May 2, 2006

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RE: Application of the CIP Rule to Give-Up Arrangements

Dear Ms. Everson and Mr. Arbit:

As you are aware, Section 326 of the USA PATRIOT Act of 2001 (the "PATRIOT Act") and its implementing regulations (together the "CIP rule") have raised significant issues for futures commission merchants ("FCMs") that are executing brokers. As a result, executing brokers in the futures industry have raised concerns with the Department of the Treasury, FinCEN and the CFTC about the application of the CIP rule in give-up arrangements.

In June of 2005, the Futures Industry Association ("FIA") met with FinCEN and other regulators to address certain of those concerns. In particular, we met to seek interpretive guidance relating to the application of the CIP rule where an FCM deals with an intermediary. As stated at that meeting, the FIA believes that, unlike clearing brokers, executing brokers do not have an account relationship with a customer that would impose a CIP obligation on the executing broker. The FIA was concerned, however, that to the extent that any CIP obligation is imposed on an executing broker, the futures industry should obtain similar parity on the intermediary issue with the securities industry, which had previously been granted that relief.[1] The lack of consistent guidance between FCMs and securities broker-dealers on this issue had created confusion, particularly where a firm was dually registered. As a result of that meeting, guidance was issued by FinCEN and the CFTC which provides that, where a financial

[1] See FinCEN and SEC, "Question and Answer Regarding the Broker-Dealer Customer identification program Rule (31 C.F.R. 103.122)" (Oct. 1, 2003).

intermediary such as a commodity trading advisor ("CTA") or investment adviser ("IA") conducts futures transactions with an FCM on behalf of underlying investors, it is the intermediary, and not the underlying investors, that is the customer for purposes of the CIP rule.[2] This relief was particularly significant to the member firms that were present at the meeting in that they conduct substantial business with customers who are CTAs or IAs, acting on behalf of their own clients. The FIA recognizes and appreciates the intermediary relief that it received as a result of the meeting.

As we pointed out in that meeting, however, executing brokers are still in need of the additional requested relief. The issue of the application of the CIP rule to executing brokers in the give-up context is significant for all of our members, as it applies to all their customers. For executing brokers, it would be extraordinarily difficult, if not impossible, to conduct CIP on their many thousands of customers that execute trades through them on a give-up basis. Indeed, while all FCMs executing trades are seriously affected by this issue, the problem is especially acute for a small number of very significant players in the futures industry that execute a significant percentage of these trades, and for smaller firms for which execution services constitutes a majority of their business. The interpretation sought and promised would relieve all executing brokers of any obligation to conduct CIP when a domestic carrying broker clears the transaction. The FIA requested this relief based upon the absence of an account relationship between the executing broker and the carrying broker's customer, the redundancy created by having the executing broker and carrying broker both conduct CIP, and the burden created by having executing brokers conduct CIP given the way in which give-up transactions are processed.

Since the June meeting, the FIA has continued to address the need for this relief with both the CFTC and FinCEN. We understand that the primary reason that the relief has not yet been granted is the concern by banking and securities regulators, expressed at the June meeting, as to whether this interpretation is necessary in light of the existing reliance agreement provisions in the CIP rule and whether granting this relief to the futures industry would create an unjustified lack of parity between the futures industry and the securities and banking industries.

To address these concerns, the FIA has prepared the enclosed Give-up Paper (the "Paper"), which sets forth the regulations relating to FCMs, the historical use of give-up arrangements between executing brokers and carrying brokers, and the effect of the application of the CIP rules to executing brokers. As the enclosed paper explains in greater detail, the relationship between the executing broker and the carrying broker's customer does not rise to the level of an account. In the Paper, we indicate how the existing guidance provided by FinCEN and the banking regulators' guidance in other contexts supports this interpretation.

[2] FinCEN and CFTC, "Frequently Asked Question Regarding Customer Identification Programs for Futures Commission Merchants and Introducing Brokers (31 C.F.R. 103.123), FIN-2006-G004 (Feb. 14, 2006). ("Intermediary Guidance").

The Paper also explains how the relationship between the executing broker and the customer in the give-up arrangement is very different from the regulatory scheme and business practices in the securities industry's prime brokerage arrangements. In particular, in the prime brokerage relationship, the executing broker has Know Your Customer obligations with respect to the customer -- an obligation which is clearly not applicable to the executing broker in the futures industry. Finally, we explain why the application of the reliance agreement provision in the context of the futures industry give-up arrangement is generally unworkable, thereby leaving the executing brokers with little choice but to implement a costly and unnecessary CIP operation that could adversely impact their profitability.

Accordingly, the FIA is seeking relief from the CIP obligations for FCMs who act as executing brokers in give-up arrangements. In sum, we believe that this approach is supported by the historical role of the executing broker, the fact that these brokers do not open a traditional account for customers, the different regulatory responsibilities between the executing broker and the carrying broker, and the difficult competitive and compliance issues involved in a give-up arrangement.

We appreciate your continued willingness to consider our concerns and in turn will continue to work with you to ensure the successful implementation of the PATRIOT Act's regulatory scheme applicable to the futures industry.

Very truly yours,

Barbara Wierzynski
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Customer Identification Programs in Give-Up Arrangements Between Executing Brokers and Carrying Brokers

Introduction

The Futures Industry Association (the "FIA")[1] submits this analysis to further its ongoing dialogue with the U.S. Department of Treasury, the Financial Crimes Enforcement Network ("FinCEN"), the Commodity Futures Trading Commission, the National Futures Association and other relevant regulatory bodies concerning application of the USA PATRIOT Act (the "PATRIOT Act") implementing rules in the context of the futures industry. By this submission, we are seeking further relief that will enable Futures Commission Merchants ("FCMs") to comply with their AML responsibilities in the most practical and effective way.

Anti-money laundering statutes generally impose on financial institutions ("FIs"), including FCMs, certain obligations designed to enhance their ability to prevent the FI from being abused by money launderers. Among those obligations are the requirement that FIs adopt an anti-money laundering ("AML") program, and that they develop and implement a customer identification program ("CIP"). As part of the CIP, an FI must obtain certain identifying information from each customer with whom it deals, and verify through documents or other appropriate means the identity of that customer.

The FIA strongly supports the policy objectives behind the CIP rule and continues to encourage and facilitate rigorous compliance with all aspects of the PATRIOT Act. In our experience, the most effective AML compliance measures maximize the industry's ability to conduct a thorough, risk-based approach and minimize bureaucratic inefficiencies. The implementing rules of the PATRIOT Act best accomplish these goals where they comport with the existing compliance obligations of industry participants, rather than require a reordering of existing responsibility among those participants.

[1] The Futures Industry Association is a principal spokesperson for the commodity futures and options industry. Its regular membership is comprised of approximately 40 of the largest futures commission merchants in the United States. Among its approximately 150 associate members are representatives of virtually all other segments of the futures industry, both national and international, including U.S. and international exchanges, banks, legal and accounting firms, introducing brokers, commodity trading advisors, commodity pool operators and other market participants, and information and equipment providers. Reflecting the scope and diversity of its membership, FIA estimates that its members effect more than 90 percent of all customer transactions executed on U.S. contract markets.

The FIA respectfully submits that the CIP rule, as potentially applied in the context of give-up relationships, ignores the industry's existing framework for meeting its compliance responsibilities and instead superimposes on it a requirement that is both unnecessary and unworkable. Both the historical evolution and current allocation of compliance responsibilities in the futures industry warrant a different approach that reflects the industry's unique characteristics and structure. Accordingly, the FIA is seeking relief from the CIP obligations for FCMs who act as executing brokers in give-up arrangements. As discussed more fully in this submission, we think this is supported by the historical role of the executing broker, the fact that these brokers do not open a traditional account for customers, the different regulatory responsibilities of the executing broker as compared with those of the carrying broker, and the difficult competitive and compliance issues involved.[2]

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Current Division of Compliance Responsibilities and Structure of Relationship Between FCMs and Executing Brokers

For most of the twentieth century, customers used the services of one FCM to both execute a trade, as well as to clear and carry the position. Over the last few decades, however, an industry practice has developed in which it is routine for many market participants to use one or more executing brokers (either an FCM or floor broker) to execute its trades and a different legal entity (an FCM) to clear the trades and carry the positions on its books (the "carrying broker'). In fact, even with a single trading strategy, one market participant may use multiple executing brokers to execute that strategy, and a different carrying broker to clear and carry these trades. In either situation, the executing broker is said to "give-up" the trade to the customer's clearing or carrying FCM.[3]

A give-up arrangement, at a minimum, involves three parties: the executing broker, the carrying broker, and the carrying broker's client (in this case, an individual or corporate client).[4] A four-party give-up arrangement may also occur where an end user has given trading authorization to a Commodity Trading Advisor ("CTA") or Investment Adviser (" IA") or other operator of commodity pools ("CPOs") and other collective investment vehicles (collectively, advisors"*)*.[5]

[2] In this submission, we only address the obligations of an FCM that is executing futures trades and not any securities trades it might transact as a dually-registered FCM/broker-dealer.

[3] Under the CIP rule for FCMs, a customer is "a person that opens a new account with a futures commission merchant." 31 C.F.R. § 103.123(a)(5)(i). For purposes of this submission, we use the term "customer" only to refer to the customer of the carrying broker and not the executing broker. As we discuss below, the carrying broker's customer is not necessarily a customer of the executing broker.

[4]*See generally* National Futures Association and the Futures Industry Institute Recommendations for Best Practices in Order Entry and Transmission of Exchange-Traded Futures and Options Transactions (March 15, 2001) at 20 n.26

[5] The US Department of the Treasury has issued a temporary exemption from compliance with the AML requirements of the PATRIOT Act for CTAs and CPOs. 31 C.F.R. § 103.170. A Proposed AML Rule for CTAs was issued in May 2003. 68 Fed. Reg. 23640 (May 5, 2003). CTAs and CPOs are expected to become subject to these anti-money laundering provisions in the future.

A futures customer, including an advisor, may elect to use one or more executing brokers for a number of reasons:

- the carrying broker may not be a member of a particular exchange on which the contract in question is listed for trading;
- particularly in the case of larger institutional customers, the customer may elect to use one or more executing brokers in order not to disclose its trading strategy to other market participants;
- the customer may prefer the executing broker's electronic trading offerings or its traditional voice-brokered order desk;
- the unbundling of the costs of execution and carrying may result in the executing broker charging less for this service than the carrying broker;
- certain brokers simply develop a reputation for being able to execute transactions in particular futures contracts well (or different types of transactions such as spread or calendar trades), while the carrying broker provides superior "back office" services; or
- the executing brokers may provide access to research services and market commentary in connection with their execution services.

As a result of the separation of the execution and clearing functions, the futures industry has become a "hub and spoke" system, with the carrying firm acting as the hub in its role as the financial guarantor to the exchange clearing house of both the customer and the customer's transaction, and the executing brokers acting as the spokes.

For example, since customer financial performance is only of concern to the FCM carrying the account and not the executing broker, all credit and other daily risk-monitoring of the customer's account have typically remained the sole responsibility of the carrying FCM. Customers rely ultimately on the capital of their carrying FCM for financial security. Whereas in the U.S., customer securities accounts are insured through the Securities Investors Protection Corp. ("SIPC"), there is no equivalent insurance scheme in the futures industry.

Further, the executing broker ordinarily is paid its execution "commissions" from the carrying broker and not the customer, because it is the carrying broker that is in the position to debit the customer's funds and pay the customer's execution-only brokers.

With many futures transactions, FCMs acting as executing brokers merely facilitate rather than physically execute the trade, such as by providing a conduit to a floor broker who physically executes the trade through open outcry or simply by providing an electronic connection vehicle via computer or other connectivity which links directly to an exchange's computer system. Once the trade is executed, it is "given up" or transferred to a carrying broker where the client's account actually resides. Indeed, while on most exchanges the carrying FCM has a brief moment to accept all incoming transactions, on some exchanges, transactions are "dumped" en masse into the carrying FCM subject to *ex post facto* review by the carrying FCM only.[6] Practically, therefore, in both cases carrying brokers are required to accept 100% of all

[6] *See* NYMEX Rule 9.11A - Give-Up Trades.

executed trades. This operationally highlights the very limited role of executing brokers and the principal role of carrying brokers.

CIP Responsibilities Should Reflect Existing Compliance Responsibilities

FIA submits that the determination of which party or parties to a give-up arrangement must conduct CIP should conform to the historical evolution and current configuration of the futures industry by recognizing the existing roles of the participants and their compliance responsibilities. Since at least the early 1980s, futures trades have been conducted as part of a bifurcated system, with a complete regulatory and practical divide between the functions of carrying brokers and those of executing brokers. In this system, the carrying firm is the acknowledged repository of the client relationship, handles all account-related paperwork and transfer of assets and retains all Know Your Customer ("KYC") and disclosure duties.[7] The executing broker merely acts as a conduit and a facilitator of a trade and consequently has circumscribed regulatory and recordkeeping duties with respect to the carrying firm's customer.

A. The Carrying FCM is Uniquely Positioned to Conduct CIP

As it presently reads, the CIP Rule for FCMs imposes on all FCMs, regardless of whether they are executing brokers or carrying brokers, the responsibility to fulfill customer identification and verification procedures. As a practical matter, this approach to CIP in the context of an executing broker/carrying broker relationship is not consistent with the ordinary course of business between such financial institutions. Although the executing broker has responsibilities with respect to the trade executed on behalf of the customer, [8] in the ordinary scheme, it is the carrying broker that assumes most compliance responsibilities for information relating to its customer. Due to the manner in which the relationship develops, in a third-party give up arrangement, the carrying broker is uniquely positioned to obtain customer information and has the ability to, and maintains, significantly more extensive records reflecting its interaction with the customer.[9] Customers, including advisors, provide their carrying firm, and not their multiple executing brokers, with the information necessary to perform adequate CIP and KYC reviews. Moreover, all cash transactions flow through the carrying broker, which is therefore the only party with the ability to monitor for suspicious money movements. This is why under the KYC rules for the National Futures Association and consistent with industry practice, it is the carrying broker that has the responsibility for compliance with the KYC Rule."[10]

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[7] *See* NFA Rule 2-30 (KYC); CFTC Rule 1.55 (disclosure).
[8] For example, executing brokers must prepare and maintain records of the transactions they have executed on behalf of any customer (*e.g.*, order tickets). *See* CFTC Rule § 1.35(a-1).
[9] In a four-party agreement, the CTA or IA is uniquely positioned to obtain identifying information from the underlying customer. For that reason, Treasury has recognized that it is appropriate to view the CTA or the IA as the customer of the FCM for purposes of the CIP Rule. See FinCEN and CFTC, "Frequently Asked Question Regarding Customer Identification Programs for Futures Commission Merchants and Introducing Brokers (31 C.F.R. 103.123), FIN-2006-G004 (Feb. 14, 2006) ("Intermediary Guidance").
[10] NFA Rule 2-30(e), Customer Information and Risk Disclosure.

Regardless of the particulars of a specific give-up arrangement, it is the carrying broker that conducts the KYC obligations and has the more direct, comprehensive relationship with the advisor or investor, and not the executing broker. It is similarly the carrying broker that is in a better position to verify the identity of such customer or advisor for purposes of compliance with anti-money laundering programs. It is only the carrying broker that: (1) enters into a carrying account agreement with the customer, establishing the parties' respective rights and obligations, and in the process, conducts a credit review and obtains documentation from the customer covering areas such as identity verification and legal entity structure; (2) is responsible for maintaining records of, and is able to monitor on a daily basis, all of the customer's transactions that it carries;[11] and (3) accepts customer funds to margin or secure such transactions and disburses such funds in accordance with the customer's instructions, if at all.

Imposing separate customer identification obligations on both executing and carrying brokers is inconsistent with FinCEN's frequently articulated position that it does not intend to change the structure of the broker's relationship with the customer.[12] Nor is it consistent with the legislative history of the PATRIOT Act. In discussing the proposed CIP requirement, the House Committee on Financial Services stated: "It is the Committee's intent that the verification procedures prescribed by Treasury make use of information currently obtained by most financial institutions in the account opening process. It is not the Committee's intent for the regulations to require verification procedures that are prohibitively expensive or impractical."[13] Thus, whereas carrying brokers were already required by regulation to collect customer identification information during the account opening process, executing brokers in give-up arrangements were not and are not required to collect such information. Requiring executing brokers to conduct CIP would therefore not be consistent with Congressional intent. Moreover, consistent with the concerns raised by Congress, requiring customers and advisors to provide, and multiple executing brokers to collect, such information would both be "prohibitively expensive" and commercially "impractical". Further, as a practical matter, where the same customer executes trades through multiple brokers, as is sometimes the case, requiring multiple FCMs (*i.e.*, the various executing brokers, as well as the carrying broker) to conduct CIP on the same customer would not only be duplicative, it would be excessive.[14] Importantly, it would offer no added regulatory benefit.

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[11] As noted above, executing brokers have some other limited recordkeeping responsibilities with respect to the transactions they execute.

[12] *See also* the Preamble to the Final SAR Rule for Broker-Dealers: "[I]t should be noted that the final rule does not require a broker-dealer to alter its relationship with its customers in a way that is inconsistent with industry practice . . . The rule is intended to adjust to the different operating realities found in different types of financial institutions." 67 Fed. Reg. 44048, 44054 (July 1, 2002).

[13] House Committee on Financial Services Report (Oct. 17, 2001).

[14] On a related matter, we note that it would be even more duplicative and burdensome for an executing broker to conduct due diligence with respect to correspondent accounts and private banking accounts under the Final 312 Rule. There, procedures for investigating the customer's source of funds, employment status, anticipated account activity and other information are even more resource intensive and further magnify the issues we have described.

B. There Is No Account Relationship with the Executing Broker

The entire structure of a CIP program is superimposed and dependent upon the existence of an account relationship. If there is no account relationship, as with give-up transactions, there is no predicate on which to establish CIP. Due to the nature of the relationship between the executing broker and the carrying firm customer that engages in a give-up trade, no account relationship, as defined by the regulations, develops. The definition of "account" in the CIP Rule for FCMs is "a *formal* relationship with a futures commission merchant, including, but not limited to, those established to effect transactions in contracts of sale of a commodity for future delivery, options on any contract of sale of a commodity for future delivery, or options on a commodity" (emphasis added).[15] While there is no question that the transaction involves a contract of sale, there is no formal relationship established by the market participant with the executing broker, and only a standard two-page give-up agreement may be in place.[16]

The historical evolution of the role of FCMs acting as executing brokers further supports the conclusion that there is no account relationship between the customer and the executing broker. Executing brokers are solely conduits that execute and process trades. They were, and still are, solely mere processors or conduits to facilitate exchange transactions, and in such capacity, act as merely a utility. These floor brokers would (and still) obtain execution business of institutional investors directly from such entities without the involvement of an FCM other than the FCM that clears the investor's accounts, *i.e.*, the carrying broker. In fact, floor brokers, even today, are not required to, and do not, register as FCMs under the Commodity Exchange Act ("CEA") and therefore they are not subject to the CIP Rule.[17] Floor brokers, as mere processors, have no formal account relationship with the investor. The "customer" relationship exists solely between the customer and the carrying FCM, to whom the floor broker or other executing broker "gives up" each trade, and not between the executing broker and the carrying FCM's customer.[18]

Given this historical development and the current function of FCMs acting as executing brokers, they should not be treated any differently than floor brokers for this purpose. <u>The fact that an executing broker is now part of an FCM does not change the nature of its role or formalize the relationship with the investor itself, as its function essentially remains the same - to facilitate trading on an exchange.</u>

[15] 31 C.F.R. § 103.123(a)(1)(i).

[16] This distinction is even more significant in the context of Rule 312. There the regulators point out that the relationship with the customer must not only require a formal relationship but the relationship must involve a regular course of dealing. Thus in the Final 312 Rule, Treasury excludes from the definition of account "one-time, isolated, or infrequent transactions." 71 Fed. Reg. 496, 498 (Jan. 4, 2006). As applied to FCMs, the definition of account for purposes of section 312 is "any formal relationship established by a futures commission merchant to provide *regular* services . . ." 31 C.F.R. § 103.175(d)(2)(iii) (emphasis added).

[17] Futures floor brokers have their own CFTC registration category under § 4(e) of the CEA (7 U.S.C. § 6(e)), and as such they are not even subject to the AML program rules.

[18] Because it is the carrying broker and not the executing broker with the account, the NYMEX ¶ 2031 Give-Up Trades - Trades Executed by Open Outcry, Rule 9.11A(B) provides that the executing broker has the obligation to confirm that the customer has a valid account with the carrying member.

This analysis applies whether the executing broker is dealing with an advisor, i.e. a CTA or an IA representing an institutional investor, or directly with an investor itself. Where the CIP obligation runs only to the account advised by the advisor (frequently, an omnibus account), that "account" is established, maintained and administered by the carrying broker, and not the executing broker.[19] In both cases, the carrying broker remains the one that establishes, maintains and administers the customer's account and is responsible for maintaining all positions and customer funds.

Thus, neither the regulatory definition nor the traditional concept of a futures account readily applies in the context of the executing broker's actions under a give-up arrangement. Rather, in such relationships, FCMs acting as executing brokers more closely fulfill the role of a service provider. Since it is the carrying broker that knows the customer, has the ongoing relationship with the customer, and provides the panoply of traditional brokerage services for the customer other than trade execution, it is the carrying broker that has the account and that should conduct CIP responsibilities, and not the executing broker.

The regulators' interpretive guidance on the definition of "account" in the CIP rules is instructive on this point. In an April 28, 2005 FAQ, FinCEN and the bank supervisory agencies indicated that data processing, warehousing, and transmission services did not establish an account relationship.[20] As the guidance points out, as the definition of account required "a formal banking relationship" focusing on "bank products and services that relate to the deposit, lending or custody of funds or other assets on behalf of a customer," data processing, warehousing and transmission services "generally do not involve a service, dealing, or financial transaction that, taken alone," constitutes such a relationship. If there is no formal account relationship, there is no attendant duty to conduct CIP. The trade facilitation services that an executing broker provides in the futures context are akin to that of a service provider, *i.e.*, it executes a trade on behalf of the customer. Like data processing, transmission services and warehousing, the provision of such services does not result in a formal account relationship as conceptualized in this guidance.

Similarly, FinCEN and the bank supervisory agencies have determined that a relationship with an investor does not constitute a "formal banking relationship established to engage in services, dealings or other financial transactions" where a bank acts as a registered transfer agent for an issuer and effects transactions for the investor in the securities of an issuer as part of the issuer's dividend reinvestment plan.[21] Just as the mere execution of securities transactions for a dividend reinvestment plan does not create a customer relationship between the bank and the underlying investor, neither should the mere execution of futures transactions in a give-up situation be deemed to create a customer relationship between the executing broker and the carrying broker's customer.

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[19] As with any omnibus situation, it is the intermediary financial institution itself , and not its underlying investors, that is considered the customer for purposes of CIP. *See Intermediary Guidance* at note 9, above. In that situation, the underlying investor's name may be disclosed in the give-up agreement for the limited purpose described in the FAQ.

[20] "FAQs: Final CIP Rule" at FAQ #3 (April 28, 2005).

[21] "Interagency Interpretive Guidance on Customer Identification Program Requirements under Section 326 of the USA PATRIOT Act," FAQ #8 (Apr. 28 2005).

C. Costs Would Greatly Outweigh Any Benefits If Burden Were on the Executing Broker to Conduct CIP

The duplication of effort among FCMs with comparable regulatory obligations is potentially enormous and the benefits negligible. Many FCMs have give-up arrangements involving hundreds and, in some cases, thousands of customers. If every executing broker were required to conduct customer identification procedures on each customer, there could be multiple verifications of the same customer by that customer's executing brokers alone, resulting in an inefficient and wasteful allocation of resources, as well as a serious and unnecessary imposition on customers that are faced with multiple such requests for information and documentation.[22]

Moreover, a customer often uses the services of multiple executing brokers. Even a series of simultaneous futures trades by a single customer may be divided among multiple executing brokers. Where a customer uses multiple executing brokers to execute a single or multiple trades, each executing broker is responsible for only a portion of the customer's overall transactions and therefore would **not** have an ongoing formal business relationship with that customer. However, under the current rule, a customer would potentially still have to submit its CIP information to multiple FCMs in order to execute even a single trade.

In addition, as noted above, the CIP Rule is premised on the existence of an account relationship and the information collected when an account is opened. When a customer has only executed trades through an FCM, which are given up to another FCM, no traditional account has been opened. Therefore, there is no framework for conducting customer identification and verification. As the volume of trades is quite high, it is impracticable for executing brokers to collect, record and retain data they would not normally obtain, and the burden of creating a CIP system would be significant and create inefficiencies in the market. As executing brokers have no existing capacity or systems to obtain and verify any additional customer information for trades they give-up to other FCMs, they would be required to add costly operational components, presenting a large financial burden on executing brokers.[23] Given that the profit margins on individual executions is small, adding a significant cost of doing business to this process could materially impact the profitability of many executing brokers in a negative manner, or cause a significant repricing of execution services because of the added regulatory requirement, thereby making the business less competitive.

D. Distinction from Prime Brokerage Arrangements for Securities Trades

[22] If clients had to provide all their KYC documentation to each executing broker, such duplicative requests would also be very difficult from the client perspective. Presently, due to the risk based approach, requests for documentation from FCMs are not uniform and each FCM requests different levels of documentation from its customers. Requiring customers to submit the different types of documentation to multiple executing brokers would impose a great burden on them, which could cause them to either use fewer executing brokers or become uncooperative in complying with the documentation requests.

[23] We recognize that there are FCMs that both clear and execute at the same time for the customer. Where the customer both executes and clears through the same FCM, the FCM could utilize the existing data obtained in its role as the carrying broker for CIP purposes. However, where a customer only executes trades through that FCM, FCMs have no existing information or operational systems for conducting CIP.

We understand that the securities regulators have questioned whether give-up arrangements are analogous to prime brokerage in the securities industry. Prime Brokerage is a system that was developed by full-service firms to facilitate the clearance and settlement of securities trades for substantial retail and institutional investors who are active market participants.[24] In prime brokerage arrangements, the executing broker executes trades on behalf of a customer who is also a customer of the prime broker. While there are some significant differences between the two types of transactions, the most significant difference emanates from the fundamental distinction that whereas in a securities prime brokerage situation, the executing broker has to meet its KYC obligation, in a futures give-up situation, there is no corresponding duty on the executing broker.[25]

As an initial matter, in the prime brokerage context, U.S. executing brokers must be fully registered as broker-dealers under the securities laws. In the futures context, executing brokers are not required to be FCMs; in fact, they can be floor brokers or FCMs. This fundamental regulatory difference has resulted in the development of divergent regulatory schemes in the securities and futures industries. In the prime brokerage context, as both firms are registered broker-dealers, each starts with the same distinct set of responsibilities. Given the interaction between the two broker-dealers in the prime brokerage context, the securities regulators have responded by articulating in a no-action letter (the "No-Action Letter")[26] the specific responsibilities of each, carving out limited exceptions for an executing broker so that it is not required to meet all of the traditional broker-dealer responsibilities in certain specifically identified situations where those responsibilities are clearly handled by the prime broker. All prime brokers and executing brokers engaged in prime brokerage arrangements must meet the conditions specified in the No-Action Letter.[27]

In contrast, in the futures industry, executing brokers evolved from floor brokers who did not, and do not, have all of the regulatory responsibilities of an FCM registered with the CFTC. Recognizing this historic evolution, the futures regulators have never imposed the full panoply of account opening requirements on an executing broker in a give-up context. As a result of these contrasting regulatory schemes, there continue to be significant differences in the responsibilities imposed on the executing broker in the securities industry and on the executing broker in a give-up transaction.[28] One of the more significant differences is that, as stated above, whereas the executing broker in a prime brokerage situation has KYC obligations, and therefore has an existing information and operational framework on which to build a CIP program, the executing broker in a futures context does not have the KYC obligation and therefore lacks such a

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[24]*See* Securities Industry Association -- Prime Broker Comm. Request, 1993-1994 *Fed. Sec. L. Rep. (CCH) P76,819 at 78,312* (avail. Jan. 25, 1994), *cited in* Louis Loss and Joel Seligman, Securities Regulation, 3d ed., Ch. 8, Regulation of Brokers, Dealers and Investment Advisers at n. 286 (2004).

[25] Securities and Exchange Commission No-Action Letter (Jan. 25, 1994) ("SEC No-Action Letter"), contained in NYSE Information Memo 94-6 at 11 (Feb. 28, 1994), attached as Exhibit A.

[26] *Id.*

[27] The NYSE Information Memo accompanying the SEC No-Action Letter indicates that "[e]xchange examiners will monitor for compliance with all of the requirements contained in the [no-action] letter as part of their routine examinations." NYSE Information Memo 94-6, attached as part of Exhibit A.

[28] It would be ironic if the FCM acting as an executing broker had a CIP obligation simply because it is part of an FCM, whereas, the floor broker, from which it derives, and who continues to conduct this same type of transaction, does not.

framework. To impose a CIP obligation where the existing business model does not support it squarely contradicts Congress' stated intent, described above, to avoid verification procedures that are both expensive and impractical.

The divergent regulatory schemes are similarly reflected in the significant differences in documentation for prime brokerage versus give-up situations. In the futures context, there is no requirement of an agreement between the executing broker and the customer. Additionally, there is no requirement that an agreement be executed among the executing broker, carrying broker and customer, although firms typically opt to have such a contract or give-up agreement for practical reasons.[29] Significantly, however, in the prime brokerage context, the No-Action Letter requires that agreements be entered into between: (a) the prime broker and the executing broker; (b) the prime broker and its customer; and (c) the executing broker and its customer. Form agreements to meet these requirements under (a) and (c) have been prepared by the Securities Industry Association ("SIA") and are utilized generally as standard documentation in the industry.[30]

These standard forms are quite detailed and reflect the significant obligations that remain with executing brokers under the terms of the No-Action Letter. For example, in the standard form agreement required to be signed between the executing broker and prime broker in a prime brokerage relationship (Form 150), the specific obligations of the prime broker and the executing broker are set forth regarding each party's dealings with the customer. Consistent with the requirements in the No-Action Letter, "the executing broker must acknowledge it has a responsibility for knowing each customer, obtaining all proper documentation (including all new account documents), and conducting its own credit checks." Also significant is the inclusion in each prime brokerage agreement of an addendum that lists the prime broker's customers approved for trading on the part of the executing broker. This information is provided to the executing broker to enable the executing broker to comply with its KYC and credit obligations. In fact, it is anticipated that this information will be enhanced in the future specifically to help with the executing broker's CIP obligations. Executing brokers in the futures context receive no such list. Additionally, in the prime brokerage context, the executing broker must determine the availability of shares to cover any short sales. There are no analogous obligations for a futures executing broker in a futures give-up situation.

Similarly, the prime brokerage agreement with the customer is also quite detailed and spells out the relationship between the customer and the executing broker, including for example, issues relating to confirmations and margin. In addition, while in a prime brokerage arrangement, the executing broker has an obligation to send a confirmation of each transaction to the customer or, based on instructions from the customer, to the customer care of the prime

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[29] *See* Trader Form 202, Uniform Brokerage Execution Services ("Give-Up") Agreement: Trader Version (Oct. 2005), attached as Exhibit B. One exchange, the New York Mercantile Exchange, has an express rule that governs give-up relationships in the absence of such agreements – clearly contemplating that such agreements are not always used. See NYMEX Rule 9.11A

[30] *See* SIA Form 150, Prime Brokerage Agreement (July 2001), attached as Exhibit C; SIA Form 151, Agreement for Prime Brokerage Clearance Services (Mar. 2006), attached as Exhibit D. The FIA's contract for give-up arrangements, referenced above at n. 29, is not mandated by any regulatory agency and does not address nearly as many issues as does the documentation for prime brokerage arrangements.

broker, in a give-up situation, the executing broker has no obligation to send confirmations of trades.

Also, the executing broker in a prime brokerage arrangement must open a "broker-dealer credit account" in the name of the prime broker, or maintain a net capital of at least $1,000,000 where it is self-carrying. These obligations are absent in a give-up arrangement. Further, the SEC considers an investor to be a customer of the executing broker for all purposes including Regulation T and Rules 15c3-1, 15c3-3, 17a-3 and 17a-4, if the prime broker disaffirms or DKs the trade.[31] This is not the case with give-up arrangements.[32]

Thus, there are significant differences in both regulatory structure and industry practice that make it inappropriate, for purposes of CIP obligations, to treat executing brokers in a give-up situation like prime brokers in a prime brokerage arrangement. Requiring executing brokers in the futures industry to conduct KYC on carrying broker customers would radically alter the current practice. This is not the case in the securities industry where executing brokers already are obligated to know their customers.

E. Reliance Agreements Between Executing and Carrying Brokers Are Impractical and Unworkable

The unique nature of the give-up relationship makes executing brokers particularly inappropriate subjects of a CIP obligation. Even if the regulators, however, were to apply the CIP obligation in a manner inconsistent with executing brokers' historical evolution and current practice, given the centrality of the carrying broker's relationship with the customer, the executing brokers should be able to depend on the carrying broker to verify the identity of the customer, including obtaining the necessary documentary support. Although the CIP rule allows for a reliance agreement whereby both parties can enter into a written agreement that the other party (here the carrying broker) will conduct the CIP, for the reasons discussed below, we submit that it is completely unworkable in the context of this relationship to require such an agreement.[33]

It is important to remember that carrying FCMs normally have the ability–and would prefer–to both execute and clear transactions on behalf of their customers. It is the carrying broker's customer that, for the reasons identified above, elects to execute transactions through one or more executing brokers (i.e. FCMs or floor brokers) and carry such transactions through

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[31] *See* SEC No-Action Letter, cited above at n. 26.

[32] Where a carrying broker disaffirms a trade in a futures give-up arrangement, an executing broker may have the right, but has no obligation under regulations or the standard give-up agreement, to carry the futures position on behalf of the investor. If the executing broker exercised the right to carry the position on behalf of the investor, the executing broker would become a carrying broker with respect to that investor and would be required to treat the investor as its customer subject to the CIP Rule, as well as other CFTC regulations.

[33] 68 Fed. Reg. 25149, 25157 (May 9, 2003). This reliance provision acknowledges the unique roles of different types of brokers and their varying degrees of contact and receipt of information. In order for the executing broker to rely on the carrying broker, the reliance must be reasonable under the circumstances; the carrying broker must be subject to the AML compliance program requirements of the PATRIOT Act and be regulated by a federal functional regulator; and the carrying broker must enter into a contract with the executing broker whereby the carrying broker that is being relied upon certifies annually that it is fulfilling all of the elements of its own AML program. See 31 C.F.R. § 103.123(b)(6).

another FCM. To that end, the customer selects both a carrying broker and an executing broker(s), often to the consternation and disappointment of the carrying broker. The carrying FCM may interact with the executing broker and act on behalf of the same customer or advisor with the executing broker, but in reality, it also competes for that same customer's business.

To require reliance agreements in the context of this historically competitive relationship between carrying firms and executing firms is unworkable and may have an extremely deleterious effect on the ability of executing brokers to survive. As carrying brokers have the capacity to execute, as well as clear their customer's trades, they view external executing brokers as competitors. It would therefore be very difficult for an executing broker to prevail upon the carrying broker to conduct CIP on its behalf and provide it with a reliance agreement, when the carrying broker would much rather persuade the customer that it could avoid filling out CIP paperwork on multiple occasions if it simply both cleared and executed through the carrying broker.

Thus, it is impractical to expect that the executing broker will be able to obtain reliance agreements from carrying brokers in order to eliminate the need to conduct their own CIP procedures. The carrying broker, which would prefer to execute its own trades, has no incentive to ease the cost or burden of the executing broker. In fact, it is probable that the only practical means to ensure that an executing broker could obtain a reliance agreement from a carrying broker would be for the regulators to require it. And even then, there would remain the significant administrative task of negotiating, obtaining and recertifying reliance agreements from the large number of carrying firms with which most executing brokers deal. Requiring an executing broker either to adopt a costly and unnecessary system in order to obtain the CIP documentation already obtained by the carrying broker or somehow induce the carrying broker to provide it with a reliance agreement that would undermine the latter's own business or alternatively possibly lose the transactions to a floor broker not subject to the same CIP requirements creates a situation that Congress certainly could not have intended.

We submit that reliance agreements are successful only in situations where it is in the interest of both parties to the agreement to share the provision of services and therefore regulatory responsibilities. For example, when broker A introduces customers to broker B for the purposes of providing its customer with a service that it alone cannot offer, Broker A may be willing to permit Broker B to rely on its own CIP in order to induce Broker B to provide that service. Likewise, it may be mutually advantageous for an introducing broker to enter into a reliance agreement with a clearing broker where each provides services that the other cannot or chooses not to provide.

Even where such agreement is in both firms' interest, it has been difficult for many financial institutions to obtain reliance agreements from other regulated financial institutions. Many financial institutions have been reluctant to sign these agreements for fear of assuming additional legal and regulatory exposure. In a give-up situation, the divergent incentives of the executing broker and the carrying broker exacerbate these concerns. Thus, if Treasury were to conclude -- despite the industry's commonly held view -- that the investor's relationship with the executing broker falls under the definition of an account, we urge Treasury to relieve the executing broker of the obligation to apply its CIP procedures to the carrying broker's customer

where, as here, the carrying firm already is doing so. If Treasury were to do otherwise, it is unlikely that even the business desires of the customer to utilize the services of both the executing broker and the carrying broker would convince the carrying broker to assume this responsibility and potential liability for the sake of a competitor.

The ability of the executing broker to depend on the carrying broker's own CIP procedure will allow brokers to focus their resources more precisely on the goals the anti-money laundering regulations are intended to achieve. This approach will also reduce the administrative burden on customers that otherwise could have to respond to numerous duplicative or multiple identification verification inquiries.

The Relief Requested Would Not Create a Gap in AML Compliance

How does this proposal work in practice and how can Treasury and the regulators satisfy themselves that if this relief is granted, they have not created a gap in the overall scheme designed to prevent money laundering? As an initial matter, where a trade is executed on a U.S. futures exchange on behalf of a customer, a domestic carrying broker will always be involved, and that carrying broker already conducts CIP. Thus, in each of the give-up scenarios we have described above, at least one regulated financial institution will be conducting CIP in a manner that is consistent with the AML rules. For example, if a customer of a domestic carrying broker opens an account, that carrying broker will perform CIP on that customer. If that same customer executes a trade through a different executing broker on a U.S. exchange, that executing broker will give up the trade to the domestic carrying broker that has already performed its CIP. Notwithstanding that it is not conducting the CIP, the executing broker will still continue to retain the responsibility to establish and maintain an AML program, including an obligation to detect and report suspicious transactions. However, the identification and verification process would rest with the U.S. carrying broker.

What if the customer were a non- U.S. customer? If the account were carried with a U.S. carrying firm, then the scenario would be no different than the one above. What if, however, the account were carried with a non-US carrying firm? In that instance, the order might be placed with a U.S. executing broker, who would then give up the trade to a U.S. carrying broker that would clear the trade. The customer of the U.S. carrying broker in that scenario would be the non-U.S. financial institution. The U.S. carrying broker would treat the account held by the non-U.S. financial institution as an intermediary account or as an omnibus account on which it would perform its own CIP obligations. Moreover, with respect to that non-U.S. financial institution, the U.S. carrying broker would also have to apply its due diligence or enhanced due diligence obligations under Rule 312 on that non-U.S. financial institution.[34] Thus, providing the relief requested should not create any AML regulatory gaps.

Conclusion

For all of the foregoing reasons, we submit that the give-up relationship between an executing broker and a customer of a carrying firm does not fall within the CIP definition of

[34] As a practical matter, many of these entities are based in the U.K. and many are affiliates of the carrying firm and subject to its own AML rules.

account, and in any event, that the fundamental purposes of the anti-money laundering regulations will best be served if it the responsibility for verifying the identity of a customer is vested exclusively with the customer’s carrying broker, without the need for a reliance agreement.