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Division of Clearing and
Intermediary Oversight

James L. Carley
Director

CFTC letter No. 04-34
September 16, 2004
No-Action
Division of Clearing and Intermediary Oversight

Re: Section 1a(23) and Regulation 1.3(mm) -- No Action Position Concerning the Definition of an Introducing Broker

Dear :

This is in response to your letter dated March 10 2004, and emails dated May 25, 2004 and June 10, 2004, to the Division of Clearing and Intermediary Oversight ("Division") of the Commodity Futures Trading Commission ("Commission"), as supplemented by telephone conversations with Commission staff. By your correspondence, you requested, on behalf of "X", that the Division confirm that it will not recommend that the Commission commence any enforcement action against "X" based solely upon its failure to register as an introducing broker ("IB") under the Commodity Exchange Act ("Act"),[1] in connection with its marketing of a software program with the ability to access the order-entry system of the futures commission merchant ("FCM") or IB of the endusers' choice, as described in your correspondence.

Facts

Based upon your representations, we understand the relevant facts to be as follows. "X" is an affiliate of a software development company, "Y" that controls the rights to a "trade order-entry" software program (the "Software Program"). "X" has entered into a marketing arrangement with "Y". "Y" receives compensation from "X" based on the number of Software Program units that it licenses, regardless of how many trades are placed using the software. The Software Program allows institutional customers to gather and analyze third-party market data to "test investment strategies against real-time or recorded market data." The data feeds containing market information are provided by unaffiliated third parties who do not give compensation to, or receive compensation from, "X" or "Y" for providing market data to "X's" customers. Neither "X" nor "Y" provides market data to its customers. The software assists "X's" customers in making trading decisions, but does not provide express "buy" or "sell" signals.

[1] 7 U.S.C. § 1 *et seq.* (2000).

You represented that "X" plans on licensing the Software Program to institutional customers that are "accredited investors" for their own use and to IBs and FCMs for their own use and for the use of their clients that are "accredited investors" to permit these customers to access the order-entry system of the FCM or IB of their choice.[2] You represented that "X's" customers that will use the Software Program will select their own FCMs or IBs and negotiate any and all fees for executing trades between themselves and the FCM or IB.

The orders will go directly from the end user to the executing FCM or IB without "X" or a third party seeing details of an individual order. The Software Program software would reside on the customers' computers and "X" would have no network connection to the Software Program. Periodically, the FCM or IB would generate reports to "X" detailing how many times the customer has used the software to place orders with the FCM or IB of their choice.

"X" will not recommend, propose, or encourage customers to use any particular FCM or IB, even in response to a customer inquiry, nor will it solicit customers for an FCM or IB in any other manner. The customer will inform "X" of the FCM or IB with which it has an account or with which it wishes to trade and "X" will work with the FCM or IB to implement the required technology to provide the customer access to the FCM's or IB's order-entry system.[3]

When the technology has been implemented, the customer will be able to directly access its selected FCM's or IB's order-entry system through the the Software Program screen, without opening a new application. The customer will log into the FCM's or IB's system and enter its trade in the FCM's or IB's system as it normally would, except that it would be trading through the Software Program screen. As a result, the customer will log-on and place orders with the FCM or IB directly through the Software Program screen. The Software Program would provide a method of entering trades without opening a separate application, which would facilitate order-entry in a more efficient manner.

You have represented that this software will be available to all of "X's" customers, except natural persons, that are accredited investors and that "X" is not involved in any way with the selection of an FCM for any customer.

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[2] "X" will only license The Software Program to entities that are "accredited investors" as that term is defined in Securities and Exchange Commission Regulation D, 17 C.F.R. § 230.501 (2003), but it will not license the Software Program to natural person accredited investors. FCMs and IBs, by a licensing agreement with "X", may also market private label versions of the Software Program to their customers that are non-natural person accredited investors.

[3] You represent that the The Software Program will use the Financial Information eXchange Protocol ("FIX") to transmit customers' orders to the FCM or IB of their choice. You represent that FIX is a standardized protocol used to transmit financial data and that it is widely-used in the financial services industry.

"X" does not have a right or ability to view a customer's orders, positions or the types of contracts traded or the times or prices of these trades. The orders go directly from the customer's computer terminal to the FCM's computer (without passing through "X's" computers). "X" receives a flat monthly fee payment directly from its customers for the use of the the Software Program, except in the event that a customer's usage exceeds a certain maximum amount, in which case the customer will be liable for the excess usage fees that may be negotiated with the customer.[4] The excess usage fee is based on the number of contracts executed using the Software Program that exceed a certain maximum and is not associated in any way with fees the customer might pay to the FCM for executing the trade.

Analysis

Section 1a(23) of the Act defines an IB as:

> [A]ny person (except an individual . . . registered as an associated person of a futures commission merchant) engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market or derivatives transaction execution facility who does not accept any money, securities, or property (or extend credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom.[5]

The Futures Trading Act of 1982,[6] amended the Act to require persons known as "agents" of FCMs to register as IBs, so as to "resolve[ ] any existing uncertainty as to the status of [these] agents."[7] In creating the separate IB registration category, Congress intended to "protect the public" from the "sales abuses" of such agents for which FCMs "frequently disavow[ed] any responsibility."[8]

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[4] The first _____ trades per month are included in the flat monthly fees. "X" may, separately, contract with customers to provide software technical support, but such technical support will not involve buy/sell recommendations and customers. No portion of the excess usage fee will be shared with the FCM or IB.

[5] Rule 1.3(mm) similarly defines an IB, 17 C.F.R. § 1.3(mm). Commission rules referred to herein are found at 17 C.F.R. Ch.1 (2004).

[6] Pub. L. No. 97-444, 96 Stat. 2294 (1983).

[7] H.R. Rep. No. 97-565, pt. 1, at 49 (1982).

[8] *Id.*

In establishing the rules relating to IBs and their registration, the Commission noted that the intent of the Futures Trading Act of 1982 was "to require those persons who performed the type of activities traditionally engaged in by agents to register with the Commission as an [IB]."[9] The Commission indicated that "[h]istorically, agents . . . carried all of their accounts on a fully-disclosed basis with an FCM which provided 'back office' services for those accounts."[10] The Commission further stated that "the phrase 'soliciting or accepting orders,' . . . must be construed to encompass not just the literal solicitation or acceptance of customers' orders, but also the solicitation of customers . . . for referral to an FCM for the institution of a trading relationship and the execution of those orders."[11]

"X's" central business activities are the marketing and distribution of software services. "X" does not solicit customers or orders for an FCM or IB or the trading of futures contracts. Customers indicate to "X" the FCM or IB with which they have an existing relationship or with whom they wish to trade. Even in response to a customer inquiry, "X" does not recommend, propose, or encourage that customers use any particular FCM or IB, or place any orders for futures contracts. "X" is compensated by fees that are paid to it by the customer, and are not associated with the fees charged by the FCM or IB for the placement of customer orders. "X's" fee is paid by the customer based on a flat monthly rate, with an additional charge for excess usage based on the number of contracts executed with the FCM or IB, not based on the FCM's or IB's commission or the price of the contract traded.

Because "X" is collecting an excess usage fee based on the number of contracts executed with FCMs using the Software Program, and to which customers wish to establish a link, "X's" net income may be affected by its providing this service. "X", however, is not accepting customer orders, since it has no involvement with the placing of customer orders and does not recommend a particular trade or an FCM, even if asked to do so by the customer. "X" is simply providing technology that connects the customer to its FCM's order entry system. The customer is submitting its order to the FCM and not to "X". The Division, therefore, will not recommend that the Commission commence any enforcement action against "X" based solely on its failure to register as an IB, provided that it operates in the manner described herein.[12]

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[9] 48 Fed. Reg. 35248, 35250 (August 3, 1983), *quoting* 48 Fed. Reg. 14933, 14935 (April 6, 1983).

[10] *Id.*

[11] *Id.*

[12] The Staff has only twice previously opined as to the registration requirements under the Act as they relate to data service providers, such as "X", that provide technology to facilitate the order entry process and do not engage in activities that would otherwise require registration. In

This letter does not excuse "X" from compliance with any other applicable requirements contained in the Act or in the Commission's rules issued thereunder. For example, it remains subject to the relevant antifraud provisions of the Act and Commission rules. This letter is applicable to "X" solely in connection with the activities described above.

The position taken herein is based upon the representations that have been made to the Division and is subject to the conditions set forth above. Any different, changed, or omitted facts or conditions might render the positions taken herein void. You must notify the Division immediately in the event the operations or activities of "X" change in any material way from those represented to us. Further, this letter represents the position of this Division only and does not necessarily represent the views of the Commission or any other division or office of the Commission.

If you have any questions concerning this correspondence, please contact Peter B. Sanchez, an attorney on my staff, at (202) 418-5437.

Very truly yours,

James L. Carley
Director

CFTC Staff Letter 02-91, July 30, 2002, the entity involved did not receive a per-contract compensation from the FCMs. In CFTC Staff Letter 04-15, March 22, 2004, the entity involved received a per-trade compensation fee directly from the FCM that was not related in any way to the fees charged by the FCM to their institutional customers. If in the future the Commission determines that such entities must be registered under the Act, "X" may have to comply with the applicable registration requirements at that time.