



U.S. COMMODITY FUTURES TRADING COMMISSION

Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581
Telephone: (202) 418-5430
Facsimile: (202) 418-5536

REC SEC

96-68

DIVISION OF
TRADING & MARKETS

September 3, 1996

Re: Request for Clarification of Registration Requirements with Respect to Unregistered Developers of Commodity Trading Software Recommending Introducing Broker's Associated Person to Software Purchasers

Dear :

This is in response to your letter dated March 7, 1996, to the Division of Trading and Markets ("Division") of the Commodity Futures Trading Commission ("Commission"), as supplemented by telephone conversations with Division staff. By your correspondence, you request on behalf of yourself, a registered introducing broker ("IB") doing business as "X", clarification of the registration requirements under Section 4m(1) of the Commodity Exchange Act ("the Act")^{1/} with respect to unregistered developers of commodity trading software ("Third Party Advisors") that recommend "A", an AP of your IB, to purchasers of the software.

You and "A" represent that "A" has dealt with a total of five persons who have developed and offered for sale computer software programs that generate buy/sell signals for trading in commodity interests:^{2/} "B" and "C" of "Y", from October 1994 to

^{1/} 7 U.S.C. § 6m(1) (1994). Commission rules referred to herein are found at 17 C.F.R. Ch. I (1996).

^{2/} Currently, "X" uses two customer agreements to initiate trading pursuant to computer systems: an Order Placement Power of Attorney authorizing "X" and "A" to place customer orders and a Letter of Direction authorizing "X" to place customer orders pursuant to signals generated by a trading system.

You represent that, over the past six months, approximately 35 percent of "A's" business has involved trading pursuant to computer systems. Approximately 70 percent of this business involved one account that belongs to a Third Party Advisor who does not offer or sell his system to the public, and the remaining 30 percent involved five accounts that are active "from time

(continued...)

August 1995; "D" of "U", from November 1994 to October 1995; and "E" of "Z" and "F", from January 1995 to the present.^{3/} Commission records show that three of the developers are or have been registered in some capacity: "B" as a commodity trading advisor ("CTA") and principal of his own firm, from August 16, 1995 to January 17, 1996; "D" as a CTA and principal of his own firm, as of June 7, 1995, and as an associated person ("AP") of "W", as of March 18, 1996; and "F" as a CTA, as of November 23, 1984, and principal of his own firm, as of April 9, 1984. Accordingly, "F" has been registered as a CTA during all of your dealings with him, and "D" was registered as a CTA during four of the months that you dealt with him. Neither "Y" nor "U" is registered as a CTA.

Based upon your representations, the Division finds that the Third Party Advisors were or are engaging in activities that come within the statutory definition of the term "CTA."^{4/} The Division previously has determined that persons who provide commodity interest trading advice by developing and offering for sale computer software are advising others as to the value or advisability of trading in commodity interests and thus come within the statutory definition of a CTA and must register as

^{2/} (...continued)

to time" and trade different computer systems that the customers have purchased. All of "A's" computer trading represented approximately 8.18 percent of "X's" business.

^{3/} As evidenced by attachments to a May 1996 report on your firm by the National Futures Association, "A" has engaged in the promotion and marketing of trading systems in the past. Your firm distributed promotional material prepared by "Y" that includes a glowing testimonial by "A" regarding a Standard & Poor ("S&P") trading program developed by "B", as well as hypothetical performance results developed at least in part by "A". In addition, "A" signed a January 20, 1995 letter on your letter-head, apparently for distribution to customers, that was accompanied by performance summaries for a pork belly trading system and an S&P trading system based on his tracking and testing of the systems, solely on a hypothetical basis. Both sets of materials mention the potential for significant profit, without mentioning the risk of loss in an equally prominent manner.

^{4/} That definition includes, among others, persons who, for compensation or profit, advise others either directly or through publications, writings or electronic media as to the value or advisability of trading in commodity interests. 7 U.S.C. § 1a(5) (1994).

such.^{5/} Accordingly, the Third Party Advisors must comply with the registration requirements of Section 4m(1) of the Act and register as CTAs.

The question of whether "A" is required to register as a CTA would arise whether or not the Third Party Advisors were themselves registered as CTAs. To the extent that "A" uses the information or trading signals generated by the trading systems to discuss or encourage potential trades by customers, even if such customers directly own the system, he would be advising others as to the value or advisability of entering into futures contracts and would be acting as a CTA.^{6/} "A" would be required to register as a CTA unless an exemption from CTA registration applies.

The determination as to whether "A" is required to register as a CTA because of advice offered through the trading systems is governed by Rule 4.14(a)(3), which exempts a registered AP from registration as a CTA when any advice provided is solely in connection with his employment as an AP.^{7/} Any determination in this regard would be based on the facts of the specific situation in question. Here, personal endorsement of trading systems by "A" in publications touting such systems indicates that he is promoting his own trading skill and expertise as a trader, marketing himself individually and personally associating himself with the trading systems, which would be inconsistent with his providing advice solely in connection with his employment as an AP. This determination is consistent with the factors generally considered by the Division in this context, including: (1) whether the advice provided is approved by the IB or consistent with other advice provided by the IB pursuant to the trading

^{5/} See, e.g., CFTC Interpretative Letters No. 95-101, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,565 (November 21, 1995) and No. 94-51, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,115 (May 10, 1994).

^{6/} He also would be providing such advice for compensation since all stand to gain financially if a customer enters into a trade. It is not necessary that a client actually enter into the contract or agreement based on "advice" given for the definition of a CTA to apply. CFTC Interpretative Letter No. 96-17, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,629 (February 9, 1996).

^{7/} Whether you must register as a CTA would be governed by Rule 4.14(a)(6), which exempts a registered IB from CTA registration when the IB's commodity interest trading advice is provided solely in connection with its business as an IB.

systems; (2) whether the advice is furnished in the name of an individual AP or that of the IB; (3) whether there are substantial variations in the advice provided by APs who make use of the trading systems; (4) whether the IBs provide guidelines to APs for use of the trading systems when dealing with customers and whether the individual APs follow such guidelines; and (5) whether the AP exercises discretionary trading authority over customer accounts.^{8/}

In essence, the greater the independence or discretion held by an AP in using the trading systems, the stronger the likelihood that the AP is required to register individually as a CTA. If the Third Party Advisors and their customers likely would follow "A" if he became employed by another IB or a futures commission merchant or established his own business as a CTA or IB, then his advisory services are unlikely to be solely in connection with his current employment and thus he would be required to register as a CTA.

Based upon your representations, it appears that "A" should register as a CTA under Section 4m(1) of the Act if he intends to continue his current relationships with the Third Party Advisors, either through your firm or another firm. In addition, it appears that he should obtain information regarding the Third Party Advisors and their trading programs, including the past performance of these programs, sufficient to comply with his obligation to provide customers with a Disclosure Document containing all material facts prior to opening an account.^{9/}

^{8/} See CFTC Interpretative Letters No. 95-85, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,540 (October 12, 1995) (discussing CTA registration requirements as applied to APs) and No. 75-6, [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,093 (August 13, 1975) (discussing the application of some of these listed factors).

^{9/} See CFTC Interpretative Letters No. 96-47, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,717 (May 31, 1996) (discussing disclosure obligations of a CTA using computer trading systems) and No. 95-85 (discussing disclosure obligations of IBs and APs); see also CFTC Advisory No. 86-3, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,037 (April 25, 1986) (specifying material disclosures that must be included in Disclosure Documents where CTAs use independent advisory services). Moreover, if the Third Party Advisors solicit customers through the efforts of an IB or AP, the Third Party Advisors also may have an obligation to deliver Disclosure Documents.

Failure to comply with the registration and disclosure requirements for CTAs and use of misleading promotional materials constitute violations of the Act and the Commission's regulations, and may result in enforcement proceedings or other Commission actions. You, your firm and any persons participating in or aiding in such conduct may be subject to a law enforcement action for violation of the antifraud provisions of Section 40 of the Act,^{10/} regardless of registration status. In addition, immediate compliance with the Commission's registration requirements does not necessarily preclude the Commission from taking action against you, your firm or any other persons for any past, present or future violations of the Act or the Commission's regulations thereunder.

If you have any questions concerning this correspondence, please contact me or Natalie A. Markman, an attorney on my staff, at (202) 418-5450.

Very truly yours,

Susan C. Ervin
Chief Counsel

^{10/} 7 U.S.C. § 60 (1994).