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Who Is a Proprietary Trader 2004?

By John D. Ruark and Paul B. Uhlenhop

I. INTRODUCTION

A. The Changing Environment

When our article "Who Is a Proprietary Trader? A Changing and Rocky Landscape" was published in the *Futures & Derivatives Law Report* in November 2000, we noted increasing attention and focus on whether individuals described as "proprietary traders" were truly trading on behalf of a firm or were, in fact, customers trading under the guise of proprietary trader. Nearly four years later, regulatory guidance in this area remains inconsistent and continues to result in uncertainty and conflict regarding who is a true proprietary trader and for what purposes. The level of uncertainty has been increased by the regulatory approach that whether an individual trader is a true proprietary trader for the firm or is a customer trading for his own account is a facts-and-circumstance test. This regulatory "I-know-it-when-I-see-it" position raises the possibility that a proprietary trading agreement entered into in good faith could later be attacked as a sham by regulators.

Since November 2000, significant changes regarding who is a futures proprietary trader have occurred as futures exchanges have modified rules, interpretations and fee audit practices as to what is necessary for a proprietary trader to receive the lowest exchange fees. While the

(continued on page 3)

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In This Issue

Who Is a Proprietary Trader 2004?
By John D. Ruark and Paul B. Uhlenhop *1*
Regulatory guidance is uncertain and inconsistent when attempting to determine whether individuals described as "proprietary traders" are truly trading on behalf of a firm or are in fact customers trading under the guise of proprietary trader. In the past four years, futures exchanges have modified rules, interpretations and fee audit practices that have an effect on who will be treated as a futures proprietary trader. Also, securities regulators are now in the process of reviewing this area.

From the Editors
By Michael S. Sackheim and Richard A. Miller......*2*

Agency Settlements May Fuel Plaintiff Suits: In Re Natural Gas Commodity Litigation
By Athena Y. Velie..*15*
Defendants, Beware! Plaintiffs are likely to use any settlement you enter into with the CFTC, the FERC, or other federal agencies, even if you neither admit nor deny the agency's allegations or "findings" against you, in subsequent civil litigation. An overview of the recent District Court decision in the *Natural Gas Commodity Litigation* class action.

. . . Proprietary Trader 2004?

(continued from page 1)

securities regulation has been relatively static in comparison to changes by futures regulators, we understand that securities regulators are in the process of reviewing this area.

B. Reasons Why Proprietary Trading Has Grown

On the securities side, the proprietary account issue first came to the forefront due to perceived abuses of Regulation T margin requirements through proprietary trading arrangements, particularly by certain BDs that might be described as day-trading firms. On the futures side, it became an issue primarily due to exchange fees, as will be discussed below. The issue itself came about due to the rapid increase in proprietary trading that began in the mid-1990s, which was fueled in part by the uncertainty that came to traditional open-outcry exchanges in both the securities and futures industries at that time. Many floor members and traders either left the exchange floor entirely or began trading upstairs electronically. Naturally enough, these professional traders wanted to receive the same favorable margin treatment when trading off the floor that they always had received as floor members. Also driving this change was the increased attention that clearing firms focused on proprietary trading. Clearing firms that had previously cleared floor traders realized that, in a time of rapidly shrinking commission rates, they could make a good deal more money by engaging in proprietary trading operations.

[S]ignificant changes regarding who is a futures proprietary trader have occurred as futures exchanges have modified rules, interpretations and fee audit practices as to what is necessary for a proprietary trader to receive the lowest exchange fees.

While this entailed accepting the potential downside of unprofitable trading, many firms felt they were already bearing this risk since, under exchange rules, the clearing firm has the ultimate responsibility if a trader goes bust, whether the trader is a proprietary trader or a customer. For traders, giving up a percentage of profits may be worthwhile because the firm bears the risk of catastrophic loss and can also provide facilities, risk management and a variety of other services to proprietary traders at a lower cost than the traders would be able to obtain if trading as individuals. Furthermore, a proprietary trader may be subject to much different requirements regarding margin, capital and exchange fees than a customer. Importantly, as characteristics of certain securities products and futures products have converged, individual traders desiring to be able to trade arbitrages between such securities and futures have found that such strategies almost impossible to execute as an individual customer due to margin and capital requirements. For all these reasons, the number of firms engaging in proprietary trading (and the volume traded by such firms) has grown dramatically in the last decade.

C. Proprietary Trading Costs Are Lower: Proprietary Haircuts Are Less Than Customer Margins

Whether a trader is categorized as a customer or as a proprietary trader trading on behalf of a broker-dealer ("BD") or a futures commission merchant ("FCM") makes a significant difference in the cost of trading. For positions of a true proprietary trader of a BD or a FCM, the firm itself, if it is a clearing firm, has no securities margin requirements under Regulation T[1] or under SRO margin requirements.[2] While a BD must take deductions from its regulatory capital for the positions of its proprietary traders, these charges against regulatory capital (called haircuts) are significantly less than margin requirements. Thus, trading in a BD's proprietary account may be effected with the employment of significantly less capital than the equivalent amount of trading would require in a customer account. By way of comparison, haircuts for listed securities are 15%, while the Regulation T margin requirement is 50%.

Furthermore, in many cases the haircuts for a hedged position in a proprietary account are even lower. Contrast this to the treatment of hedged positions in a customer account where, in most cases, the hedged position or covered position is not recognized for margin purposes. For example, in a customer account, the 30-year U.S. Government Bond carries a margin requirement of 6% of the market value of the particular position, even if the position is hedged with a short futures contract for which the bond is a deliverable security. If a customer were to buy $1.0 million of cash 30-year bonds and to sell futures against the cash position, it would require $60,000 in securities margin, in addition to approximately $20,000 in futures margin. (Futures margin on the 30-year bond futures is typically about $2,000 per contract.) Thus, a customer must have $80,000 to support such a position, even though the market risk for such a position is far less. However, for a proprietary account, the haircut for such a hedged position is zero. Furthermore, for futures exchange-member firms, proprietary trading will generally receive member rates on exchange and clearing fees, which would not be available for customers.

II. SECURITIES ISSUES

A. The Day-Trading Phenomenon

In the mid to late 1990s, when Internet-based brokerage began, a number of brokerage firms noticed that many traders would trade in and out of their position on the same

day. Further noticing that style of trading was very profitable to the broker, the firms began to provide facilities at the firm so that such traders could trade full time. In addition to commissions, such firms charged fees for data feeds, research and sometimes for rent. A number of firms advertised to recruit day-traders by offering training courses in day-trading.

B. Day-Trading Firms and "Proprietary Accounts"

Certain firms were less than candid with respect to the risk of day-trading and its profitability. Some day-traders were recruited from the ranks of retired individuals who had little to occupy their time during the day and were looking for an additional source of income. Day-trading was permitted with deposits of $10,000 or less in some cases. Nevertheless, day-trading as a customer was limited by Regulation T margin requirements[3] and, simply put, a trader with only $10,000 in capital, limited to Regulation T's 2-to-1 leverage, just couldn't trade that many shares. Certain firms argued that Regulation T did not apply when positions were opened and cleared on the same day. While the NASD revised Rule 2520 in 2001 in regards to day trading, it made clear that, at most, a customer would be permitted 4-to-1 leverage for day trading of securities.

To permit greater leveraging of these accounts, a number of firms determined to attempt to make "proprietary traders" out of individual day-trading customers. First, the broker-dealer would enter into a joint back office ("JBO") arrangement with its clearing firm (see below for more on this). Then, the individual would become an "owner" of the broker-dealer, usually a limited liability company ("LLC"), by contributing capital in the amount of $25,000, $50,000 or $100,000 for a Class B LLC interest.[4] The trader's LLC capital account would then, in effect, become his trading account, with trading permitted based upon the amount of capital contributed. Trading in the account would be subject to all of the usual brokerage charges of the firm—commissions, research and other in the same manner as if the trader was a customer albeit at a lower rate than would be charged to an ordinary customer. All profits and losses from trading would be credited or charged, as applicable to the Trader's Class B capital account. To the extent the trading was profitable, the individual trader could withdraw profits subject to certain holdbacks. In some cases, the Class B holder would not be liable for the other liabilities of the firm unless all of the Class A capital was eliminated by reason of losses. Generally, the LLC operating agreement would provide that the Class B member could redeem his capital account interest on demand or, alternatively, would provide that redemption of the interest could be requested and the firm could, at its discretion, pay out the redemption price. In practice, however, the firm would always pay out. This practice of paying out on demand has been reduced due to an SEC Market Regulation letter which stated, in the context of day trading firms, that equity contributions which remained in the firm for less than one year could not be considered as good regulatory capital. However, if the firm was willing to forego using the capital contributions for regulatory capital, payouts could occur upon demand, even less than one year following contribution.

By making the individual trader into a "proprietary trader," the trader no longer had Regulation T margin requirements, assuming the BD was a clearing firm or a JBO participant. Of course, the firm would have a capital haircut requirement on the trader's positions. Trading would be permitted up to the amount of the capital contributed by the Class B member. If the trader used additional firm capital beyond that amount, interest on the additional capital would be charged. For example, if the trader had contributed $50,000 in capital, the trader would be able to put on positions equivalent to approximately $333,000. (Remember, the firm has to take a 15% haircut against the proprietary position. Fifteen percent of $333,000 is approximately $50,000.)

C. Additional Regulatory Requirements

In 1998, the NASD began requiring that proprietary traders of member firms that traded equity securities must pass the Series 7 and Series 55 qualification exams. At that time, if the broker-dealer was a non-NASD member, but was a member of the Chicago Stock Exchange, Inc. (CHX), the Philadelphia Stock Exchange (PHLX), the Pacific Stock Exchange (PCX), or the Chicago Board Options Exchange, Inc. (CBOE), no such examinations were required. However, CHX, PHLX and PCX all now require proprietary traders of a member firm to have passed the Series 7. The CBOE resisted the move to requiring proprietary traders to pass exams.

D. Do the Interests Purchased Qualify as Securities?

One interesting sidelight in the creation of proprietary traders has arisen regarding the treatment of the interests purchased. Are such interests securities? Sometimes, firms would argue that the Class B interests were not securities, arguing that the trader only made profits or losses from his own trading. Therefore, applying the *Howey*[5] test, the Class B interest in the LLC did not involve the efforts of others and thus would not be considered a security. Having decided that the interest was not a security, the firm would not prepare offering documents or other disclosures in compliance with the private offering exemptions of the Securities Act of 1933, as amended ("1933 Act"). Notwithstanding the above arguments, it is likely that a court would find such an interest in an LLC to be a security, due both to the possibility of sharing in losses from the firm as a whole and to the structure of the charges applied to trading in the

account. Furthermore, SEC and state securities commission staffs appear to almost unanimously consider LLC interests to be securities unless the business of the LLC is conducted as a true general partnership, *i.e.*, all investors share not just profits and losses but also management responsibility.[6] Finally, there is a logical contradiction in arguing that the interests are not securities. If the interest isn't a security, then it probably isn't an investment or contribution to the capital of the LLC. If it isn't a contribution to capital, then it must be a customer account. However, the United States Circuit Court of Appeals for the Fourth Circuit recently held that an LLC interest was not a security and not an investment contract because the investor was an active participant in the business.[7]

E. Joint Back Office Arrangements

Under Regulation T section 220.9(c),[8] a broker-dealer may operate as a member of a clearing group pursuant to a JBO arrangement and thereby avoid margin requirements on its proprietary transactions. JBO arrangements were originally intended to permit a group of broker-dealers to set up a single, jointly owned clearing firm that would reduce the cost of clearing through economies of scale. The Federal Reserve Board granted special relief for these arrangements in Regulation T so that the firms in such a group would have the same relief from Regulation T on their proprietary positions cleared by the JBO clearing firm as a self-clearing firm.[9] All of the broker-dealer owners of the JBO clearing broker-dealer are considered as a single firm for credit purposes under regulations. However, under the SEC net capital rule, the clearing firm is required to take haircuts against its proprietary positions in excess of the participating firm's equity.[10]

In the early 1990s, JBO arrangements became more common. As it became common for the "ownership" requirement to be satisfied with a relatively small purchase of preferred stock, regulators became concerned with capital issues with the clearing broker-dealer. As a result of their concerns, the SROs amended their margin rules with respect to joint back office requirements.[11] Currently, a JBO clearing firm itself must have $25,000,000 in tentative net capital unless its primary business is clearing options market makers. Any owner broker-dealer participating in the JBO clearing firm must have minimum equity in its account at the JBO clearing firm of no less than $1,000,000.

Some day-trading firms became JBO participants by buying a limited interest in a JBO clearing firm. In an additional twist, certain firms attempted to stretch JBO arrangements even further by having groups of traders form an LLC and then having the LLC become a Class B interest holder in the JBO owner broker-dealer. This presents all of the problems discussed above but with an additional problem regarding whether the LLC should be treated as a "proprietary trader" of the owner BD or a "customer" of the owner BD.

Such an LLC, trading through a JBO owner broker-dealer, would itself be a broker-dealer because it is engaged in buying and selling securities. Such an arrangement is not eligible for the JBO owner broker-dealer capital treatment. Further, it would have to maintain regulatory capital as a proprietary trading BD and have its positions margined as a customer.

F. Capital Contributions

The SEC and securities SROs have taken the position that contributions to equity capital are not good regulatory capital if such contributions are transitory or withdrawn less than a year after contribution. For example, an NASD Regulatory & Compliance Alert stated as follows:

> The SEC has repeatedly emphasized that capital contributions to a broker/dealer must not be temporary. The SEC has stated that an infusion of capital into a broker/dealer and subsequent withdrawal within one year of the infusion would be viewed as a loan and considered a liability of the broker/dealer from the time the infusion was received. In addition, if a capital contribution is made with an understanding that the contribution can be withdrawn at the option of the investor, the contribution may not be included in the firm's net capital computation and must be characterized as a liability from the date of infusion. *Any withdrawal of capital by an investor within one year*, other than a withdrawal described in paragraph (e)(4)(iii) of Rule 15c3-1, *is presumed to have been a loan*, and not a capital contribution, and must be treated as such on the books of the broker/dealer.[12] (emphasis added).

G. Evolving Positions of Securities Regulators

The SEC has been unusually quiet regarding whether certain of the arrangements described above might, in fact, be customer accounts. The SEC has stated that the classification of an account as proprietary or customer depends on all relevant facts and circumstances. However, the SEC has never issued a definitive release in this area. Rather, the law of this area consists of SEC staff positions, many of which are not published at all, and self-regulatory organization ("SRO") enforcement proceedings, the details of which are not published. Further, the NASD generally has not objected to the Class B LLC trading arrangements discussed above as part of a broker-dealer's initial membership reviews or during periodic reviews. Likewise, the SEC does not seem to be raising objections to a Class B LLC interest holder acting as a proprietary trader. Neither the SEC nor the NASD appear to be currently contending that these arrangements create a customer relationship as long as the

trader is appropriately licensed. Even so, guidelines and safe harbors in this area are murky. There are, however, certain SEC and SRO rules or positions that have been promulgated that are relevant.

H. SEC Interpretations

In 1999, when Congress became interested in day-trading as the stock market surged, Arthur Levitt, then Chairman of the SEC, testified before a Senate Committee as follows:

> Other day-trading firms choose to organize as entities such as limited liability companies ("LLCs"), which sell interests in the firm to individuals wishing to day trade. These firms are registered as broker-dealers, but because individuals who day trade at these firms are part owners of the day-trading firms, they are not considered "customers." Instead, these individuals are "associated persons" of the firm. The day-trading firm allows these individuals to trade using a portion of the firm's capital often an amount tied to the amount of each individual's capital contribution.
>
> Second, as discussed further below, day traders who trade a firm's capital can lawfully use leverage significantly beyond the levels permitted by the customer margin requirements promulgated by the Board of Governors of the Federal Reserve System ("Federal Reserve") and the SROs.[13]

Interestingly, Chairman Levitt's discussion of day trading firms structured under the Class B LLC model provided no overt criticism of these structures. It appears from Chairman Levitt's statement and the seeming acceptance of Class B LLC arrangements by the NASD and the SEC that the capital contribution is deemed not to conflict with the joint account interpretations described below. Most likely, this is because the capital in a Class B LLC relationship is required to be maintained for one year and, unlike a joint account, may not be withdrawn at will or on short notice. However, an old SEC staff capital rule interpretation regarding the treatment of a joint account states:

> A broker-dealer is required to include as a proprietary commitment its portion of a joint account in which it is a participant, whether or not it carries the account.
>
> In the event the broker-dealer is carrying the entire joint account, the other participants are to be considered as "non-customers" or "customers" as appropriate, since they are dealing for their own accounts. In the event such an account is in deficit, in effect it is to be considered as a proprietary account in the computation of net capital. If there is an equity in the account, the other participants' portion must be sufficient to meet the margin requirements of the designated examining authority. If not, the deficiency is charged pursuant to paragraph (c)(2)(xii).[14]

In essence, this states that where there is a contribution of capital by an individual to a joint account with a broker-dealer and the profits and losses are split between the broker-dealer and the individual trader, the arrangement may be a "joint account," unless the trader is a broker-dealer (such as an exchange-member market maker) or has a position at the broker-dealer such that the trader would be deemed to be a "non-customer." Under the interpretation, an individual trader's part of the account would be treated as a customer account requiring margin. As noted above, the SEC and NASD seem to distinguish this interpretation from a Class B LLC-type arrangement where capital must be maintained for one year and may not be withdrawn at will and the trader is a registered representative of the firm. In the event that both participants are broker-dealers, then both participants would be subject to the capital rules unless the transactions involve exempt floor transactions under the capital rule.[15]

The SEC has stated that the classification of an account as proprietary or customer depends on all relevant facts and circumstances.

Importantly, the joint account position should be distinguished from situations where owners of the firm contribute capital to the firm *and* participate in the firm's profits and losses as a whole, even though they are active traders for the broker-dealer. It is this participation in the profits and losses of the firm as a whole or a part of the firm which would make a telling difference. This seems to have been adopted by the Federal Reserve Board (see discussion below) and, consequently, it appears that when an individual trader participates in a part of the firm's overall trading profits and losses beyond his own trading results, then that trader almost always should be considered a true proprietary trader.

If capital is contributed in the form of an approved subordinated loan or secured demand note, the SROs appear to consider such to be a *bona fide* capital contribution because it has a minimum term of one year and can be repaid earlier only with the approval of the broker-dealer's designated examining authority. But what happens if capital contributed as a Class B LLC interest cannot be withdrawn or redeemed for a period of at least one year? If the Class B LLC interest represents permanent capital of a broker-dealer, even if the LLC trades the capital for his own account, then the account appears to be a proprietary account of the broker-dealer. At a minimum, this lock up of capital is a "good fact" in the facts-and-circumstances tests of whether such an account is a true proprietary account.

I. SRO Margin Rules and Interpretations

The New York Stock Exchange and the NASDR have margin rules that are almost exactly identical and are

designed to be read and interpreted in tandem.[16] The New York Stock Exchange has interpreted its Rule 431, dealing with joint and proprietary accounts, as follows:

> *(3) Joint Accounts in which the Carrying Organization or a Partner or Stockholder Therein has an Interest*
>
> In the case of a joint account carried by a member organization, in which such organization, or any partner, member, allied member or any stockholder (other than a holder of freely transferable stock only) of such member organization participates with others, each participant other than the carrying member organization shall maintain an equity with respect to such interest pursuant to the margin provisions of the Rule as if such interest were in a separate account.
>
> The Exchange will consider requests for exemption from the provisions of this sub-section (e)(3), provided... [17]
>
> *Employee Participation*
>
> *(a) Sharing in Profits*
>
> If any employee as part of his compensation is participating in only the profits in a firm account, such an account would be deemed a proprietary account. The Exchange has no objection to such arrangements, provided the employee's participation is recorded as a salary or bonus incentive or in another similar manner. Exchange permission is not required for such arrangements.
>
> *(b) Sharing in Losses*
>
> The Exchange does not prohibit an employee from sharing in the losses of firm accounts. However, it should be understood that in such instances the member organization is extending or maintaining credit on the employee's behalf. Thus, such an account would represent a "joint venture" between the employee and the member organization. These accounts, as well as general partners' personal accounts, are customer accounts and must be properly margined in their entirety by the respective participant in proportion to their interest.[18]

It should be noted that these same provisions are not included in other SRO rules, such as the PCX, the CBOE or PHLX. This interpretation may be reconciled with then Chairman Levitt's comments in 1999. On the surface, this interpretation might seem to weaken the idea that Chairman Levitt's comments in 1999 represented tacit approval of the Class B LLC model for day trading firms. However, this interpretation from the New York Stock Exchange guide can be reconciled with a Class B LLC model if the capital contribution is not withdrawable at will and must be maintained as part of the firm's capital because then the profits and losses would result from use of the *firm's* capital. Further, under the above interpretation the employee may not be responsible for losses at the termination of the relationship.

J. The Regulation T Test

In light of the fact that obtaining relief from Regulation T restrictions on leverage is one of the primary driving forces behind proprietary trading in securities, the Federal Reserve Board has maintained an unusually low profile in this area. However, in 2001, the staff of the Federal Reserve Board took the position that a Class B LLC interest would not constitute a customer trading account under a facts-and-circumstances test where:

1. The B class shares in the portion of the profits and costs of all of the firm's short-term trading accounts;
2. There is no relationship between the amount of capital contributed by the B member and the size of the trading account that the B member trades;
3. B members are not liable for losses except that their capital is at risk for the firm as a whole;
4. Members would not be required to contribute additional money to the firm or incur additional liabilities based on losses incurred by the member.
5. Quarterly distributions be made as determined by various formulas, including determination of the net gain attributable to the trading activities of the individual member, the net profits of the short-term trading business of the firm as a whole.
6. If the firm as a whole is profitable, the member may receive a distribution even if there are no net gains attributable to the trading activities of that member.
7. If the firm as a whole is not profitable, the trader may still receive a distribution if the member has net gains attributable to his or her activities.

Under these circumstances described above, the staff of the Federal Reserve Board concluded that he account would not be treated as a customer account for purposes of Regulation T,[19] which would tend to indicate that the Federal Reserve Board does not consider the Class B LLC trading model to be a customer account. Because of the close working relationship between the Federal Reserve Board staff and the staff of the SEC, it is likely that the SEC staff was consulted and concurred in this Federal Reserve Board interpretation.

While the staff of the Federal Reserve Board has several other earlier opinions stating that the determination of whether a trading account is a proprietary trading account or a customer account or a joint account is a facts-and-circumstance test regarding the relationship between the firm and the trader,[20] no further interpretations on this subject have been issued since 2001.

K. FASB 150 Statement

In May 2003, the Financial Accounting Standards Board ("FASB") released Statement No. 150—Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity (the "Statement").[21] Under the FASB Statement, any liabilities or contractual obligations to redeem an equity interest create a liability. This could have a significant impact on broker-dealer's capital. For example, in the Class B LLC model, if the Class B LLC interest must be redeemed if the trader dies or ceases to trade, the interest must be treated as a liability as opposed to a contribution to capital. The SEC has provided a one year tolling period for broker-dealers from the net capital rule as a result of the treatment set forth in the FASB Statement provided notice was sent to the firm's designated examining authority prior to May 10, 2004. Whether this will be extended by the SEC remains to be seen.

[B]oth SROs appear to have taken the position that, if the trader is potentially responsible for a debit or a percentage of a debit in the trading account, then no true proprietary trading arrangement exists and the trading account must be treated as a customer account.

The accounting treatment mandated by the Statement severely impacts the Class B LLC model. Firms will be required, if they wish to use the Class B LLC capital for regulatory capital, to provide that redemption of the Class B interest may not be mandatory upon the trader's death or termination even after a one year period. A Class B LLC interest might be structured to give the firm a right of first refusal or the firm may have a call on any of the Class B LLC interest or the trader may be able to put the interest back to the firm. While these arrangements appear to be acceptable to the SEC and FASB for the time being, it is likely that there will be further developments in this area. However, this may not be acceptable to the SEC or FASB.

L. What Do SRO Interpretations Really Mean?

On the face of the NYSE interpretation of Rule 431(e)(3) discussed above, it appears that a trader could not participate in any loss without being a customer. However, that is not the practice in the industry nor is it the position of the SEC. Proprietary traders are compensated on a percentage of the net profit on all trades, not by cherry-picking winners. No one believes that the above interpretation says that a trader may receive a percentage solely of winning trades and not participate in losing trades. In fact, trades with gains are netted against trades with losses, and the trader is paid based on a percentage of the net profits from trading. Neither the New York Stock Exchange nor the NASD prohibits such participation.

However, both SROs appear to have taken the position that, if the trader is potentially responsible for a debit or a percentage of a debit in the trading account, then no true proprietary trading arrangement exists and the trading account must be treated as a customer account. For example, imagine a situation where the trader trades the account into a debit and then terminates the arrangement. If the trading agreement between the firm and trader permitted the firm to go after the trader for all or part of the debit, then the NYSE and NASD would say that this was *not* a proprietary account. Rather, they would see it as a joint account, with the trader's percentage of the account to be treated as a customer account and margined as such.

A strong indicator that an account is a proprietary account occurs when the BD provides all trading capital.

Many proprietary trading agreements provide that the firm will hold back a percentage of profits as a reserve. Because such reserve accounts represent earlier net profits, offsetting later losses against the reserve is not considered to cause the trader to be responsible for account losses for securities regulatory purposes. Furthermore, draws of cash or securities from a proprietary account should be permitted. The withdrawals should be permitted to be offset against net profits in the account at the time of the withdrawal or in the future. Likewise, some trading agreements provide that, upon termination, the proprietary trader must repay to the firm the amount of any negative balance in the trading account caused by withdrawals or losses, but only to the extent that the trader's percentage of net profits has been withdrawn from the firm so that his allocated percentage of losses versus profits is no more than zero. In other words, the trader is not liable for losses *except* to the extent that the trader has received (or been credited with) previous net profits in the account. It is the authors' understanding that the SEC concurs that potential liability up to the amount of the trader's share of cumulative net profits would not undermine the characterization of an account as proprietary.

Other variations in trading agreements include providing that the proprietary traders must indemnify the firm from any losses resulting from the trader's violation of the firm's trading parameters, the law, rules thereunder or SRO rules. The indemnification may be offset against a reserve account from a percentage of accumulated profits. Is an initial deposit permissible? An initial deposit for the indemnification may be permissible on the securities side but would probably cause the account to be ineligible for the lowest futures exchange fee rates.[22]

M. Hallmarks of Proprietary Accounts Versus Customer Accounts

It was noted above that the categorization of accounts as customer or proprietary is a "facts-and-circumstances" test. In view of this, what follows is a list of some of the characteristics normally associated with different types of accounts.

1. *Presumptive Customer Account*

If the individual trader (i) contributes capital, which may be *withdrawn at will*, which the trader trades; and (ii) the trader is credited 100% of the profits and losses from such trading, then the account is presumed to be an account for the benefit of the individual trader and is a customer account. Any type of contribution of capital—such as Class B interest in a limited liability company—probably would be considered, under these circumstances, a presumptive customer account. This analysis is probably unchanged even if there is a remote possibility that the trader might lose all or a portion of his capital contribution if the broker-dealer lost significant capital. However, if the individual trader (i) contributes capital, (ii) participates in part of the *overall* profits and losses of the broker-dealer, (iii) the capital account may not be withdrawn at will; and (iv) the trader is appropriately registered, then the above analysis would most likely be considered a proprietary account. Likewise, if the capital is contributed in the form of approved subordinated loan or secured demand note, it should not create a presumptive customer account because approved subordinated loans and secured demand notes have a minimum term of one year. The status of a Class B LLC interest that may not be redeemed for more than one year has become clearer over the years. It is unclear as to what effect holding a Series 7 (or Series 7 and Series 55 for NASD member firms) securities registration by the trader would have in determining the status of the account. While it appears that the SROs in examining broker-dealers generally are giving a significant weight to the fact that the individual has a Series 7 in determining whether the trading account is proprietary or customer, it is unlikely that merely having the proper registration would be dispositive in all instances.

2. *Joint Accounts*

As explained above, a joint account between a broker-dealer and a non-broker-dealer is treated as part proprietary account and part customer account. Is a Class B LLC account where the trader receives 100% of the profits and losses of his trading a joint account? If the answer is yes, then customer margining would be required on the customer part of the account and any deficit treated as a capital deduction to the broker-dealer. Here, the unanswered question is this: if this arrangement does create a joint account, why didn't then-Chairman Levitt say so in his September 1999 testimony?[23] His testimony presented an ideal opportunity to criticize these structures, and categorizing joint accounts as proprietary accounts, creating the potential for violation of margin requirements, would seem to be ripe for criticism. But Chairman Levitt did not do so in 1999. Further, the NASD, SEC and Federal Reserve Board appear to recognize Class B LLC interests and to treat them as proprietary accounts for the reasons described above. However, the trader must be registered appropriately and the Class B LLC contribution may not be withdrawn at will for at least one year. It would be advisable for the trader contributing capital to share in some part of the overall profits of the firm or a discrete part of the firm. In any event, under the NASD rules, the creation of a Class B LLC program would be deemed to represent a change in business and requires submission to the NASD for approval. NASD approval or failure to object to this Class B LLC model should provide some comfort. More importantly, the practice of the SEC, the NASD, the Federal Reserve Board and Chairman Levitt's remarks are important factors is constructing a Class B LLC relationship with a trader as a proprietary relationship provided certain other requirements are met.

3. *Proprietary Account*

A strong indicator that an account is a proprietary account occurs when the BD provides all trading capital. Yet, this does not mean that contribution of capital by the trader means that the account cannot be characterized as a proprietary trader. Where the trader (i) contributes the capital to the firm; (ii) participates in profits and losses from the trader's own trading; and (iii) participates in part in the overall gains and losses of the firm or a discrete division of the firm, then the trader could still be and is probably a bona fide proprietary trader.

4. *The Profit Split*

Another important indicator of whether a proprietary account exists is the profit split between the trader and the firm. The general rule here is that the greater the firm's allocation of profits, the more the account looks like a "true" proprietary account. While no regulator has specifically indicated the percentage split that the firm must have, the firm should have a relatively significant percentage. It is likely that regulators would find a trading split with less than 75% to the trader to be a bona fide proprietary account. A split of 80% to the trader and 20% to the firm is more aggressive but probably acceptable by the regulators. Anything under 10% for the broker-dealer's participation starts to raise a question as to whether the account may be a customer account. Furthermore, for NYSE or NASD member firms, the prohibition against sharing in losses discussed above would be applicable.

However, as discussed above, the better interpretation is that sharing in losses means losses in excess of profits over

the life of the account. Consequently, percentage holdbacks, liability for withdrawals above profits, and losses up to the amount of net profits in the account over its existence, particularly if the trader has a long history of professional trading, probably would not cause an account to be categorized as a customer account. However, without public pronouncements from regulators to rely upon in this area, it is still not a certainty.

Both the SEC and securities SROs seem to place considerable weight on the individual's registration status as a substantial consideration in determining whether an account is proprietary.

It should be noted that many proprietary trading agreements provide that the trader will indemnify the firm if the trader violates his authorized trading parameters, laws, rules or SRO rules. While, at first glance, such provisions might seem to be very similar to a provision requiring a trader to be responsible for a trading debit, they are qualitatively different because they exist not to transfer market risk from the BD to the trader, but rather to create a disincentive for misbehavior. A contrary position by the regulators would be self-defeating from an enforcement standpoint and undermine the regulatory goal of having risk parameters and compliance within broker-dealers.

5. Securities Proprietary Trader Registration

Engaging in securities proprietary trading activity for a broker-dealer usually requires registration as an associated person of a broker-dealer. Under the rules of most SROs, the trader must have passed the Series 7 (or Series 7 and Series 55 exams for NASD member firms).[24] Both the SEC and securities SROs seem to place considerable weight on the individual's registration status as a substantial consideration in determining whether an account is proprietary.

6. Is the Trader an Employee?

One other item that could be a factor in determining whether an individual trader is a proprietary trader or a customer is whether the trader is an actual employee of the firm. If the trader is a W-2 employee, salaried on a percentage of his trading profits, with the firm withholding and paying social security or FICA for the employee, it is a factor which would be considered by the SEC and SROs, but it is not necessarily determinative. Again, this would be a "good fact" to have in the mix when a regulator is conducting a facts-and-circumstances evaluation. Even so, there is no reason why an independent contractor relationship, in and of itself, would prevent a *bona fide* proprietary trading relationship from being created.

To date, the views of the IRS and the state tax authorities regarding such an arrangement are unknown. In situations where an employee proprietary trader receives a salary based upon a percentage of his trading profits, one interesting question arises when the trading account is charged with the firm's share of social security and FICA as expenses of the trading account. In other words, the firm passes its withholding expenses onto the trading account. While there are many of these types of arrangements in existence, to date the authors have not seen any such challenge by the IRS. Still, it would be prudent to recognize that the IRS may ultimately question such arrangements. Many proprietary traders that are trading futures (or securities, to the extent that mixed straddle treatment is available) like to receive 1099 treatment so that with respect to their futures trades they receive the 60%-40% split (60% long-term capital gains rate, 40% short-term capital gains rate) with respect to their trading. If a proprietary trader qualifies as an owner in the proprietary trading firm, the proprietary trader will receive a K-1 report for his investment in the firm and the part relating to futures trading may also be eligible for 60-40 treatment. This raises a tension between the firm and the proprietary trader. If the individual qualifies under the IRS guidelines as an independent contractor and not an employee, 1099 treatment would be appropriate but if not 1099 treatment could result in the firm being liable to the IRS for failure to withhold income tax, social security and other deductions. In addition, the firm would be liable for its share of social security and other taxes.

7. Payments to Entities Owned by Proprietary Traders

While all practitioners know that the SEC requires that payments for securities transaction-based compensation to be paid only to individuals who are registered representatives or entities that are registered broker-dealers, it is less widely known that SEC staff has interpreted the registration requirements for broker-dealers to include any entity that receives a portion of trading profits from the proprietary trading of a registered broker-dealer. As a result, proprietary traders may not designate a separate entity wholly-owned by them to receive payments for the proprietary trading unless that entity is registered as a broker-dealer.[25]

N. Ways to Structure Proprietary Securities Accounts

The most conservative set of facts for structuring a proprietary account would be as follows: (1) the firm supplies the trading capital; (2) the proprietary trader is treated as a W-2 employee; (3) the trader is not liable for losses in the account on a net basis either annually or at the termination of the account; and (4) the firm's percentage of the account's profits is at least 10%. A less conservative, but relatively defensible position, would be for an independent contractor relationship. The trader may be liable for losses in the account up to his allocable percentage. Under either approach, the trader should be appropriately regis-

tered with Series 7 and/or Series 55 where required (for NASD member firms, the Series 72 would be appropriate in situations where only government securities are traded), and the firm should provide all of the trading capital. Capital contributed by the employee should not be a condition of the trading agreement and should be separate from the trading agreement.

A third approach would be to use a Class B LLC interest where the trader contributes capital to that which may not be withdrawn for at least one year (and, pursuant to FAS 150, may not be subject to "mandatory redemption" upon an event certain to occur). Under this approach, the trader's trading capital should not be tied to the amount of contributed capital and there should have an interest in part of the overall profits of the firm or discrete division. Importantly, the capital of the trader should not be subject to losses as a result of the trader's trading activity absent violation of trading parameters or the laws and rules applicable to the trader. However, it could be reduced by losses of the firm or a discrete part of the firm. As in the other scenarios, the trader would have to be a registrant of the broker-dealer and appropriately licensed. This third alternative Class B LLC position appears to have been accepted by the NASD, the SEC and the Federal Reserve Board by their failure to object to it and by the affirmative statement of former Chairman Levitt. However, it is less certain then the first scenario described above.

III. PROPRIETARY FUTURES ACCOUNTS

A. Background

As previously discussed, in both the securities and futures areas, many floor brokers, floor traders, and market makers have left exchange floors to trade both futures and securities electronically upstairs. Sometimes, this movement upstairs was motivated by a belief that upstairs trading would be more profitable than floor trading, a belief that was supported by, for example, the dramatic drop in open outcry volume on the CBOT bond room floor once parallel electronic trading of the same market became available. Finally, of course, many financial futures products are derivatives of securities instruments and hedging (or arbitraging) futures positions could entail trading the underlying instrument.

As an exchange member, a futures floor trader may receive favored futures margin treatment on his futures transactions. However, if the trader uses securities to offset risk of the trader's futures position (except for certain U.S. Government securities transactions), the futures trader will be considered a customer subject to the securities margin requirements and other customer requirements. Furthermore, to execute these securities transactions (except in the case of certain U.S. Government securities transactions), the trader's clearing firm must be registered as a broker-dealer. As a broker-dealer carrying customer accounts, the carrying firm will be subject to certain requirements, such as the reserve account requirement of SEC Rule 15c3-3.

B. The Incidental Securities Transaction Exemption

Generally speaking, a futures commission merchant must also be registered as a broker-dealer to handle transactions in securities for floor traders and floor brokers, regardless of whether such transactions are for customers or for the FCM's own account. However, a FCM that is not registered as a BD may handle certain securities transactions for futures floor traders under SEC Rules 3a-43-1 (agency transactions) and 3a-44-1 (proprietary transactions).[26] Rule 3a-44-1 of the Securities Exchange Act of 1934 provides a limited exemption from broker-dealer registration for certain U.S. Government security transactions that are incidental to future transactions, including hedging transactions. Rule 3a43-1 provides a similar limited exemption for agency transactions. However, the two rules are narrow in scope and require that any such securities transactions be "incidental" to the firm's futures-related business. Thus, for example, the hedging or arbitraging positions in cash government securities can only be entered for existing or contemporaneously created futures positions. Thus, opportunities in arbitrage under this exemption are limited because the cash government securities leg may never be entered into prior to the futures leg.

If customers or the firm engage in transactions outside of the scope of the two rules, the FCM would have to register as a broker-dealer. Some FCMs do effect significant amounts of U.S. Government securities transactions under Rule 3a-43-1 for their futures customers or within the constraints of Rule 3a-44-1 for their own proprietary accounts. If the FCM can do so, it avoids broker-dealer registration and more importantly avoids the onerous requirements of Regulation T margin rules for itself and its customers. As noted above, the maintenance margin rules are onerous because they do not permit futures on U.S. Government securities to offset cash U.S. Government securities even though it represents a fully hedged position. Interestingly, the SEC does recognize this in its capital rules, as a futures position in an underlying government security may be used as an offset for capital purposes.[27] Because of this divergence between treatment for margin purposes and treatment for capital purposes, to the extent that a FCM can stay within the requirements of Rule 3a-43-1 for customer transactions, the FCM will have a significant advantage over a FCM that is also a broker-dealer. If the FCM is also a broker-dealer, it must charge Regulation T margin on the securities transactions for floor traders and floor brokers as customers.[28]

In the past, the futures SROs have devoted little time in audits of FCMs to compliance with SEC Rules 3a-43-1 and 3a-44-1, there have been some indications recently that the topic is receiving greater attention.

C. Futures Exchanges and Marketplace Proprietary Trading Fee Rules

Additionally, futures exchanges have closely examined members' trading activities to determine if they are conducted in accounts properly identified as proprietary, customer or joint accounts. This is due primarily to the significant expansion in volume of upstairs proprietary or customer trading by individual members of the futures exchange. Partly, and perhaps most importantly, this is due to revenue concerns of futures exchanges, which are scrutinizing proprietary trading accounts to see if accounts receiving member clearing rates are actually entitled to such rates.

The differences in exchange clearing fees between member clearing rates and customer rates can be significant, particularly for accounts trading substantial volume, and can have a material effect on the profitability of an account. Audits by the Chicago Board of Trade ("CBOT") and the Chicago Mercantile Exchange, Inc. ("CME") have imposed significant additional charges for fees where the proprietary trader agreement or practices did not conform to the CBOT or the CME rules. Some of these fee audits have resulted in charges in excess of $1 million.

The CME, CBOT and other futures exchanges have extensive rules, policies and interpretations with respect to what is necessary for a proprietary trader of a member firm to qualify for the lowest exchange fees. These policies, procedures and interpretations are not consistent between exchanges. Further, the exchanges have refined and revised these rules and interpretations several times over the last few years. Furthermore, these interpretations differ in some respects from the CFTC's definition of proprietary trader and the SEC's definition of proprietary trader. This necessitates careful attention to proprietary trader agreements.

Generally, an exchange-member firm will obtain the lowest exchange rates for its proprietary trading if it owns the requisite number and type of memberships. The number of memberships required varies among the exchanges. If the individual proprietary trader owns or leases a seat on the exchange, this may qualify the arrangement between the firm and trader for different treatment than if the trader is a non-member.

By rule or interpretation, futures exchanges generally prohibit a firm from obtaining a deposit from its proprietary traders to be security against future losses. However, the exchanges permit gains to offset losses in a trader's account. If a firm takes only a *de minimis* percentage of the trading profit, as noted above, this may result in an account be recharacterized as a customer account, particularly if the trader capitalizes the account by a deposit or Class B LLC interest and receives all or most of the account's profit or loss.

By interpretation, certain exchanges permit indemnification to the firm from the proprietary trader if the proprietary trader violates the firm's trading parameters or applicable laws, rules or SRO rules. The exchanges also generally permit the firm to hold back part of a trader's profits as a reserve against which such indemnified losses may be offset although there may be time limits as to how long such holdbacks may be held before disbursement. The exchanges generally do not permit a deposit at the beginning of trading to be used as security for the indemnification against violation of trading parameters or the laws, rules or SRO rules.

Whether a futures trader is a W-2 employee can be a significant factor in whether an account receives favorable exchange fee rates.

The CME requires that proprietary trading accounts be settled at least once every twelve months. Thus, if the proprietary trader has a net loss in his account at the end of the twelve months, the firm must absorb that loss and reset the account at zero. While the CBOT had a similar policy in place until November 2003, the CBOT no longer restricts member firms as to the time period over which trader performance is judged.

The CME and CBOT apply different rules where the proprietary trader is an owner/investor in the proprietary trading firm or its parent. The CME requires a minimum $500,000 investment for such treatment. The CBOT requires a minimum of $200,000 investment to qualify. If a trader qualifies for such treatment, the capital must be permanent capital in the firm, meaning that it must remain in the firm for one year. This would be required for it to be good capital for regulatory capital purposes.

D. Is the Futures Trader an Employee?

Whether a futures trader is a W-2 employee can be a significant factor in whether an account receives favorable exchange fee rates. Many proprietary traders want to receive a Form 1099 or K-1 report instead of a Form W-2 because if a trader receives 1099 or K-1 income, the trader may treat the futures part as 60-40 (60% long-term capital gains, 40% short-term capital gains). If the trader receives a W-2, income will be treated as ordinary income. Consequently, there is a great tax incentive for proprietary traders to obtain 1099 or K-1 status.

Under CME guidelines, proprietary traders generally must receive a Form W-2 if the account is to receive favorable exchange fee treatment unless the trader is also an owner of the firm. The CBOT formerly required W-2 treatment but except for firm owners or traders that owned

or leased membership but the rule changes in November 2003 has removed that requirements.

While this article is not intended to discuss tax issues at length, it should be noted that while a trader receiving a 1099 may qualify for favorable exchange fee rates, it does not necessarily mean that the Internal Revenue Service would agree that such 1099 treatment is appropriate. If a firm provides 1099 treatment to a proprietary trader and the IRS later recasts the trader as an employee who should have received W-2 income, the proprietary trading firm may be liable for significant taxes and penalties.

E. Haircut and Margin Issues

The CFTC capital rule is integrated with the SEC's capital rule and incorporates large parts of the SEC rule. Further, because each of the agencies generally attempts to harmonize its capital rules so that the interpretations are consistent, the CFTC and futures SROs will usually apply the SEC and the securities SRO rules and interpretations concerning whether an account is deemed to be a proprietary or a customer account for purposes of CFTC Rule 1.17, the capital rule. The CFTC capital rule applies the same haircuts to positions held in proprietary accounts as the SEC rule. The CFTC has acquiesced in the long-standing SEC position that, for equity capital to be considered good capital for regulatory purposes under the CFTC Capital Rule 1.17, such capital must remain in the firm for a period of greater than one year. Any transitory or temporary capital contribution must be made in the form of a temporary subordinated loan provided for by both the SEC and the CFTC capital rules.

F. Trading Capital

It is the authors' understanding that the futures SROs follow the SEC positions regarding contributions to capital in determining whether an account is a customer account or a proprietary account. Contributions in the form of a Class B LLC interest or similar contributions to capital which are used for an individual trader's own trading and for which the trader is liable for the losses and gains will be considered by the SROs as evidence of a customer account as opposed to a proprietary account. As noted above, this is consistent with the CBOT and CME positions as to what is a proprietary trading account for exchange fee purposes. If capital is contributed to the trading account or to the firm solely for purposes of trading the account by the participant, the account will likely be considered a customer or joint account.

G. The CFTC's Definition of Proprietary Trading and Joint Accounts

In contrast to the securities side, there is specific language as to what "proprietary account" means under the Commodities Exchange Act. In relevant part, CFTC Regulation 1.3(y) provides that accounts of which ten percent or more are owned by the firm are proprietary.[29] However, as noted above, the exchanges go far beyond CFTC Rule 1.3(y) for purposes of determining if an account is proprietary account for member rates.

For purposes of determining whether joint accounts are entitled to member rates, the futures exchanges have long looked to the identity of all joint account owners and then applied the highest rate which would apply to any of the joint account owners, i.e., a joint account between a full member and a non-member would pay customer rates, even if the full member had a substantially greater ownership interest in the account.

H. Registration and Licensing

Proprietary trading firms that trade futures are often registered as futures commission merchants ("FCM"). However, they are not required to be registered as a FCM if the firm engages solely in proprietary trading. Likewise, individual proprietary traders trading only futures need not be licensed as associated persons of a FCM or introducing broker if they trade only for the firm's account. As explained above, if securities are traded, securities registration is required for the proprietary trader and the firm unless exempt under SEC Rule 3a44-1.

I. Hallmarks of Futures Proprietary Account Versus a Futures Customer Account

1. Presumptive Customer Account

Like a presumptive securities customer account, if the customer contributes the capital and shares in the profits and losses and the capital may be withdrawn, it would appear to be a customer account. However, considerable weight is given to licensing on the securities side. Since licensing is not required on the futures side, this is not a consideration.

2. Futures Joint Accounts

Joint accounts are treated in the futures area essentially as they are in the securities area. For purposes of haircuts, the proprietary part of a joint account is treated as a proprietary account and the customer portion of a joint account is treated as a customer account for margin and segregation purposes. As noted above, the futures exchanges look at the participants in a joint account and apply the highest fee rate which would apply to any of the joint account owners.

3. Proprietary Futures Account

Like a securities proprietary account, it is important that the firm provides the trading capital, and that the proprietary trader is not liable for the net losses at termination. Also like a securities account, the profit split is

important in determining whether the account is a customer account or a proprietary futures account. Due to CFTC Rule 1.3(y), in no event may the firm have less than a 10% interest in the account.

To ensure that legitimate proprietary accounts are recognized as such by regulators, it is important to structure such accounts so that they have the "hallmarks" of proprietary accounts.

J. Ways to Structure a Proprietary Futures Account

Like structuring a proprietary securities account, a conservative set of facts for structuring a proprietary futures account would be similar in that (1) the firm supplies the trading capital; (2) the proprietary trader is treated as an employee; (3) a trader is not liable for losses in the account on a net basis either annually or at the termination of the account; and (4) the firm's percentage of the account is at least 10%. An appropriate reserve account and indemnification against loss caused by violation of trading parameters, the applicable laws, rules and SRO rules should survive scrutiny. However, advance deposits, or certain contributions in the form of subordinated loans or similar contributions to the capital of a FCM can cause the account to be ineligible to receive member rates unless the contributions to capital share in a meaningful way in the profits and losses of the firm or a division of the firm.

IV. CONCLUSION

For both securities and futures accounts, the issue of proprietary accounts is one that is attracting significant regulatory attention. Attracted by the lower trading costs associated with proprietary accounts, many firms have structured arrangements which have attempted to characterize as "proprietary" accounts which may well be customer accounts. Consequently, it is likely that this is an issue that will receive greater regulatory scrutiny.

To ensure that legitimate proprietary accounts are recognized as such by regulators, it is important to structure such accounts so that they have the "hallmarks" of proprietary accounts. Structuring such agreements and policies by a firm is difficult because of the conflicting and uncertain standards that are applicable. Since most proprietary trading accounts trade both securities and futures, a proprietary trading agreement must weave between the securities requirements, including capital, margin and SRO requirements and the futures requirements, the exchanges fee requirements and other CFTC and SRO rules. In addition, the proprietary trading accounts must be structured so that the firm is not liable for failure to withhold under IRS or state law. ■

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1 12 C.F.R. 220, *et. seq.*

2 *See, e.g.,* New York Stock Exchange Rule 431; National Association of Securities Dealers Rule 2520(e)(6).

3 *See* NYSE Rule 431; NASD Rule 2520.

4 For ease of reference, this structure will be referred to as the "Class B LLC Model."

5 *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). The *Howey* test for determining if an interest was a security required a three-pronged analysis: Was the interest: (1) an investment of money in a common enterprise; (2) with an expectation of profits; (3) solely through the efforts of others? Only if an interest met all three prongs would it be considered a security.

6 *See, e.g., In the Matter of Express Communications*, Blue Sky L. Rep. (CCH) ¶74,001 (Ill. Admin. Proc., Dec. 13, 1993). *See also* McGinty, *Are Interests in Limited Liability Companies Securities?*, 25 Securities Reg. L. Journal 121 (1997). Mr. McGinty notes, "In those cases that have produced judicial writings, courts have seemed to assume that the securities laws give them jurisdiction. The consistency with which courts accept jurisdiction makes it likely that a court facing a case in which LLC interests are widely marketed to many unsophisticated investors will deem the LLC Interests to be securities." (citations omitted).

7 *Robinson v. Glynn, et al.*, (CCH) Fed. Sec. L. Rep. ¶92,617 (November 13, 2003).

8 12 C.F.R. 220.9(c).

9 If a broker-dealer does *not* clear its own transactions and is not a JBO participant, it must be charged customer margin on its proprietary trades in equities.

10 SEC Rule 15c3-1; 17 C.F.R. 240.15c3-1.

11 *See* NYSE Rule 431(e)(6)(B), effective August 28, 2000; NASDR Rule 2520(e)(6)(B), effective August 21, 2000.

12 NASD Regulation, Inc., Regulatory & Compliance Alert, Summer 2000, p. 23.

13 Testimony of Arthur Levitt, Chairman of the U.S. Securities and Exchange Commission, before the Senate Permanent Subcommittee on Investigations Committee on Governmental Affairs, concerning day trading, p. 2 (September 16, 1999), Available at http://www.sec.gov/news/testimony/tsty2099.htm

14 NYSE Interpretation Handbook, SEC Rule 15c3-1(c)(2)(vi)/02, at p. 169.

15 *See* SEC Rule 15c3-1(b)(1) and (2); 17 C.F.R. 240.15c3-1(b)(1) & (2).

16 NYSE Rule 431(e)(3); NASDR Rule 2520(e)(3).

17 NYSE Rule 431(e)(3).

18 NYSE Interpretation Guide Rule 431(e)(3)/01, p. 4380.

19 Letter, Scott Holz, Sr., Counsel, Federal Reserve Board to White & Case, July 12, 2001.

20 *See* Staff Opinions of October 19, 1984, and November 10, 1994, digested in the Federal Reserve Regulatory Service at 5-621.51 and 5-638.9, respectively.

21 NASD Notice to Members 04-33, April 2004; *see* attached letter to Michael J. Levinson, Chair Capital Committee, the Securities Industry Association from Michael A. Macchiaroli, Associate Director to the Division of Market Regulation of the Securities and Exchange Commission dated February 19, 2004.

22 *See* Section III.C, *supra.*

23 *See* note 11, *supra.*

24 NASD rules also permit proprietary traders to trade equities when the trader has passed the Series 42 and Series 55.

25 No-action letter, Division of Market Regulation to Vanasco, Wayne & Genelly, February 17, 1999.

26 17 C.F.R. 240.3a43-1; 17 C.F.R. 240.3a43-1.

27 *See* Section (a)(3)(i) of Appendix B to Rule 15c3-1.

28 The broker-dealer FCM does receive regulatory relief in one area. To the extent that a FCM broker-dealer has professional floor traders as customers, an SEC no-action letter does provide some relief from SEC Rule 15c3-3.

29 Regulation 1.3(y) is quite lengthy and this oversimplifies it. However, for purposes of this paper, what's important is the ten percent threshold for categorization of an account as proprietary. *See* CFTC Rule 1.3(y); 12 C.F.R. 1.3(y).