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Who Is a Proprietary Trader? A Changing and Rocky Landscape

by Paul B. Uhlenhop and John D. Ruark

Introduction

Recently, the Securities and Exchange Commission ("SEC") and the Commodities Futures Trading Commission ("CFTC") have brought proceedings and focused investigations on an issue which had previously received little, if any, attention: 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. Because regulators have provided little guidance in this area, these actions have caused both great consternation and great uncertainty regarding who is a true proprietary trader for regulatory purposes. The level of uncertainty has been increased by the regulators' position 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-circumstances test. This regulatory "I-know-it-when-I-see-it" approach has left firms uneasy, believing that it raises the possibility that proprietary trading agreements entered into in good faith could later be attacked as a sham by regulators.

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 an FCM, the firm itself, if it is a clearing firm, has no 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

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Letter from the Editors:

Changing Landscape

Recently, at the Futures Industry Association Expo held in Chicago, Steven D. Spence, FIA's chairman and managing director and head of financial futures and options at Merrill Lynch, made some observations regarding the trends affecting both the securities and futures markets worldwide. He noted at the outset of his remarks that "the mounting trend has leaned toward regulatory reform, automated markets, demutualization and tightening commissions." He observed, "these trends have inspired a wave of unprecedented change throughout both the futures and stock markets," which has resulted in a blending of both markets to the point that they are nearly indistinguishable.

Mr. Spence then proceeded to review some of the changes in the major global derivative exchanges, which we have summarized below.

- The Sydney Futures Exchange has eliminated open outcry trading and replaced the trading floor with a totally electronic exchange. The exchange has also become a demutualized entity. The rapid replacement of a trading floor with electronic screens is very similar to the destruction, two years ago, of the LIFFE floor.

- SIMEX, the futures exchange in Singapore that has a mutual offset relationship with the CME, has merged with the Stock Exchange of Singapore to create an integrated stock and derivative exchange. This merger will expedite the move to a totally electronic platform. The new combined entity will demutualize early in 2001.

- The Hong Kong Futures Exchange has merged as well with the Hong Kong Stock Exchange. The new exchange, following the lead of LIFFE has successfully moved to an electronic platform, and is discussing demutualization.

- The CME, LCH and LIFFE, in April 2000, successfully initiated a cross-margining program across international borders. The cross-margining program enables the CME and LCH to provide substantial risk-based cost savings to clearing member firms and their affiliates who have positions in the CME's Eurodollar contract and LIFFE's Euribor or Euro LIBOR contracts. Mutual Access is one of the initiatives resulting from the CME/LIFFE Partnership. Mutual Access now enables the members of each exchange to trade the products of the partner exchange via their existing LIFFE CONNECT™ or GLOBEX®*2* terminals.

  To develop LIFFE CONNECT further, Cap Gemini Ernst & Young is working with Battery Ventures and the Blackstone Group, which propose to provide up to £60 million of additional capital to LIFFE for continuing expansion of its commercial potential.

- Clearnet SA and London Clearing House Limited (LCH), the two main central counterparty services in Europe, announced plans in April 2000 to collaborate. Their goal is to create a consolidated

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Who Is a Proprietary Trader?....

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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 Reg T margin requirement is 50%.

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.

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. However, for a proprietary account, the haircut for such a position is zero. Furthermore, for exchange-member firms, proprietary trading will generally receive member rates on exchange and clearing fees, which would not be available for customers.

Why Has This Become an Issue?

The Move to Upstairs Trading

On the securities side, the proprietary account issue has come to the forefront principally due to perceived abuses of proprietary trading arrangements by certain BDs, particularly firms that might be described as day-trading firms or "DOT-shop firms."[3] On the futures side, it has become an issue for reasons that will be discussed below. The issue itself has been exacerbated by the uncertainty that has come to traditional open-outcry exchanges in both the securities and futures industries. Many floor members and traders have either left the floor entirely or have begun trading upstairs electronically at least occasionally. Naturally

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enough, these professional traders want to receive the same favorable margin treatment as upstairs traders that they always had received as floor members.

On the securities side, the proprietary account issue has come to the forefront principally due to perceived abuses … by certain BDs, particularly firms that might be described as day-trading firms or "DOT-shop firms."

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.

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 Reg T margin requirements[4] and, simply put, a trader with only $10,000 in capital, limited to Reg T's 2-to-1 leverage, just couldn't trade that many shares.

To permit greater leveraging of these accounts, a number of firms determined to attempt to make "proprietary traders" out of individual day-trading customers. 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.[5] The trader's LLC capital account then, in effect, becomes his trading account, with trading permitted based upon the amount of capital contributed. Trading in the account is subject to all of the usual brokerage charges of the firm—commissions, research and other in the same manner as if he was a customer. The profit and losses from the customer's trading would be charged 100% to the Class B interest holder's individual 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.

In summary, by making the individual trader into a so-called "proprietary trader," the following occurred: the trader no longer had margin requirements but the firm would have a capital haircut requirement. 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, he 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.)

Additional Regulatory Requirements

In some cases, the broker-dealer required the so-called proprietary traders to have taken securities examinations—Series 7 or Series 55 or both—if required. Originally, if the firm 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. To date, the CBOE has resisted the move to requiring proprietary traders to have passed exams. Of course, if an individual trader is a member of an exchange, no such examination is generally required.

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*[6] 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"). It is the authors' view that, notwithstanding the above arguments, such an interest in an LLC is 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 general true partnership, *i.e.*, all investors share not just profits and losses but also management responsibility.[7] 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, it must be a customer account.

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 joint back office ("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 in Regulation T so that the firms in the group would not be charged margin by the clearing firm or the BD on their proprietary positions cleared by the JBO 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. Thus, the broker-dealer owners of the clearing firm would be considered a clearing firm for purposes of exemption from the margin rules for the broker-dealer's proprietary transactions. However, under the SEC net capital rule, such owner broker-dealers are required to haircut proprietary positions.[10] In other words, the JBO clearing firm must treat the proprietary positions of the JBO participant firms as its own and must take a haircut against such positions.

Some day-trading firms became JBO participants by buying a limited interest in a JBO clearing firm. However, in the view of the regulators, the "proprietary traders" for such firms are nothing more than customers in disguise, seeking lower margins.

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 equity unless it clears only options traders. Any owner broker-dealer participating in the JBO clearing firm must have at all times a net liquidating amount 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. However, in the view of the regulators, the "proprietary traders" for such firms are nothing more than customers in disguise, seeking lower margins. In an additional twist, certain firms have attempted to stretch JBO arrangements even further by having groups of so-called proprietary 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.

Regulatory Responses to "Proprietary Traders"

The SEC and certain SROs have begun to question and attack certain of these arrangements as shams, contending that the accounts were, in fact, customer accounts. Furthermore, the SEC and securities SROs have resurrected a long-standing (but previously dormant) unwritten policy 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, a recent 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]

Evolving Positions of Regulators

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 enforcement proceedings, the details of which are not published. Consequently, guidelines and safe harbors in this area are extremely murky. There are, however, certain SEC and SRO rules or positions that have been promulgated that are relevant.

SEC Interpretations

Arthur Levitt, Chairman of the SEC, testified regarding day-trading 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 was surprisingly neutral. Certainly, his testimony provided no overt criticism of these structures. In apparent contrast to Chairman Levitt's neutral statements is the SEC staff capital rule interpretation regarding the treatment of a joint account:

> 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 broker-dealer and the profits and losses are split between the broker-dealer and the individual trader, the account is a "joint account," unless the trader is a broker-dealer (such as a exchange-member market maker). The individual trader's part of the account is to be treated as a customer account requiring margin. 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] Does this mean that any proprietary account is a joint account to the extent that a trader participates in profits and losses and must be margined appropriately under SRO rules?

[P]rovided that 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.

Reading the tea-leaves of this statement, one can divine that if a individual, non-broker/dealer trader contributes capital to a firm and participates in a joint trading arrangement, then the individual probably will be considered a customer, and certainly will be to the extent the individual trades the capital he contributed. Importantly, this position may 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 which makes the telling difference. Incidentally, it is the authors' view that, provided that 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.

SRO Margin Rules and Interpretations

The New York Stock Exchange and the NASDR have margin rules that read almost exactly in parallel and are designed to be so and interpreted in parallel.[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. Nevertheless, this interpretation does seem to undermine somewhat the concept that Chairman Levitt's neutral comments represented a tacit approval of the Class B LLC Model for day trading firms.

What Do SRO Interpretations Really Mean?

On the face of the NYSE interpretation of Rule 431(e)(3), 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 NASDR 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.

[T]he SEC concurs that potential liability up to the amount of the trader's share of net profits would not undermine the characterization of an account as proprietary.

Many proprietary trading agreements provide that the firm will hold back a percentage of commissions or profits as a reserve. These reserves should not trigger or be considered losses even though losses in the account may be offset against them because the withheld amounts represent earlier net profits in the account. 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 he 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 net profits would not undermine the characterization of an account as proprietary.

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.

Presumptive Customer Account

If the individual trader contributes capital, which may be in *fact withdrawn at will*, which the trader trades and from which he 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—would be considered, under these circumstances, a presumptive customer account even if the profit and loss percentages were less than 100%. This analysis is probably unchanged whether the trader has a Series 7 or 55 securities registration or 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 contributed capital and participates in the *overall* profits and losses of the broker-dealer, the above analysis would likely change. 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. Still unanswered is the status of a Class B LLC interest that may not be redeemed for more than one year.

Joint Accounts

As explained above, a joint account between a broker-dealer and a non-broker-dealer is treated for the broker-dealer as a proprietary account and for the other participant as a customer account. Is a Class B LLC account where the trader receives 100% of the profits and losses of his trading a joint account? Probably so. If the answer is yes, then customer margining would be required and any deficit treated as a capital deduction to the broker-dealer. Here, the unanswered question is this: if it is a joint account, why didn't Chairman Levitt say so in his September 1999 testimony?[19] 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. Thus, until the SEC provides more information regarding its position toward such Class B LLC model accounts, the answer is simply not known.

Proprietary Account

One strong indication that an account is a proprietary account is when the BD provides the trading capital. This does not mean that an individual who contributes capital to the firm will never be characterized as a proprietary trader. In the case when the trader contributes the capital to the firm and participates in the overall gains and losses of the firm, then the trader could still be a *bona fide* proprietary trader even if he receives a percentage of net profit of his other trades.

Other Factors

The Profit Split

Another important indicator of whether a proprietary account exists is the profit split between the trader and the firm. While no regulator has specifically indicated the percentage split that the firm must have, the firm needs to have a relatively significant percentage. It is likely that regulators would find a trading split of between 60% to 80% to the trader to be a hallmark of a bona fide proprietary account. It is, however, the authors' view that a split of 80% to the trader and 20% to the firm is an aggressive position to take. Anything under 20% for the broker-dealer's participation raises 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, until SROs issue written interpretations in this area, it is not a certainty.

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, securities laws 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.

Is the Trader an Employee?

One other factor that could be a significant factor in determining whether an individual trader is a proprietary trader or a customer is whether the trader is an employee. 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.

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 an 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 20% or, better yet, 30%.

Most importantly, if the trader contributes capital, he should share in the overall profits and losses of the firm or, in the event that he makes a subordinated loan to the firm, he should receive interest.

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. This position is certainly defensible, provided the firm is not a NYSE or NASD member.

Under either approach, the trader should probably be appropriately licensed with Series 7 or Series 55 (the Series 72 might be appropriate in situations where only government securities are traded), and the firm should provide all of the trading capital. Any capital contributed by the employee should not be a condition of the trading agreement and should be separate from the trading agreement. Most importantly, if the trader contributes capital, he should share in the overall profits and losses of the firm or, in the event that he makes a subordinated loan to the firm, he should receive interest.

Proprietary Futures Accounts

Background

As previously discussed, in both the securities and futures areas, floor brokers, floor traders, and market makers are leaving exchange floors to trade both futures and securities electronically upstairs. Sometimes, this movement upstairs is motivated by a belief that the floor markets will become electronic markets, and the traders want to know how to trade electronically. Other traders desire to day-trade securities or engage in other trading strategies of securities from upstairs. 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 receives special margin treatment on his futures transactions. However, if he uses securities to offset risk of his futures position (except for certain U.S. Government securities transactions), the futures trader will be considered a customer subject to the 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.

A futures commission merchant generally must be registered also as a broker-dealer to handle transactions in securities for floor traders and floor brokers whether trading as customers or trading proprietary. However, an 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).[20] 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.[21] Because of this divergence between treatment for margin purposes and treatment for capital purposes, to the extent that an FCM can stay within the requirements of Rule 3a-43-1 for customer transactions, the FCM will have a significant advantage over an FCM that is also a broker-dealer. If the FCM is also a broker-dealer, it must charge Reg T margin on the securities transactions for floor traders and floor brokers as customers.[22]

In the past, the futures SROs have not audited FCMs for compliance with SEC Rules 3a-43-1 and 3a-44-1, but recently several of the futures SROs have begun examining their members for compliance and suggesting strongly under threat of reporting them to the SEC that the firms become broker-dealers or cease any activity immediately outside of Rules 3a-43-1 or 3a-44-1.

Additionally, futures SROs have also recently begun closely examining members' trading activities to determine if they are conducted in accounts properly identified as proprietary, customer or joint accounts. This is due partly to greater SEC scrutiny of such activities, as such concerns do get communicated among regulators. Partly, this is due 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 such accounts are entitled to receive member clearing 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.

Policy Issues

The CFTC and futures SROs have provided very little guidance in its releases or otherwise which might give direct guidance as to what is a proprietary account and what is a customer account. Because the CFTC capital rule is integrated with the SEC's capital rule and incorporates large parts of the SEC rule and further because each of the agencies attempt to harmonize their capital rules so that the interpretations are the same, the CFTC and futures SROs generally apply the SEC and the securities SRO positions concerning what is a proprietary or what is a customer account with certain exceptions.

In contrast to the securities side, there is specific language as to what "proprietary account" means on the futures side. In relevant part, CFTC Regulation 1.3(y) provides that accounts of which ten percent or more are owned by the firm are proprietary.[23]

The CFTC and futures SROs have provided very little guidance in its releases or otherwise which might give direct guidance as to what is a proprietary account and what is a customer account.

However, the exchanges do not follow CFTC Rule 1.3(y) for purposes of determining if an account is proprietary for member rates. Under the literal wording of the Commodity Exchange Act and the rules thereunder, a 10% interest by a firm in an account makes it a proprietary account for purposes of futures trading. However, for purposes of entitlement to member rates, the futures exchanges have always recognized a joint account and for a number of years have had policies regarding joint accounts. For example, as a general matter, the Chicago Board of Trade's method for determining whether a joint account is entitled to member rates is to look to the identity of all joint account owners and then apply 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.

It is the authors' understanding that the futures SROs take the same position that the SEC does with respect to contributions to capital. They do not consider an account a proprietary account but a customer or joint account if capital is contributed to the trading account or to the firm for purposes of trading the account by the participant. Furthermore, 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 broker-dealer for a period of one year and one day. 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.

Conclusion

For both securities and futures accounts, the issue of proprietary accounts is one that is beginning to attract 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 are almost certainly customer accounts. Consequently, it is the authors' expectation that this is an issue that will receive greater regulatory scrutiny.

Notwithstanding this fact, there are many firms that have legitimate uses for proprietary accounts and do so use proprietary accounts. To ensure that these 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. In particular, firms need to pay attention to proprietary trading profit splits, employee status of the trader and potential trader liability for debits or other losses in the account. ■

Notes

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 "DOT" refers to the New York Stock Exchange DOT (Designated Order Turnaround) system, a system that electronically routes orders to the exchange floor. The name comes from the fact that virtually all orders from such firms are entered electronically.

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

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

6 *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.

7 *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).

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

9 If a broker-dealer does not clear its own transactions, it must be charged customary margin on its proprietary trades at its clearing firm.

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/testmony/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 *See* note 13, *supra*.

20 17 C.F.R. 240.3a43-1; 17 C.F.R. 240.3a43-1.

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

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

23 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).

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European clearinghouse that will meet the requirements of global market participants and will complement the consolidation occurring among Europe's exchanges and its securities settlement systems. This strategic initiative has been approved unanimously by the boards on both sides. The consolidated European clearing house will be the largest central counter-party in Europe for capital, energy and commodity markets, in both cash and derivatives, regardless of whether they are traded on organized exchanges or OTC.

Clearnet and LCH will seek to build a consolidated European clearinghouse in two stages. The first is a joint venture, which is targeted for completion in early 2001. The second stage will be a complete merger between the two entities to follow as soon as possible thereafter. The consolidated European clearinghouse will be user-governed, market and settlement independent and open to all markets, systems and/or users requiring clearing services. It will use a single set of clearing and netting systems, based on Clearing 21 technology (adapted by ParisBourse from the Chicago Mercantile Exchange original software), and centralize its operations.

The consolidated clearinghouse will also be open to collaboration with other European clearing houses that are interested in providing their members (or owners) with the benefits of common systems, operations and transparent self-governance. As Clearnet is now part of EURONEXT, the consolidated clearinghouse will cover the UK, French, Belgian and Dutch exchanges.

- On September 27, three Nordic Equity Options and Futures and Options on the Dow Jones Nordic STOXX 30℠ and on the Finnish Traded Stock Index (FOX™) were launched exclusively on Eurex. In August 2000, the EUREX/CBOT Alliance was signed to create A/C/E, which provides the platform for electronic trading at the CBOT.

- In September, EURONEXT was officially born from the merger of the stock exchanges in Amsterdam, Brussels and Paris. Member firms of the exchanges forming EURONEXT are "grandfathered" to have the same membership status within EURONEXT and have access to the full product range.

- The Oslo Stock Exchange has announced that it has decided to commence negotiations regarding future cooperation with the Swedish-Danish exchange alliance NOREX.

- Tradepoint and the SWX (Switzerland) will merge by year-end to form VIRT-X.

- In the U.S there are several initiatives, including the Cantor Exchange. Although Cantor has not attracted any significant liquidity, it has a very appealing and robust model. In addition there is the BrokerTec initiative, which has experienced modest success in its cash venture and is awaiting approval from the CFTC on its futures initiative. These two ventures are indicative of competition unforeseen to the traditional exchange just three years ago.

The above initiatives, together with the completed demutalization of both the CME and the NYMEX, point only to further changes for 2001. Moreover, as we went to press, the CFTC published its long-awaited New Regulatory Framework that will, no doubt, add to the velocity and scope of industry changes. There is no question that Mr. Spence's trends will continue unabated. ■

For-Profit Exchanges and the Public Director: Will the CFTC Adapt its Rules to the New Paradigm?

by Richard A. Miller

The Commodity Futures Trading Commission has started to embrace the new paradigm for commodity exchanges consisting of for-profit corporations, as opposed to the old model of mutualized, not-for-profit exchanges. In the latter instance, exchanges are owned and governed by their members, all of whom own seats, and the exchange's net revenues are shared solely among the member class. There is no shareholder equity separate from membership, and the members dominate the governing board. In the for-profit model, an exchange is much like any other corporate entity. It is owned by shareholders and governed by a board of directors that is elected by those shareholders qualified to vote in such matters. The company is expected to earn a profit that will be distributed to its shareholders, who may or may not also be seat-holders. To date, the Commission has approved two new for-profit exchanges and is expected to add a third shortly. Additionally, the Chicago Mercantile Exchange has demutualized, becoming a for-profit corporate entity; and the New York Mercantile Exchange is expected to do likewise.

As these new markets emerge, however, certain anachronisms latent within the Commission's regulations begin to become clear. Consider the case of the "public director."

Commission Regulation §1.64 effectively requires that each self-regulatory organization ("SRO") (*e.g.*, an exchange and, for these purposes, also a "clearing organization") "must maintain in effect standards and procedures with respect to its governing board which have been submitted to the Commission" which "ensure" among other things that 20% or more of the regular voting members of the board are persons who meet the following five criteria:

1. Are knowledgeable of futures trading or financial regulation or are otherwise capable of contributing to governing board deliberations, and
2. Are not members of the SRO,
3. Are not currently salaried employees of the SRO,
4. Are not primarily performing services for the SRO in a capacity other than as a member to the SRO's governing board, or
5. Are not officers, principals or employees of a firm which holds a membership at the SRO either in its own name or through an employee on behalf of the firm.

Simply put, this rule is calculated to create a class of "independent" or "public" directors whose judgment should not be affected by conflicting considerations arising from their employment by the exchange or the potential impact of their decisions upon their (or their firm's) sizable economic and enterprise investment in the SRO. This rule has functioned well in the old brick and mortar exchange world, as exchanges have drawn their public directors from government service, often including former CFTC commissioners, and academia. But without any other form of currency available to them, the old, mutualized exchanges have compensated their public directors with just fees and the perquisites of office.

In the new order, however, there is common stock ownership available and it would be customary to compensate independent, outside directors with stock and fees. Generally, that is the way of corporate America today. Boards are populated with independent, non-employee directors. Moreover, as a rule, these independent corporate directors are most assiduous in protecting shareholder values and putting management to the test, notwithstanding (or perhaps, because) they are also shareholders themselves. In short, if the prevailing corporate model is followed, there should be no conflict of interest entailed in an independent (non-employee) exchange director also owning an equity interest in the company. In the new order, the most qualified candidates for independent, public directorships are likely to insist upon a stock and fee compensation package.

Unfortunately, Commission rules presently stand in the way of this reasonable evolution. As stated above, Regulation §1.64(b)(ii)(A) excludes "members" from the permitted class of independent directors. A "member of a contract market" is defined by Regulation §1.3(q) to include "individuals … owning or holding membership in … a contract market." In the light of the new paradigm, this rule is unfortunately ambiguous and can be read in either of two ways.

In the first interpretation, "owning" is an alternative to "holding" "membership." If this is correct, the definition of "member" would not impact the ability to compensate independent directors with SRO equity, because in this instance the equity interest is not a "membership."

However, the rule is capable of a second, more troubling interpretation. Here, the verb "owning" modifies a "contract market." In other words, a "member" includes

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persons who "own" the SRO. As common stock is tantamount to an ownership interest, it could be said that the public director becomes a "member" as defined by §1.3(q) when he or she "owns" such exchange's stock. In the old paradigm, this is literally true, of course; the members own their exchange by virtue of the memberships. In the new paradigm, "member" is a misnomer when applied to a mere shareholder who does not enjoy any trading privileges.

In any event, the Commission seems to be of the view that the interplay between the definition of "member" in 1.3(q) and the "no member" criterion in 1.64(b)(ii)(A) effectively means that an SRO cannot provide equity ownership *(i.e.*, common stock) to its public, independent directors.

The Commission should consider modifying this rule by means of either an interpretation, stating for example that "owning" refers only to "membership" and therefore, a public director is not precluded from holding an equity interest in the SRO; or alternatively, by means of a rule making. In the latter case, the Commission could rewrite §1.64(b) to modernize the concept of an independent director. Persons who are not employees of the SRO or an SRO member and who are knowledgeable of futures trading or financial regulation should be qualified to serve notwithstanding their ownership of, for example, up to five percent of the SRO's common stock. ■

The SDNY Twists the History of the Treasury Amendment—The CEA's Dimpled Chad

by Geoffrey F. Aronow

Of all the twists and turns in the interpretation of provisions of the Commodity Exchange Act ("CEA"), none twists and turns more than the interpretation of the Treasury Amendment. The Treasury Amendment states that transactions involving certain commodities, most importantly government securities and foreign currencies, are excluded from regulation under the CEA "unless such transactions involve the sale thereof for future delivery conducted on a board of trade."[1] There has been a running argument as to the scope of the Treasury Amendment for the past 15 years, between those who say that it excludes from the CEA's reach any relevant instrument that is not traded on something that looks exactly like a traditional futures exchange, like the Chicago Board of Trade, and those who would confine the exclusion more narrowly, principally to allow the Commodity Futures Trading Commission ("CFTC") leeway to police scams aimed at retail customers, which in recent years have generally involved "off-exchange" sales of foreign currency. But the ramifications of this interpretative controversy are much greater because of the potential impact of its outcome on the vast "off-exchange" market in government securities and foreign currency derivative instruments.[2]

Many people thought, or at least hoped, that the United States Supreme Court's decision in *Dunn et al. v. Commodity Futures Trading Commission*, 519 U.S. 465 (1997), which addressed the interpretation of the Treasury Amendment, would settle much of the controversy. That decision did contain some language that gave comfort to those advocating a broad reading of the Treasury Amendment and has been so read by some courts.[3] But the Court's actual holding answered the much narrower question of whether the Treasury Amendment applied to options,[4] and other courts have so recognized the decision's limited reach.[5] Thus, the debate has raged on.

In November, the Southern District of New York, which has taken both sides in the debate,[6] weighed in again with a decision that is likely to send shivers through the OTC community. *Lehman Brothers Commercial Corp. v. Minmetals International Non-Ferrous Metals Trading Co.*[7] involves a series of legal claims arising out of "a foreign exchange and swap-trading relationship."[8] In a variant on a common theme, a financial services firm and a client were involved in exchange trading (in this case, on the London Metals Exchange), as well as off-exchange foreign currency trading and swaps transactions. The relationship went well for a while. Then a market event occurred (the Federal Reserve's raising of interest rates in 1994), the client's positions went bad quickly, large margin calls ensued which were not met, positions were liquidated, and litigation followed.

The financial firm here, Lehman, claimed the contracts were entered into at arms length, with full knowledge on the part of the client. The client claimed it was relying on the advice and counsel of the firm, that it did not realize that the firm was taking the opposite side of trades and (as is also not uncommon) that the employee of the client doing

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the trading was not authorized to enter into many of the transactions, which the financial firm would have known if it had acted with proper diligence. The client here, as is often the case, is not a mom-and-pop operation, but rather "an international trading conglomerate that conducts business throughout the world and trades in more than 100 countries and regions. . . [It is] headquartered in Beijing …, is owned by the State, and reports directly to China's Ministry of Foreign Trade and Economic Cooperation."[9]

[The S.D.N.Y.] concluded that the legislative history showed that the ["board of trade" provision] "was intended to apply … only to off-exchange interbank transactions."

In Lehman's suit to enforce the contractual obligations, the defendant raised numerous defenses and counterclaims, including that Lehman engaged in fraud in violation of Section 4b of the CEA, that it committed fraud as a Commodity Trading Advisor ("CTA"), in violation of Section 4o of the CEA, and that it committed fraud in violation of the CFTC's Rule 32.9, which prohibits fraud in connection with the trading of commodity options. The recent decision in the matter disposed of cross-motions for summary judgment.

Most of the opinion deals with the various other claims, counter-claims, and defenses. But about one and one-half pages of the opinion are devoted to denying Lehman's motion as it relates to the two CEA statutory claims and granting the motion with regard to the claim under Rule 32.9.[10] It is quite a significant page and one-half.

Lehman argued that the claim under Section 4b failed by virtue of the operation of the Treasury Amendment. The Court concluded Lehman was wrong.[11] First, the Court rejected the assertion that *Dunn* decided the issue, instead taking the position that the Court in *Dunn* only decided that options were covered by the Treasury Amendment, but "did not clarify the meaning of the term 'board of trade.'"[12]

The SDNY judge then turned to the issue of whether the transactions could be said to have occurred on a "board of trade" within the meaning of the Treasury Amendment. The Court reasoned that the meaning of the term "board of trade" as used in the Treasury Amendment is "ambiguous," and thus it needed to look to the provision's legislative history in order to determine the phrase's meaning. Then, in a rather summary fashion, it argued that "two district courts within the Second Circuit" had concluded that the legislative history showed that the provision "was not intended to apply to all 'off-exchange' transactions, *but only to off-exchange interbank transactions*," which the Court explained limits the reach of the of the Treasury Amendment to off-exchange transactions "between two banks," citing *Rosner v. Peregrine Finance Ltd.*, 1998 WL 249197 at 5 (S.D.N.Y. May 18, 1998), and *CFTC v. Standard Forex, Inc.*, 1993 WL 809966 at *10-*11 (E.D.N.Y. Aug. 9, 1993).[13] Thus, the Court concluded, since the two parties in the case before it were not both banks, the Treasury Amendment provided no protection from the application of the CEA.[14]

This analysis is striking and foreboding for the OTC market in two respects. First, while the Court claimed to be relying simply on the analysis in the earlier *Rosner* and *Standard Forex* decisions, neither of those decisions so starkly stated the proposition—and may not have intended to suggest—that only off-exchange transactions between two banks are covered by the Treasury Amendment.

Second, the Court here, in contrast to the courts in the earlier decisions, applied this proposition to a classic transaction between a major swaps and foreign currency dealer and a large institutional, arguably sophisticated, business entity. The earlier *Rosner* and *Standard Forex* decisions dealt with classic boiler room operations that had been selling to the retail consumer. Generally up until now, courts have found an analytic basis to allow cases to proceed under the CEA when they involve retail boiler rooms, while concluding that the Treasury Amendment stopped cases involving "true" off-exchange swaps or forex transactions. The analytic tensions between these two conclusions have been apparent to observers of the case law development and have been growing as the case law developed. Nonetheless, the courts have managed for the most part to avoid addressing those tensions directly while generally maintaining the ability of the CFTC and others to pursue "bucket shops" without creating greater legal uncertainty for the "legitimate" OTC business. In stark contrast, this new decision tramples right over that dichotomy by adopting a starkly narrow reading of the Treasury Amendment in what appears to be a prototypical OTC transaction involving a large commercial client and a major financial institution. Thus, the two worlds have now collided.[15]

The consequences of that collision are uncertain. The courts are divided on the interpretation of the Treasury Amendment in this important regard, and even the judges in the Southern District of New York have taken different tacks. The issue may ultimately be ripe for appeal, although the procedural posture of the case means that an appeal is not likely to be heard any time soon, and the issue could well never reach an appellate tribunal in this case. At the least, this decision cannot help but to ratchet up the degree of legal risk that these transactions are subject to scrutiny under the CEA and even, in some cases, to challenge by disgruntled purchasers as illegal, off-exchange instruments.[16]

This risk presumably will further stoke the effort to make statutory reform of the Treasury Amendment a high priority in the next Congress. Indeed, this decision could increase pressure to enact statutory clarification of the Treasury Amendment independent of the broader effort to reform the CEA. Whatever else is true, this latest twist in the Treasury Amendment's interpretation has made its application more uncertain and thus of greater danger to those transacting business in the Amendment's shadow. ■

Notes

1 Section 2(a)(1)(A)(ii), 7 U.S.C. §2(ii).

2 The history and developments over the past few years in this interpretive controversy are reviewed in Aronow, "Developments in the Interpretation of the 'Treasury Amendment' to the Commodity Exchange Act," 32 *Securities & Commodities Regulation* 227 (Dec. 8, 1999).

3 *See, e.g., Kwiatkowski v. Bear Stearns Co., Inc.*, 1997 WL 538819 at *10 (S.D.N.Y. 1997) (in *Dunn*, "the Supreme Court read the Treasury Amendment as excluding OTC transactions in foreign currency").

4 *See* 519 U.S. at 469-70.

5 *See, e.g., Rosner v. Emperor International Exchange Co.*, 2 Comm. Fut. L. Rep. (CCH) ¶27,344 at 46,587 (S.D.N.Y. 1998) (calling the *Kwiatkowski* decision "a misreading of *Dunn*").

6 *See, e.g.,* the cases cited in *supra*. nn. 3 & 5.

7 2000 WL 1702039 (S.D.N.Y. Nov. 13, 2000).

8 *Id*. at *1.

9 *Id*. at *2.

10 *Id*. at *24-*26.

11 *Id*. at *25-*26.

12 *Id*. at *24.

13 *Id*. at *25 (emphasis added).

14 In a similarly summary fashion, the Court also turned aside cases that applied a broader reading of the Treasury Amendment. It said it "simply disagrees with the inferences the Ninth Circuit draws from the legislative history" in *CFTC v. Frankwell Bullion*, 99 F.3d 299 (9th Cir. 1996), and that "[t]he de Kwiatkowski decision expands the scope of Dunn too far … and therefore the Court finds the holding in de Kwiatkowski unpersuasive." 2000 WL 1702039 at *25 n.28.

15 The Court also disposed of Lehman's other arguments for summary judgment, but in a manner without any obvious impact on the interpretation of the Treasury Amendment. It held that summary judgment was not appropriate on Lehman's claim that the CEA does not apply to principal-to-principal transactions because "material issues of fact exist concerning whether the transactions in this case were truly principal-to-principal arm's-length transactions." *Id*. at *25. It similarly rejected summary judgment on the Section 4o claim based on Lehman's assertion that it was not acting as a CTA because "the exact nature of the relationship between" the parties "and the nature of Lehman's advice and recommendations . . . are issues for a jury to resolve." *Id*. Finally, the Court did grant summary judgment on the claim for fraud under CFTC Rule 32.9 on the ground that "there is no private action for violations of CFTC rules." *Id*. at *25-*26.

16 Of course, the Swaps Exemption, 7 C.F.R. Part 35, may protect some of these transactions, but possibly not all.

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