CFTC Letter No. 97-38

March 26, 1997

Division of Trading & Markets

Re: Request for No-Action Relief with Respect to Provision of Securities Investment Advice by a Registered Investment Adviser to Futures Commission Merchants (FCMs) in Connection with Investment of such FCMs Segregated Customer Funds

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Dear :

This is in response to your letter dated January 10, 1997 to the Division of Trading and Markets (the "Division") of the Commodity Futures Trading Commission (the "Commission"), as supplemented by telephone conversations with Division staff. By your correspondence, you request on behalf of X confirmation that: (1) the Division will not recommend enforcement action against X or its futures commission merchant (FCM) clients if X provides securities investment advisory services to such FCMs in connection with the segregated customer funds held by such client FCMs; and (2) that the provision and receipt of such advisory services will not require X to be registered in any capacity under the Commodity Exchange Act (the Act).[1]

Based upon the representations in your correspondence, we understand the relevant facts to be as follows. X is registered with the Securities and Exchange Commission (SEC) as an investment adviser under the Investment Advisers Act of 1940 (the Advisers Act[2]) and under various state securities laws.[3] Although X is not registered with the Commission in any capacity, it is a wholly-owned subsidiary of Y , a registered FCM.[4] X s primary business activity is providing short-term money management services for institutional clients. X provides cash management services to clients pursuant to written advisory agreements by directing investment of a client s available cash in short-term instruments, including short-term instruments subject to repurchase agreements. X receives advisory fees for its services equal to a percentage of the funds under X s management.

X proposes to offer its advisory services to FCMs with respect to segregated funds belonging to the customers of such FCMs. Pursuant to a written advisory agreement, X would have complete and sole discretion and authority to make all investment decisions with respect to such segregated funds and to purchase, sell and otherwise trade in such

instruments (Securities) as are permissible for investment of customer funds under Section 4d(2) of the Act[5] and Commission Rule 1.25.[6] Securities purchased with customer funds at X s direction and any proceeds of sales of such Securities would be deposited directly with the respective FCM s segregated funds depository and held in a segregated funds account pursuant to Rule 1.26. You state that customer funds and property held in a segregated account will not be permitted to be commingled or pooled with any other funds or property. In no event will X physically receive or hold in its own name securities or funds belonging to customers of its FCM clients.

You anticipate that certain of the Securities purchased with segregated customer funds will be purchased subject to agreements to resell such Securities to the respective counterparties (Reverse Repo Agreements). X would execute such Reverse Repo Agreements on behalf of its FCM clients, but X would in no event become a party to any such agreement. The Reverse Repo Agreements would provide that Securities would be transferred directly by the counterparty to the FCM s segregated account in exchange for a transfer of funds directly from the segregated account to the counterparty, with a simultaneous agreement to reverse the transaction at a specified later date and price. Any transfer of customer funds or property from the segregated account or from the counterparty to or for the benefit of X would be prohibited.

You further anticipate that X may be permitted to execute on behalf of an FCM client a single master Reverse Repo Agreement with a counterparty, setting forth the terms pursuant to which reverse repurchase transactions may be effected for each of several FCM segregated accounts. [7] Each reverse repurchase transaction under such a master agreement would be accounted for separately. Confirmations would be provided by the counterparty directly to the FCM and the segregated funds depository. Moreover, each Reverse Repo Agreement would comply with the requirements of the Division s Financial and Segregation Interpretation No. 2-1.[8]

Pursuant to the written advisory agreement between X and an FCM client, X would be obligated to supply all necessary information with respect to the purchase or sale of Securities to permit the FCM to meet its recordkeeping obligations under the Act and Commission rules (including Rules 1.27 and 1.28). The FCM would remain responsible for compliance with such recordkeeping requirements and with Financial and Segregation Interpretation No. 2-1. X s fee would be calculated as a percentage of the segregated funds as to which X provides cash management services and in no event would such fee be paid by means of, or with customer funds from, a segregated account.

Based upon the representations made in your correspondence, we believe that your request has merit. Nevertheless, we do not believe it is consistent with the Act and Commission rules for an FCM to purport to grant complete and sole discretion and authority to a third-

party service provider to make all investment decisions concerning the segregated funds of the FCM s customers, even if such third-party service provider is restricted to investing such funds in instruments permitted by Section 4d(2) of the Act and Rule 1.25. The responsibility to segregate and treat customer funds in accordance with Section 4d and Rules 1.20 through 1.30 remains that of the FCM and may not be delegated, even though an FCM may employ others to assist it in carrying out this function. Also, the FCM must maintain appropriate internal controls in order to avoid the necessity to report a material inadequacy in internal control pursuant to Rule 1.12, and Rule 166.3 requires the FCM (like all Commission registrants) to supervise diligently all aspects of the handling of accounts carried by it. Accordingly, provided that X receives a limited power of attorney or similarly circumscribed grant of discretion from the FCM client and provided, further, that each FCM using X s services maintains appropriate internal controls of its own over the funds and securities managed by X as a part of the FCM s diligent supervision of such activities, we do not believe that the activities X proposes to undertake would violate the Act or the Commission s rules thereunder. Nor do we believe that such activities would require X to register in any capacity under the Act or the Commission s rules.[9]

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. In this connection, we request that you notify us immediately in the event the operations or activities of X or its client FCMs change in any way from those represented to us. Further, this letter is applicable to X solely in connection with its provision of securities investment advice to its client FCMs.

We note that this letter does not excuse X from compliance with any applicable requirements contained in the Act or in the Commission s regulations issued thereunder. For example, X remains subject to the antifraud provisions of Sections 4b and 4o of the Act, 7 U.S.C. §§ 6b and 6o (1994), and to the reporting requirements for traders set forth in Parts 15, 18 and 19 of the Commission s regulations.

If you have any questions concerning this correspondence, please contact me or Susan C. Ervin, the Division s Chief Counsel, at (202) 418-5450.

Very truly yours,

Andrea M.
Corcoran

Director

[1] 7 U.S.C. § 1 et seq. (1994).

[2] 15 U.S.C. § 80b-1 et seq. (1994).

[3] X is not registered as a government securities broker or as a government securities dealer.

[4] X is also an affiliate of Z , a registered commodity pool operator.

[5] 7 U.S.C. § 6d(2) (1994).

[6] Commission rules referred to herein are found at 17 C.F.R. Ch. I (1996). Permissible investments include obligations of the United States, general obligations of any state or of any political subdivision thereof, and obligations fully guaranteed as to principal and interest by the United States. You note that under no circumstances will X provide advice concerning, or enter orders for, futures or commodity option transactions.

[7] As noted above, X would execute such a master Reverse Repo Agreement on behalf of an FCM client, but would in no event become a party to such an agreement.

[8] 1 Comm. Fut. L. Rep. (CCH) ¶ 7,112A (December 15, 1993).

[9] Although you requested no-action relief, based upon our views regarding X s activities (and because in each case FCM customer funds or Securities will be transferred directly between the counterparty to an investment transaction and the FCM s segregated funds depository without being received or handled by X), such relief is unnecessary. See CFTC Interpretative Letter No. 95-103, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,567 (November 21, 1995).