



COMMODITY FUTURES TRADING COMMISSION

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94-79

DIVISION OF  
TRADING AND MARKETS

July 26, 1994

Re: Section 4m(1) -- CBOE Broker-Dealer and Its Nominees

Dear :

This is in response to your letter dated April 11, 1994, to the Division of Trading and Markets ("Division") of the Commodity Futures Trading Commission ("Commission"), as supplemented by letters dated May 18, 1994 and July 12, 1994 from "A" of your firm and telephone conversations between "A" and Division staff. By your letter, as supplemented, you request regulatory relief in connection with the operation of "W" under the facts set forth below.

Based upon the representations made in your letter, as supplemented, we understand the relevant facts to be as follows. "W", an Illinois limited partnership formed in July, 1991, is registered with the Securities and Exchange Commission ("SEC") as a broker-dealer and is a member of the Chicago Board Options Exchange ("CBOE"). The General Partner of "W" is "X", of which "B" is the president and sole shareholder. "B" is registered as a commodity pool operator ("CPO") and is a member of the Chicago Mercantile Exchange and the Chicago Board of Trade.<sup>1/</sup>

"W" currently has ten limited partners, described as follows:

1. "Y", formed in 1986, was an original investor in "W".<sup>2/</sup> Its general partners are "B" and "V".<sup>3/</sup> It has eleven limited partners, each of whom is an accredited investor

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<sup>1/</sup> He also is registered as a broker-dealer and is a member of the CBOE.

<sup>2/</sup> In fact, as your letter more fully explains, "W" succeeded to the business of "Y".

<sup>3/</sup> "V" is solely owned by "L", a qualified eligible participant ("QEP") as that term is defined in Rule 4.7. Commission rules referred to herein are found at 17 C.F.R. Ch. I (1993).

and has been a limited partner since "Y's" formation in 1986.<sup>4/</sup> "Y" is not seeking to admit additional limited partners.

2. "Z", formed in 1987, also was an original investor in "W" (in July, 1991) and is a registered broker-dealer and CBOE member. "C" is its general partner. It has eight limited partners, each of which is either a member of "C's" immediate family or an employee of "Z" since at least 1989. "Z" may admit additional limited partners but is not actively seeking to do so. Any such additional limited partner will have the same characteristics as the existing limited partners.

3. and 4. "D" who is a registered broker-dealer and a CBOE member, and his father, "K".

5. "E", whose husband is a registered broker-dealer and a CBOE member.

6. through 10. "F", "G", "H", "I" and "J", each of whom is a registered broker-dealer and a CBOE member.

With the exception of "K" and "J", each limited partner has been a limited partner in "W" since at least January 1992.<sup>5/</sup> Moreover, each natural person limited partner except for "K" and "E" has known "B" professionally since at least 1989 -- either because he traded in the same CBOE pit, because he was involved in the management of firms that cleared "B"'s options market-maker account, or served with "B" on one or more CBOE committees. An immediate family member of each of "K" and "E" has known "B" professionally since 1989.

"W's" business involves proprietary market-making activity in the Standard & Poor's ("S&P") 500 Stock Index ("SPX") and S&P 100 Stock Index ("OEX") options on the CBOE trading floor. It conducts its market-making business through market-maker nominees (the "Nominees") it selects.<sup>6/</sup> Specifically, "W" authorizes

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<sup>4/</sup> Messrs. "B" and "L" are two of the eleven limited partners. The remaining nine limited partners have had a business relationship with "B" since at least 1984.

<sup>5/</sup> While "J" only recently became a limited partner, we note that he also is registered with the Commission as a floor broker and that it is intended that he will become an officer of and shareholder in "X" in the near future.

<sup>6/</sup> "W" currently employs seven market-maker nominees, but in the past has employed as few as three or as many as eight.

each of the Nominees to trade for "W's" account on a discretionary basis, using "W's" capital but his or her own best judgment and trading skills. Like other market-makers in the SPX and OEX pits, the Nominees hedge their option positions through the purchase and sale of S&P 500 futures contracts.<sup>2/</sup>

You have made three requests of the Division. First, you request relief from CPO regulation for "X" in connection with its operation of "W" as it currently is comprised. In support of this request we note, among others, your representations that: (1) "B", the sole owner of "X" and its president, is registered as a CPO and is a member of several designated contract markets; (2) subject to the two exceptions noted above, each of "W's" limited partners has been a limited partner since at least 1987; (3) except for "K" and "E", each of "W's" limited partners has had a professional relationship with "B" since at least 1989 and an immediate family member of each of "K" and "E" has known "B" professionally since at least 1989; (4) except for "K" and "E", each natural person limited partner is a registered broker-dealer and a CBOE member; (5) "K's" father and "E's" husband are each registered broker-dealers and CBOE members; and (6) "W" will trade commodity futures solely for hedging purposes. Accordingly, the Division will not recommend that the Commission take any enforcement action for failure to register as a CPO against "X" in connection with its operation of "W" as it is currently constituted.

Second, you request relief from CPO regulation for "X" in the event that it accepts additional limited partners in "W". In this regard, you explain that while "W's" current capitalization (\$3.95 million at December 31, 1993) is adequate in light of its current operations, "W" wishes to increase its capital in order to take better advantage of opportunities in the index option markets, as well as to extend its trading through relationships with various traders in interest rate, foreign currency, and other options and related futures contracts. "W" does not intend to engage in any general solicitation of new limited partners. Rather, "W" would admit any such partner only in the event that "X" determined that increasing "W's" capitalization was consistent with "W's" investment objectives. Any such new limited partner would be required to be: (1) (a) an individual principal

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<sup>2/</sup> In this regard, and in support of the request, "A" represented that any commodity futures trading engaged in by "W" would constitute "bona fide hedging" as that term is defined in Rule 1.3(z)(1).

of "W";<sup>8/</sup> (b) a QEP who has known such a principal professionally for at least the three years preceding the date of his admittance as a limited partner;<sup>9/</sup> or (c) a member of one or more contract markets, a member of CBOE or another national securities exchange or a registered broker-dealer for at least three years prior to admittance (an "Eligible Limited Partner"); (2) an immediate family member of an Eligible Limited Partner; or (3) a trust created for the benefit of an Eligible Limited Partner or immediate family member whose investment decisions are made by an Eligible Limited Partner. Further, "W" will at no time have more than fifteen limited partners.

Third, and finally, you request relief from commodity trading advisor ("CTA") regulation for the Nominees and any subsequently selected Nominee who, as noted above, has discretion over "W's" trading, including its commodity futures trading, and thus will be acting as a CTA with respect to "W".<sup>10/</sup> In support of your request you represent that any such Nominee: (1) is or will be sought out by "W" to trade its account, based upon the Nominee's reputation, trading skills, and the like; (2) will be prohibited by contract from engaging in similar activities for any other person; (3) will not hold itself out generally to the public as a CTA; and (4) will not be subject to a statutory disqualification under Section 8a(2) or 8a(3) of the Commodity Exchange Act (the "Act"), 7 U.S.C. § 12a(2) or 12a(3) (1988 and

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<sup>8/</sup> For this purpose, the term "principal" means any individual who has trading discretion or other authority over the assets of "W" or who is otherwise substantially responsible for "W's" trading activity. Thus, this definition includes "B" and, upon his becoming an officer of "X", "J", as well as the CBOE nominees (some of whom are already limited partners of "W") to whom "W" entrusts capital for transactions in the options and commodity interest markets. The term "principal" also includes a limited number of key "W" employees who, while not engaged in floor trading activity, nonetheless have substantial day-to-day responsibility for evaluating market opportunities and formulating trading strategies for "W".

<sup>9/</sup> A limited partner will have known an individual principal of "X" professionally if, like most of the existing natural person limited partners, he traded with such a principal in the same CBOE pit, has been involved in the management of a firm that cleared such principal's (or "X's") options market-maker account, or served with such principal on one or more CBOE committees.

<sup>10/</sup> This request was not made by your April 11, 1994 letter, but was made subsequently by "A" pursuant to telephone conversations with Division staff.

Supp. IV 1992).<sup>11/</sup> Based upon the foregoing, the Division will not recommend that the Commission take any enforcement action for failure to register as a CTA against a Nominee.

The relief issued by this letter does not excuse "X" or any Nominee from compliance with any other applicable requirements contained in the Act or the Commission's regulations thereunder. For example, each remains subject to the antifraud provisions of Section 4<sub>o</sub> of the Act, 7 U.S.C. §6<sub>o</sub>, to the reporting requirements for traders set forth in Parts 15, 18 and 19 of the Commission's regulations, and to all other provisions of Part 4. Further, the Division notes that it is not excusing, or in any way limiting the Commission's ability to proceed against "X" or any of the Nominees for, any past violations of the Act or the Commission's regulations if the Commission determines that such action is appropriate. The relief granted herein is prospective only, effective as of the date of this letter.

This letter is based on the representations you have made to us, as stated above, and is solely applicable in connection with the operation of "W". Any different, changed or omitted facts or conditions might require us to reach a different conclusion. In this regard, we request that you notify us immediately in the event that "W's" operations, including its commodity futures trading and membership composition, including the membership composition of "Y" and "Z", change in any way from those as represented to us.

This letter represents the position of the Division of Trading and Markets only. It does not necessarily reflect the views of the Commission or any other office or division of the

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<sup>11/</sup> In support of this request, "A" claims that a Nominee should not be deemed to be a CTA because its futures trading is ancillary to, and merely implements, "W's" main trading activities. Neither the Act nor the Commission's regulations contain any such exclusion from the CTA definition for persons who engage in such activities. Alternatively, you claim that the Nominees qualify for relief from CTA registration pursuant to Section 4m(1) of the Act, 7 U.S.C. §6m(1) (1988 & Supp. IV 1992). We do not concur in this view, which would require us to count "Y" and "Z" as one person.

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Commission. If you have any questions regarding this letter, please contact me or Barbara S. Gold, Assistant Chief Counsel, at (202) 254-8955.

Very truly yours,

Susan C. Ervin  
Chief Counsel