CFTC Letter No. 00-91

September 13, 2000

No-Action

Division of Trading & Markets

> Re: Rule 1.46 -- Request for Relief from Requirement for Same-Day Closing Out by a Futures Commission Merchant of Offsetting Long and Short Positions Held for the Account of the Same Customer

Dear :

This is in response to your letter dated July 28, 2000 to the Division of Trading and Markets (the "Division") of the Commodity Futures Trading Commission (the "Commission"), as supplemented by your e-mail transmission dated August 22, 2000 and by telephone conversations with Division staff. By your correspondence, you request relief on behalf of "U", "V" and "W" (collectively referred to herein as "X") from the requirement in Commission Rule 1.46[1] that offsetting long and short positions generated by "X's" various trading programs (when used in combination) be closed out (i) by the futures commission merchant ("FCM") with whom any of the pools operated by "X" maintains an account; or (ii) by the FCMs carrying accounts of pools operated by commodity pool operators ("CPOs") unaffiliated with "X" and for which "X" acts as the commodity trading advisor ("CTA").

You seek this relief in order to permit "X" to use with its pools, and unaffiliated CPOs to use with their pools, a combination of trading programs that may, from time to time, result in a pool customer holding long and short positions in the same futures contract and contract month. You believe that application of Rule 1.46's requirement promptly to close out such positions would make impractical the use of "X's" Short-Term Program in combination with any of "X's" long-term technical trend-following trading strategies.

Based upon the representations made in your correspondence, we understand the relevant facts to be as follows. "U" is registered with the Commission as a CPO and as a CTA and is wholly-owned by "V" and "W". "V" is registered both as a CPO and as a CTA, and "W" is registered as a CTA. "X" operates commodity pools and provides commodity interest trading advice to pools operated by unaffiliated CPOs.

"X" currently offers four trading strategies to its clients: "AA", "BB", "CC" and "DD" (collectively referred to herein as the "Long-Term Strategies"). Each of the Long-Term Strategies is traded pursuant to "X's" long-term technical trend-following program, which analyzes a number of interrelated mathematical and statistical formulae and techniques that are quantitative, that are proprietary in nature, and that have

been either learned or developed by "A", "B" and/or "C". Each of the Long-Term Strategies is non-discretionary in that market entry or exit decisions (which may be generated or effectuated at any time during the 24-hour trading day) are based on computer generated signals. "X", while maintaining discretion over all computer-generated trading parameters, does not, except in rare circumstances, override the technical trading program.[2] Trades are made only when markets are perceived to be trending, and trades are typically of long-term duration, averaging from 8 to 10 weeks (in "X's" trading to date, positions in certain commodity interest contracts have remained open for periods in excess of 12 months).

"X" has recently developed its Short-Term Program. Unlike the Long-Term Strategies, the Short-Term Program is not a long-term, trend-following program, but one that utilizes a technical, systematic approach that does not depend on the occurrence of major price trends in generating trading signals. The Short-Term Program is non-discretionary in that all orders are computer-generated after the close of the New York/Chicago trading day for execution in the next day's market and, absent extraordinary circumstances, no intervention to modify the computer-generated order selection is permitted. Trades are made under various market conditions and are typically of short duration, averaging two to five days.

Trades generated by "X's" long-term technical trend-following program (as utilized by the Long-Term Strategies) are not part of the data considered by the Short-Term Program and, therefore, have no impact on the trades generated by the Short-Term Program. Similarly, trades generated by the Short-Term Program are not considered by the long-term technical trend-following program. The mechanical trading signals generated by both "X's" long-term technical trend-following program and its Short-Term Program are documented and are retained on file by "X" as part of its books and records, which are available for inspection.

"X" now wishes to be permitted to combine the Short-Term Program with one or more of the Long-Term Strategies without causing the FCMs carrying accounts that use such combined programs to be required to close out offsetting long and short positions as required by Rule 1.46. In particular, you request exemption from the requirement of Rule 1.46 to close out offsetting positions generated by "X's" different commodity interest trading programs (when used in combination) that would otherwise be applicable to: (i) any FCM carrying the account of one of the pools operated by "X"; or (ii) any FCM carrying the account of a pool operated by an unaffiliated CPO, but for which "X" acts as the CTA. You state that "X" would consent to conditioning such relief upon the following:

    1. "X" uses each such pool client[3] to maintain separate accounts (or sub-accounts) with its FCM for Long-Term Strategies trades and for Short-Term Program trades;

    2. "X" provides a copy of this letter to each FCM maintaining accounts for such pool clients;

    3. "X" maintains records of each offsetting trade executed pursuant to this letter;

    4. "X" will not receive any portion of the round-turn brokerage fees generated by trades executed for the account of any such pool client;

5. "X" will assure compliance with the requirements of Rule 1.46(d)(9)(i) and (ii) with respect to each offsetting trade to be executed pursuant to this letter;

6. "X" will obtain prior written permission to maintain opposite positions from any CPO or trading manager electing to use the Short-Term Program in combination with any of the Long-Term Strategies; and

7. A risk factor substantially similar to the following text will be added to "X's" Disclosure Document and to the Confidential Private Placement Memorandum and Disclosure Document for each pool operated by "X" (and you expect that the same text would be incorporated into the offering materials of any pool retaining "X" and trading the Short-Term Program in combination with one or more of the Long-Term Strategies):

Programs Trading Independently of Each Other; Programs may Take Positions Opposite Each Other. "X's" "AA", "BB", "CC" and "DD" are long-term technical, trend-following strategies, while the Short-Term Program is a technical, systematic strategy of a different nature. The Short-Term Program does not depend on trend-following and generates trades of significantly shorter duration. As a result, selection of the Short-Term Program in combination with one or more of "X's" "AA", "BB", "CC" and "DD" may result in the taking of opposite positions in respect of certain commodity interest contracts from time to time. In certain circumstances, the Short-Term Program may reduce or eliminate profitable positions generated by the long-term technical, trend-following strategies. Furthermore, the [Funds] [pool's account] will pay brokerage commissions and related costs in connection with any such offsetting positions.

Rule 1.46 provides in relevant part that, absent the applicability of one of several exceptions set forth in the rule, an FCM must, on the same day that it makes a purchase or sale for the account of any customer, apply such purchase or sale against that customer's previously held short or long position, respectively, in the same futures contract and contract month (or in the case of an option contract, the same strike price and expiration date) of the same commodity on the same market, and must close out such offsetting long and short positions on a first-in, first-out basis. Originally adopted by the Commission's predecessor agency, the Commodity Exchange Authority,[4] Rule 1.46 was promulgated to safeguard against the holding of offsetting customer positions for improper purposes, such as wrongful allocation of trades or generation of excessive commissions.[5]

Your correspondence discusses two of the exceptions to Rule 1.46's requirement to close out offsetting positions.[6] Rule 1.46 (d) (4) is an exception for separate accounts of a commodity pool, each of which is directed by an unaffiliated CTA acting independently. Each CTA's trading decisions must be made independently of trading decisions made by other CTAs, each trade must be made by open and competitive means subject to a contract market's rules, and no position held pursuant to the exception may be closed out by transferring it to another separate account of the pool. Rule 1.46(d)(9) is an exception for separate accounts of a customer who has granted discretionary authority to an FCM, an FCM's associated person ("AP") or a CTA trading separate trading programs that have been marketed separately. As with Rule 1.46

(d)(4), each trade must be made by open and competitive means subject to a contract market's rules, and no position held pursuant to the exception may be closed out by transferring it to another separate account of the customer.

"X" finds itself unable to use either of the foregoing exceptions. Rule 1.46(d)(4) covers pool customers, but it requires separate accounts, each directed by a different, unaffiliated CTA. Rule 1.46(d)(9) applies to a customer of a single CTA, but the different trading programs must be "separate trading programs which have been marketed separately." You note in your correspondence that the existence of an exception specifically applicable to pool customers (Rule 1.46(d)(4)) suggests that reliance by "X" upon Rule 1.46(d)(9) in connection with its pool customers would be inappropriate. Moreover, "X" has not clearly demonstrated that it has marketed separately the Short-Term Program and the Long-Term Strategies.[7]

The Division notes that in connection with its proposed new regulatory framework the Commission has published for comment proposed rules that would, among other things, amend Rule 1.46 to permit any customer or account controller to instruct an FCM to depart from what would become the "default" rule of closing out all offsetting positions on a first-in, first-out basis, looking across all accounts the FCM carries for the customer, and thereby permit such positions to be held open or to be closed out on a different basis than first-in, first-out. Under the proposal, CPOs and CTAs would be required to disclose to their pool participants or clients their election so to instruct the FCM.[8]

In support of your request you state that "X's" fees consist of a flat-rate management fee (typically from 1 percent to 2 percent of net assets annually), and a performance fee (typically up to 25 percent of net trading profits after deduction of expenses, and not including interest income). The performance fee, which is typically paid quarterly, is determined on a "high-water mark" basis. For accounts that trade more than one program, the performance fee is based on the net performance of all programs combined, not on an individual program-by-program basis. Thus, adding the Short-Term Program to existing accounts will not result in "X" having an additional "sub-account" on which it can earn a performance fee.[9] You further state that "X" does not receive rebates of round-turn brokerage commissions generated as a result of its trading decisions on behalf of the pools that it operates or any client (including pools for which "X" acts as an independent CTA).[10] Thus, you state that "X's" sole interest in managing its accounts is to maximize performance, thereby generating performance fees and preserving client relationships. "X" is not affiliated with any FCM and has no incentive to generate additional brokerage commissions (which, in any event, would reduce "X's" performance fees).

Having considered the facts as represented in your correspondence and the safeguards that "X" is willing to maintain, we believe your request has merit.[11] Accordingly, the Division will not recommend that the Commission take any enforcement action under Rule 1.46 against any FCM that carries a pool customer account for which trading is directed by "X" (whether in the case of pools operated by "X" or pools operated by others and for which "X" acts as CTA) solely by reason of such FCM's failure promptly to close out offsetting positions generated as a result of such pool client's use of the Short-Term Program in combination with one or more of the Long-Term Strategies. This position is, however, subject to the conditions that: (1) "X" causes each such pool client to maintain separate accounts with such FCM for

Short-Term Program trades and for Long-Term Strategies trades; (2) "X" provides a copy of this letter to each such FCM maintaining separate accounts for a pool customer; (3) "X" maintains records of each offsetting trade executed pursuant to the relief hereby granted; (4) "X" will not receive any portion of round-turn brokerage fees generated by trades executed for the account of such pool client; (5) "X"'ll assure compliance with the requirements of Rule 1.46(d)(9)(i) and (ii) with respect to each offsetting trade executed pursuant to the relief hereby granted; (6) "X" will obtain from any CPO and/or trading manager that selects the Short-Term Program in combination with any of the Long-Term Strategies prior written permission to maintain offsetting positions, including an acknowledgment of the costs associated with maintaining offsetting positions in futures contracts or commodity options; and (7) "X" will include in its CTA Disclosure Document and in the Confidential Private Placement Memorandum and Disclosure Document for each pool operated by "X", and will cause the CPO of any pool not operated by "X" but that retains "X" as its CTA and trades the Short-Term Program in combination with one or more of the Long-Term Strategies to include in the offering materials of such pool, a risk factor in substantially the following form:

> **Programs Trading Independently of Each Other; Programs may Take Positions Opposite Each Other.** "X's" "AA", "BB", "CC" and "DD" are long-term technical, trend-following strategies, while the Short-Term Program is a technical, systematic strategy of a different nature. The Short-Term Program does not depend on trend-following and generates trades of significantly shorter duration. As a result, selection of the Short-Term Program in combination with one or more of "X's" "AA", "BB", "CC" and "DD" may result in the taking of opposite positions in respect of certain commodity interest contracts from time to time. "X" will instruct the FCM carrying accounts for a pool for which such a combination of trading programs has been selected to hold open any offsetting positions until the applicable trading program signals that each such position should be closed out. In certain circumstances, the Short-Term Program may reduce or eliminate profitable positions generated by the long-term technical, trend-following strategies. Furthermore the [Funds] [pool's account] will pay brokerage commissions and related costs in connection with any such offsetting positions.

This letter is based upon the representations provided to us. Any different, changed or omitted facts or circumstances might require us to reach a different conclusion. You must notify us immediately in the event that the operations or activities of "X" change in any way from those as represented to us. Further, this letter is applicable to FCMs carrying accounts of commodity pools operated by or advised by "X", solely in connection with trades executed at the direction of "X". To the extent that the final amendments to Rule 1.46 adopted by the Commission are inconsistent with this letter, those final rule amendments will supersede this letter from and after the effective date of the amendments.

We note that this letter does not excuse "X" or any FCM from compliance with any other applicable requirements contained in the Commodity Exchange Act (the "Act"), 7 U.S.C. §1 *et seq*. (1994), or in the Commission's regulations issued thereunder. For example, "X" and each FCM carrying accounts of commodity pools operated by or advised by "X" remains subject to all antifraud provisions of the Act, and to the reporting requirement for traders set forth in Parts 15, 18 and 19 of the Commission's regulations.

Further, this letter represents the position of the Division of Trading and Markets only. It does not necessarily reflect the views of the Commission or of any other office or division of the Commission. If you have any questions concerning this correspondence, please contact me or Christopher W. Cummings, an attorney on my staff, at (202) 418-5445.

Very truly yours,

John C. Lawton
Acting
Director

1 Commission rules referred to herein are found at 17 C.F.R. Ch. 1 (2000).

2 You note that while "X" relies primarily on its mechanical trading systems in making investment decisions, the strategy does include the latitude to depart from this approach if market conditions are such that, in the opinion of "X", execution of trades recommended by the mechanical systems would be difficult or would expose an account to unusual risk. The rare instance may occur when "X" will override the system to decrease market exposure.

3 You use the term "pool client" to include those pools "X" operates and provides commodity interest trading advice to, as well as the pools (operated by CPOs unaffiliated with "X") to which "X" provides commodity interest trading advice in the capacity of an independent CTA. We adopt your usage for purposes of this letter.

4 13 Fed. Reg. 7820, 7840 (December 18, 1948).

5 57 Fed. Reg. 34533 at 34535 (August 5, 1992).

6 You do not refer to (and we need not consider) the other exceptions: 1.46(d)(1) and (2) (bona fide hedging transactions); 1.46(d)(3) (sales for purposes of making delivery during a delivery period); 1.46(d)(5) (transactions covering the obligations of a leverage transaction merchant); 1.46(d)(6) (separate accounts for which trading is directed by unaffiliated persons); 1.46(d)(7) (persons granted exemption from position limits); and 1.46(d)(8) (purchases and sales held in error accounts).

7 In adopting Rule 1.46(d)(9) the Commission stated that it did not propose to define "separate systems," but did propose that to be eligible for the exception, to the extent the trading programs are marketed, they must be marketed separately. *See* 57 Fed. Reg. 55082 at 55083 (November 24, 1992). Although you state that "X" markets each of its programs separately, that the Short-Term Program is distinguished in the "X" Disclosure Document with a separate description of its methodology and separate risk factors peculiar to the Short-Term Program, it is not clear that this constitutes marketing the programs separately for purposes of Rule 1.46.

8 *Rules Relating to Intermediaries of Commodity Interest Transactions* 65 Fed. Reg. 39008, 39017, 39022, 39025 (June 22, 2000).

9 You assert that a CPO may achieve additional diversification and potential reduction of volatility without the additional cost of performance fees based on the trading of another CTA during a period when the pool's account, on an overall basis, has negative performance.

10 In certain cases, "X's" management fee is a percentage of either a flat-rate brokerage commission or wrap-fee charged by a pool's FCM, where such FCM is an affiliate of the pool's CPO.

11 You refer to CFTC Staff Letter No. 96-68, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶26,794 (September 13, 1996), in which the Division took a no-action position with respect to the failure to close out offsetting positions generated in pool trading accounts in the course of using a combination of long-term and short-term trading programs. You acknowledge that the facts in your request are different to the extent that the same principals of "X" operate the Long-Term Strategies as well as the Short-Term Program. The Division does not believe that this distinction should require denial of your request.