When is an FCM, CTA or Pool a Securities Broker-Dealer, an Investment Adviser or an Investment Company Under the Securities Laws?

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I. Introduction

Futures Commission Merchants ("FCMs"), Commodity Trading Advisers ("CTAs"), Commodity Pool Operators ("CPOs") and commodity pools frequently deal with securities incidental to futures and futures options activities ("futures activities"). Considerable uncertainty exists as to when these securities activities trigger registration as a broker-dealer, investment adviser or investment company. These uncertainties have increased dramatically in the last year, as electronic trading has caused future trading to move off the exchange "floor" to the upstairs offices. "Upstairs" traders desire to trade not only futures and options on futures, but options on securities and other securities products at the same time. Likewise, the advent of electronic communications and electronic execution facilities have caused retail investors to want access through a single firm having a platform for all financial products and services.

The Securities Exchange Act of 1934, as amended ("34 Act"),[3] requires a person effecting transactions for the account of others or dealing in securities to register with the Securities and Exchange Commission ("SEC") as a broker-dealer.[4] All states have similar laws.[5] The Investment Advisers Act of 1940, as amended ("Advisers Act"),[6] requires registration of persons providing advice regarding securities for compensation.[7] All but two states have similar laws.[8] The Investment Company Act, as amended ("40 Act"),[9] generally requires entities having pooled securities to register with the SEC.[10]

At the same time, the various securities statutes, rules promulgated pursuant to the statutes, no-action letters applying those statutes and rules and SEC and staff interpretations of those statutes and rules provide exemptions from the registration provisions for persons in the futures business engaging in activities that are incidental to their futures business. This paper discusses these exemptions and interpretations and provides an outline of various considerations for an FCM, CTA, CPO or commodity pool engaged in securities activities incidental to futures activities.

II. The SEC Broker-Dealer Registration Requirements

A. Broker-Dealer Registration Requirements in General

Section 15 of the 34 Act[11] requires the registration of brokers or dealers as defined in the Act.[12] A "municipal securities broker,"[13] or "dealer,"[14] and/or a "government securities broker"[15] or "dealer"[16] as defined in the Act, must also register.[17]

Section 3(a)(4) of the 34 Act defines the term "broker" as follows:

> The term 'broker' means any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank.[18]

Section 3(a)(5) of the 34 Act defines the term "dealer" as follows:

> The term 'dealer' means any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business.[19]

The terms "municipal securities broker," "municipal securities dealer," "government securities broker" and "government securities dealer" have the same elements as the definitions of "broker" and "dealer" except for the type of securities involved. Significantly, while banks are excluded from the general definition of "broker" or "dealer" and "government securities broker"

or "government securities dealer," they are not excluded from the definition of "municipal securities broker" or "municipal securities dealer."

The SEC staff and the courts have broadly interpreted the definitions of both "broker" and "dealer."[20] On the face of these definitions, most operations involving buying or selling of securities by an FCM, a commodity pool or a hedge fund bring the entity within the definition of "broker-dealer" for federal or state law. However, there are a few key exemptions important to the futures industry. Further, the SEC interpretations in no-action letters have also provided some commercial reasonableness to the broad scope of the words "broker" and "dealer" contained in the 34 Act definitions. State exemptions and interpretations tend to follow federal exemptions and interpretations, but are not uniform.

SEC Rule 15a-6[21] provides an important exemption from registration for United States broker-dealers that are FCMs and effect swap transactions for foreign affiliates with United States customers involving underlying securities. Swaps involving securities include swaps that are related to the value, principal, return, interest or otherwise related to a security or a security index. Under Rule 15a-6, broker-dealers acting as agents for foreign affiliates or foreign broker-dealers that write swaps involving securities may deal with United States customers. Swap transactions involving securities are invariably effected in private placements involving individually tailored swap contracts specifically designed to avoid registration under the Securities Act of 1933, as amended ("33 Act").[22] An FCM may not rely on the Rule 15a-6 exemption unless it is a broker-dealer, because the transactions in the United States have to be effected through a United States registered broker-dealer, even though the FCM may be a foreign bank, broker-dealer or other entity.[23]

Although the SEC has offered only a few actual interpretations dealing with exemption from the definition of "broker" or "dealer," it has issued numerous no-action letters, many of which are in apparent conflict. The SEC staff maintains that each no-action letter is a private interpretation intended for the specific use of the letter-writer, and only the recipient of a no-action letter may rely on it. The SEC Enforcement Division, however, frequently takes the somewhat contradictory position that a no-action letter puts the industry on notice of the state of

the law. Consequently, reliance on no-action letters is problematic.[24] Nevertheless, several principles run through most no-action letters that are recognized by the SEC staff in both the Division of Enforcement and the Division of Market Regulation.

1. Exemption from Definition of "Broker."

With respect to the definition of "broker", there are three important elements: first, there must be a security; second, there must be a person effecting a securities transaction for another person; and, third, the person effecting the transactions must be engaged in the business of effecting securities transactions. The SEC has interpreted "engaged in the business" to mean "regularly" engaged.[25] However, more than an occasional transaction, i.e., more than one a year, may trigger "regularly engaged in business."[26] Furthermore, the SEC has taken the position that holding oneself out to the public as a "broker" or "dealer" is "regularly" engaging in business. Thus, most types of solicitation would bring an agent effecting securities transactions within the definition of "regularly engaged."

One of the common activities that may require an FCM to register as a broker-dealer is the offering of interests in a commodity pool. If an FCM offers interests in a commodity pool to its customers, it is engaged in the business of acting as agent in the sale of a security, because all, or almost all, pool interests are securities. The interest must be registered or exempt from registration under the 33 Act,[27] the seller must register or be exempt from registration as a broker-dealer under the 34 Act, and the seller must satisfy the applicable state broker-dealer registration requirements for the states in which purchasers of the pool reside.

The sale of an interest, by the pool, itself, does not generally require broker-dealer registration, if the offering meets the criteria of the SEC's interpretive exemption for issuer sales.[28] By contrast, the sale of an interest by a commodity pool operator and its officers and employees is not covered by the issuer exemption, unless the commodity pool operator is the general partner or controls or is under common control with the pool.

Officers, partners or employees of a pool who sell interests in the pool are also subject to registration as broker-dealers, unless exempt under SEC Rule 3a4-1.[29] Rule 3a4-1 exempts from registration certain persons associated with an issuer, provided the person meets the provision of the Rule. SEC Rule 3a4-1 contains a number of preliminary eligibility requirements to its applicability: An associated person of an issuer must (a) not be subject to statutory disqualification; (b) not receive transaction-based compensation; and (c) not have been affiliated with a broker-dealer within the past 12 months. If the associated person meets these preliminary conditions, Rule 3a4-1 permits that associated person to make sales only to qualified institutions and certain intermediaries, in certain types of transactions exempt under Sections 3(a)(7), 3(a)(9) or 3(a)(10) of the 33 Act,[30] and in connection with certain sales pursuant to employee benefit plans. Of particular importance to a pool, an associated person may sell securities for a pool if the person performs substantial other duties for the pool and does not participate in the sale of securities of any issuer more than once every 12 months. The Rule also exempts certain administrative activities in processing sales for the issuer. Under this third alternative, oral communications with customers are not permitted.[31] This exemption is designed to permit processing of written inquiries from potential purchasers, primarily in connection with mutual fund activities.

2. Exemptions from Definition of "Dealer."

With respect to the definition of "dealer", the interpretations become even murkier. First, the transaction must involve securities; second, the person must be buying and selling securities; and third, it must be part of a business. The definition of "dealer" includes any person in the business of buying and selling securities for his own account, through a broker or otherwise. However, the definition does not include "a person insofar as he buys and sells securities for his own account not part of a business." Thus, the difference is the term "in the business." The SEC construes this definition, focusing on the term "business," using the criteria discussed above in connection with the term "broker." Regularity of activity and holding out are key elements. The SEC staff also seems to acquiesce in the position that, so long as an entity like a pool or hedge fund does not hold itself out to the public as a "broker" or "dealer" and

effects all of its transactions through a registered broker-dealer, it is not engaged in the regular business of buying and selling securities.[32]

The SEC staff also distinguishes between a "trader," who buys and sells for his own account, and a "dealer," by focusing on whether the entity holds itself out as a "dealer." This is a practical and probably sound interpretation, but flies in the face of the literal wording of the statute and regulations, because a pool or hedge fund is in the business of buying and selling securities. However, the no-action positions are ambiguous and contradictory regarding "holding out." The SEC has taken the position that advertising, promotion, designating oneself as a "dealer" are all included within the term holding out.[33]

In addition, other activities that involve solicitation such as posting both a bid and ask for a particular security in an inter-dealer quotation system would be included within the SEC staff's view of holding out or solicitation.[34] Yet, as discussed later in Section II. 3(b)(iv), use of the Cantor Fitzgerald, LP ("Cantor") system for trading government securities apparently does not constitute acting as a "dealer." Under the Cantor system, one may post a bid price to buy securities or an ask price to sell securities through Cantor, who, in turn, posts the bid or ask of another person. Absent other factors, a trader is not posting both a bid and ask at the same time and is not holding itself out as willing to both buy and sell and, therefore, is not a "dealer."

The SEC, in a no-action letter,[35] identified the following factors in determining whether a party is a "dealer":

1. Acting as an underwriter or participant in a selling group in any distribution of securities;

2. Carrying a dealer inventory in securities;

3. Quoting a market in any security;

4. Advertising or otherwise holding itself out to the public as a dealer, or as being willing to buy or sell any security on a continuous basis;

5. Rendering any investment advice;

6. Extending or arranging for the extension of credit on securities; and

7. Lending any securities.

It appears that any one of the first four numerated items would probably make one a "dealer." Items 5, 6 and 7 probably do not in and of themselves cause one to fall within the definition of "dealer." As noted above, it is the informal position of the SEC that, so long as a person's purchases and sales of securities are through a registered broker-dealer, dealer registration is not required provided that the person does not hold itself out as a broker-dealer. Importantly, the SEC staff has construed the term "dealer" so that proprietary securities trading activities of an FCM through a registered broker-dealer or purchasing and selling securities for investment by an FCM do not require registration, provided the person does not hold itself out to the public as a securities dealer.[36] However, as discussed above, an FCM that makes markets or offers securities to the public must register as a broker-dealer.

The SEC also has an administrative interpretation that the performance of administrative or ministerial functions in connection with the purchase or sale of a security does not make one a "broker" or "dealer"; however, this is a very limited exemption and the activities must be very minimal.[37]

B. Government Securities

1. In General. For an FCM dealing in United States government securities, the principal relief from registration is contained in SEC Rules 3a43-1 and 3a44-1,[38] which concern United States government securities transactions incidental to an FCM's futures activities. Though addressed to FCMs, these rules may provide some arguments for exemptions from registration for certain securities activity of pools and CTAs involving government securities. Rule 3a43-1 addresses customer related activities incidental to an FCM's futures business; Rule 3a44-1 concerns proprietary transactions in government securities incidental to the futures activities of an FCM. Each rule provides a series of exemptions for the day-to-day transactions of an FCM incidental to certain defined futures activities. Because the rule exemptions are relatively narrow, many FCMs have decided to register as broker-dealers to

avoid restrictions imposed by the rules. For those FCMs that are not registered as broker-dealers, however, the two rules should be kept well in mind.

2. SEC Rule 3a43-1 Provides an Exemption for FCM Customer Agency Transactions.

(a) General conditions. Rule 3a43-1 provides an express exemption only for registered FCMs. Nevertheless, the policies underlying the Rule 3a43-1 exemption arguably apply to certain incidental activities of pools or CTAs. However, the SEC, in adopting the rule, did not expressly include CTAs and pools within the exemption, creating considerable uncertainty as to whether the SEC was requiring registration of such entities for incidental activities or whether the SEC believed such activities did not require registration because of prior interpretations.[39]

Rule 3a43-1(b) contains two general conditions to qualification for the exemption. First, customer funds and securities associated with customer transactions must be kept in a regulated futures account, except where delivery is permitted through a delivery account. Regulated account is defined as a segregation account required by Section 4(d) of the Commodities Exchange Act ("CEA")[40] or under CFTC Rule 30.7.[41] Proprietary accounts (non-segregation accounts) subject to CFTC recordkeeping are deemed to be in a regulated account for purposes of the SEC rule, even though they are not regulated accounts under the CEA.

Second, FCM advertising must be directed only to futures activities and not to securities activities.[42] The FCM must not hold itself out as a broker in United States government or other securities. The SEC does permit limited statements, advertisements and promotional material that mention or describe the securities services provided by the FCM that are incidental to futures trading and the investment of excess customer funds. However, the emphasis in advertising and promotion must be directed at futures activities.

(b) Exempted transactions.

(i) Agency transactions. Agency transactions in United States government securities, in response to a customer's order, are exempt under Rule 3a43-1(b)(1). Riskless principal trades are considered agency transactions only if a commission or transaction fee is charged.[43] Agency transactions do not include other transactions executed from an FCM's inventory. An agency transaction also does not include a transaction involving a markup, but does include a transaction involving a commission or sales charge.

(ii) Delivery transactions. Rule 3a43-1(b)(1)(i) exempts agency transactions in government securities to effect delivery pursuant to a futures contract.

(iii) Arbitrage or risk reduction transactions. Rule 3a43a-1(b)(1)(ii) exempts transactions for risk reduction or arbitrage of existing or simultaneously created futures or options positions. If there is an existing futures position, United States government securities may be purchased or sold to hedge or arbitrage the position; if there is no existing futures position, the SEC interpretations require the simultaneous entry of a cash order and futures order. As long as the orders are entered simultaneously, the cash order may be executed prior to the futures order.[44]

(iv) Transactions involving U.S. Government Securities held as margin and excess customer funds. Rule 3a43-1(b)(2) permits transactions as agent for a customer for investment of margin and excess funds, provided that the transactions fall into one of three categories. The first of these possible exemptions is simply that the customer funds be invested in short-term securities, with a maturity of less than 93 days at the time of the transaction. The second safe harbor is accommodation transactions on an agency basis that generate no monetary profit to the FCM beyond the cost of executing the transactions. Under this standard, an incremental fee directly attributable to the cost of the service to the customer may be charged by an FCM. This, of course, creates the problem of maintaining records to reasonably prove the cost of the service.

For this reason, FCM's seldom rely on the second exemption. The third possible exemption is monetary, in that the gross income from government securities transactions, including transactional fees passed on to customers, must not exceed two percent of the FCM's total revenue. Gross income includes income received in connection with transactions exempt under 3a43-1(b)(2)(iii) of the Rule.

(v) EFP exemption. Paragraph (b)(3) of Rule 3a43-1 provides an exemption for exchange of futures for physical ("EFP") transactions involving customers, in which an FCM acts as either agent or principal in effecting an EFP involving United States government securities.

3. SEC Rule 3a44-1 Provides an Exemption for Principal Transactions by a Registered FCM and Certain Others.

(a) General requirement. Rule 3a44-1 may be relied upon by a registered FCM, floor broker, contract market or clearinghouse. It should be noted that to engage in proprietary futures transactions, an entity is not required to register as an FCM, however, an unregistered entity would not be able to avail itself of the proprietary trading transaction exemptions because Rule 3a44-1 is applicable only to a registered FCM, floor trader, contract market and affiliated clearing house. Rule 3a44-1 also is not applicable to a hedge fund that is not registered as an FCM and engages in futures proprietary trading that amounts to "dealing" in the sense of the "dealer" definition. However, as discussed above, registration is not required if the transactions are effected through a registered broker-dealer or bank and the fund does not hold itself out as a "dealer."

This rule also conditions its applicability on the requirement that the CFTC-regulated person not advertise or otherwise hold itself out as a "government securities dealer." This does not prohibit some advertising, indicating that the FCM engages in proprietary futures transactions involving government securities and, incidental thereto, effects delivery or other transactions involving United States government securities. The rule requires that transactions be effected through a bank or a regulated government

securities broker-dealer; otherwise, in the SEC's view, an FCM is engaged in the business of buying and selling securities and is required to register as a "dealer." The proprietary transactions incidental to futures or futures options activities exempted under Rule 3a44-1 parallel those for customer transactions in Rule 3a43-1.

(b) Exempted Transactions.

(i) Delivery transactions. Transactions in United States government securities to effect delivery pursuant to futures or options on futures positions are exempt under Rule 3a44-1(b)(1).

(ii) EFP transactions. Proprietary exchanges of United States government securities for futures in a qualified EFP transaction are exempt under Rule 3a44-1(b)(2).

(iii) Arbitrage and risk reduction transactions. Rule 3a44-1(b)(4) exempts risk reduction and arbitrage transactions executed in connection with futures activities, but only to the extent that the transactions are made with a registered government securities broker or dealer or with a CFTC-regulated person. If the futures position is already in place, there is no restriction on executing the United States government securities transaction against the position. To qualify for the exemption, a position may involve more futures than United States government securities, but not the other way around. SEC staff interpretation permits placing an order for United States governments to cover an existing futures position.[45] Placing proprietary orders simultaneously for the futures and cash side is permitted even if the futures side is executed after the cash side.

(iv) Transactions involving segregated funds. The proprietary exemption rule in Rule 3a44-1(b)(3) permits investment, including repurchase and reverse repurchase, transactions for segregation and 30.7 accounts. These transactions are exempt only if effected through a bank or a broker-dealer.

(v) FCM clearing firms matched book transactions involving repos and reverse repos. Rule 3a44-1(b)(5) contains a special exemption for FCM clearing firms engaged in proprietary matched book repurchase or reverse repurchase transactions with other regulated entities, such as floor traders. This permits a clearing FCM to effect a repurchase or reverse repurchase with a floor trader that it clears and to offset the transaction in a matched book transaction to a bank or securities broker-dealer.

(vi) Cash management. Significantly, the SEC did not include an exemption for cash management transactions in Rule 3a44-1. However, in its adopting release, the SEC explained that it did not believe that such an exemption was necessary so long as the government securities transactions were for cash management of an FCM's or other entity's own transactions.[46] The SEC stated that, "based on traditional interpretations the definition of 'dealer', the firm that invests its own capital through regulated government securities broker-dealers for cash management purposes may be acting as an investor and not 'engaged in the business' and therefore not a 'dealer'."[47] The SEC's reasoning should apply, by analogy, to pools or any other business and any other type of security.

4. Areas of Uncertainty

The trading of United States government securities by basis traders and other similar trading operations that involves both futures and government securities provides the area of greatest uncertainty for an FCM. In most cases, the FCM should qualify for the arbitrage or hedging proprietary exemption described above. However, if an FCM that is a basis trader engages in transactions where it posts both a bid and ask for United States government securities, the SEC has held that the FCM is, in most cases, acting as a "dealer," because it holds itself out as willing to both buy and sell securities as part of its business.

The SEC has issued several no-action positions involving United States government securities that make it relatively clear when an entity is a trader and when it is not a

"dealer." In United Savings Assoc. of Texas,[48] the SEC staff did not require registration of a savings and loan that engaged in government securities transactions, where the entity: (1) did not buy or sell as principal from or to customers or otherwise except through regulated government securities broker-dealers; (2) did not carry a dealer inventory; (3) did not quote a market; (4) did not hold itself out as a government securities dealer; and (5) did not run a book of repurchase or reverse purchase agreements or act as an interdealer broker. In another no-action position, Louis Dreyfus Corporation,[49] the SEC staff concluded that engaging in repurchase and reverse purchase transactions in order to finance government securities trading in connection with futures did not constitute a "dealer" transaction.

Thus, an entity effecting cash United States government securities transactions through a screen broker, such as the "Cantor" screen, would not require dealer registration, so long as the FCM did not show a bid and offer for the same security simultaneously on the broker's screen. Cantor is a broker-dealer and the entities placing bids or asked for particular securities are considered customers of Cantor. However, if the customer placed bids and offers for the same security simultaneously, the SEC would probably consider the FCM a "dealer" and require broker-dealer registration, even if the bid and offer were in connection with basis trading or other permitted transactions under Rule 3a44-1.

C. Municipal Securities

From time-to-time, an FCM may engage in municipal securities transactions. For example, an FCM may buy or sell municipal securities for investment of customer's funds held in segregation.[50] If these transactions are executed as cash management transactions in the ordinary course of the FCM's business, the SEC staff does not consider them to be "dealer" transactions.[51] Likewise, if the transactions are primarily for investment and the FCM does not hold itself out to the public as a municipal securities broker or dealer, or the FCM invests only for its own account through a registered broker-dealer or bank, the FCM should not fall within the definition of "dealer." On the other hand, if an FCM engages in agency transactions for customers involving municipal securities, the FCM may be acting as a "municipal securities broker."

D. Equities and Options

Since many of the most important futures products involve equity indices, customers often desire to use securities index products in connection with futures transactions. An FCM that engages in agency transactions in equities or options on securities for its customers is clearly acting as a broker-dealer and is subject to registration. The more difficult question arises when an FCM engages in equity or option proprietary transactions as part of a hedging or arbitraging strategy in connection with futures products based upon a securities index, such as the S&P 500 Index or similar futures products. Analogizing this to other SEC positions, if (i) the FCM does not hold itself out as being a securities or an options dealer, (ii) the FCM effects transactions through a registered broker-dealer, and (iii) the transactions are related to hedging or arbitraging a futures product, a strong case can be made that the FCM is not acting as a "dealer" based upon existing SEC staff interpretations. However, if the FCM is engaged as a securities market-maker or is otherwise engaged in placing bid and ask quotations in any securities inter-dealer quotation system, the SEC considers the FCM a "dealer," analogizing to the positions that it articulated in adopting rule 3a44-1.

E. Summary

As can be determined from above, there are a number of issues that arise regularly for an FCM that engages in futures and futures options transactions related to United States government securities. Rules 3a43-1 and 3a44-1 provide some relief for most day-to-day transactions; however, the Rules present compliance restrictions, which need to be constantly monitored. Fortunately, the SEC has been relatively pragmatic in its releases and no-action letters. Likewise, futures regulators, in auditing FCMs, have been practical and generally given firms the benefit of the doubt for transactions that are within the general ambit of the rule. Furthermore, futures self-regulatory organizations do not generally audit for compliance with the exemptions, and the SEC and securities self-regulatory organizations do not audit FCMs that are not broker-dealers.

III. Commodity Trading Adviser, Commodity Pool Operator and Investment Adviser Registration

The federal and state securities laws and interpretations severely limit what, if any, advice a CTA or CPO may give clients concerning securities transactions that are incidental to futures transactions, except in the case of United States government securities. A CTA or CPO is required to register as an "investment adviser" if it gives any advice for compensation with respect to any securities, other than United States government securities, unless the CTA or CPO is within the limited client exemption.

The Advisers Act requires registration of persons within the broad definition of the term "investment adviser," which is defined in Section 202(a) of the Advisers Act[52] as follows:

> "'Investment adviser' means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities; but does not include (A) a bank, or any bank holding company as defined in the Bank Holding Company Act of 1956, which is not an investment company; (B) any lawyer, accountant, engineer, or teacher whose performance of such services is solely incidental to the practice of his profession; (C) any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor; (D) the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation; (E) any person whose advice, analyses, or reports relate to no securities other than securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States, or securities issued or guaranteed by corporations in which the United States has a direct or indirect interest which shall have been designated by the Secretary of the Treasury, pursuant to Section 3(a)(12) of the Securities Exchange Act of 1934, as exempted securities for the purposes of that Act; or (F) such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order."[53]

Investment advisers with $25,000,000 or more in client assets under discretionary management may register with the SEC;[54] advisers with $30,000,000 or more in client assets under discretionary management must register. Advisers to investment companies, advisers

required to register in 30 or more states, certain consultants and nationally recognized statistical rating organizations may also be required to register with the SEC.[55] All other investment advisers must register under state law in each state where they have clients unless exempt under state law. There are other exemptions, most of which are not applicable in this context.[56] An adviser registered under state law does not have to register with the SEC until it has more than $30,000,000 or more of client assets under discretionary management.[57]

Although the definition of "investment adviser" is very broad, it excludes advisers with respect to United States government securities. Thus, a CTA or CPO that advises a client with respect to investing money in United States government securities in lieu of cash collateral at an FCM and advises as to particular issues or securities is not acting as an "investment adviser" because of the specific wording of Section 202(a)(11) excepting United States government securities advice. This same exemption applies to other United States government securities transactions that are incidental to futures, such as delivery, hedging, arbitraging, EFPs or other futures activities.

The SEC and the states have not adopted rules that exempt CTAs or CPOs with respect to offering advice relating to other securities transactions that are incidental to futures transactions. Recommendations by a CTA or CPO as to the investment of customer funds held as collateral at an FCM or arbitraging or hedging advice and similar activities relating to non-United States government securities are not covered by an exemption. However, it should be noted that a CTA or CPO rendering advise regarding foreign currency options traded on securities exchanges need not register as an investment advisers.

A CTA, under certain circumstances, may avoid registration under the limited client exemption of Section 203(b)(3) of the Advisers Act, which exempts from registration investment advisers who have fewer than fifteen clients and have not held themselves out generally to the public as investment advisers during the preceding twelve months. Under this limited client exemption, a CTA or CPO could not hold itself out as providing advice relating to these securities and not have more than 15 clients.[58]

Even if the CTA or CPO is rendering advice regarding futures transactions that are hedged or arbitraged with either securities options or equity or similar transactions, the SEC's position is clear that the CTA or CPO must register with the SEC as an investment adviser. There are no exemptions for a CTA or CPO advising about equity securities or securities index products that are used to hedge or arbitrage futures products. Likewise, a CTA that advises an institutional client regarding futures transactions and, in connection with that advice, advises the client on cash management activities involving non-United States government securities, such as corporate debt, is considered to be an investment adviser requiring registration under the Advisers Act.

One of the most significant factors in the SEC's determination as to whether a CTA or CPO is an "investment adviser" requiring registration is whether the CTA or CPO holds itself out as having expertise with respect to advising on securities. The SEC will generally require a CTA or CPO that holds itself out to the public as having expertise in securities transactions incidental to futures in its promotional materials (including internet advertising and websites) to register as an investment adviser, even if the CTA or CPO clearly states that the securities advice is incidental to futures transactions. However, see Part IV, infra, regarding a CTA that advises a pool that invests in a pool.

The issue of investment adviser registration also arises in connection with swap transactions. The SEC appears to have taken the position that any swap that has a securities component is subject to the securities laws and would be considered a security. In the BT Securities Corp. consent order,[59] the SEC stated that any derivative instrument necessarily involves a securities option, if it could be dismembered from an economic standpoint into a series of securities options, any one of which references principal, interest or value relating to a security or security index. Thus, if a CTA or CPO is advising a pool that uses swaps to hedge futures - particularly futures on United States governments or on securities indices - the SEC likely will take the position that the CTA is rendering advice with respect to securities, even though such activity is clearly incidental to the hedging or arbitrage or other activities related to futures products. Indeed, the United States government securities exemption found in Section

202(a)(11)(E) might not be applicable, because the underlying securities option would be considered a separate security.

Although states usually, but not always, follow the SEC's interpretation, each state's investment adviser law must be examined. The state laws are a serious concern because, in many cases, failure to register creates a rescission remedy.

IV. Commodity Pools and Regulations Under the 40 Act

Commodity pools engage from time to time in securities transactions that are incidental to their futures positions. This raises a series of questions, including whether the CTA or CPO, as discussed above, may be required to register as a broker-dealer. This securities activity also raises a question as to whether the pool, itself, is investing in securities in a manner requiring that the pool register as an investment company under the 40 Act. As discussed below, securities activities incidental to futures activities by a pool may result in the pool being included within the definition of an investment company.

The 40 Act defines an "investment company" as including an issuer, which holds itself out as being engaged primarily in the business of "investing, reinvesting or trading in securities."[60] Section 3(a)(1)(C) further defines an investment company to include an issuer engaged in the business of "investing, reinvesting, owning, holding or trading in securities" that owns investment securities that have a value over 40 percent of the value of the issuer's total assets.[61] For purposes of Section 3(a)(1)(C) total assets are exclusive of United States government securities and cash. Further, government securities are also excluded from the meaning of investment securities.

Notwithstanding the inclusive language of Section 3(a)(1)(C), Section 3(b)(1) of the 40 Act[62] excludes certain issuers from being deemed investment companies, provided that the issuer is "primarily engaged" in a business other than that of "investing, reinvesting, owning, holding or trading securities." The test under this Section of the 40 Act focuses upon a determination of

the "primary engagement" of an issuer. Exclusion under this "primary engagement" test provides the key exemption for most commodity pools.

The SEC staff has articulated the factors that they consider important in determining a pool's "primary engagement." The factors considered by the SEC as important are:

1. The issuer's historical development.
2. Its public representation of policy.
3. The activities of its officials.
4. The nature of its assets.
5. The sources of its income.[63]

In 1996, the Managed Futures Association received an important no-action letter from the SEC.[64] In that letter, the SEC staff articulated that, in order to be excluded from the definition of an investment company, a commodity pool may not hold itself out as being primarily engaged in the business of investing or reinvesting of trading in securities, and must be primarily engaged in the business of trading commodity interest. The staff set forth three criteria in determining whether a pool was primarily engaged in investing in commodity interests: (1) the pool must look primarily to commodity interests as its principal and intended source of gain; (2) the pool must anticipate that the commodity interests present the primary risk of loss; and, (3) the pool's historical development, public representations and activities must demonstrate that its primary business is investing or trading commodity interests rather than securities.[65] Most commodity pools should be able to meet this definition. Furthermore, the SEC in the Managed Futures Assoc. no-action letter permitted investment by a pool in other pools that met the three tests, even though the interest in the pools were securities. The SEC staff would look through the securities held by a pool constituting an investment in another commodity pool.

The Managed Futures Assoc. letter leaves open the question as to whether a CTA or pool operator must register as an investment adviser if the pool invests in another commodity pool whose interests are securities. Technically, it seems that the wording of the statute would require

the CTA to register, even if the pool is exempt as explained above. This would be an absurd result and, thus, the CTA should be within the rationale of the no-action letter and not be required to register as an investment adviser.

The 40 Act, Section 3(c)(1),[66] exempts a pool with fewer than 100 beneficial owners that is not offered to the public. The SEC has adopted rules regarding who is a beneficial owner for purposes of this exemption.[67]

Likewise, Section 3(c)(7),[68] recently added to the 40 Act, provides an exemption for "qualified purchasers," provided that the pool is not making a public offering of such securities. Although this section does not limit the number of "qualified purchasers," the definition of "qualified purchaser" in Section 51 of the 40 Act,[69] does contain substantial limitations. Under Section 51, a qualified purchaser must be one of the following:

1. A natural person with $5 million in investments, as defined;

2. A family company owning not less than $5 million in investments;

3. A trust as to which the trustee or person authorized to make decisions and each settler or other contributor, is a "qualified purchaser";

4. Any person, acting for its own account or the account of a qualified purchaser, who, in the aggregate owns and invests on a discretionary basis, not less than $25 million in investments; and

5. Certain qualified institutional investors, as defined in Rule 144A.

In the event that the pool does not fall within one of the exemptions because of the number of beneficial owners, the pool must then look to the definition of an "investment company" or the other exemptions of the 40 Act to determine whether the amount of securities activities in connection with futures or options on futures require registration.

As discussed above in connection with CTAs, a pool may, from time-to-time, use swaps or similar derivative products to hedge arbitrage futures contracts. The SEC maintains that any derivative contract that references a principal, interest, value, index or other component of a

security for valuation purposes, can be dismembered as a matter of economic options. Such dismemberment or disintegration, in the SEC's view, would cause the swap to be, in fact, an option on securities and a security for purposes of the federal securities laws. Such a contract would have to be included as a security in determining whether the pool fell within the definition of an investment company, as explained above. It is not completely clear how one would value such a contract for purposes of determining whether a pool was an investment company within the above-described definitions.

A pool may also have to review whether it is a broker-dealer. Conceivably, any pool or hedge fund could be a broker-dealer, as explained in Section II. Nonetheless, if a pool's transactions are for investment or trading, the pool effects its securities transactions through broker-dealers, carries its accounts at broker-dealers or a custodian, and the pool does not hold itself out to the public as being engaged in buying and selling securities, the pool probably falls outside the definition of "dealer" as discussed above in Section II. If a hedge fund engages in futures transactions in United States government securities or other securities transactions incidental thereto through an FCM whose transactions are exempt under Rule 3a43-1, it would be the authors' position that those transactions also do not make the pool or hedge fund a "dealer." Likewise, normal activities of a hedge fund trading through a network such as Cantor or effecting securities transactions, even on-line through another registered broker-dealer, should not require broker-dealer registration.

Another major consideration for a pool is that, in almost all cases, interests in a pool will be securities that may not be offered or sold unless registered or exempt under the 33 Act and in each state in which an investor resides. The securities of many pools are offered in private placements under the SEC exemptions of SEC Regulation D (Rules 501 to 505)[70] or under Section 4(2) of the 33 Act.[71] Most states have similar exemptions, but each state's law must be reviewed. Other exemptions exist, but usually are not of use to a commodity pool.

V. Conclusion

FCMs, CTAs and CPOs should not assume that securities activities incidental to their futures activities are exempt from the various provisions of federal and state securities laws. Many, but not all, incidental activities are not exempt. FCMs, CTAs and CPOs should periodically review their activities and maintain supervisory procedures to avoid securities activities that require registration. Alternatively, to avoid possible violations and to offer clients a full range of products, many firms may elect to register under the applicable securities laws.

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[3] 15 U.S.C. §78a et. seq.
[4] Id. §15.
[5] See e.g., Illinois Security Act of 1953, as amended, 815 ILCS 5/8 (Smith Hurd).
[6] 15 U.S.C. §80b-11 et. seq.
[7] Id. §80b-3.
[8] See e.g., Illinois Securities Act §8, 815 ILCS 5/8.
[9] 15 U.S.C. §80a-1 et. seq.
[10] Id. at §80a-8.
[11] 15 U.S.C. §78o.
[12] The Financial Services Modernization Act of 1999 ("FSMA"), Pub. L. No. 106-102, §201, signed by President Clinton on November 12, 1999, amends the 34 Act to include certain bank activities within the definition of "broker" and "dealer," thus subjecting them to registration requirements and regulation under the 34 Act. These changes, which do not materially affect the analysis contained in this article, are effective eighteen (18) months after the date of enactment. See FSMA at §209.
[13] The term "municipal securities broker" is defined in Section 3(a)(31) (15 U.S.C. §78c(a)(31)) as follows: "The term 'municipal securities broker' means a broker engaged in the business of effecting transactions in municipal securities for the account of others."
[14] The term "municipal securities dealer" is defined in Section 3(a)(30) (15 U.S.C. §78c(a)(30)) as follows: "The term 'municipal securities dealer' means any person (including a separately identifiable department or division of a bank) engaged in the business of buying and selling municipal securities for his own account, through a broker or otherwise, but does not include- (A) any person insofar as he buys or sells such securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business; or (B) a bank, unless the bank is engaged in the business of buying and selling municipal securities for its own account other than in a fiduciary capacity, through a broker or otherwise: Provided, however, That if the bank is engaged in such business through a separately identifiable department or division (as defined by the Municipal Securities Rulemaking Board in accordance with Section 15B(b)(2)(H) of this title), the department or division and not the bank itself shall be deemed to be the municipal securities dealer."
[15] The term "government securities broker" is defined in Section 3(a)(43) (15 U.S.C. §78c(a)(43)) as follows: "The term 'government securities broker' means any person regularly engaged in the business of effecting transactions in government securities for the account of others, but does not include-(A) any corporation the securities of which are government securities under subparagraph (B) or (C) of paragraph (42) of this subsection; or (B) any person registered with the Commodity Futures Trading Commission, any contract market designated by the Commodity Futures Trading Commission, such contract market's affiliated clearing organization, or any floor trader on such contract market, solely because such person effects transactions in government securities that the Commission, after consultation with the Commodity Futures Trading Commission, has determined by rule or order to be incidental to such person's futures-related business."
[16] The term "government securities dealer" is defined in Section 3(a)(44) (15 U.S.C. §78c(a)(44)) as follows: "The term 'government securities dealer' means any person engaged in the business of buying and selling government

securities for his own account, through a broker or otherwise, but does not include- (A) any person insofar as he buys or sells such securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business; (B) any corporation the securities of which are government securities under subparagraph (B) or (C) of paragraph (42) of this subsection; (C) any bank, unless the bank is engaged in the business of buying and selling government securities for its own account other than in a fiduciary capacity, through a broker or otherwise; or (D) any person registered with the Commodity Futures Trading Commission, any contract market designated by the Commodity Futures Trading Commission, such contract market's affiliated clearing organization, or any floor trader on such contract market, solely because such person effects transactions in government securities that the Commission, after consultation with the Commodity Futures Trading Commission, has determined by rule or order to be incidental to such person's futures-related business."

[17] 34 Act §15B&C, 15 U.S.C. §78oB&C.

[18] 34 Act §3(a)(4), 15 U.S.C. §78c(a)(4).

[19] 34 Act §3(a)(5), 15 U.S.C. §78c(a)(5).

[20] L. Loss & J. Seligman, VI Securities Regulation (hereinafter "Loss & Seligman") 2976 et seq. (Little Brown & Co. 3rd Ed. 1990); D. Lipton, 15 Securities Law (hereinafter "Lipton") "Broker-Dealer Regulation," §1.04 (Clark & Boardman 1999).

[21] 17 C.F.R. 240.15a-6.

[22] 15 U.S.C. §77(a) et. seq.

[23] Three of the SEC rule exemptions from broker-dealer registration, Rules 15a-2, 15a-4 and 15a-5 (17 C.F.R. 240.15a-2to5), are not relevant to most futures transactions. Rule 15a-2 concerns shares of cooperative apartment houses (17 C.F.R. 240.15a-2); Rule 15a-4 addresses the forty-five day exemption for persons formerly associated with a registered broker-dealer to wrap-up their affairs (17 C.F.R. 240a-4); and Rule 15a-5 involves transactions involving small business administration loans (17 C.F.R. 240.15a-5).

[24] Donna M. Vagy, Judicial Reliance on Regulatory Interpretations in SEC No-Action Letters; Current Problems and a Proposed Framework, 83 Cornell Law Review 921 (hereinafter "Vagy") (1998).

[25] Loss & Seligman, at 2980; See also Walter Musa, Jr., SEC No-Action Letter, [1976-77 Transfer Binder] Fed. Sec. L.Rep. (CCH) ¶80,973 (January 31, 1977) (regarding regularity of participation).

[26] Joseph McCully, SEC No-Action Letter, [1972-73 Transfer Binder] Fed. Sec. L.Rep. (CCH) ¶78,982 (September 1, 1972). See also for once a year Wainoco 73 Co., SEC No-Action Letter, (July 19, 1973).

[27] 33 Act §5,15 U.S.C. §77e.

[28] Securities Exchange Release No. 13195 (Jan. 21, 1997).

[29] 17 C.F.R. 240.3a4-1.

[30] 15 U.S.C. §§77c(a)(7), (9), (10).

[31] 17 C.F.R. 240.3a4-1(a)(4)(iii).

[32] Loss & Seligman at 2983.

[33] Vagy at 931.

[34] Thomas R. Vonbec, SEC No-Action Letter (available March 24, 1974); SEC v. Schmidt [1971-72 Transfer Binder] Fed. Sec. L.Rep. (CCH) ¶93,202 (S.D. N.Y. 1971); Joseph McCully, SEC No-Action Letter, [1972-1973 Transfer Binder] Fed. Sec. L.Rep. (CCH) ¶74,487, (September 1, 1972).

[35] Davenport Management, Inc., SEC No-Action Letter, [1993 Transfer Binder] Fed. Sec. L.Rep. (CCH) ¶76,643 (April 13, 1993).

[36] 34 Act Release 34-24726, 52 FR 27962 [1987 Transfer Binder] Fed. Sec. L.Rep. (CCH) ¶84,147 (July 22, 1987) (hereinafter, "Adoption Release").

[37] See e.g., Lipton, §1.04(3)(b)(iv).

[38] 17 C.F.R. 240.3a43-1; 17 C.F.R. 240.3a44-1.

[39] Adoption Release, supra.

[40] CEA §4(d), 17 U.S.C. §4(d).

[41] 17 C.F.R. 30.7.

[42] Adoption Release at 88,798.

[43] Id. at 88,790.

[44] Id. at 88,799 n.21.

[45] Id.

[46] Id. at 88,803-04

[47] Id. at 88,803.

[48] SEC No-Action Letter, 1987 WL 107923 (1987).

[49] In Louis Dreyfus Corporation, SEC No-Action Letter, [1987-88 Transfer Binder] Fed. Sec. L.Rep. (CCH) ¶78,526, 1987 WL 108160 (July 23, 1987).
[50] CFTC Rule 1.25, 17 CFR 1.25.
[51] Adoption Release at 88,803.
[52] 15 U.S.C. §80b-2(a)(11).
[53] Advisers Act §202(a)(11); 15 U.S.C. §80b-2(a)(11).
[54] Advisers Act §203A, 15 U.S.C. 80b-3(a)&(b); Rule 203A-1, 17 C.F.R. 275.203A-1.
[55] Rules 203A-1 to A-4, 17 C.F.R. 275.203A-1 to A-4.
[56] See Advisers Act §203, 15 U.S.C. §80b-3.
[57] Rule 203A-4, 17 C.F.R. 275.203A-4.
[58] 15 U.S.C. §80b-3(b)(3).
[59] In Re BT Securities Corp., 33 Act Release No. 33-7124, 58 SEC Docket 1145, 1994 WL 710743 (Dec 22, 1994).
[60] 15 U.S.C. §80a-3(a)(1)(A).
[61] 15 U.S.C. §80a-3(a)(1)(C).
[62] 15 U.S.C. §80a-3(b)(1).
[63] Investment Company Act Release No. 10,937 n24 (Nov. 13, 1979) (factors articulated in Tonoph Mining Company of Nevada, 26 SEC 426 (1947)).
[64] Managed Futures Assoc, SEC No-Action Letter, [1996-97 Transfer Binder] Fed. Sec. L.Rep. (CCH) ¶77,231, 1996 WL 422672 (July 15, 1996).
[65] Id., at 77,160.
[66] 15 U.S.C. §80a-3(c)(1).
[67] Rule 3c-1, 17 C.F.R. 270.3c-1.
[68] 15 U.S.C. §80a-3(c)(7).
[69] 15 U.S.C. §80a-2(a)(51).
[70] 17 C.F.R. 230.501 et. seq.
[71] 15 U.S.C. §77(d)(2).