology or administrative personnel of W (as Senior Managers<sup>4</sup>) Membership in W is restricted to these three categories. Membership is compulsory for W Traders, and elective for Senior Managers who wish to tie their compensation to the overall profitability of W. Membership is not open to friends or relatives of members or to passive investors. You represent that none of the members of W is subject to statutory disqualification under Section 8a(2) or 8a(3) of the Act.<sup>5</sup>

W's commodity interest trading is effectuated by six of the W Traders, each of whom is registered with the Commission as a floor broker.<sup>6</sup> Two of these traders trade S&P 500 futures contracts, filling orders placed by other W Traders to manage risks associated with CBOE option positions, as well as orders unrelated to W's business that are placed by non-affiliated persons.<sup>7</sup> The other four traders trade options on S&P 500 futures contracts, initiating on their own trades for the account of W.

The Management Committee oversees the operations of W, including the development and application of its option trading model and the preparation of administrative policy. The members of the Management Committee are C, D and E (collectively, the Management Committee Members).<sup>8</sup> One Management Committee Member (C), who has been designated the Managing Member of W, is more involved than the other members in the daily implementation of policy.

At the conclusion of each calendar year, trading income (after deduction for employee salaries, fixed overhead expenses, transaction fees and related costs) is allocated among the members of W. No advisory fees (management or incentive fees) are charged. All members are entitled to share pro-rata (in accordance with their respective capital account balances) in the first thirty percent of such allocated profits. One hundred percent of losses are allocated on the same pro-rata basis. The remaining seventy percent of profits is allocated by the Management Committee to members based upon the extent, if any, to which each member's efforts contributed to W's profitability. (Efforts of both W Traders and other members are considered for this latter allocation).

All securities and commodity interest trading by W is for W's account<sup>9</sup> and is based generally on a proprietary model developed by current and former W members. Trading is decentralized, and each W Trader is assigned to a particular trading pit with responsibility for deciding when to execute trades and which trades to make. Every morning W Traders as a group determine the variable inputs to the proprietary pricing model, and the research and technology staff generates a print-out of the model containing updated prices (which data may be further updated during the day to account for significant market movements). Each W Trader uses the printout only as a guide for implementing his trading strategy.

In support of your request you represent that in no event does (or will) a member's interest in W represent an indirect investment by another person. As stated above, each person who becomes a W Trader must become a member of W, and the only other persons who are permitted to become members are Senior Managers.<sup>10</sup> You thus claim that each person who is (or will be eligible to become) a member of W is financially sophisticated, experienced in the industry in which W operates, and knowledgeable concerning the business and activities of W.

Based upon the foregoing, the Division believes that W is a pool within the meaning of Rule 4.10 (d)(1). This is because funds contributed by traders and by non-traders are pooled and used to trade, *inter alia*, commodity interests, for speculative purposes. Nevertheless, under the specific circumstances you describe, the Division believes that it would not be contrary to the public interest to grant registration relief to the Management Committee and W Traders. Accordingly, the Division will not recommend that the Commission take any enforcement action pursuant to Section 4m(1) of the Act based solely upon (1) the failure of the Management Committee Members to register as CPOs in connection with the operation of W or (2) the failure of the W Traders to register as CTAs in connection with forming or implementing commodity interest trading strategies on behalf of W. These positions, however, are subject to the conditions that:

1. Only W Traders and Senior Managers will be permitted to become members of W;
2. The only commodity interests traded by or on behalf of W will be S&P 500 futures contracts and options on S&P 500 futures contracts;
3. Each member of W confirms in writing that his interest in W does not represent an indirect investment by another person;
4. W submits to such special calls as the Commission may make to determine compliance with the terms of this relief; and
5. Each member of W who trades commodity interests and executes commodity interest transactions on behalf of W will be registered with the Commission as a floor broker.

This letter is based upon the representations provided to us. Any different, changed or omitted facts or circumstances might require us to reach a different conclusion. In this connection we request that you notify us immediately in the event the operations or activities of W or its members change in any way from those represented to us. Further, this letter is applicable to W and its members solely in connection with the trading activities described in your correspondence.

We note that this letter does not excuse W or any of its members from compliance with any applicable requirements contained in the Act or in the Commission's regulations issued thereunder. For example, W and the W Traders remain subject to the antifraud provisions of Sections 4b and 4c of the Act, 7 U.S.C. §§ 6b and 6c (1994), and to the reporting requirements for traders set forth in Parts 15, 18 and 19 of the Commission's regulations. If you have any questions concerning this correspondence, please contact me or Christopher W. Cummings, an attorney on my staff, at (202) 418-5445.

Very truly yours,

Susan C. Ervin

Chief Counsel

<sup>1</sup> Commission rules referred to herein are found at 17 C.F.R. Ch. I (1996).

<sup>2</sup> 7 U.S.C. § 6m(1) (1994).

<sup>3</sup> Those individuals are A and B. B is registered as a floor trader. You represent that a general partnership named W was formed in 1987 or 1988. In 1991 X was formed. Its assets were sold to Y in late June 1993, and it was renamed Z. In June 1995, the company was repurchased by its original owners and named W.

<sup>4</sup> You state that these individuals are senior managers who either supervise other personnel or who have significant decision-making authority with respect to W's finances (for example, chief financial officer or controller).

As described more fully below, the returns received by W members, whether they are traders or not, are based in part on the members' respective contributions to the profitability of W. In this sense, none of the members is a truly passive investor in W.

<sup>5</sup> 7 U.S.C. § 12a(2) or 12a(3) (1994).

<sup>6</sup> Specifically, these persons are F, G, H, I, D and J. All are registered with the CME as members of broker association V. Two of these persons own their own CME seats, two lease seats from other W traders, and two lease seats from persons unaffiliated with W.

<sup>7</sup> In response to staff inquiries you confirmed that although these W Traders fill a small amount of orders for non-W accounts, they are nonetheless full-time employees of W.

<sup>8</sup> D is registered with the Commission as a floor broker. Neither E nor C is registered with the Commission in any capacity.

<sup>9</sup> As noted above, two of the W Traders are not required to trade exclusively for W, but may also fill commodity interest trading orders for persons not affiliated with W. We take no position herein whether such filling of orders for non-affiliated persons entails registration or other obligations beyond those applicable to registered floor brokers under the Act and Commission rules.

<sup>10</sup> As also stated above, two individuals who were principals of W predecessor entities have been permitted to become members.