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Summer 6-1-1983

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### Recommended Citation

Don L. Horwitz and David J. Gilberg, *Introducing Brokers Under The Commodity Exchange Act: A New Category Of Commodity Professionals*, 40 Wash. & Lee L. Rev. 907 (1983).

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# WASHINGTON AND LEE LAW REVIEW

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Volume 40

Summer 1983

Number 3

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## INTRODUCING BROKERS UNDER THE COMMODITY EXCHANGE ACT: A NEW CATEGORY OF COMMODITY PROFESSIONALS

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### I. INTRODUCTION

During congressional hearings on the Futures Trading Act of 1982,<sup>1</sup> representatives of the Commodity Futures Trading Commission (CFTC) testified that some 1000 brokers operated in the United States in a regulatory no man's land.<sup>2</sup> The CFTC had long permitted these brokers, primarily smaller firms or individuals unable or unwilling to become subjected to government regulation under the Commodity Exchange Act

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The authors wish to acknowledge the substantial assistance of Carol Feder, (J.D. Candidate, Columbia University (1983)), in the preparation of this article.

<sup>1</sup> Pub. L. No. 97-444, 96 Stat. 2294 (1983). The Commodity Futures Trading Commission operates under a unique sunset provision in the Commodity Exchange Act, which requires Congress expressly to reauthorize the CFTC every four years. See Horwitz and Markham, "Sunset" on the Commodity Futures Trading Commission: Scene II, BUS. LAW. (1983). The CFTC, which was established under the CFTC Act of 1974, underwent its first reauthorization process in 1978. See H.R. REP. NO. 1181, 95th Cong., 2d Sess. (1978); S. REP. NO. 850, 95th Cong., 2d Sess., reprinted in 1978 U.S. CODE CONG. & AD. NEWS 2087; *Hearings Before the Senate Subcommittee on Agricultural Research and General Legislation of the Committee on Agriculture, Research and Forestry on Reauthorization of the CFTC*, 95th Cong., 2d Sess. (1978); *Hearings Before the House Subcommittee on Conservation and Credit of the Committee on Agriculture to Extend Commodity Exchange Act*, 95th Cong., 2d Sess. (1978). See generally Bor, *Some Issues Arising in Consideration of the Futures Act of 1978*, 34 REC. A.B. CITY N.Y. 278 (1979); Gaine, *The 1978 Sunset Review of the CFTC: Analysis and Comments*, 34 REC. A.B. CITY N.Y. 290 (1979); Schneider and Santo, *Commodity Futures Trading Commission: A Review of the 1978 Legislation*, 34 BUS. LAW. 1755 (1979).

<sup>2</sup> S. REP. NO. 384, 97th Cong., 2d Sess. 40 (1982) [hereinafter cited as SENATE REPORT]. As of March 18, 1982, one year prior to the reauthorization hearings, 843 such brokers operated, 15% of whom registered as associated persons, 45% of whom registered with

(CEA),<sup>3</sup> to operate as the designated "agents" of futures commission merchants (FCMs). The CEA, however, did not require these brokers to register in any capacity and the regulations did not subject these brokers to any substantive regulations or exchange supervision. To codify this existing practice, foster the development of these brokers, and resolve many of the uncertainties surrounding their status and relationships with FCMs, Congress in 1982 established a new category of registered commodity professionals, "introducing brokers", which provides the CFTC with regulatory authority over such brokers.

This article will first discuss the treatment of agents under the CEA prior to the new law, and the bases for the longstanding practice under which these agents operated. The article will then analyze the 1982 legislation, and the analogous regulation of introducing brokers under the federal securities laws. Finally, this will be contrasted with the CFTC's recently adopted regulations for introducing brokers.

## II. DESIGNATION OF AGENTS UNDER THE COMMODITY EXCHANGE ACT

### A. *Registration and Regulation of Futures Commission Merchants*

The CEA establishes several categories of registration for commodity professionals, each category imposing a separate set of regulatory requirements. Principal among these is the futures commission merchant category. FCMs are the commodities analogue of securities broker-dealers, encompassing all major commodity brokerage firms in the United States, and including those individuals or entities engaged in the solicitation, acceptance and carrying of customer funds.<sup>4</sup> Futures commission merchants are also responsible for the clearing and execution of customer orders, and are involved, in some capacity, in the vast majority of all transactions in commodity futures contracts.<sup>5</sup>

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the CFTC in some other capacity, and 55% of whom were not registered. *Hearings on S. 2109 Before the Subcomm. on Agricultural Research and General Legislation of the Senate Comm. on Agriculture, Nutrition and Forestry, 97th Cong., 2d Sess. 78 (1982)* [hereinafter cited as *Senate Hearings*]; see *infra* notes 20-23 (associated persons). See generally *Hearings Before the Subcomm. on Conservation, Credit, and Rural Development of the House Comm. on Agricultural on H.R. 5447, 97th Cong., 2d Sess. 10-11 (1982)* [hereinafter cited as *House Hearings*]; H.R. REP. NO. 565, Part I, 97th Cong., 2d Sess. 48-49, 133 (1982) [hereinafter cited as HOUSE REPORT]; H.R. REP. NO. 964, 97th Cong., 2d Sess. 40-41 (1982) [hereinafter cited as CONFERENCE REPORT].

<sup>4</sup> 7 U.S.C.A. § 6d (West Supp. 1983). See generally CHICAGO BOARD OF TRADE, COMMODITY TRADING MANUAL, 8 (1982) (explanation of nature and role of futures commission merchants); I P. JOHNSON, COMMODITIES REGULATION, §§ 1.33-1.41 (1982).

<sup>5</sup> See JOHNSON *supra*, note 4 at § 1.33. The Commodity Exchange Act sets out registration and regulatory provisions concerning commodity trading advisers and commodity pool operators. See 7 U.S.C.A. §§ 2(a)(1), 6m (West Supp. 1983). Additionally, the CFTC has established separate regulations governing disclosure, reporting and other requirements for these categories of commodity professionals. See 17 C.F.R. §§ 4.1-4.41 (1982); see also JOHNSON, *supra* note 4, at §§ 1.53-1.64; Mitchell, *The Regulation of Commodity Trading Ad-*

As a result of this central role, the CEA and CFTC regulations impose upon FCMs, in addition to registration requirements, a host of extensive and often burdensome regulatory requirements that govern virtually every aspect of their business activities.<sup>6</sup> The CEA, for example, requires futures commission merchants to maintain detailed books and records of all transactions and positions entered into or carried for their own or customers' accounts.<sup>7</sup> FCMs must keep such records for a minimum of five years, in a form specified by the CFTC and these records must be readily available to the CFTC or to the United States Department of Justice.<sup>8</sup> In addition, FCMs must maintain daily records of all transactions executed.<sup>9</sup>

Regulations also require futures commission merchants to supply customers with a "Risk Disclosure Statement" and to receive a signed attestation from these customers, prior to the opening of an account, that the customers have received and read the statement.<sup>10</sup> In addition, FCMs must comply with continuous reporting and disclosure requirements, and must constantly update their CFTC filings.<sup>11</sup> Moreover, CFTC regulations mandate that FCMs provide customers with monthly statements of the status of the customers' accounts, and with copies of confirmation tickets for executed orders.<sup>12</sup>

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visors, 27 EMORY L.J. 956 (1978). In addition, separate registration provisions exist for associated persons. See *infra* notes 21-23.

<sup>6</sup> See 7 U.S.C.A. §§ 2(a)(1), 6m (West Supp. 1983); 17 C.F.R. §§ 4.1-4.41 (1982); see also, N.Y.L.J. Seminar, *Commodity Regulation 1978*, 419-525 (1978).

<sup>7</sup> 7 U.S.C.A. § 6g (1980 & West Supp. 1983).

<sup>8</sup> 17 C.F.R. § 1.31 (1982).

<sup>9</sup> 7 U.S.C.A. § 6g(3) (West Supp. 1983); see JOHNSON, *supra* note 4, at § 1.38. The regulations require futures commission merchants to file daily reports with the CFTC on each account carried by it that holds or controls open futures positions above a reportable amount. 17 C.F.R. § 15.03 (1982). These large trader reporting requirements are separate from the CFTC's speculative position limits. 7 U.S.C.A. § 6a (1980 & West Supp. 1983).

<sup>10</sup> 17 C.F.R. § 1.55 (1982). The text of the Risk Disclosure Statement includes explicit warnings concerning the risks of speculative and margin trading. Failure to provide the statement can give rise to a private action by the customer against the broker, if it can be demonstrated that the customer was injured thereby. See, e.g., *Abeyta v. Baar, Stearns & Co.*, [1980-82 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,350 (1982); *Sher v. Dean Witter Reynolds, Inc.*, [1980-82 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,486 (1982).

<sup>11</sup> 17 C.F.R. §§ 1.32-1.37, 15.00-15.05, 21.00-21.02 (1982); see JOHNSON, *supra* note 4, at § 1.38. In addition to the large trader reports required of futures commission merchants, the CFTC may issue special calls concerning customer accounts carried by futures commission merchants or the identity of those exercising trading authority over such accounts. 17 C.F.R. Part 21 (1982).

<sup>12</sup> 17 C.F.R. § 1.33 (1982). The purpose of the regulation requiring monthly statements of customer accounts is to assure that customers are kept apprised of the status of their accounts. As a result, a customer receiving monthly account statements may be charged with notice of the statement's contents and, therefore, held to be estopped from raising untimely protests concerning the trading conducted for the account. See, e.g., *Anderholdt v. Rosenthal & Co.*, [1980-82 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,218 (1981). In contrast, a failure to provide account statements not only preserves the customer's right to protest the handling of the account, but may in itself give rise to an action against the broker. See *Smith v. Comvest*, [1980-82 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,306 (1978).

The most extensive requirements imposed upon FCM's, however, are the segregation and net capital rules.<sup>13</sup> The former requires that futures commission merchants maintain all funds of a customer in a separate account and that FCMs treat and deal with these funds as belonging to the customer.<sup>14</sup> In addition, the FCMs use or investment of such funds is restricted.<sup>15</sup> The net capital, or minimum financial regulations require futures commission merchants to maintain a specified dollar amount of liquid assets.<sup>16</sup> Moreover, the actual net capital balance required is substantial, thereby preventing those brokers without sizable assets from registration as FCMs.<sup>17</sup>

### B. *The Role of Agents in the Commodities Industry*

The burden and expense of futures commission merchant registration rendered it impracticable, if not impossible, for many smaller brokers to register in that capacity.<sup>18</sup> The cost and staffing required for compliance with the numerous recordkeeping requirements could in themselves be prohibitive. The most significant barrier, however, was the net capital requirement, which in effect prohibited smaller firms from registration and operation as futures commission merchants. These firms, often with only a few employees, or even operating as individuals, with a limited number of customers, simply could not comply with minimum financial requirements as high as \$50,000 to \$100,000.<sup>19</sup>

At the same time, it was often infeasible for these brokers to register

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<sup>13</sup> 7 U.S.C.A. §§ 6d(2), 6f(2) (West Supp. 1983); 17 C.F.R. §§ 1.17, 1.20-1.27 (1982).

<sup>14</sup> 17 C.F.R. § 1.20 (1982). In addition to the segregation and net capital rules, the regulations set out other specific requirements concerning the handling of customers' funds.

<sup>15</sup> *Id.* § 1.25 (1982). In general, a futures commission merchant may invest customer funds only in obligations of the federal or state governments. *Id.* Moreover, even with respect to these investments, the use of the funds must be identified clearly with the customer to whom they belong and detailed records must be kept. *Id.* §§ 1.26-1.27 (1982). In addition, the futures commission merchant must compute daily the amount of money, securities and property that must be segregated in order to comply with the Act. *Id.* § 1.32 (1982).

<sup>16</sup> *Id.* § 1.17 (1982). Section 4f(2) of the Act, 7 U.S.C.A. §§ 6f(2) actually requires only that contract markets adopt minimum financial requirements for futures commission merchants, subject to CFTC approval. *See* 7 U.S.C.A. § 6f(2) (West Supp. 1983). In 1978, however, the CFTC adopted a new regulation, 17 C.F.R. § 1.52, which mandated that contract markets adopt net capital rules at least as stringent as, if not more so than, CFTC standards. Because the CFTC retains exclusive authority under the regulations to grant extensions of time or waivers on net capital requirements the minimum financial regulations in effect became fully centralized. *See* 17 C.F.R. § 1.17(g) (1982); JOHNSON, *supra* note 4, at §§ 2.48, 3.49. Regulations also require futures commission merchants to maintain detailed records on, and obtain regulatory approval for, their treatment of assets and liabilities for purposes of the complex net capital computations. 17 C.F.R. § 1.17(h) (1982).

<sup>17</sup> 17 C.F.R. § 1.17 (1982). The net capital requirements imposed upon broker-dealers under the federal securities laws are not as strict. *See infra* notes 89-98 and accompanying text.

<sup>18</sup> *Senate Hearings, supra* note 2, at 5, 273, 597.

<sup>19</sup> 17 C.F.R. § 1.17 (1982). The difference in net capital treatment depends on whether the FCM is a member of the National Futures Association. *See infra* note 153.

as "associated persons" of futures commission merchants. Associated persons are registered representatives of a futures commission merchant, engaged in the solicitation and acceptance of customer funds on a FCM's behalf.<sup>20</sup> Because associated persons are under the FCM's supervision, associated persons are subject to reduced regulatory requirements.<sup>21</sup> Although some FCMs employed and sponsored smaller brokers as associated persons, many were unwilling or unable to undertake the responsibility of supervising the operations of an independent firm over which it might exercise little control.<sup>22</sup> In addition, associated persons can act in that capacity for only one registered FCM.<sup>23</sup> This restriction further limited the ability of independent firms to register as associated persons since the firms would not be permitted to deal freely with clearing brokers. As a result, most smaller brokerage firms could not associate with a registered FCM. The small, independent brokerage firms, not quite employees and not quite futures commission merchants, operated, therefore, in a regulatory vacuum.

These brokers, however, played a significant role in the commodities industry, introducing the accounts of many traders to registered futures commission merchants. Because many of these traders might be reluctant to deal directly with a futures commission merchant, or might be unaware of the means of doing so, these agents often provided traders with the only means of trading on the commodities exchanges.<sup>24</sup> The customer thus could open an account with an independent broker, who would transmit all funds and orders to a futures commission merchant with whom the broker had a correspondent relationship.<sup>25</sup> This resulted in significantly expanding the opportunity for traders and unregistered

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<sup>20</sup> 7 U.S.C.A. § 6k (West Supp. 1983). Associated persons, alternatively labelled as account executives, registered representatives or as part of some other category, are the sales staffs of many futures commission merchants. As such, they are extensively screened before being hired and generally are trained rigorously before beginning their sales operations. See JOHNSON, *supra* note 4, § 1.43. Associated persons of those futures commission merchants who are members of contract markets must become registered not only with the CFTC but also with that contract market, to accept orders thereon. *Id.* Registration of associated persons, as in the case of other registered commodity professionals is accomplished under procedures prescribed by CFTC regulation. 17 C.F.R. § 3.12 (1982).

<sup>21</sup> See JOHNSON, *supra* note 4, §§ 1.44, 1.46. Associated persons, for example, are not subject to minimum financial requirements nor to any significant recordkeeping or reporting obligations. *Id.* Instead, the futures commission merchant's compliance with the regulations suffices for its associated persons as well.

<sup>22</sup> *Senate Hearings, supra* note 2, at 219-20, 597-98.

<sup>23</sup> 17 C.F.R. § 3.12(f) (1982). The CFTC's regulations governing those categories of registration created by the 1982 legislation allow associated persons to be affiliated with no more than one FCM or introducing broker, although the regulations may establish multiple associations with commodity trading advisors or commodity pool operators. See 48 Fed. Reg. 35248, 35255 (August 3, 1983). Up to the present, regulations prohibited only futures commission merchants or agents employed by associated persons, and dual affiliations.

<sup>24</sup> *Senate Hearings, supra* note 2, at 597.

<sup>25</sup> *House Hearings, supra* note 2, at 568; 48 Fed. Reg. 14933, 14935 (April 6, 1983).

brokers to trade on the futures markets, additional overall market liquidity, and increased markets for the clearing futures commission merchants.

In fact, these "introducing brokers" existed for many years in the commodities industry, primarily in three forms: the country grain elevators, the small commodity "store front" operations, and securities broker-dealers handling futures business. Each of these entities initially entered the industry in order to service customers who might otherwise not engage in futures trading, and only gradually developed a more substantial involvement.

The principle function of country grain elevators, for example, is the storage and reselling of crops on behalf of farmers. In addition to providing these services, elevator operators also served as advisors to farmers regarding their futures transactions and, over the years, many such operators established relationships with FCMs. Through such relationships, operators entered futures orders for farmers and received a portion of the FCMs' commissions. In effect, the operators became agents of the FCMs. Many FCMs developed substantial client bases through these arrangements, establishing close relationships with the country grain elevators and taking responsibility for their futures activities.

The second category of introducing brokers includes the small, local firms acting as independent entities, who cleared customer transactions through one of the major FCMs. The customer's relationship was therefore with the introducing broker, although the research, clearing facilities and customer statements came from the clearing FCM.

The third form of introduced relationship was that between regional securities broker-dealers and registered FCMs.<sup>26</sup> Many of these broker-dealers were registered securities introducing brokers who, in order to allow their clients to engage in futures trading, entered into introduced relationships with the futures arm of a securities clearing firm. The broker-dealer preferred to introduce this business on a fully disclosed basis through the clearing firm, rather than become an FCM or exchange clearing member.

FCMs were often willing to enter into these introduced relationships, despite the fact that they were thereby required to deal with potential competitors, to utilize more fully their trade processing and order execution facilities. Clearing memberships on commodity exchanges are expensive and require substantial capital on the part of the clearing firm to maintain these operations. The handling of additional business through

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<sup>26</sup> See *Senate Hearings*, *supra* note 2, at 78; see also *House Hearings*, *supra* note 2, at 82. The CFTC asserted during the 1982 reauthorization hearings that some ten percent of those firms or individuals operating as designated agents registered as introducing brokers under the securities laws. See *Senate Hearings*, *supra* note 2, at 78; see also *House Hearings*, *supra* note 2, at 82. This, of course, subjected these agents to regulation by the Securities and Exchange Commission. The CFTC's regulations for introducing brokers provide that compliance with certain regulatory requirements under the securities laws would satisfy CFTC regulations as well. 48 Fed. Reg. 35248, 35263 (August 3, 1983).

an introduced relationship permitted the clearing firm to achieve greater productivity from its resources without additional capital expenditures.

The benefits conferred by these arrangements on FCMs, small traders and others, as well the simultaneous inability on smaller brokerage firms to register as futures commission merchants, led to the establishment of a policy on the part of the federal regulatory authorities not only to allow but to promote the existence of these agents and their correspondent relationships with futures commission merchants. Long before the establishment of the CFTC, the CFTC's predecessor, the Commodity Exchange Authority,<sup>27</sup> exempted these brokers from registration and many of the regulatory requirements imposed upon futures commission merchants.<sup>28</sup> Known as 1.31a brokers, due to the provision of the regulations that permitted these brokers to operate, these brokers solicited orders and introduced customer accounts to registered FCMs on a fully disclosed basis without being subject to minimum financial or segregation requirements.<sup>29</sup>

The CFTC, subsequent to its creation in 1974, followed this practice although the practice still was not codified. The CFTC permitted these smaller brokers to operate as designated agents of FCMs without being registered.<sup>30</sup> This practice allowed the smaller brokers to function as independent entities under the brokers' own names in soliciting customer funds and orders. The CFTC required only that FCMs list on their registrations the identities of all agents soliciting customer accounts on their behalf and of all agents for whom FCMs cleared customer transactions.<sup>31</sup> In addition, the agents' employees could register as associated persons and would be required to identify the brokers who employed them.<sup>32</sup>

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<sup>27</sup> See Commodity Exchange Act, Pub. L. No. \_\_\_\_, 49 Stat. 149 (1936). Congress established the Commodity Exchange Authority (CEA) pursuant to the Commodity Exchange Act of 1936, and the CEA operated as a unit of the United States Department of Agriculture from 1936 to 1974, at which time it was replaced by the CFTC. See CFTC, *Annual Report, 1976*, at 23-34 (1976).

<sup>28</sup> See 36 Fed. Reg. 22810-11 (December 1, 1971). The Commodity Exchange Authority noted that the brokers transmit customers' commodity futures orders to other futures commission merchants for execution while futures commission merchants render confirmations and statements of purchase and sale, and transmit remittance, direct to such customers. *Id.* The apparent practice at the time was to refer to 1.31a brokers as "futures commission merchants" as well, despite the fact that they were not required to register in that capacity. 36 Fed. Reg. 18000 (Sept. 8, 1971); see 20 Fed. Reg. 5829 (August 11, 1955) (amending certain recordkeeping requirements); 33 Fed. Reg. 17632 (November 26, 1968) (amending minimum financial requirements); 34 Fed. Reg. 600 (January 16, 1969).

<sup>29</sup> See 13 Fed. Reg. 7820 (December 18, 1948). Section 1.31a provided that a 1.31a broker shall have complied with the regulatory requirements if the books and records described in the regulations are prepared and kept according to such regulations by either the futures commission merchant transmitting customers' commodity futures orders or by the futures commission merchant to whom such orders are transmitted. *Id.*

<sup>30</sup> *Id.*

<sup>31</sup> See 48 Fed. Reg. 14933 (April 6, 1983); *House Hearings, supra* note 2, at 567.

<sup>32</sup> See CFTC Form 8-R, COMM. FUT. L. REP. (CCH) ¶ 3521. CFTC form 8-R will be revised in the near future, in accordance with regulations implementing introducing broker registration and making changes in associated person registration. See 48 Fed. Reg. 14933 (April 6, 1983).



The CFTC also permitted unregistered foreign brokers to introduce accounts to futures commission merchants for clearing and execution of orders on United States contract markets.<sup>33</sup> In 1980, the CFTC adopted a regulation which specifically authorized this practice, but stated that the clearing futures commission merchant would be deemed the agent of the foreign broker and its customers for purposes of regulatory compliance and service of process.<sup>34</sup>

Under the CFTC's practice, agents referred customer accounts to FCMs on a fully disclosed basis. The FCM provided back office services for the agent's accounts and was responsible for compliance with minimum financial, segregation, reporting and recordkeeping requirements.<sup>35</sup> The futures commission merchant also was responsible for providing the customer with confirmations and monthly statements.<sup>36</sup> Because the agent did not carry customer funds or accounts, the futures commission merchant's regulatory compliance satisfied the agent's obligations as well. For introducing the account to the futures commission merchant, the agent received a percentage of the commissions charged to the customer by the futures commission merchant for the clearing and execution of orders.<sup>37</sup>

This CFTC policy, although never explicitly articulated, was based at least in part upon section 4f(1) of the Act, which required applicants for registration as futures commission merchants to include on their application the names and addresses of all agents engaged in the solicitation or acceptance of customer funds on behalf of the futures commission merchant.<sup>38</sup> Similarly, section 4k of the Act made it unlawful for any person to associate with any futures commission merchant or with any agent of a futures commission merchant in any capacity that involves the solicitation or acceptance of customers' orders or the supervision of any person or persons so engaged, unless such person registered with the CFTC as

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<sup>33</sup> See 17 C.F.R. § 15.05 (1982).

<sup>34</sup> *Id.* The futures commission merchant is required to notify foreign brokers and their customers of this regulation. *Id.* § 15.05(c) (1982). The futures commission merchant is not deemed to be the agent of the foreign broker if the latter or its customers executes a written agreement with a person domiciled in the United States to act as their agent for purposes of receiving delivery of CFTC communications. In promulgating the regulation, the CFTC noted that the regulation was necessary because of the CFTC's frequent inability to communicate directly and in a timely manner with foreign brokers. See 45 Fed. Reg. 30426 (May 8, 1980).

<sup>35</sup> See 48 Fed. Reg. 14933 (April 6, 1983). Under the CFTC's proposed regulations, introducing brokers will be required to refrain from engaging in any back office functions such as the processing of customer orders or the segregation of funds. Introducing brokers, unlike agents, will also be subject to minimum financial, reporting and recordkeeping requirements. 48 Fed. Reg. 35248 (August 3, 1983).

<sup>36</sup> *Id.*; see also 13 Fed. Reg. 7820, 7839 (Dec. 18, 1948).

<sup>37</sup> See 48 Fed. Reg. 14933 (April 6, 1983).

<sup>38</sup> 7 U.S.C.A. § 6f(1) (West Supp. 1983); SENATE REPORT, *supra* note 2, at 40. In fact, the Commodity Exchange Act has contained such a provision since its original enactment. See Pub. L. No. 74-675, ch. 545, 49 Stat. 1491 (1936).

an associated person.<sup>39</sup> Neither of these provisions, however, required the agents of a futures commission merchant to register as FCMs or associated persons. As a result, the CFTC was provided implicit, if not express, statutory authority for its practice of agent designation.

### C. *Liability for Agent Misconduct*

The most significant problem posed by this arrangement was that in the absence of registration, the CFTC and its predecessor, the Commodity Exchange Authority, lacked the direct regulatory control over these brokers that would have allowed them to monitor the brokers' activities, investigate their conduct or, in many instances, even establish their identities.<sup>40</sup> The CFTC did have some indirect authority over agents through the requirement that FCMs list their identities,<sup>41</sup> but the CFTC imposed no substantive regulations. These agents, however, had the opportunity to, and often did, engage in fraudulent conduct such as improper solicitations and misappropriation of funds.<sup>42</sup>

Moreover, the attenuated nature of the relationship rendered it difficult for the CFTC to hold the FCM liable for the agent's misconduct. For this reason, the Commodity Exchange Authority revoked the express regulatory provision for 1.31a brokers in 1971, expressing the concern, later raised by the CFTC during the 1982 reauthorization hearings, that the arrangement allowed futures commission merchants to avoid liability for the acts of these brokers, thereby denying customers the opportunity for relief for the mishandling of their accounts.<sup>43</sup> Nevertheless, the CFTC continued informally the practice of allowing operation of unregistered agents despite the absence of an express regulatory provision.

A CFTC advisory committee, which addressed, among other things, the use of agents by registered FCMs, voiced a similar concern in 1976. The advisory committee concluded that because of the potential for misconduct, introducing brokers should be required to register as associated per-

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<sup>39</sup> 7 U.S.C.A. § 6k (West Supp. 1983); SENATE REPORT, *supra* note 2, at 40. As noted, the sales personnel employed by agents were subject to associated person registration, even though the agents themselves were not required to register.

<sup>40</sup> See 48 Fed. Reg. 14938 (April 6, 1983).

<sup>41</sup> See *supra* note 36.

<sup>42</sup> SENATE HEARINGS, *supra* note 2, at 77. Agents have the opportunity to commit the same abuses as an associated person of the FCM. *Id.* An agent may convert customer funds, fail to provide risk disclosure, provide false or misleading information to induce a customer to trade and intentionally mishandle customer orders in a variety of ways. *Id.*

<sup>43</sup> See 36 Fed. Reg. 22810 (Dec. 1, 1971). The Commodity Exchange Authority noted that most 1.31a brokers acted as agents on behalf of the merchants with whom they carry the accounts. *Id.* The Authority further noted that these merchants often denied responsibility for the acts of the 1.31a brokers and left customers without adequate relief. *Id.*

<sup>44</sup> Report of the Commodity Futures Trading Commission Advisory Committee on Commodity Futures Trading Professionals, COMM. FUT. L. REP. (CCH) No. 29, Part II (August 20, 1976), at 20.

sons if the agents' compensation from the futures commission merchant was based upon commission revenues generated by the account.<sup>45</sup> The CFTC, although acting on portions of the advisory committee's findings, did not adopt this recommendation on agent registration.<sup>46</sup>

The inability under the CEA to require registration of agents resulted in efforts by the CFTC to impute their conduct to the futures commission merchants through whom they cleared and executed transactions. The CFTC's "regulation" of agents, therefore, essentially was premised upon the secondary liability provisions of the CEA, based upon the theory of a principal-agent relationship between introducing firms and futures commission merchants.<sup>47</sup> In particular, the CFTC came to rely upon the respondeat superior provisions of section 2(a)(1) of the Act in imposing liability upon futures commission merchants.<sup>48</sup>

Section 2(a)(1) essentially encompassed the common law of agency, holding a principal liable to the same extent as the principal's agent for the latter's acts committed within the scope of the agency.<sup>49</sup> Yet this form of liability did not characterize accurately the futures commission merchant/agent arrangement.<sup>50</sup> Indeed, the term "agent" was a misnomer in this context, since agents were independent entities who merely introduced accounts. Futures commission merchants often had only the most tenuous connection with their agents, and had little opportunity to control or supervise the agents' conduct.<sup>51</sup> Under this arrangement, the FCM was in a

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<sup>45</sup> *Id.*

<sup>46</sup> *See id.* Portions of the advisory committee's findings included, for example, adoption of minimum financial requirements for futures commission merchants, and an express duty of supervision. *Id.* at 12-13.

<sup>47</sup> *See House Hearings, supra* note 2, at 82; *infra* notes 57-65 (cases cited).

<sup>48</sup> *See* 7 U.S.C. § 4 (1976). The section provides, in part, that the act, omission, or failure of an agent acting for any association within the scope of his employment will be regarded as the act, omission, or failure of the association. *Id.*; *see* Markham and Meltzer, *Secondary Liability Under the Commodity Exchange Act—Respondeat Superior, Aiding and Abetting, Supervision and Scierter*, 27 EMORY L.J. 1127 (1978) (review of application of 7 U.S.C. § 4 and other secondary liability provisions under committee laws).

<sup>49</sup> *See, e.g.,* Markham and Meltzer, *supra* note 48.

<sup>50</sup> *See Senate Hearings, supra* note 2, at 222 (statement of Edmund Schroeder). The Chairman of the American Bar Association's Committee on Commodities Regulation, Edmund R. Schroeder, states that the problem with the CFTC's approach is that in many cases introducing brokers are independent firms scattered across the country. *Id.*; *see also id.* at 219, 542-43; *House Hearings, supra* note 2, at 545, 567-68.

<sup>51</sup> *See Senate Hearings, supra* note 2, at 222-23. In the Senate Hearings Schroeder stated that in most cases futures commission merchants cannot exercise great control over the introducing brokers. *Id.* (statement of Edmund Schroeder, past President, Futures Industry Association). Additionally, it was pointed out that the principal objection to § 2(a)(1) was that it would place responsibility for an agent on the FCM when the FCM has only limited control. *Id.* at 219 (statement of Howard A. Sotler); *see also House Hearings, supra* note 2, at 545, 567-68 (statement of Conticommodity Services, Inc.); *id.* at 545 (statement of Edmund R. Schroeder).

Introducing brokers are, in reality, independent brokers who solicit and accept orders for their own customers, and who merely utilize the services of an FCM for clearing, record-keeping and funds safekeeping. *House Hearings, supra* note 2, at 568.

sense the agent of the introducing firm, simply clearing transactions for the latter's customers.

Section 2(a)(1), however, allowed for imposition of liability simply on the basis of an agency relationship. As a result, futures commission merchants began to find themselves held strictly liable for the acts of agents over whom they exercised little or no control and with whom they may have had only a remote agency relationship. In *Perkins v. First London Commodity Ltd.*,<sup>52</sup> for example, the CFTC administrative law judge held a commodity options firm liable for the acts of its agent, despite the fact that the futures commission merchant never participated in the fraudulent or wrongful conduct. In *Perkins*, the judge found that the agent had been selling naked options and had appropriated customer funds. The CFTC administrative law judge found that, even if the futures commission merchant was not involved in the agent's fraud, it could be liable on the basis of the agency relationship. Moreover, in *McHaney v. Winchester-Hardin Oppenheimer Trading Co.*,<sup>53</sup> an administrative law judge held that a futures commission merchant who clothed a branch office with apparent authority may be liable under section 2(a)(1) if customers rely upon that authority to the customers' detriment. The administrative law judge stated that the question of whether the agent was operating as a branch office or a separate entity must be viewed from the customers' point of view.<sup>54</sup>

In *In re Big Red Commodity Corp.*,<sup>55</sup> an agent operating a branch office of a futures commission merchant and registered as its associated person, engaged in a fraudulent course of conduct with respect to numerous customers. The futures commission merchant argued that the associated person status was merely for the convenience of the agent, that it had no control or supervisory authority over the latter and that the branch office was not a part of its business, since the futures commission merchant merely cleared transactions for customers of the agent. The administrative law judge imposed liability under section 2(a)(1), however, despite an explicit finding that the futures commission merchant had had no knowledge of nor participation in the agent's fraud.

Similarly, in *Nobel v. Williston Corp.*,<sup>56</sup> a futures commission merchant asserted that a branch office operated by an agent was in fact a separate entity and that the FCM had terminated the relationship prior to the time of the alleged fraud. The administrative law judge rejected this argument based upon the judge's finding that the agent made fraudulent solicitations before termination of the branch office. The judge held the futures commission merchant liable for the agent's misrepresentations and for his failure to provide a Risk Disclosure Statement, regardless of the fact that the futures commission merchant was neither aware of nor involved

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<sup>52</sup> [1977-80 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,659 (1978).

<sup>53</sup> *Id.* ¶ 20,586 (1978).

<sup>54</sup> *Id.* at 22,425.

<sup>55</sup> *Id.* ¶ 21,390.

<sup>56</sup> *Id.* ¶ 21,227.

in the fraud committed. The administrative law judge noted that a lack of knowledge of an agent's activities does not immunize a principal from liability for that agent's activities within the scope of his employment. The principal need not profit financially from the wrongful conduct of an agent to have committed a violation.<sup>57</sup> In this context, however, the agent was not an employee of the FCM, but actually an independent contractor, underscoring the inappropriateness of relying upon section 2(a)(1) and the scope of employment test in this situation.

In *Anderholdt v. Rosenthal & Co.*,<sup>58</sup> the administrative law judge found that an agent who had engaged in unauthorized trading acted only as an independent contractor of the FCM. Nevertheless, section 2(a)(1) imputed the agent's activity to the FCM.<sup>59</sup> Under this holding, the futures commission merchant could not have structured the relationship to avoid liability for the agent's misconduct.

In the course of the 1982 reauthorization hearings, the CFTC submitted data demonstrating the rapid proliferation of brokerage firms and individuals acting as agents.<sup>60</sup> This information served to highlight that the gap in the statute under which these agents operated needed to be filled. The CFTC remained unable to hold agents directly responsible for their own conduct, while the CFTC was holding FCMs strictly liable for the actions of those they could not control. The need for some legislative response, therefore, had become apparent.

### III. ESTABLISHMENT OF INTRODUCING BROKER REGISTRATION—THE FUTURES TRADING ACT OF 1982

During the 1982 reauthorization process the CFTC, industry representatives and members of Congress all concluded that some form of statutory codification of the agent designation practice was necessary. The CFTC clearly required regulatory authority under which it could hold agents accountable for their own conduct. Although disagreement existed about the optimal means of accomplishing this goal, a general consensus existed that to require agents to register as futures commission merchants remained wholly impracticable. The burden and expense of such registration still constituted prohibitive barriers for these brokers.

Substantial disagreement existed, however, over the precise type of regulatory scheme to be adopted. The CFTC proposed that Congress amend the CEA to require agents to register as associated persons of

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<sup>57</sup> *Id.* at 25,119.

<sup>58</sup> *Id.* ¶ 21,218.

<sup>59</sup> *Id.*

<sup>60</sup> See *Senate Hearings*, *supra* note 2, at 77. In November, 1979, 630 designated agents cleared transactions through registered futures commission merchants. By March, 1982, 1,000 such agents cleared transactions, representing a 60% increase in slightly more than two years. *Id.*

an FCM.<sup>61</sup> The basis for this position was the CFTC's contention that many futures commission merchants had been relying upon agents in lieu of hiring their own sales forces, while most futures commission merchants conducted their sales efforts through branch offices, the sales staffs of which were registered as associated persons.<sup>62</sup> The CFTC therefore argued that adoption of the CFTC proposal would bring about parity of responsibility between those FCMs with their own employed sales forces registered as associated persons, and those using unregistered agents.<sup>63</sup>

Industry representatives argued, however, that this portrayal was wrong, since valid and significant distinctions exist between a futures commission merchant's use of associated persons of introducing brokers.<sup>64</sup> As noted, the latter merely uses the services of the FCM for the purpose of clearing and executing transactions, and for recordkeeping and regulatory compliance.<sup>65</sup> In contrast, the term "associated person" means that the FCM has some business connection with that person, which permits it to exercise supervisory control.<sup>66</sup> Many members of the industry,

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<sup>61</sup> SENATE REPORT, *supra* note 2, at 40-41; *House Hearings*, *supra* note 2, at 82, 122-23; *Senate Hearings*, *supra* note 2, at 306-07. As noted, the CFTC, as early as 1976, had considered adoption of such a proposal. *See supra* note 44.

<sup>62</sup> *See House Hearings*, *supra* note 2, at 122. Approximately ten percent of the futures commission merchants registered with the Commission employ eighty percent of the agents as selling arms of the firm. *Id.* (supplemental statement of Philip McB. Johnson); *see also* SENATE REPORT, *supra* note 2, at 40.

CFTC premised its position in large part on the Commission's belief that "[a]gents have the opportunity to commit the same abuses as an associated person of the futures commission merchant. An agent may convert customer funds, fail to provide risk disclosure, provide false or misleading information to induce a customer to trade and intentionally mishandle customer orders in a variety of ways. . . ." *Senate Hearings*, *supra* note 2, at 77 (responses of Philip McB. Johnson to written questions).

<sup>63</sup> *See House Hearings*, *supra* note 2, at 120, 122. The Commission considered various ways to protect the public from the abuses which occur as a result of FCM's denying responsibility for the acts of introducing brokers. *Id.*

One approach to create a new and separate registration category for "agents" (e.g., as "fully disclosed brokers") was considered. However, many of these "agents" are individuals or very small businesses, and a separate regulatory structure could prove to be too costly and burdensome for them. The Commission proposes instead to create parity between those futures commission merchants using a branch office system and those using "agents" by requiring the latter to register with the Commission under the existing registration category of "associated persons" (Section 4k(1) of the Act and Section 8(a) of the Bill). Thus, the futures commission merchant would be responsible for its agents to the same extent as for its branch offices. It should be noted that this proposal is entirely consistent with the existing provision of the Act which makes a principal liable for the acts and omissions of its agents.

*Id.*

<sup>64</sup> *House Hearings*, *supra* note 2, at 543, 568; *Senate Hearings*, *supra* note 2, at 219-20.

<sup>65</sup> *See, e.g., Senate Hearings*, *supra* note 2, at 219, 222, 240-41, 543; *House Hearings*, *supra* note 2, at 545, 567-68.

<sup>66</sup> *See House Hearings*, *supra* note 2, at 568 (prepared statement of ContiCommodity Services, Inc.). The prepared statement of ContiCommodity Services argued that agents are

therefore, believed that adoption of the CFTC proposal would be worse than the existing unregulated situation.<sup>67</sup>

Moreover, several members of the industry testified that adoption of the CFTC proposal would actually force many if not all introducing brokers out of business, thereby eliminating access to the commodities markets on the part of smaller brokerage firms and traders. John J. Conhenney, Chairman of Merrill Lynch Futures Inc., stated that unless an introducing broker contractually surrenders its identity it is unlikely that a futures commission merchant will permit registration of an agent as an associated person to occur.<sup>68</sup> Because adoption of the CFTC proposal would require the introducing broker to register as an associated person of the clearing FCM, and to be an associated person of only one firm, the clearing firm would inevitably require the introducing broker to place its operations within supervisory control of the clearing firm, thus preventing the introducing broker from operating as an independent entity.<sup>69</sup>

The Committee on Commodities Regulation of the American Bar Association (ABA), voicing industry concerns, proposed the creation of a separate category of registration for introducing brokers.<sup>70</sup> The ABA argued that adoption of its proposal would be a more accurate reflection of the relationships between industry members, since the introducing broker is in reality neither an agent nor an associated person. The proposal recommended that introducing brokers be subject to the same general types of regulatory requirements as futures commission merchants, although to a reduced extent. The ABA also advocated an exemption for introducing brokers from the CFTC's reserve and segregation requirements, since introducing brokers do not handle customers' funds.<sup>71</sup>

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independent brokers who solicit and accept orders for their own customers, and who merely utilize the services of an FCM for clearing, recordkeeping, and funds safekeeping. These independent brokers are in effect customers of the clearing FCM, and frequently change from one clearing FCM to another just as a customer might change from one broker to another. Under these circumstances the clearing FCM does not and cannot effectively control the independent broker's activities, and it would be unwarranted and misleading to use a registration category, such as that proposed by the CFTC, which suggests otherwise.

*Id.*; see also *supra* note 50 & 51.

<sup>67</sup> See *supra* note 51. The registration of agents as associated persons would increase the liability of the FCM and its principal officers and parties for the acts of people over whom, as the way business is now conducted, the FCM and its managers have extremely limited control. See *House Hearings, supra* note 2, at 82 (testimony of Howard A. Stottler).

<sup>68</sup> *Senate Hearings, supra* note 1, at 598; see also *House Hearings, supra* note 2, at 82 (testimony of Howard A. Stottler).

<sup>69</sup> See *House Hearings, supra* note 2, at 82 (testimony of Howard A. Stottler).

<sup>70</sup> See *Senate Hearings, supra* note 2, at 542-43, 556, 560-61; *House Hearings, supra* note 2, at 544-45. The ABA proposal included a definition of "introducing broker" which Congress ultimately adopted.

<sup>71</sup> See *Senate Hearings, supra* note 2, at 542-43, 556, 560-61; *House Hearings, supra* note 2, at 544-45. The CFTC, in adopting its regulations on introducing brokers, has exempted

Members of Congress, however, as well as CFTC officials, countered that an establishment of a separate registration category for introducing brokers might have the effect of insulating a futures commission merchant from liability for acts committed by its introducing brokers.<sup>72</sup> Congressman Dan Glickman asserted that this would mean that the clearing FCM could no longer be liable for the acts of the introducing broker, even if the introducing broker committed such acts within the scope of the agency relationship.<sup>73</sup> Similarly, Philip McB. Johnson, Chairman of the CFTC, testified that the introducing broker approach sought by the industry and the ABA would make introducing brokers independent contractors.<sup>74</sup> As a result, brokers would be liable for their own acts and no liability could be imputed to the clearing futures commission merchant. Johnson argued that the CFTC proposal to require registration of introducing brokers as associated persons would make the futures commission merchant responsible for the acts of such person if he were operating a branch office of the futures commission merchant.<sup>75</sup>

Nevertheless, both the House Committee on Agriculture and the Senate Committee on Agriculture, Nutrition and Forestry accepted the proposal advocated by the industry, and established the category of introducing broker.<sup>76</sup> The House and Senate bills, which were substantially identical in this respect, went to a Conference Committee which adopted the legislation as the Futures Trading Act of 1982.<sup>77</sup> President Reagan signed the conference bill into law on January 11, 1983.<sup>78</sup>

The legislation amends section 2(a)(1) of the CEA to define the term "introducing broker" as any person engaged in soliciting or accepting purchase or sale orders for the future delivery of any commodity and who does not accept money, securities, or property to secure contracts that may result. The Act excepts individuals who register as associated persons of a futures commission merchant.<sup>79</sup>

The legislation also amends section 4(k)(1) of the CEA to require that introducing brokers register with the CFTC.<sup>80</sup> As a result, individuals or entities operating as introducing brokers will have the option of registering as associated persons of the FCM, or as independent introducing brokers. The CFTC, however, is authorized to establish by regulation exemptions from introducing broker registration, such as those which pres-

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introducing brokers from the reserve and segregation requirements and imposed reduced minimum financial requirements. 48 Fed. Reg. 35248 (August 3, 1983).

<sup>72</sup> HOUSE REPORT, *supra* note 25, at 133.

<sup>73</sup> *Id.*; see also *House Hearings, supra* note 2, at 85.

<sup>74</sup> HOUSE REPORT, *supra* note 25, at 133; *House Hearings, supra* note 2, at 10.

<sup>75</sup> HOUSE REPORT, *supra* note 25, at 133; *House Hearings, supra* note 2, at 10.

<sup>76</sup> HOUSE REPORT, *supra* note 25, at 49; *Senate Report, supra* note 2, at 40-41.

<sup>77</sup> CONFERENCE REPORT, *supra* note 50, at 40-41.

<sup>78</sup> Pub. L. No. 97-444, 96 Stat. 2294 (1983).

<sup>79</sup> 7 U.S.C.A. § 4(a)(1) (West Supp. 1983).

<sup>80</sup> 7 U.S.C.A. § 6(k)(1) (West Supp. 1983).



ently exist with respect to other registration categories.<sup>81</sup> In addition, the legislation amends section 4(f) to authorize the CFTC to promulgate regulations concerning financial and recordkeeping requirements for introducing brokers.<sup>82</sup> The Conference Committee contemplated that the Commission would establish financial requirements that would enable introducing brokers to remain economically viable. The Committee intended to require that all persons dealing with the public register with the Commission, but also intended to provide these registrants with substantial flexibility on the manner and classification of registration.<sup>83</sup>

The legislation authorizes the CFTC not only to register introducing brokers, and to establish regulatory standards for their operation, but also to hold introducing brokers liable for their own misconduct. As the Senate Committee noted, however, a number of existing legal theories remain upon which the CFTC might hold a futures commission merchant liable for the acts of an introducing broker, if the introducing broker is operating as a de facto branch office of the futures commission merchant.<sup>84</sup>

In establishing introducing broker registration, Congress codified the existing practice of agent designation, rejecting the CFTC's proposal to require registration of agents to register as associated persons. The committee reports highlight the independence of introducing brokers, the inadvisability of subjecting them to branch office status and the inability of futures commission merchants adequately to supervise their activities.<sup>85</sup> Moreover, Congress mandated that the CFTC assure that introducing brokers remain economically viable and not subject to burdensome regulatory requirements.<sup>86</sup>

#### IV. REGULATION OF INTRODUCING BROKERS UNDER THE FEDERAL SECURITIES LAWS

The securities industry has followed a longstanding policy of relaxing regulatory requirements for introducing brokers to allow them to do business. In contrast to the commodities laws, however, which lacked a coherent regulatory structure for such brokers prior to 1982, the federal securities laws much earlier established a separate set of requirements

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<sup>81</sup> See *id.* Section 4k(1) essentially incorporated introducing brokers into the existing requirement of the sections with respect to futures commission merchants.

<sup>82</sup> See 7 U.S.C.A. § 6f (West Supp. 1983).

<sup>83</sup> CONFERENCE REPORT, *supra* note 2, at 41.

<sup>84</sup> SENATE REPORT, *supra* note 2, at 41.

<sup>85</sup> See SENATE REPORT, *supra* note 2, at 41. The Senate Committee report noted that the Committee adopted the introducing broker provision because a significant number of the agents of futures commission merchants utilize the services of FCMs for clearing and record-keeping functions and for safeguarding of investor's funds, and that it thus would be difficult for FCMs to exert control over such brokers. See SENATE REPORT, *supra* note 2, at 41; see also HOUSE REPORT, *supra* note 2, at 49.

<sup>86</sup> See CONFERENCE REPORT, *supra* note 2, at 41.

specifically designed to enhance the ability of introducing brokers to operate and to promote their relationships with other broker-dealers.

While the definition of broker-dealers under the Securities Exchange Act of 1934 (Exchange Act) includes introducing brokers in the securities industry,<sup>87</sup> and subjects them to the full range of regulatory requirements, the Securities and Exchange Commission (SEC) and the individual exchanges have afforded special treatment to introducing brokers in several areas. This section will outline and discuss those areas of the federal securities laws containing special provisions for introducing brokers, including net capital and reserve requirements, recordkeeping requirements, the suitability doctrine, and the relative liabilities of introducing and clearing brokers to customers under the Exchange Act.

#### A. *Separate Net Capital Requirements for Introducing Brokers*

The net capital regulations for broker-dealers<sup>88</sup> are intended, like the CFTC's minimum financial requirements, to protect customer funds through the establishment of liquidity standards.<sup>89</sup> Nevertheless, the SEC recognized at an early date that many smaller brokerage firms, whose participation was vital to the operation of the securities industry, would be unable to comply with these burdensome regulations.<sup>91</sup> Even at the time the SEC adopted the original net capital rule, the SEC explicitly recognized the need for a lesser standard in the case of those brokers who merely introduce, but do not carry, customer accounts.<sup>91</sup>

Accordingly, the SEC adopted a net capital rule which delineates five separate categories of broker-dealers, each category with its own net capital requirements, including one for introducing brokers.<sup>92</sup> Under the rules, those broker-dealers involved in a general securities business must

<sup>87</sup> 15 U.S.C.A. §§ 78a-78 (West Supp. 1983).

<sup>88</sup> 17 C.F.R. § 240.15c3-1 (1982).

<sup>89</sup> See, e.g., FERRALL, CAPITAL AND BOOKKEEPING RULES (1962); N. WOLFSON, R. PHILLIPS and T. RUSSO, REGULATION OF BROKERS, DEALERS AND SECURITIES MARKETS, Ch. 6 (1977) [hereinafter cited as WOLFSON]; Wolfson and Guttman, *The Net Capital Rules for Brokers and Dealers*, 24 STAN. L. REV. 603 (1972).

<sup>90</sup> *In re* National Association of Securities Dealers, 12 S.E.C. 322, 327 (1942).

<sup>91</sup> *Id.*

The argument has been made that some minimum capital requirement should exist which will be applicable to all brokers and dealers who do business with the public and which will, in effect, place a floor under financial responsibility. We do not need to decide the merits of this argument. The Commission is not now in a position to determine what fixed minimum capital should be prescribed without running a grave risk of needlessly penalizing certain brokers and dealers who could not meet the standard. A fixed minimum capital requirement which is adequate for a firm whose business is conducted entirely on a cash basis and in small volume might be inadequate for a firm which does a general type of business, including the carrying of customer's margin accounts and the holding in safekeeping of customers' cash and securities. *Id.*

<sup>92</sup> 17 C.F.R. § 240.15c3-1(a)(2) (1982).

maintain a net capital of not less than \$25,000.<sup>93</sup> A net capital of only \$5,000 is required, however, if the broker does not hold customers' funds or securities, or owe money or securities to customers, and does not carry customers' accounts, but merely introduces and forwards all transactions and accounts of customers to another broker or dealer who carries such accounts on a fully disclosed basis and performs one or more of several enumerated functions.<sup>94</sup>

Moreover, the SEC has adopted a relatively expansive view of the role of introducing brokers, to enhance their ability to remain in business. Although such brokers generally must refrain from clearing or carrying customer accounts, they are not strictly limited to the simple referral of such accounts to clearing brokers.<sup>95</sup> Instead, the SEC has permitted introducing brokers to engage in certain, albeit restricted, activities while still allowing them to qualify for reduced net capital treatment.<sup>96</sup> The express purpose of this approach is to assure that these smaller firms have a secure position in the securities industry.<sup>97</sup>

The SEC policy to isolate introducing firms for preferential treatment to protect their stability, is also reflected in the reserve and segregation requirements, which, as noted, also have a counterpart in the commodities industry.<sup>98</sup> Adopted pursuant to the Securities Investor Protection Act of 1970,<sup>99</sup> the reserve requirement was designed to limit use by broker-dealers of customers' funds and mandate physical possession or control by broker-dealers of fully paid and excess margin securities.<sup>100</sup> Despite the rigid requirements and detailed computations of the rule, however, an express exemption is created for an introducing broker or dealer who clears all transaction for customers on a fully disclosed basis with a clearing broker or dealer, and who promptly transmits all customer funds and securities to the clearing broker or dealer.<sup>101</sup>

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<sup>93</sup> See *id.* In addition, regulations prohibit broker-dealers from having a ratio of aggregate indebtedness to net capital of greater than 15:1. Aggregate indebtedness, like net capital, is calculated according to a lengthy and complex formula. *Id.* § 240.15c3-1 (1982). Broker-dealers may, however, elect to employ an alternative net capital computation, if they maintain net capital equal to the greater of \$100,000 or four percent of aggregate debit items. *Id.* § 240.15c3-1(f) (1982).

<sup>94</sup> *Id.* § 240.15c3-1(a)(2) (1982). Regulations, however, require introducing brokers, like all broker-dealers, to maintain a specified amount of excess net capital under the early warning requirements. *Id.* § 240.17a-11 (1982). The five permitted activities are introduction of customer accounts on a fully disclosed basis, participation in certain underwritings if all funds are forwarded promptly to an escrow agent, participation in issuance of securities if all funds are transmitted promptly, transactions with other introducing brokers, and transactions on behalf of exchange members. *Id.*

<sup>95</sup> *Id.* § 240.17a-11 (1982).

<sup>96</sup> *Id.*

<sup>97</sup> See Securities Exchange Act Rel. No. 10304 (July 30, 1973).

<sup>98</sup> 17 C.F.R. § 240.15c3-3 (1982); see *supra* notes 13-15.

<sup>99</sup> Pub. L. No. 91-598, 84 Stat. 1653 (codified at 15 U.S.C. § 78(c)(3)).

<sup>100</sup> See WOLFSON, *supra* note 90, at 8-15.

<sup>101</sup> 17 C.F.R. § 240.15c3-3(k)(2)(B) (1982). In its regulations for introducing brokers, the

### B. Recordkeeping Requirements

The SEC has employed the same rationale in exempting introducing brokers from certain of the recordkeeping requirements of section 17(a) of the Exchange Act.<sup>102</sup> Rule 17a-5 expressly exempts introducing brokers from the required provision of customer statements.<sup>103</sup>

Introducing brokers are also subject to less stringent and less frequent financial reporting requirements. For example, introducing brokers must file FOCUS reports only quarterly, rather than monthly, and may file financial information on what is essentially a short form.<sup>104</sup> In this instance as well, the SEC has fostered the growth of introducing brokers by the nature of its regulatory requirements.

### C. The Suitability Doctrine and Exchange Rules

The suitability doctrine in the securities industry requires a broker to have a good faith belief that a particular recommendation is suitable for a customer's investment needs and financial capacity.<sup>105</sup> Originating in the ethical guidelines of the industry's self-regulatory organizations, the rule now exists in various forms under SEC regulations and exchange rules.<sup>106</sup> The SEC's suitability rule is also similar to the "know your customer" rule of the New York Stock Exchange (NYSE) and to analogous rules of other self-regulatory organizations.<sup>107</sup>

CFTC has exempted such brokers from reserve and segregation requirements. 48 Fed. Reg. 14933 (April 8, 1983). The significance of the SEC's exemptions, however, is the fact that introducing brokers are exempted expressly, and have been for many years.

<sup>102</sup> 17 C.F.R. § 240.15c3-3(k)(2)(ii) (1982). The regulation further provides that the clearing broker or dealer who receives customer funds from an introducing broker must maintain and preserve the books and records according to the applicable regulations. *Id.*

<sup>103</sup> *Id.* 17 C.F.R. § 240.17a-5(c) (1982). The rule applies:

except if the activities of such broker-dealer are limited to any one or combination of the following and are conducted in the manner prescribed herein:

(1) As introducing broker or dealer, the forwarding of all the transactions of his customers to a clearing broker or dealer on a fully disclosed basis.

Again, while the CFTC has adopted a similar exemption for introducing brokers, the significant point, is the SEC's express and longstanding practice in this same area.

<sup>104</sup> *Id.* § 240.17a-5(a)(iii) (1982).

<sup>105</sup> *See, e.g., id.* §§ 240.15b10-3, 240.15c2 (1982). No analogous suitability rule exists under the Commodity Exchange Act. *See* *Avis v. Shearson Hayden Stone*, [1980-82 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,379, at 25,830, n.4 (1982). In *Avis v. Shearson Hayden Stone*, the court noted that the CFTC has never adopted any rule of suitability governing the commodity broker-customer relationship. The court also stated that the Commission did not adopt the reasoning of the administrative law judge in his decision below suggesting that suitability principles are implicit in any provision of the Act. *Id.*; *see also* *Myron v. Hauser*, 673 F.2d 994 (8th Cir. 1982); *Jensen v. Shearson Hayden Stone*, [1980-82 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,324 (1981); *Sherry v. Diercks*, [1980-82 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,221 (1981). The CFTC at one point proposed the adoption of a suitability rule, but subsequently declined to do so. 42 Fed. Reg. 44742, 44743-75 (1977); 43 Fed. Reg. 31886, 31889 (1978).

<sup>106</sup> 17 C.F.R. §§ 240.15b10-3, 240.15c2-5 (1982).

<sup>107</sup> New York Stock Exchange, Rule 405; *see also* American Stock Exchange, Rule 11

In 1982, the NYSE amended its rules to delete from the "know your customer" rule any reference to introducing brokers and to allow introducing and clearing brokers greater flexibility in allocating between themselves obligations to customers.<sup>108</sup> The amendments permit and even encourage introducing and clearing firms to structure their relationship to delineate their respective liabilities and responsibilities.<sup>109</sup>

The SEC's initial release on the proposal supported the intent of the NYSE amendments to foster the development of introducing firms. The SEC release stated that the clarification of duties would help to encourage carrying organizations to make their capital available to introducing organizations that could not otherwise afford to be broker-dealers.<sup>110</sup>

The SEC noted further that the rule was intended to enhance the viability of carrying agreements to the mutual benefit of introducers, carriers and investors.<sup>111</sup> No suitability rule analogous to that imposed under the securities law exists in the commodities industry.<sup>112</sup> Nevertheless, the manner in which the securities regulatory authorities have revised the suitability doctrine to enhance the introducing/clearing relationship is illustrative of the authorities' support for introducing brokers.

#### D. *Relative Liability of Introducing and Clearing Brokers to Customers*

In contrast to the commodities laws, in which a controlling person provision was not added until 1982, the federal securities laws have long contained this form of secondary liability.<sup>113</sup> This provision provides a good

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and National Association of Securities Dealers, Rules of Fair Practice, Art. III, § 2. See generally Mundeim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 DUKE L.J. 445 (1965) (history, purposes, and extent of suitability doctrine); Lowenfels, *An Historical Overview of Suitability and "Know Your Customer" Concepts in the Securities Field*, ALI-ABA Broker-Dealer Regulation 333 (1980); Bines, *Setting Investment Objectives: The Suitability Doctrine*, 4 SEC. REG. L.J. 276, 418 (1975). See also, *Report of the Special Study of the Securities Markets*, H.R. Doc. No. 95, 88th Cong., 1st Sess., Pt. 1, at 316 (1963).

In addition to liability under the suitability or "know your customer" rules themselves, securities brokers also may face liability for unsuitable recommendations under rule 10b-5, 17 C.F.R. § 240.10b-5, and the "shingle" theory. See WOLFSON, *supra* note 90, at ¶ 2.08.

<sup>108</sup> See Securities Exchange Act Rel. No. 18497 (February 19, 1982); Securities Exchange Act Rel. 18229 (November 2, 1981). The amendments affected rules 382 and 405 of the NYSE.

<sup>109</sup> See Securities Exchange Act Rel. No. 18497 (February 19, 1982); Securities Exchange Act Rel. No. 18229, November 2, 1981). The amendments affected rules 382 and 405 of the NYSE.

<sup>110</sup> Securities Exchange Act Rel. No. 18229 (November 2, 1982).

<sup>111</sup> Securities Exchange Act Rel. No. 18497 (February 19, 1982).

<sup>112</sup> See, e.g., *Hoetger & Co. v. Asencio & Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 558 F. Supp. 1361, 1364 (E.D. Mich. 1983); *Avis v. Shearson Hayden Stone, Inc.* [1980-82 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,379 at 25,830, n.4 (1982).

<sup>113</sup> See Securities Act of 1933, § 15, 15 U.S.C. § 77o; Securities Exchange Act of 1934, § 20(a), 15 U.S.C. § 78a. Both the Securities Act of 1933 and the Securities Exchange Act of 1934 contain controlling person provisions that state that if a relationship of control is present between an agent and principal, the controlling person can be held liable to the

faith defense to the imposition of liability upon a controlling person for a controlled person's conduct.<sup>114</sup> If the requisite relationship of control is present, the availability of this defense largely prevents application of a strict liability standard for the conduct of an agent or employee.<sup>115</sup> Securities broker-dealers have not been subject to the same type of absolute liability imposed upon FCMs for the actions of introducing brokers.<sup>116</sup>

Moreover, similar to the situation under the commodities laws, other forms of secondary liability under the federal securities laws require some knowing involvement or participation in an introducing broker's misconduct before liability of a clearing broker may be found. A showing of scienter on the part of the clearing broker is necessary for imposition of liability and some degree of knowing assistance is necessary before aider and abettor liability can attach.<sup>117</sup> As a result, in most instances, a clearing broker may be held liable for an introducing broker's misconduct only on the basis of actual involvement, or on an inability to demonstrate good faith.

This situation is a direct result of the fact that introducing brokers

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same extent as the controlled person, unless the controlling person acted in good faith and did not induce directly or indirectly the acts of the controlled person. See Securities Act of 1933, § 15, 15 U.S.C. § 77o; Securities Exchange Act of 1934, § 20(a), 15 U.S.C. § 78a; see e.g., Fischel, *Secondary Liability Under Section 10(b) of the Securities Exchange Act of 1934*, 69 CALIF. L. REV. 80 (1981); Comment, *A Comparison of Control Person Liability and Respondeat Superior: Section 20(a) of the Securities Exchange Act*, 15 CAL. W.L. REV. 152 (1979); Reininger, *Exclusive or Concurrent—the Role of Control and Respondeat Superior in the Imposition of Vicarious Liability on Broker-Dealers*, 9 SEC. REG. L. REV. 226 (1981); Comment, *Rule 10b-5 and Vicarious Liability Based on Respondeat Superior*, 69 CALIF. L. REV. 1513 (1981).

Nevertheless, considerable confusion in the securities industry has existed as to whether the controlling person provisions completely supplant, or merely supplement, common-law respondeat superior liability. Compare *Marbury Management, Inc. v. Kohn*, 629 F.2d 705 (2d Cir.), cert. denied, 449 U.S. 1011 (1980) with *Zweig v. Hearst Corp.*, 521 F.2d 1129 (9th Cir.), cert. denied, 423 U.S. 1025 (1975) and *Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981), cert. denied, 455 U.S. 938 (1982). See also Brodsky, *Controlling Person Liability—a Conflict*, 186 N.Y.L.J. 1 (1981).

The Futures Trading Act of 1982, however, amended the Commodity Exchange Act to include a controlling person provision similar to that set out under the securities laws. 7 U.S.C.A. § 13c (West Supp. 1983); CONFERENCE REPORT, *supra* note 2, at 27. The Conference REPORT, *supra* note 2, at 47-48. The amendment to the Commodity Exchange Act was made in the Futures Trading Act of 1982 and was patterned to a great extent upon the comparable provisions in the securities laws. See 7 U.S.C.A. § 13c(b) (West Supp. 1983).

The amendment to the Commodity Exchange Act was made in the Futures Trading Act of 1982 and was patterned to a great extent upon the comparable provisions in the securities laws. See 7 U.S.C.A. § 13c(b) (West Supp. 1983).

<sup>114</sup> See *infra* note 116 (cases cited).

<sup>115</sup> *Id.*

<sup>116</sup> See, e.g., *Faturik v. Woodmere Securities*, 431 F. Supp. 894 (S.D.N.Y. 1977); *Hirsch v. duPont*, 553 F.2d 750 (2d Cir. 1977); *Cannizzaro v. Bache Halsey Stuart Shields, Inc.*, 81 F.R.D. 719 (S.D.N.Y. 1979); *Edwards & Hanley v. Wells Fargo, FED. SEC. L. REP. (CCH) ¶ 96,916* (2d Cir. 1979).

<sup>117</sup> *Id.*

must register with the SEC and comply with its regulatory requirements. Therefore, the SEC may hold these brokers directly liable for their own misconduct. Yet the SEC has taken an active role in assuring the ability of introducing firms to function and in promoting the introducing/clearing firm relationship. The SEC has reduced regulatory requirements for introducing brokers and has allowed them broad flexibility in structuring their relationships with customers and other broker-dealers. With the adoption of statutory provisions on introducing brokers and controlling persons under the Commodity Exchange Act as well, the CFTC will be in a position to foster the development of a similar regulatory scheme.

#### V. CFTC REGULATIONS GOVERNING INTRODUCING BROKERS

On April 6, 1983, the CFTC published in the Federal Register the CFTC's proposed rules for regulation of introducing brokers and other newly established categories of registrants.<sup>118</sup> The proposal, intended to incorporate introducing brokers into the regulatory scheme, set out requirements for introducing broker registration, minimum financial standards, recordkeeping and reporting requirements and related matters, representing extensive changes in CFTC regulations. The proposal also set out detailed procedural requirements for registration and computation of net capital.<sup>119</sup>

During an extensive comment period, in which over 100 letters of comment were received by the CFTC, industry members generally expressed support for the proposal, although many advocated substantial changes that intended to liberalize the introducing broker requirements.<sup>120</sup> As a result, the final regulations—adopted by the CFTC on July 29, 1983—differed in several significant respects from the original proposal.<sup>121</sup> This section of the article will analyze the proposed and final regulations,

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<sup>118</sup> 48 Fed. Reg. 14933 (April 6, 1983).

<sup>119</sup> *Id.* The release also covers registration and regulatory requirements for associated persons of introducing brokers, as well as associated persons of commodity trading advisors and commodity pool operators. Previously, the employees of these latter two categories were not required to be registered with the CFTC in any capacity. The Futures Trading Act of 1982 also provided for their registration. CONFERENCE REPORT, *supra* note 90, at 11-13. The CFTC's release covered 40 pages in the Federal Register, and set out not only the regulatory requirements for new categories of registrants, but the detailed procedures for registration, included required forms and fees.

On March 22, 1983, the CFTC published in the Federal Register a notice that, until such time as the CFTC is prepared to accept registration applications from new categories of registrants, the CFTC would abide by pre-existing requirements, despite the fact that the statutory mandate would have taken effect. 48 Fed. Reg. 11926 (March 22, 1983).

<sup>120</sup> 48 Fed. Reg. 35248 (August 3, 1983) (to be codified at 17 C.F.R. § 1.3(mm)).

<sup>121</sup> *Id.* The final regulations were adopted by a CFTC release issued on July 29, 1983, but were not made effective until their publication in the Federal Register on August 3, 1983. The Federal Register release covered close to 60 pages, setting out in detail not only the nature and purpose of the final regulations, but also the CFTC's reasons for deviating from the original proposals and its responses to many of the comment letters as well.

and will identify those areas in which such changes were made as well as those in which further modifications may be necessary.

A. *Registration Requirements for Introducing Brokers*

The CFTC's proposed regulations would have required registration as an introducing broker of any person or entity who, directly or indirectly, is compensated either on a per-trade basis, or for the referral of customers to an FCM.<sup>122</sup> This provision clearly would have required registration of those formerly acting as designated agents. By proposing to define introducing broker registration in terms of the nature of the fee received, however, rather than the nature of the business engaged in, the CFTC extended the scope of the introducing broker category beyond that which was included in the 1982 amendments to the CEA.<sup>123</sup>

As noted, the CEA requires only that persons engaged in the solicitation or acceptance of customer orders register as introducing brokers.<sup>124</sup> In the securities business, a person referring customers to a broker-dealer for a fee, as a practical matter, would be required to register with the SEC in some capacity.<sup>125</sup> The CFTC's proposal, however, would have required introducing broker registration on the part of many commodity trading advisors (CTAs), securities broker-dealers and firms or individuals not engaged in a futures business but who occasionally refer a customer to an FCM.<sup>126</sup> Because each of these individuals or entities are not engaged primarily in the solicitation or acceptance of customer orders as introducing brokers, but simply refer such orders to an FCM as an incident to their principal business, they would not appear to be included within the definition of introducing broker contemplated by Congress.

The CFTC received numerous comment letters requesting that a narrower definition of introducing broker be adopted for purposes of registration and, in particular, that an exemption from such registration be included for commodity trading advisors and those brokers referring orders on an occasional basis.<sup>127</sup> In adopting the final regulations, therefore, the CFTC eliminated its proposed reliance on the form and manner of introducing broker compensation as the principle determinant of the registration requirement.<sup>128</sup> Instead, the regulations expressly exclude from the definition of introducing broker any CTA who either manages discre-

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<sup>122</sup> 48 Fed. Reg. 14933, 19435 (April 6, 1983).

<sup>123</sup> *Id.*

<sup>124</sup> 7 U.S.C.A. § 2(a)(1)(A) (West Supp. 1983).

<sup>125</sup> WOLFSON, *supra* note 89, at ¶ 1.06.

<sup>126</sup> 48 Fed. Reg. 35248, 35250-53 (August 3, 1983) (to be codified at 17 C.F.R. § 1.3(mm)).

<sup>127</sup> *Id.*

<sup>128</sup> *Id.* at 35251. Nevertheless, with the exception of CTA's, or other individuals or entities already subject to CFTC registration, any person receiving compensation for introducing accounts to an FCM will be subject to the requirement of introducing broker registration. Thus, the presence of compensation remains the principal determinant of introducing broker registration.



tionary accounts or who is not compensated on a per-trade basis.<sup>129</sup> In addition, the definition expressly excludes those persons soliciting or accepting customer orders solely in a clerical capacity, or who are not compensated, directly or indirectly, for their activities as an introducing broker.<sup>130</sup>

Conversely, the regulations establish an exemption for introducing brokers from CTA registration.<sup>131</sup> Although the CEA includes an express exemption for futures commissions merchants from CTA registration,<sup>132</sup> the CFTC originally proposed that this same exemption not be extended to introducing brokers.<sup>133</sup> As a result, the proposed regulations would have subjected introducing brokers rendering advice to customers to registration as commodity trading advisors even if such advice was solely incidental to the conduct of their business.<sup>134</sup> The CFTC had proposed to exempt from such registration those introducing brokers who neither directed customers' accounts nor guided customers' accounts by means of a systematic program.<sup>135</sup> The manner in which direct or guide would have been defined in this context was not clear, however. Moreover, the proposal left uncertain the extent to which the regulations would have subjected an introducing broker to commodity trading advisor registration if its employees, whom the regulations require to register as associated persons,<sup>136</sup> guided or managed customer accounts.

As a result of these concerns, which were raised with the CFTC during the comment period, the CFTC, adopted final regulations that exempt introducing brokers from CTA registration if their advisory activities are solely in connection with their business as introducing brokers.<sup>137</sup> Introducing brokers will be subject to a registration exemption similar to that provided for associated persons, but more limited than that available to FCMs.<sup>138</sup> This registration exemption will allow introducing brokers to provide incidental advice to their customers without the added burden

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<sup>129</sup> *Id.* In addition, FCMs, floor brokers and associated persons are similarly excluded from the definition of introducing broker. *Id.* The definition also excludes any commodity pool operator solely engaged in the operation of commodity pools. *Id.*

<sup>130</sup> 48 Fed. Reg. 35248, 35251 (August 3, 1983) (to be codified at 17 C.F.R. § 1.3(mm)). The CFTC noted that "indirect" compensation could include such things as provision of research services. The CFTC's release also sets out procedures and requirements for registration of "equity raisers" or others receiving a fee or "split" commissions for referrals. 48 Fed. Reg. 35248, 35251, 35253 (August 3, 1983).

<sup>131</sup> 48 Fed. Reg. 35248, 35252 (August 3, 1983) (to be codified at 17 C.F.R. § 4.14(a)(6)).

<sup>132</sup> 7 U.S.C.A. § 2(a)(1) (West Supp. 1983). The definitional section of the CEA contains the exemption that excludes FCMs from the meaning of commodity trading advisor.

<sup>133</sup> 48 Fed. Reg. 14933, 14936 (April 6, 1983).

<sup>134</sup> *Id.* The "solely incidental" language is derived from § 2(a)(1) of the Act, and is the basis for the exemption from CTA registration for futures commission merchants and certain other entities or individuals. 7 U.S.C.A. § 2(a)(1) (West Supp. 1983).

<sup>135</sup> 48 Fed. Reg. 14933, 14935 (April 6, 1983).

<sup>136</sup> 48 Fed. Reg. 35248, 35253 (August 3, 1983). See *infra* notes 145-49 and accompanying text.

<sup>137</sup> 48 Fed. Reg. 35248, 35252 (August 3, 1983) (to be codified at 17 C.F.R. § 4.14(a)(3)).

<sup>138</sup> 48 Fed. Reg. 35248, 35252 (August 3, 1983). FCMs, as noted, are exempt from CTA

and expense of CTA registration. Indeed, given the substantial filings and disclosures required of introducing brokers, the additional requirements of CTA registration would do little to enhance customer protection.

In addition, the proposed regulations were silent about the necessity for foreign brokers introducing accounts to futures commission merchants to register as introducing brokers. As noted above, current CFTC regulations allow foreign brokers to operate in the absence of registration, but require clearing futures commission merchants to act as their agents for purposes of regulatory compliance and CFTC notifications.<sup>139</sup> Under the final regulations, this requirement has been specifically amended to state that introducing brokers, as well as FCMs, may act as the agents of foreign brokers for whom they introduce accounts.<sup>140</sup> As a result, foreign brokers still will not be subject to registration as introducing brokers, although introducing brokers dealing with such foreign brokers will be required by regulation to assume additional responsibilities.

If an entity or individual is required to register as an introducing broker, the regulations restrict their activities to the solicitation, acceptance and referral of customer orders.<sup>141</sup> Introducing brokers are also prohibited from maintaining back office operations, although these brokers will be permitted to engage in trading for proprietary or house accounts and to solicit orders for unregulated futures transactions.<sup>142</sup> In addition,

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registration so long as their advisory activities are solely incidental to their business at FCMs. See *supra* note 142. The CFTC has stated that the applicability of the "solely incidental" standard cannot be determined according to any numerical criteria, but only through evaluation of "the context of the business concerned and the factual situation in which the services are rendered." CFTC Interpretive Letter No. 75-1, [1975-77 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,135 (February 26, 1976). Thus, an FCM publishing periodic advice may be exempt from CTA registration.

In contrast, an associated person of an FCM forwarding written recommendations or advice to existing or prospective customers has been held subject to CTA registration, since such activities are deemed by the CFTC not to be solely in connection with the associated person's business. CFTC Interpretive Letter No. 75-6, [1975-77 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,093 (August 11, 1975). Introducing brokers, as noted, will be subject to this narrower standard.

<sup>139</sup> See *supra* notes 33-34.

<sup>140</sup> 48 Fed. Reg. 35248, 35261 (August 3, 1983); 17 C.F.R. § 15.05 (1982).

<sup>141</sup> 48 Fed. Reg. 14933, 14934 (April 6, 1983). In adopting the final regulations, the CFTC noted that customers should, in most instances, transmit funds directly to the FCM carrying the account. 48 Fed. Reg. 35248, 35269 (August 3, 1983). Nevertheless, the CFTC stated that an introducing broker will not be prohibited from receiving customer funds, payable to the FCM, and depositing it in account, if certain prescribed conditions are met. *Id.* at 35270.

<sup>142</sup> *Id.* at 35267. See also 48 Fed. Reg. 14933, 14934 (April 6, 1983). "Back office" operations include processing of trades, segregation of funds and other recordkeeping. Because introducing brokers will not be carrying customer funds or processing orders, but simply transmitting these to a registered firm, introducing brokers will not maintain "back office" operations. The final regulations, while permitting introducing brokers to engage in trading for proprietary accounts, prohibit such trading in foreign futures. 48 Fed. Reg. 35248, 35267 (August 3, 1983).

Introducing brokers, by definition, also are prohibited from carrying any customer, as well as proprietary accounts. 48 Fed. Reg. 35248, 35267 (August 3, 1983). Introducing

the CFTC had proposed to prohibit the solicitation of orders for options transactions by introducing brokers, but has now determined to allow such solicitations provided that the introducing broker is a member of a self-regulatory organization that regulates its options activities, is a member of a contract market approved for the regulation of options trading by its members, or has entered into a guarantee agreement with an FCM.<sup>143</sup>

The partners, officers, employees or agents of an introducing broker, like those of a futures commission merchant, will be required to register with the CFTC as associated persons if they are engaged in the solicitation or acceptance of customer funds, other than in a clerical capacity or in the supervision of persons so engaged.<sup>144</sup> In addition, the sponsorship and fingerprinting requirements will be equally applicable to such associated persons and their employers.<sup>145</sup> Previously, as noted, associations with more than one futures commission merchant by an associated person were prohibited.<sup>146</sup> This prohibition has been maintained and, in addition, associated persons may not, under the new regulations, associate with one FCM and one introducing broker.<sup>147</sup> The regulations also extend the duty of supervision imposed on FCMs to introducing brokers as well.<sup>148</sup>

### B. *Minimum Financial Requirements*

The minimum financial or net capital regulations, as set out above, constituted the single most significant barrier to small firm registration under the Commodity Exchange Act.<sup>149</sup> For this reason, in amending the CEA to include introducing broker registration, the conference committee expressed an intent that the small firm introducing broker remain economically viable.<sup>150</sup> The minimum financial requirements originally pro-

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brokers, however, may accept funds in the name of the carrying FCM, subject to certain prescribed conditions. *Id.* at 35269-70.

<sup>143</sup> *Id.* at 35272 (to be codified at 17 C.F.R. § 33.3). The CFTC's earlier position was that, because its options program has been implemented on a pilot basis only, the program must remain limited until such time as its viability can be demonstrated. *Id.*; see also, Markham and Gilberg, *Stock and Commodity Options—Two Regulatory Approaches and Their Conflicts*, 47 ALB. L. REV. 741 (1983); 48 Fed. Reg. 14933, 14934 (April 6, 1983).

<sup>144</sup> 48 Fed. Reg. 35428, 35253 (August 3, 1983).

<sup>145</sup> *Id.* This regulation requires introducing brokers to perform background checks on their associated persons and to verify, among other things, their prior employment history. 17 C.F.R. § 3.12 (1982).

<sup>146</sup> See *supra* note 23.

<sup>147</sup> 48 Fed. Reg. 35248, 35255 (August 3, 1983) (to be codified at 17 C.F.R. § 3.12(f)). Associated persons, however, may become associated with more than one CTA or commodity pool operator. *Id.* The regulations permit a one time "transfer" of registered status for associated persons formerly employed by unregistered agents. 48 Fed. Reg. 35248, 35260 (August 3, 1983). Such associated persons may become affiliated with an FCM or introducing broker without re-registration.

<sup>148</sup> 48 Fed. Reg. 35248, 35274 (August 3, 1983) (to be codified at 17 C.F.R. § 166.3).

<sup>149</sup> See *supra* notes 18-24 and accompanying text.

<sup>150</sup> CONFERENCE REPORT, *supra* note 2, at 41.

posed by the CFTC for introducing brokers, however, while less than those imposed upon FCMs, were substantial and would have made business difficult for some smaller introducing brokers. The final regulations, therefore, establish minimum financial requirements for introducing brokers less than those requirements originally proposed, and set out an alternative method of compliance.<sup>151</sup>

The CFTC's proposal would have required introducing brokers to maintain a net capital of \$50,000 or, if the broker is a member of the National Futures Association, \$25,000.<sup>152</sup> Moreover, because the proposal would have required that introducing brokers maintain 150 percent of this net capital figure at all times, to comply with the CFTC's early warning regulations introducing brokers would have had to meet minimum financial requirements of \$37,500 or \$75,000.<sup>153</sup> In contrast, the SEC imposes a net capital requirement of only \$5,000 upon introducing brokers operating in the securities industry, although these brokers may be subject to greater requirements in some instances.<sup>154</sup>

Under the final regulations, however, introducing brokers will be required to maintain net capital of \$20,000 and will not be required to submit monthly financial reports if their capital falls below the early warning

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<sup>151</sup> 48 Fed. Reg. 35248, 35261-70 (August 3, 1983).

<sup>152</sup> 48 Fed. Reg. 14933, 14942 (April 6, 1983). See 7 U.S.C.A. § 21 (West Supp. 1983); see also 17 C.F.R. § 170.1-12 (1982). The National Futures Association (NFA) is registered as a futures association under § 17 of the CEA which contains provisions for regulation and oversight of such organizations by the CFTC. The NFA took four years to develop, and represents an attempt by the commodities industry to establish a nationwide self-regulatory body.

Congress amended the CEA during the 1978 reauthorization to permit compulsory membership, a requirement that the Department of Justice had objected to as anti-competitive. Pub. L. No. 95-405, 92 Stat. 864. See generally *NFA, Application to the CFTC For Registration Under Section 17 of the CEA* (March 16, 1981); S. REP. NO. 850, 95th Cong., 2d Sess. 30-31 (1978); 1982 *Senate Hearings, supra* note 2, at 322. The CFTC, however, adopted the compulsory membership rule, effective August 8, 1983, and this rule requires all FCMs to become NFA members. 48 Fed. Reg. 26304 (June 7, 1983). Moreover, because NFA by-laws prohibit members from doing business with non-members, introducing brokers will in effect be subject to the same requirement. 48 Fed. Reg. 35248, 35261 (August 3, 1983).

<sup>153</sup> 48 Fed. Reg. 14933, 14958-59 (April 6, 1983). The early warning requirements assure that futures commission merchants maintain more than the required amount of net capital at all times. See 17 C.F.R. § 1.12 (1982).

<sup>154</sup> 17 C.F.R. § 240.15c3-1(a)(2) (1982). Regulations subject securities introducing brokers, like broker-dealers and futures commission merchants, to "early warning" requirements that mandate that securities introducing brokers maintain a specified amount of excess net capital. 17 C.F.R. § 240.17a-11 (1982). This excess amount is stated in terms of a percentage of net capital or of aggregate indebtedness, if the alternative net capital method is elected.

In its original proposal, the CFTC noted that securities introducing brokers are subject not to a \$5,000 minimum financial requirement, but actually to the greater of \$5,000 or 6-2/3% of aggregate indebtedness. 48 Fed. Reg. 14933, 14934, n.3 (April 6, 1983). This, however, is not the case. The 6-2/3% computation applies only to subsidiaries of registered broker-dealers who elect not to follow the alternative net capital computation. 17 C.F.R. § 240.15c3-1(f)(2) (1982).

level.<sup>155</sup> Introducing brokers will be required to give notice only in those instances in which their net capital falls below the required levels.<sup>156</sup> As a result, rather than being required to maintain an actual net capital of \$37,500, introducing brokers will be subject to the \$20,000 requirement only.<sup>157</sup>

Further, the CFTC has adopted a regulation, which was not contained in the original proposal, that will allow an introducing broker to satisfy the minimum financial requirements by entering into a guarantee agreement with a clearing FCM.<sup>158</sup> This agreement, the content of which has been specified by the CFTC as a supplement to form 1-FR, provides that the FCM will guarantee performance by the introducing broker of all its obligations under the CEA and CFTC regulations.<sup>159</sup> By entering into such an agreement, an introducing broker can exempt itself from the minimum financial requirements and may engage in options transactions.<sup>160</sup>

Nevertheless, while the final regulations constitute a relaxation of the net capital obligations proposed for introducing brokers, the alternative method of compliance may not be viable for many introducing brokers. Thus, while introducing brokers may avoid the minimum financial requirements entirely by entering into a guarantee agreement, whether FCMs generally will be willing to do so is not clear. The regulations require a guarantee by the FCM of all the introducing broker's operations including solicitations and other actions over which the FCM will have little or no control.<sup>161</sup> As a result, the alternative requirement apparently will benefit only those introducing brokers associated closely enough with a clearing futures commission merchant to allow the latter to guarantee fully all the operations of the former.<sup>162</sup> Because many futures commission merchants may be unwilling to do so, the provision may be of limited effectiveness for many introducing brokers.

### C. *Recordkeeping and Reporting Requirements*

The regulations require an introducing broker to prepare and keep

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<sup>155</sup> 48 Fed. Reg. 35248, 35261-62 (August 3, 1983).

<sup>156</sup> *Id.* at 35269.

<sup>157</sup> *Id.* at 35261. Securities broker-dealers registered with the SEC, and with the CFTC as introducing brokers, will be subject to a net capital requirement of \$25,000, the amount established for broker-dealers engaged in a general securities business. Broker-dealers registered with the SEC as introducing brokers, subject to the SEC's reduced net capital requirement of \$5,000, will be required to maintain net capital of \$20,000 if also registered with the CFTC as an introducing broker.

<sup>158</sup> 48 Fed. Reg. 35248, 35264-66 (August 3, 1983) (to be codified at 17 C.F.R. § 1.17(a)(2)(ii)).

<sup>159</sup> 48 Fed. Reg. 35248, 35261 (August 3, 1983). The release and regulations also set out in detail the required form and procedures for such guarantee agreements.

<sup>160</sup> *See id.*; *see also supra* note 143.

<sup>161</sup> 48 Fed. Reg. 35248, 35261 (August 3, 1983).

<sup>162</sup> *Id.* A number of futures commission merchants, however, do have such close business relationships with their introducing brokers and will likely be willing to guarantee their

current the same type of financial records which an FCM must maintain.<sup>163</sup> The CFTC had proposed to require that introducing firms also file the same financial statement required of futures commission merchants, thus imposing substantial additional burdens upon introducing brokers.<sup>164</sup> In contrast, as noted, SEC regulations require introducing brokers in the securities industry to file only an abbreviated financial statement, and less frequently than broker-dealers generally.<sup>165</sup>

The CFTC modified certain of these requirements in adopting the final regulations. Introducing brokers will be required to file financial reports, certified by an independent public accountant, with their applications for registration and annually thereafter to satisfy requirements equally applicable to futures commission merchants.<sup>166</sup> In addition, introducing brokers will be required to submit FCM filed quarterly financial reports, which need not be certified.<sup>167</sup> If, however, the introducing broker's designated self-regulatory organization adopts regulations, approved by the CFTC, which allow the filing of semiannual reports, quarterly filings need not be made.<sup>168</sup> Further, in filing the required financial reports, introducing brokers will be permitted to file a simplified form 1-FR, the financial reporting form for futures commission merchants.<sup>169</sup> Moreover, introducing brokers operating pursuant to a guarantee agreement will not be required to file any financial reports, and special provisions have been made for firms also registered as broker-dealers with the SEC, and for country grain elevators.<sup>170</sup>

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operations: "And we feel that we are a firm [the FCM] for that agency [the introducing broker]". *Senate Hearings, supra* note 2, at 219 (statement of Howard A. Stottler).

<sup>163</sup> See 17 C.F.R. §§ 1.10, 1.12, 1.16, 1.17 (1982); 48 Fed. Reg. 14933, 14957-63 (April 6, 1983). The regulations require introducing brokers, like futures commission merchants, to include in their reports detailed statements of financial condition and transactions affecting that condition. See 48 Fed. Reg. 14944, 14952 (April 6, 1983) (to be codified at 17 C.F.R. § 1.18).

<sup>164</sup> 48 Fed. Reg. 14933, 14949-52 (April 6, 1983). The regulations set out the requirement of certification of financial reports by an independent public accountant. See 17 C.F.R. § 1.16 (1982). The regulations require that accountants meet certain qualifications and prepare reports in a specific form and manner. *Id.*

<sup>165</sup> See *supra* note 105.

<sup>166</sup> 48 Fed. Reg. 35248, 35263 (August 3, 1983) (to be codified at 17 C.F.R. § 1.10(a)).

<sup>167</sup> 48 Fed. Reg. 35248, 35263 (August 3, 1983) (to be codified at 17 C.F.R. § 1.10(b)(1)).

<sup>168</sup> 48 Fed. Reg. 35248, 35263 (August 3, 1983) (to be codified at 17 C.F.R. §§ 1.10(b)(3), 1.52). In addition, either the NFA or a contract market of which the introducing broker is a member may serve as its designated self-regulatory organization.

<sup>169</sup> 48 Fed. Reg. 35248, 35262 (August 3, 1983). The specific alterations that will be made to form 1-FR for filings by introducing brokers is not clear yet. The CFTC indicated in its release adopting the regulations that the CFTC simply will include separate instructions for introducing brokers and highlight those portions of the form which are inapplicable to an introducing broker's operations. *Id.*

<sup>170</sup> *Id.* at 35249, 35262-63. Introducing brokers registered as broker-dealers with the SEC may file a copy of their FOCUS Report, Part II or Part IIA, and an introducing broker which is also a country grain elevator may file a report submitted pursuant to a Uniform Grain Storage Agreement.

The regulations also require introducing brokers, as well as futures commission merchants, to prepare a time-stamped record of each customer order and a daily journal of all customer trades.<sup>171</sup> Because the regulations do not permit introducing brokers to carry customer accounts, introducing brokers will not be required to prepare detailed financial and contract ledgers of all transactions nor to supply confirmation, monthly and purchase and sale statements to customers, since the futures commission merchant will remain liable for these requirements.<sup>172</sup>

## VI. Conclusion

Introducing brokers, in one form or another and under numerous labels, have long been a significant part of the futures industry serving to enhance customer access to exchanges as well as market liquidity. The need for these brokers today, however, in a time of rapid expansion in trading volume, is perhaps even more compelling than in the past. Yet at the same time, a regulatory structure governing the activities of introducing brokers is essential to the adequate protection of the many customers with whom they do business. The formidable task now facing the industry and the CFTC, therefore, is the achievement of a delicate balance that will assure customer protection while allowing introducing firms to function effectively.

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<sup>171</sup> 48 Fed. Reg. 14933, 14953 (April 6, 1983); 17 C.F.R. § 1.35(b) (1982). The time-stamping and recordkeeping requirements are intended to allow reconstruction of an "audit trail" in order to determine the existence of liability in instances of customer complaints.

<sup>172</sup> 48 Fed. Reg. 14933, 14953 (April 6, 1983); 17 C.F.R. § 1.33, 1.46 (1982). The final regulations add a requirement that monthly confirmation and purchase and sale statements provided to customers indicate that the account for which the statements are provided was introduced to the FCM by an introducing broker. 48 Fed. Reg. 35248, 35272 (August 3, 1983). In addition, the regulations have been amended to require either an FCM or introducing broker to provide a Risk Disclosure Statement to commodity futures customers. *Id.* at 35273 (to be codified at 17 C.F.R. § 1.55). The CFTC has stated, however, that it is primarily the responsibility of the introducing broker to provide a Risk Disclosure Statement. 48 Fed. Reg. 35428, 35273 (August 3, 1983).