CFTC Materials, CFTC Interpretative Letter No. 87-2. (Classification of Accounts of Officers and Employees of Affiliated Companies.), ¶23,652, Commodity Futures Trading Commission, (Jun. 8, 1987)

Commodity Futures Archive - Selected materials
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¶23,652. Commodity Futures Trading Commission. Division of Trading and Markets. June 8, 1987. Correspondence in full text.

Headnote

Definitions: Customer Acccunts: Proprietary Accounts: Affiliated Companies: Officers or Employees..– Since the specific categories of proprietary accounts set forth in Reg. §1.3(y) are not exclusive, the proper classification of accounts owned by officers or employees of affiliated companies should be determined on a case-by-case basis. However, some general guidelines can be provided and in certain cases it could be presumed that an individual's account should be classified as a proprietary account.
See ¶4003, "Definitions" division, Volume 1.

This is in response to your letter dated April 23, 1987 regarding the proper classification of accounts owned by officers or employees of affiliated companies. Your question is whether the accounts of such persons are to be classified for most purposes as proprietary accounts or as customer accounts. [1] As you noted in your letter, the Commission's definition of a proprietary account specifically refers to the accounts of a business affiliate, but not those of the affiliated company's officers and employees. [2] You further stated that since this issue is not addressed specifically in the Commission's regulations and it may potentially affect Exchange clearing members, you would like a written interpretation of the Division's recommended treatment of accounts of officers and employees of affiliated companies, as well as any additional guidelines or comments which we may have regarding this issue.

Although the Commission's predecessor agency, the Commodity Exchange Authority ("CEA"), did not adopt a formal rule setting forth a definition of a proprietary account until shortly before the Commission's creation (39 Fed. Reg. 28618, August 9, 1974), [3] the issue of account classification arose more than fifty years ago with the enactment of the Commodity Exchange Act ("Act") in 1936. Section 4d(2) of the Act requires that futures commission merchants keep funds belonging to their customers separate from the firm's own funds, so it became important to determine whether any particular firm or individual was a "customer." In United States Department of Agriculture Solicitor's Opinion No. 15 (November 8, 1937), it was stated that "Congress meant 'customer' to include the type of person usually brought to mind by the word, but not the type of person who in some respects could be considered a customer but whose whole relation to the firm is entirely different from that of an ordinary customer." *See also, e.g.,* United States Department of Agriculture Solicitor's Opinion No. 4 (September 26, 1936) (floor trader clearing his trades through an FCM but having no other relationship with the FCM is a customer of such FCM). The last major pronouncement by the CEA in this area prior to the adoption of Rule 1.3(y) was Administrative Determination ("AD") No. 216 (January 31, 1969). That AD served as a precursor for the proprietary account definition and stated that the following persons could not be considered customers of an FCM: (1) an employee of the registrant; (2) the sole proprietor of the registrant; (3) a partner of the firm, if the registrant is a partnership; (4) an officer, director or an owner of 10 percent or more of the capital stock of the firm, if the registrant is a corporation; or (5) a member of the immediate family of any of the above persons.

Citing Solicitor's Opinion No. 15, it was concluded that “the traders in question have relationships with the futures commission merchant which are quite different from those of an ordinary customer.”

There are several reasons why account classification is important. These include lessening the risk of loss to ordinary customers in the event of a firm's financial failure, removing customer funds from availability for use by a firm or its managers or principals for the firm's or such persons' own trading, increasing the visibility to a firm's management of accounts of proprietary persons so that it is harder for such persons to trade illegally (*e.g.,* allocating good trade executions to their own or relatives' accounts and bad trade executions to ordinary customers) or “carry” their personal or relatives' positions using excess margins of ordinary customers, and preventing persons with ready access to information such as buying or selling order trends, customer delivery capabilities and/or intentions, or “stop loss” price levels from using such information, which is unavailable to the ordinary customer, to obtain a trading advantage. The Division has been mindful of these concerns in its deliberations with respect to account classification. These concerns are also reflected in the Commission's Bankruptcy Rules (17 C.F.R. Part 190 (1986)) and the Commission's Trading Standards Rules (17 C.F.R. Part 155 (1986)). [4] The Bankruptcy Rules embody the concept of a customer priority over proprietary persons in the distribution of a bankrupt estate, especially in Rule 190.08(c) (17 C.F.R. §190.08(c) (1986)). The Trading Standards Rules embody the concept of “customer first” in order execution. The Bankruptcy Rules incorporate by reference the customer/proprietary account distinction set forth in Rule 1.3(k) (17 C.F.R. §1.3(k) (1986)) and Rule 1.3(y). The Trading Standards Rules use the term “affiliated person,” which is defined in Rule 155.1 (17 C.F.R. §155.1 (1986)) and provides as follows:

> For purposes of this part, the term “affiliated person” of a futures commission merchant or of an introducing broker means any general partner, officer, director, owner of more than ten percent of the equity interest, associated person or employee of the futures commission merchant or of the introducing broker, and any relative or spouse of any of the foregoing persons, or any relative of such spouse, who shares the same home as any of the foregoing persons.

Although the Commission's rules do not specifically refer to the proper classification of accounts of officers and employees of affiliated companies, the Division is of the opinion that the specific categories of proprietary accounts set forth in Rule 1.3(y) are not exclusive, and that the proper classification of accounts owned by officers or employees of affiliated companies should be determined on a case-by-case basis. However, in light of the concerns expressed in the preceding paragraph, it is the Division's view that some general guidelines can be provided and that in certain cases it could be presumed that an individual's account should be classified as a proprietary account. For example, if an FCM is owned 100 percent by a parent company, the trading account of the president of the parent company should generally be classified as a proprietary account by the FCM. Similarly, if an FCM is affiliated with a securities broker/dealer, where one firm is the subsidiary of the other or both firms are under common ownership, the trading accounts of persons employed by the securities broker/dealer who would meet the other criteria of Rule 1.3(y), such as account executives, should be presumed to be proprietary accounts by the FCM. On the other hand, if the holding company of an FCM has a minority ownership interest in a company not involved in financial services, such as a car rental agency, an officer of the affiliated company who has no contact with the FCM other than his trading account could generally be treated as an ordinary customer by the FCM.

As the preceding discussion makes clear, the Division would tend to approach the account classification issue on a case-by-case basis. Since your letter does not set forth the facts of a specific case, it is difficult to respond with a definitive answer. We would certainly be willing to discuss any particular case in more detail if you wish to do so. We would prefer to treat the issues generally on an informal basis as we have done in the past, rather than under formal “no-action” requests. Of course, in particularly complex or novel fact situations, Division staff may request a written submission of the details.

We also wish to make two other points. One could argue that the bias always should be in favor of classifying an account as a customer account rather than as a proprietary account unless the account in question clearly comes within the proprietary account definition, and thus if there is no specific reference in that definition to accounts of officers and employees of affiliated companies they should be classified as customer accounts. However, in the Division's view such an approach would be inconsistent with the spirit if not the letter of the rule. Classification of any particular account as a customer account may be advantageous to the owners of that particular account, but it could also cause the benefits and protections afforded to other customers to be wrongfully diluted if there is a deficit in an account which is improperly classified as a customer account.

If the Exchange or an FCM is uncertain as to the proper classification of a particular trading account, we encourage the seeking of staff advice with respect to the specific factual question presented. A firm which is uncertain as to the proper account classification and determines to treat a particular person as an ordinary customer may have an obligation to disclose to that person that because of his relationship to the firm, his account may later be treated as a proprietary account rather than as a customer account and that significant benefits and protections may thereby be unavailable. The firm may further have an obligation to inform the person that in order to avoid that possibility and the loss of certain benefits and protections which accompany customer accounts, the person might want to consider having his account carried at another, completely unrelated firm.

We trust that you will find the foregoing discussion useful. Please note that the views expressed herein are those of the Division of Trading and Markets only and are not necessarily those of the Commission or of any other unit of the Commission's staff.

Footnotes

1 For purposes of Commission Rule 1.17 (17 C.F.R. §1.17 (1986)), the minimum financial requirements for futures commission merchants ("FCMs") and introducing brokers, such accounts would be classified as either noncustomer accounts or customer accounts, respectively. *See* Rule 1.17(b)(2), (3) and (4).

2 The Commission's definition of a proprietary account (17 C.F.R. §1.3(y) (1986)) provides in pertinent part that:

(y) Proprietary account. This term means a commodity futures or commodity option trading account carried on the books and records of an individual, a partnership, corporation or other type association (1) for one of the following persons, or (2) of which ten percent or more is owned by one of the following persons, or an aggregrate of ten percent or more of which is owed by more than one of the following persons:

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(vii) A business affiliate that directly or indirectly controls such individual, partnership, corporation or association.

(viii) A business affiliate that, directly or indirectly is controlled by or is under common control with, such individual, partnership, corporation or association.

3 The current definition of a proprietary account remains essentially unchanged from the definition promulgated originally in 1974, except for the addition of the ten percent or more ownership requirement set forth in paragraph (y)(2) of Rule 1.3. That amendment to the definition was adopted by the Commission in place of the original provision which stated that *any* partial or joint ownership of an account by a proprietary person as set forth in Rule 1.3(y) made such an account a proprietary account. 44 Fed. Reg. 29448 (May 21, 1979).

4 Both of these sets of rules were drafted principally by the Division and the Division is the unit of the Commission with primary supervisory authority over matters subject to these rules.