



U.S. COMMODITY FUTURES TRADING COMMISSION

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Division of Clearing and
Intermediary Oversight

Ananda Radhakrishnan
Director

CFTC letter No. 05-22
November 10, 2005
Exemption
Division of Clearing and Intermediary Oversight

Re: Section 4m(1) – Request for Relief From the Commodity Trading Advisor
Registration Requirement Where Third-Party System Developer and Registered
Introducing Broker Have Common Principals

Dear :

This is in response to your letter dated March 1, 2005, to the Commodity Futures Trading Commission (the “Commission”), which has been referred to the Division of Clearing and Intermediary Oversight (the “Division”) for response. By your letter, subsequent emails, and telephone conversations with Division staff (collectively, the “correspondence”), you have requested that the Division not recommend that the Commission commence any enforcement action against “X” for failure to register as a commodity trading advisor (“CTA”) under Section 4m(1) of the Commodity Exchange Act (the “Act”).¹

Based on the correspondence, we understand the facts to be as follows. You are the President of “X”, and you and your wife, “A”, are the sole owners of “X”. “X” has developed and sells various trading systems that are supported by a computerized software platform that generates trading signals. In connection with purchasing “X’s” trading systems, “X’s” clients execute a “letter of direction” authorizing “Y”, a registered introducing broker (“IB”), to trade their accounts in accordance with “X’s” trading signals. “X” markets this service on its website as the “Broker-Assisted Trading Program.”² You and “A” are also the sole principals, and registered associated persons (“APs”), of “Y”. All of “Y’s” customers have issued a letter of direction in favor of “Y” authorizing “Y” to place trades in accordance with “X’s” trading

¹ 7 U.S.C. 6m(1) (2000). The Act and the Commission’s regulations may be accessed at: http://www.access.gpo.gov/uscode/title7/chapter1_.html and <http://www.gpoaccess.gov/ecfr/>, respectively.

² Although in the past “X” has solicited and sold its trading systems to clients whose accounts were self-directed, all of “X’s” new clients are required to participate in the Broker-Assisted Trading Program with “Y”.

signals, and “Y” does not at this time provide services to its customers other than trading their accounts pursuant to “X’s” trading signals.

Preliminarily, the Division notes that, although you seek relief from the CTA registration requirement on behalf of “X”, because “Y” exercises discretionary authority over client accounts by trading those accounts using trading systems developed by you and “A” (albeit in your capacity as principals of “X”), “Y”, too, comes within the CTA definition. Rule 4.14(a)(6) governs the question of whether “Y”, as a registered IB, is exempt from the CTA registration requirement of Section 4m(1) of the Act. Rule 4.14(a)(6) exempts from the CTA registration requirement any registered IB whose commodity interest trading advice is provided solely in connection with its business as an IB. In considering whether commodity interest trading advice is provided solely in connection with IB activity, the Division has considered, among other things: (1) whether the advisory services originate with the IB or are supplied to the IB by a third-party, and the extent to which an IB modifies or deviates from the trading recommendations supplied by a third-party; (2) the proportion of the IB’s accounts to which it is providing advisory services; and (3) whether the IB exercises discretionary trading authority over a majority of the accounts it introduces.³

As you and “A” are the sole owners of both “X” and “Y”, the trading systems “X” uses to trade its customers’ accounts are not supplied by an independent, unaffiliated third-party.⁴ Further, as all of “Y’s” customers have executed a letter of direction in favor of “Y” directing that their accounts be traded in accordance with “X’s” trading signals, “Y” exercises discretionary authority over all of the accounts it handles. It appears that “Y’s” sole purpose may be to facilitate the discretionary management of customer accounts based on trading signals developed by its sister company, “X”. As “Y’s” business is devoted exclusively to exercising

³ See CFTC Staff Letter No. 96-17, [1994-96 Transfer Binder], Comm. Fut. L. Rep. (CCH) ¶ 26,629 (February 9, 1996) (an IB may be required to register as a CTA if it uses another CTA’s trading system to solicit discretionary authority over or effectively guide certain accounts); CFTC Staff Letter No. 95-17, [1994-96 Transfer Binder], Comm. Fut. L. Rep. (CCH) ¶ 26,344 (February 24, 1995) (IB required to register as a CTA where IB directs a high percentage of the accounts it introduces).

Other factors the Division may consider in determining the applicability of Rule 4.14(a)(6) include (1) whether the IB markets its advisory services generally to the public or limits its availability to established customers, and (2) the manner in which the IB is compensated for the advisory services. See CFTC Staff Letter No. 96-17, *supra*.

⁴ See CFTC Staff Letter No. 93-6, [1992-94 Transfer Binder], Comm. Fut. L. Rep. (CCH) ¶ 25,571 (January 27, 1993) (requiring an IB to register as a CTA where the IB directs trading in the majority of its customer accounts and the trading program offered by the IB had been developed by the IB’s sole proprietor).

discretionary authority over customer accounts, the Division believes that “Y’s” commodity interest trading advice is not being provided solely in connection with its business as an IB.⁵ Accordingly, “Y” does not qualify for the registration exemption in Rule 4.14(a)(6), and it must register as a CTA.⁶

As a registered CTA, “Y” must provide a Disclosure Document to each of its customers that participate, or will participate, in “X’s” Broker-Assisted Trading Program. That Disclosure Document must include, among other information, past performance disclosures with respect to each of “X’s” trading systems. As a result of this disclosure obligation, the Division does not believe that requiring “X” to register as a CTA would provide any additional benefit to “X’s” clients.⁷

Accordingly, based on the representations made in the correspondence, the Division will not recommend that the Commission commence any enforcement action against “X” for its failure to register as a CTA under Section 4m(1) of the Act. This relief is, however, applicable to “X” solely with respect to the Broker-Assisted Trading Program as currently implemented⁸ and is subject to the conditions that “Y”: (1) registers with the Commission as a CTA; and (2)

⁵ Cf. *In the Matter of Armstrong, et al.*, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,657 (CFTC Feb. 8, 1993) (finding that a publisher did not fall within the publisher exclusion of the CTA definition because its trading advice “far from being ‘solely incidental’ to its publishing business, was the very point of that business”).

⁶ Rule 4.14(a)(9) provides for a registration exemption for CTAs that (1) do not direct client accounts and (2) do not provide advice based on the circumstances or characteristics of particular clients. Inasmuch as “Y” is directing accounts, the Division believes that “Y” does not qualify for the exemption from CTA registration in Rule 4.14(a)(9).

Furthermore, because the Division has determined that “Y” is required to register as a CTA, the Division has not considered the extent to which “X” may be eligible to claim the registration exemption of Rule 4.14(a)(9). Accordingly, this letter should not be construed as suggesting that “X”, as a third-party trading system developer, either is or is not eligible to claim the registration exemption of that rule.

⁷ The Division notes in this regard that the principals of “X” (you and “A”) have already registered as APs, and are designated as the sole principals, of “Y” and thus have satisfied the proficiency, fitness, and registration standards established by both the Commission and the National Futures Association.

⁸ Thus, for example, in the event that “X’s” clients participate in the Broker-Assisted Trading Program by authorizing IBs other than “Y” to trade their accounts, the no-action position taken by this letter may no longer obtain.

provides to each of “X’s” clients participating in the Broker-Assisted Trading Program a Disclosure Document as specified by Part 4 of the Commission’s regulations.

The relief issued by this letter does not excuse “X” from compliance with any otherwise applicable requirements contained in the Act or the Commission’s regulations issued thereunder. For example, “X” remains subject to all antifraud provisions of the Act and the regulations, the reporting requirements for traders set forth in Parts 15, 18, and 19 of the regulations, and to all other applicable provisions of Part 4 of the regulations.

The no-action position taken in this letter is based upon the representations you have made to the Division and is subject to compliance with the conditions set forth above. Any different, changed, or omitted facts or conditions might render this position void. Moreover, this letter represents the position of the Division only and does not necessarily reflect the views of the Commission or any other office or division of the Commission. If you have any questions concerning this correspondence, please contact R. Stephen Painter Jr., an attorney on my staff, at (202) 418-5416.

Very truly yours,

Ananda Radhakrishnan
Director