A POOL TOO BIG FOR A FCM OR A BROKER-DEALER

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I. Introduction – The Problem of the "Inadvertent Pool"

The financial world was once divided into two distinct areas: futures and securities. The futures area traded physical commodities like soybeans and pork bellies; the securities area traded stocks like IBM.

Since the introduction of financial futures in the 1970s, the once clear distinction between the two areas has blurred; today, many securities and futures products are virtually interchangeable. Soon security futures products, the first product to be both a security and a futures contract, will begin trading. One result of this convergence of securities and futures is that firms that might once have been thought of as strictly "securities" firms increasingly engage in futures activities. While this might initially seem trivial, it becomes less so when one realizes that, in nearly every instance, these entities, by trading futures contracts, have become commodity pools and their managers have become unregistered commodity pool operators. Often, the people running the entity are unaware of the problem – and are unaware that they have inadvertently become commodity pools.

The broad definition of "commodity pool operator" and "commodity trading adviser" in the Commodity Exchange Act ("CEA"), as amended[1], and the broad definition of a "pool" as defined by Commodity Futures Trading Commission ("CFTC") Rule 4.10(d)(1)[2], together with the very broad interpretations of these terms by the CFTC staff, has led to the "inadvertent pool" problem for many registered broker-dealers and futures commission merchants ("FCM") engaged in proprietary trading activities. These problems have increased significantly over the last five years as futures products have been used interchangeably with securities products with respect to a number of instruments. For example, futures on United States government securities are used by professional traders not only for hedging but also as a surrogate for cash United States government securities. Futures and options on futures on United States government securities and broad securities indices are routinely traded by market makers, arbitrageurs and a variety of others. Hundreds of broker-dealers and FCMs engage in proprietary trading of futures but their managements are rarely registered as commodity pool operators and their traders are rarely, if ever, registered as commodity trading advisers.

With the growth of futures and advent of security futures, the problem of whether a FCM or broker-dealer is a commodity pool will become more pronounced and difficult under the broad definitions currently existing and the absence of exemptive rules or clear interpretations from the staff of the CFTC. The purpose of this article is to address the problem faced by a professional trading organization, registered as a broker-dealer or FCM, when such professional trading organization trades futures products for its own account.

II. The Broad Definitions and the Problems

The definition of "commodity pool operator" is contained in Section 1a(5)[3] of the CEA and reads as follows:

> The term "commodity pool operator" means any person engaged in a business that is of the nature of an investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in any commodity for future delivery on or subject to the rules of any contract market or derivatives transaction execution facility, except that the term does not include such persons not within the intent of the definition of the term as the Commission may specify by rule, regulation, or order.

The definition of "pool" in CFTC Rule 4.10(d)(1)[4] reads "any investment trust, syndicate or similar form of enterprise operated for the purpose of trading commodity interests." The definition of pool clearly would apply to virtually any broker-dealer or FCM that is not a sole proprietor and that engages in proprietary trading. This is compounded by the definition of commodity pool operator, which includes any person which, in connection with a pool, "solicits, accepts, or receives from others funds, securities or property, directly or through capital contributions, the sale of stock or other forms of securities or otherwise for the purpose of trading…." All FCMs and broker-dealers need capital. They accept and receive capital through subordinated loans, equity investments and a variety of other financing techniques. Doing so brings management of such firms within the literal language of the definition of "commodity pool operator" if the firm also engages in proprietary trading of futures.

"Commodity trading adviser" is defined in Section 1a(6)[5] of the CEA and reads as follows:

> (A) IN GENERAL. Except as otherwise provided in this paragraph, the term "commodity trading adviser" means any person who –
>
> (i) for compensation or profit, engages in the business of advising others, either directly or through publications, writings, or electronic media, as to the value of or the advisability of trading in –
>
> (I) any contract of sale of a commodity for future delivery made or to be made on or subject to the rules of a contract market or derivatives transaction execution facility;
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> (II) any commodity option authorized under section 4c; or
>
> (III) any leverage transaction authorized under section 19; or
>
> (ii) for compensation or profit, and as part of a regular business, issues or promulgates analyses or reports concerning any of the activities referred to in clause (i).
>
> (B) EXCLUSIONS….

These three important definitions were intentionally drafted to be very broad to encompass all types of organizations that may engage in trading of interests in futures or options on futures. The CFTC staff, motivated by the laudable regulatory purpose of preventing evasion of the registration and customer protection requirements of the CEA and the rules thereunder, has consistently declined to apply a narrow reading to the definitions. As discussed below, while the CFTC has promulgated rules creating limited exemptions from the pool rules for certain otherwise regulated persons and for certain very small pools, these exemptions do not provide relief from commodity pool operator registration or commodity trading adviser registration to professional trading firms that are registered as broker-dealers or FCMs. This problem is compounded by the broad scope of the statutory definitions, the CFTC rules, the broad interpretations by the CFTC Division of Trading and Markets, and the different enforcement posture of the CFTC Division of Enforcement.

III. Current Exemptive Rules and Interpretations Are Not Applicable

A. CFTC Rules

Subject to certain conditions and filings, CFTC Rule 4.5[6] excludes certain otherwise regulated persons from the term "commodity pool operator" in connection with their operation of specified trading entities. Rule 4.5 also provides a self-executing exclusion from the term "pool" for certain employee benefit plans. Rule 4.5's companion, Rule 4.6,[7] provides a similar exclusion from the term "commodity trading advisor" for certain otherwise regulated persons. Unfortunately, Rules 4.5 and 4.6 are not helpful for professional trading firms. The relief offered by these rules is effectively limited to registered investment companies, insurance companies, banks or other depository institutions and employee benefit plans. Furthermore, relief under Rule 4.5 limits use of futures to bona fide hedging transactions and places limits on the amount of futures trading which can be engaged. Thus, even if professional trading firms were eligible for relief under Rules 4.5 and 4.6, such relief would likely be of little use.

CFTC Rule 4.7[8] also provides certain relief for registered commodity pool operators with respect to pools whose participants are limited to "qualified eligible persons" as defined in the rule and for commodity trader advisers with respect to advising such pools. Rule 4.7 provides important relief, but rarely works well for registered broker-dealers or FCMs. First, the relief is only available to registered CPOs. While a FCM or its principals can have an effective CPO registration quickly, this is not generally an option for broker-dealers. Furthermore, because full relief under the rule is predicated upon filing notice with the CFTC prior to offering interests, it is not available to operating entities that have already been capitalized. Thus, an existing broker-dealer that determines to trade a small number of futures does not have the ability to claim the full relief available under Rule 4.7.[9] A lesser level of relief is available if the notice for the claim of exemption is filed prior to the time the entity enters into its first commodity interest transaction. However, it is a rare professional trading firm indeed which deals with this issue prior to actually trading futures.

CFTC Rule 4.12[10] provides an exemption from part of the regulations for registered commodity pool operators provided that the trading entity is primarily involved in buying and selling securities and the initial margins and premiums from commodity futures and commodity option contracts do not exceed ten percent of the fair value of the pool's assets. Finally, CFTC

Rule 4.13[11] provides an exemption from registration for CPOs who do not receive any compensation for operating a pool and who operate only one pool at a time or who operate pools involving less than $200,000 in aggregate. In summary, while certain exemptions from CPO registration exist, they are generally usable only for an entity obtaining funds for the first time and may not be easily used by an established broker-dealer or FCM that seeks to add proprietary trading of futures to its operations.

B. Division of Trading and Markets Staff No-Action Letters

The staff of the Division of Trading and Markets has consistently held that a broker-dealer or FCM that engages in proprietary trading of futures is a commodity pool. Although the staff has granted three no-action letters under various circumstances, in each of those no-action letters, the CFTC staff has made very clear its belief that the broker-dealer and/or FCM was in fact a commodity pool because of its futures activities. Notwithstanding the language of the no-action letters, some have attempted to use the no-action letters as quasi interpretations providing broad relief from CPO registration. It is not clear that the no-action letters can fulfill this role. While the principles from which such conclusion are reached are sound, this is contrary to what appears to be the express position of the Division of Trading and Markets. Since there are no other general exemptive rules for broker-dealers or FCMs, the broker-dealer or FCM engaging in futures activities, whether for hedging or otherwise, appears to be a commodity pool by definition and the operator of such pool should be registered. It is instructive to look at the three no-action letters of the staff of CFTC Division of Trading and Markets because in these letters the staff sets forth a number of conditions which would provide a sound basis for an exemptive interpretation or rule.

1. CFTC Interpretative Letter 94-79.[12]

In this case, a limited partnership with a corporation as its general partner was registered with the SEC as a broker-dealer. The corporation and its president were also registered broker-dealers and members of the Chicago Board of Options Exchange ("CBOE"). Furthermore, the corporation was a registered commodity pool operator and a member of the Chicago Mercantile Exchange ("CME") and the Chicago Board of Trade ("CBOT"). One limited partner was a member firm of the CBOE registered as a broker-dealer. The remaining limited partners were all registered broker-dealers and members of the CBOE except one who was the wife of one of the other limited partners and another who was the father of one of the other CBOE member broker-dealers. The limited partnership's business involved proprietary market making on the CBOE in the S&P 500 Index options and S&P 100 Stock Index options. The firm wanted to use CME stock index futures to hedge its CBOE trading. All of the limited partnership's market makers were individual market maker members of the CBOE and registered with the SEC as broker-dealers. The firm proposed to admit additional limited partners who would be one of the following:

1. qualified eligible participant as defined in the CFTC Rule 4.7[13];
2. registered with the SEC as a broker-dealer;
3. a member of one or more contract markets; or
4. immediate family member of any of the foregoing or trust or entity controlled by them.

The firm indicated that it would not engage in any solicitation of new partners. The firm represented that principals were not subject to statutory disqualification. The CFTC staff concluded it would take no action if the general partner of the limited partnership did not register as a commodity pool operator. The staff also granted no-action relief from commodity trading adviser registration for nominee market makers having discretion over the trading of the limited partnership. Although the relief was granted, the CFTC staff pointed out clearly that the parties remain subject to the anti-fraud provisions of the CEA, and various reporting requirements for traders. The CFTC staff was quite clear that the letter was based on the specific representations in the letter and "is solely applicable in connection with the operations of [the limited partnership]."

2. CFTC Letter No. 97-30.[14]

In this CFTC no-action letter, P, a limited partnership and registered broker-dealer, sought confirmation that enforcement action would not be taken against it as a commodity pool or against Q in its capacity as general partner of the limited partnership for failure to register as a commodity pool operator. The limited partnership, P, was registered with the SEC as a broker-dealer. The sole general partner was an entity owned by a member of the CME who was a registered floor broker, accredited investor and a qualified eligible participant as defined in CFTC Rule 4.7(a)[15] ("QEP") and was a listed principal of three other CFTC registrants. The other owner of the limited partnership was a trust, the co-trustees of which were a former CBOE member, accredited investor, a QEP and a registered floor trader. The limited partners of P were the owners of the general partner and a former CBOE member that was an accredited investor, a QEP and a registered floor broker. The limited partnership acted as a market maker on the CBOE trading through various nominee market makers, trading primarily the S&P 100 Index options and S&P 500 Index options which were hedged with stock index futures contracts on the CME. The partnership also occasionally traded futures on United States government securities which might not have qualified as bona fide hedge transactions within the meaning of CFTC Rule 1.3(z)[16], although they were considered part of the risk management program of the limited partnership. Q represented that it did not solicit investors in P nor did it propose to add any additional investors. It was also represented that none of the participants in the limited partnership were subject to statutory disqualification. Based upon these conditions, the staff found that P was a commodity pool and its general partner a commodity pool operator. Nevertheless, the Commission granted a no-action position. The Commission further qualified the no-action relief, stating that permitted in commodity interests by the limited partnership "remains limited to hedging and risk management in connection with CBOE options positions." Again, the relief was limited to the firm requesting the relief. As in the earlier letter, the staff of the CFTC pointed out that, notwithstanding the relief granted, the parties remained subject to the anti-fraud provisions of the CEA and various reporting requirements for traders.

3. CFTC Letter No. 97-38.[17]

In this no-action letter, the CFTC staff addressed a request from a limited liability company and its management committee. The LLC, which was registered as a broker-dealer and FCM, sought confirmation that it was not a commodity pool, its management committee was not a commodity pool operator and its discretionary traders were not commodity trading

advisers. The broker-dealer FCM and its traders were market makers in the CBOE S&P 500 Index and S&P 100 Index options. The firm also traded on the CME S&P 500 Index futures, S&P 100 Index futures and options on such futures contracts. The firm stated that it traded futures contracts primarily for managing the risk of its CBOE market making operations but there was no restriction on the amount or other speculative trading in futures or options on futures. All members of the firm were one of the following: (1) persons who traded full time for the firm; (2) persons who were principals of the predecessor of the firm; or (3) senior qualitative analysis, information technology, or administrative personnel of the firm. The firm represented that no member, principal or associated person was subject to statutory disqualification. The firm also stated that after deduction for salaries and other expenses, thirty percent of the trading income was allocated pro rata without any sort of advisory, management or incentive fees being charged. The remaining seventy percent of profits were allocated by the management committee based upon its judgment as to members' efforts in contributing to the firm's profitability. The staff in response stated that it believed that the limited liability company was a pool within the meaning of Rule 4.10(d)(1) because funds contributed by traders and non-traders are pooled and used to trade commodity interests for speculative purposes. Nevertheless, the Division granted no-action relief with respect to the registration of the management committee as a commodity pool operator and the traders as commodity trading advisers. As in its earlier letters, the staff specifically noted that the entity remained subject to the anti-fraud provisions and reporting provisions of the CEA.

4. Analysis of Division of Trading and Markets Staff Position

The analysis, policy and relief granted in the three no-action letters are sound and consistent with public policy. From a policy standpoint, the CFTC staff is faced with the problem of following the statutory language. From a practical standpoint, the staff does not want to open the door so that any registered broker-dealer or FCM could automatically escape commodity pool operator registration and be, in effect, exempt from the pool regulatory scheme. At the same time, these no-action letters recognize that professional trading firms, under specific circumstances, should not be subject to a duplicative registration scheme. Broker-dealers are required to register with the SEC and maintain constant information concerning the firm, its structure and business. Broker-dealers must maintain customer funds and securities in appropriate reserves or control locations, provide monthly financial reports, annual audited financials and are subject to a significant number of other regulations. FCMs are subject to a similarly intensive regulatory scheme. Furthermore, the SEC and CFTC share information with respect to registered broker-dealers and FCMs and much of the information with respect to a broker-dealer's operations are readily available to the CFTC staff, either on-line through the self-regulatory organizations, such as the NASD or New York Stock Exchange ("NYSE"). Furthermore, registered broker-dealers and FCMs are audited annually by at least one self-regulatory organization, reporting to either the SEC or the CFTC. Under these circumstances, a duplicative registration scheme requiring commodity pool operator registration or commodity trading adviser registration really amounts to regulatory overkill. For example, under the conditions described in any of the no-action letters, a duplicative registration scheme serves little regulatory purpose since there are no public customers involved and hence no real customer protection rationale for overlapping regulation. Most importantly, the extensive regulatory burden that is placed upon registered broker-dealers and FCMs means that few, if any, firms would attempt to avoid pool registration by becoming a registered broker-dealer or FCM. Furthermore, if one attempted to use a registered

broker-dealer or FCM as a means to evade pool registration, the CFTC and NFA staff could easily detect such attempt at evasion because of the audit and reporting scheme discussed above.

The no-action letters are based on sound policy considerations. We believe that the relevant policy rationale for the three no-action letters have in common the following points.

1. The firm must be a registered broker-dealer or FCM subject to a registration scheme readily accessible to the CFTC staff.

2. Investors in the firm must have a strong pre-existing relationship with the firm prior to investment, such as:

    a. Direct or indirect owners involved in the trading for the firm, active in the firm's operations, intellectual property, research or management; or

    b. Family members sharing the same household of an owner or officer of the firm.

    c. Former owners who were active in the firm for a substantial period.

3. Traders or management that make decisions on a discretionary basis regarding commodity futures or options on futures would not be considered commodity trading advisers.

4. Futures and options on futures would be permitted for both hedging and speculative purposes.

5. No general solicitation for investment in the firm would be permitted.

6. Owners of the firm must <u>not</u> be compensated by a scheme similar to that used in most pools.

7. The principals and associated persons of the firm and its owners must not be statutorily disqualified persons within the meaning of §8a(2) or 8a(3) of the CEA.[18]

8. All of the other provisions of the CEA, including the anti-fraud provisions[19] and large trader reporting provisions would apply.[20]

The CFTC has distinguished between "no-action" letters and "interpretative" letters in Rule 140.99.[21] This rule provides, in part, that third parties may rely on "interpretative" letters, but may not rely upon "no-action" letters. However, Rule 140.99 went into effect in 1999 and applied only on a prospective basis, i.e., the three above no-action letters, all issued prior to 1999, were not affected by the rule. Unfortunately, by their express language, the no-action letters apply only to the firms that sought such relief. Thus, it seems likely that these letters are equivalent to "no-action" letters under Rule 140.99, in that third parties may not rely upon them. Accordingly, these no-action letter are probably not available for general use by the bar, as interpretative letters would be. Furthermore, the highly fact-specific nature of each of the no-action letters limit the ability of these letters to serve as general guidance. However, if the no-action letters were translated into general guidance for use by all entities, substantial confusion with respect to broker-dealer and FCM professional trading firms would be alleviated. As discussed below, we offer a series of suggestions based upon these policies of the staff and certain other considerations which we think should be considered in connection with an interpretation or rule.

C. The Enforcement Division's Position

There is a significant gap between the position of the Division of Trading and Markets regarding what is a commodity pool and the actual enforcement cases brought by the Division of Enforcement. We believe that there may be hundreds of broker-dealers and FCMs that are technically pools within the literal definition but, for good reason, none are being pursued by the Division of Enforcement. The Division of Enforcement appears to have as a guideline that a registered broker-dealer or FCM that is an inadvertent pool will not be a target for enforcement action unless fraud exists. The Division, which has had a number of successes in pursuing and shutting down unregistered pools engaged in fraud, appears to be allocating its resources to protecting the general public who do need the protection contemplated by the CEA rather than pursuing technical violations of the law.

The authors fault neither the Division of Trading and Markets nor the Division of Enforcement for their different positions because each position is a practical position considering the limited resources of the CFTC staff. However, this gap between regulatory policy and enforcement policy creates a potential credibility problem for the CFTC. More importantly, it makes compliance difficult for the firms. It is most difficult for conscientious firms that wonder why they have to register when their competitors do not. This gap could be significantly narrowed by a rule or interpretation incorporating the elements of the relief granted by the CFTC in the no-action letters discussed above.

IV. Proposed Interpretations or Rule.

The Commission should develop and promulgate promptly a rule or interpretation dealing with the activities of registered broker-dealers and FCMs with respect to activities that would bring them within the broad definition of a commodity pool, commodity pool operator or commodity trading adviser. The potential credibility gap that currently exists will only be accentuated by security futures and the continuing expansion of futures trading for all types of securities products

if no such interpretation or rule is issued. For that reason alone, the Commission and its staff should promptly address these issues.

As explained above, we believe that the no-action letters of the Division of Trading and Markets have already identified the key elements of a rule interpretation or policy statement. Our suggestion for a rule or interpretation would be as follows:

1. That the firm must be registered as a broker-dealer, FCM, or be an exchange-member firm exempt from FCM registration under CFTC Rule 3.10(c).

2. Ownership of the firm should be limited to the following:

    a. Direct or indirect beneficial owners must be involved in trading for the firm, active in the operation, intellectual property, research, management or, if the firm has customers, servicing customers and customer activity and former employees or members of the firm who were active for a period of five years.

    b. Additional equity investments should be permitted by five or fewer qualified eligible persons as defined in Rule 4.7(a) provided that their total capital investment at the time of investment does not exceed more than fifty percent of the aggregate ownership of the firm.

    c. Regulatory approved subordinated debt or secured demand notes should not be considered in determining an entity's status as a pool.

    d. Similarly, other debt instruments and preferred stock that do not have voting rights or equity participation and provide only for an interest or fixed dividend percentage payment also should be excluded when determining an entity's status as a pool.

    e. The spouse or a relative living in the household of an owner or officer of the firm should be deemed to have the same status as the owner or officer for purposes of investing in the firm.

3. Traders or management of a firm registered as a broker-dealer or FCM that make decisions on a discretionary basis regarding proprietary trading of commodity futures or options on futures should not be considered commodity trading advisers.

4. Futures and options on futures should be permitted for hedging or speculative purposes.

5. There must be no general solicitation of investment in the firm.

6. The compensation of the firm management should not follow the ordinary pool compensation model, but should be consistent with that of a trading firm (i.e., no asset-based fee on the capital contributed or fixed percentage of profits allocable to management of the firm).

7. The Rule would provide that firms or associated persons remain subject to anti-fraud provisions and trading reporting requirements.

Finally, although the no-action letters provide that individuals associated with a firm may not be disqualified persons within the meaning of Section 8(a)(2) or (3) of the CEA, this provision is redundant for registered broker-dealers or FCMs since the disqualification provisions of the Securities Exchange Act of 1934, as amended, or CEA already apply to the firm and its associated persons.

V. Conclusion

We submit that it is urgent that the CFTC consider a rule or interpretation clarifying the relationship of registered broker-dealers and FCMs and certain exchange member trading firms because of the ever-increasing use of index futures, futures on United States government securities and the advent of security futures. Many securities firms engaged in proprietary trading, whether engaged in market maker activities, basis trading, specialist operations, hedging, or over-the-counter activity, frequently use futures for hedge, arbitrage or speculative purposes. Futures markets participants use securities for the same purpose. Certain futures and securities products have become virtually interchangeable. As a result, the marketplace looks upon them as economic equivalents. Consequently, registered broker-dealers or FCMs should not be treated as pools, particularly where the activity is primarily professional trading. It is urgent that the Commission act to narrow what is now a significant gap between the policies of the Division of Enforcement and the Division of Trading and Markets which has created a potential credibility issue for the Commission and its staff. More importantly, the professional trading community urgently needs clarification of this area. Continuing current positions will only create more uncertainty as security futures and other futures products play a more prominent role in all professional trading.

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[1] Commodity Exchange Act, §1(a)5 and §1(a)6; 7 U.S.C. §§1a-5, 1a-6.

[2] 17 C.F.R. 4.10(d)(1).

[3] 7 U.S.C. §1a-5.

[4] Note 2 *infra*.

[5] 7 U.S.C. §1a-6.

[6] 17 C.F.R. §4.5.

[7] 17 C.F.R. §4.6.

[8] 17 C.F.R. §4.7.

[9] We recognize that CPO registration could be sought, a new entity created, applicable notice filed and then the existing entity merged into the new entity. However, this is such an awkward and time-consuming "solution" that it scarcely seems worth the bother for an entity that may want to only trade a few futures contracts.
[10] 17 C.F.R. §4.12.
[11] 17 C.F.R. §4.13.
[12] Comm.Fut.L.Rep. [1994] (CCH) ¶26,208 (July 26, 1994).
[13] 17 C.F.R. §4.7; prior to August 4, 2000, "qualified eligible persons" under Rule 4.7 were "qualified eligible participants".
[14] Comm.Fut.L.Rep. [1996-98] (CCH) ¶27,040 (April 2, 1997).
[15] 17 C.F.R. 4.7(a).
[16] 17 C.F.R. 1.3(z).
[17] Comm.Fut.L.Rep. [1996-98] (CCH) ¶27,068 (May 28, 1997).
[18] 7 U.S.C. §8a(2) or §8a(3).
[19] CEA, §§4b and 4o; 7 U.S.C. §6b & 6o.
[20] CFTC Rules Parts 15, 18 and 19; 17 C.F.R. Part 15, 18, 19.
[21] 17 C.F.R. §140.99.