

TYPES NOT MAPPED YET March 30, 2016 | TTR not mapped yet | Richard T. Reibman

Commodities traders, know thyself: Are you a pool or prop shop?

Do you trade commodity futures, options or swaps with a partner or a group of partners? If so, you need to know if your business model is properly described as a commodity pool or as a proprietary trading firm. The answer is not always clear and the regulatory guidance is very limited. The answer is important in determining whether your business is subject to CFTC and NFA registration and regulatory requirements. It's also important because your clearing broker will want to know who its customer is, and may refuse to hold your account if the clearing broker believes you are a pool operator that has failed to register (or claim an applicable exemption).

By way of example, assume John and Jane are both employed as traders for Oldco. They decide to open their own trading shop, Newco. Their budget is tight but John's Dad has a deep pocket, and he offers to bankroll Newco by investing \$1 million. John and Jane agree to handle all of the trading decisions. John, Dad, and Jane each own one-third of Newco and will share profits equally. Leaving aside registration exemptions that might be available, what is the nature of this enterprise: Is it a commodity pool or a proprietary trading firm?

[CFTC Rule 4.10\(d\)\(1\)](#) defines "pool" as "any investment trust, syndicate or *similar form of enterprise* operated for the purpose of trading commodity interests." (Italics added). The regulations do not define "investment trust" or "syndicate." However, an "investment trust" may be defined as a closed-end fund established to produce income through investments." Webster's describes "syndicate" as "a group of persons ... who combine to carry out a particular transaction." To most lawyers, in common usage, reference to a "pool" or a "fund" speak to an investment vehicle in which (a) an ongoing offering (typically private) occurs, (b) investors have liquidity in and out, (c) the investment is passive insofar as someone else runs the pool and the investor merely writes a check, and (d) whoever is running the pool receives fees from the investors. In contrast, the typical proprietary trading firm is a closely-held business that engages in speculative trading for its own account. It does not manage money for outsiders and does not act as an advisor in any capacity. Its business model is P&L driven, not fee driven.

Unfortunately, the ostensible clarity of the regulatory definition of "pool" is sometimes stretched by regulators in practice. In the context of routine regulatory exams and [NFA Bylaw 1101](#) compliance, some futures commission merchants have reported regulatory insistence that any account beneficially owned by more than person must be treated as a "pool" unless there are two owners who are married. We respectfully disagree. The definition of "pool" does not state that a pool is any business that is owned by two or more people and trades commodity futures. If that were the case, one can imagine that the definition in Rule 4.10(d)(1) would simply be "A combination of two or more persons who trade commodity interests." Instead, the phrase "*or similar form of enterprise*" clearly signifies that the business model must look like an "investment trust" or "syndicate" to fall within the definition of "pool."

Prop shop or pool?

Here are several key considerations that could impact whether your trading firm is a "prop shop" or a pool:

1. Pools need investors to operate. Accordingly, in the typical pool, there is an ongoing solicitation of investors. If this is true for your business? If so, it is likely it is a pool absent other unusual facts.
2. Are the people who contributed capital to your enterprise involved in management decisions or trading decisions? If not, it looks like a purely passive investment by the investor, which speaks to a pool.
3. The typical pool holds itself as such because it needs to promote itself in order to attract new investors, grow its assets under management, and earn more fees. The business model of prop shops, on the other hand, is not fee-based. As such, they do not need to promote themselves because they don't need to grow their investor base. Typically they only promote themselves in order to attract new hires.

4. [Investment lock-ups](#) are not commonplace in commodity pools, where investors typically expect liquidity. How easy is it for the beneficial owners of the enterprise to withdraw their investments? The greater the liquidity, the more likely a pool.
5. In the typical pool or investment offering, the business model for the organizers is to profit through management fees or incentive fees. Are any fees being paid in your enterprise, or are the beneficial owners simply dividing the net trading profits?
6. On several occasions, through Interpretive Letters, the [CFTC](#) has expressed the view that certain “small pool” enterprises would not be treated as pools. An example is a general partnership consisting of four friends and business associates, all of whom were trading industry professionals, and all were involved in defining the partnership’s activities. None were statutorily disqualified. ([CFTC Interpretive Letter 94-26](#)). This is sometimes informally referred to as the “small pool” exception, but it is not codified.

Returning now to our hypothetical start-up, a starting point for analysis is whether Dad is merely a passive investor, or whether he is involved in management of the company. Let’s break it down:

- The more involved Dad is, the better (assuming we want this enterprise to operate as a prop shop). We know that John and Jane do the trading but Dad may be involved in the decision-making process for the company’s operations.
- Second, have John and Jane promised Dad any liquidity? Can he take his money out at any time? If not, Dad looks more like the third partner in Newco who is merely contributing capital, and less like a traditional investor in a pooled investment vehicle.
- Third, are John and Jane collecting any fees for making trading decisions before the net profit is divided into thirds? Fees are traditionally something collected by sponsors of pools, not by owners of prop trading firms.

If you have any questions about how to structure your trading operations, it’s best to consult with an attorney well versed in the legal and regulatory aspects of the financial markets.

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