CFTC Letter No. 00-86

August 9, 2000

Exemption

Division of Trading & Markets

Re: Rules 4.21, 4.22 and 4.23: -- Exemption from certain disclosure and reporting requirements otherwise applicable to a registered CPO, where the CPO is the general partner of the holding company for a group of affiliated real estate and restaurant development, operation and management entities, and is also the general partner of a special purpose entity formed to hold and manage the group's liquid assets, which entity engages in commodity interest trading for risk management purposes.

Dear :

This is in response to your letter dated February 28, 2000, to the Division of Trading and Markets (the "Division") of the Commodity Futures Trading Commission (the "Commission"), as supplemented by your letter dated April 4, 2000, your e-mail messages dated May 11, 2000, June 5, 2000 and July 7, 2000 and by telephone conversations with Division staff. By your correspondence, you request on behalf of your clients "W", a registered commodity pool operator ("CPO"), "X" and "Y" that the Division issue an interpretation that: (1) "W" is not a commodity pool operator ("CPO") as defined in Section 1a(4) of the Commodity Exchange Act (the "Act");[1] and (2) neither "X" nor "Y" is a pool as defined in Commission Rule 4.10(d)(1).[2] For the reasons provided below, we have decided to deny your request, but to provide certain relief to "W" from the requirements otherwise applicable to registered CPOs.

Based upon the representations made in your correspondence, we understand the relevant facts to be as follows.

"X" and "Y"

"X", a limited partnership, acts as the holding company for a complex of more than twenty special purpose corporations, partnerships and joint ventures formed for investment in, and development and operation of, various real estate properties and restaurant concepts. In order to rationalize the management and administration of these entities, in January 1998 the partners and shareholders consolidated their interests in the special purpose entities into a single entity ("X").

"X" is owned by approximately 150 partners who are family members of "A", their friends and business associates.[3] Each of the partners has had a relationship with "A" for more than five years. The history of "X" is an evolution of an investment group that, through investment in real estate, restaurants and operating companies, grew assets of approximately $4.3 million at the end of 1992 to approximately $35 million at the end of 1999. Substantially all of that increase in value has been due to profits from, and increases in the value of, the entities and activities comprising "X's" real estate, restaurant and operating company activities (and not from commodity interest trading). As "A" and the small group of immediate family members and associates who comprised the initial investors undertook additional investment projects, individual aunts, uncles, in-laws, cousins, friends and associates of "A's" immediate family heard, through family channels, about these investment activities and asked to be permitted to participate.

Individuals who were not friends or associates of partners of the original investors with "A" were turned away. Only "A's" family and his most immediate friends and associates have been permitted to invest in "X". There has been no advertisement or solicitation of investors.

"X" makes available to all of its partners annual compiled financial statements prepared by an outside certified public accountant. An annual meeting of all "X" partners is held at "X's" offices. The purpose of the meeting is to discuss the activity, status and value of all "X" projects and to poll the partners as to their desires regarding the investments and liquidity of "X". Because many of the partners have either initiated or maintained a continuous involvement in some of "X's" projects, it is a working meeting. All partners are notified 3 to 4 weeks in advance of the meeting date and are requested to attend. The meeting is usually attended by 30 to 50 partners.

"Y" is a special purpose limited partnership, whose purpose since January 1, 1998 has been to hold substantially all of the liquid assets of "X" and to facilitate (by guarantees, indemnification and otherwise) financing transactions of the real estate development and construction operations of "X" entities.[4]. Throughout the last year, "Y" held approximately 5 percent to 15 percent of "X" assets. This percentage fluctuates with the market value of marketable securities, placement of cash in "Y" when "X" assets are sold, and removal of cash from "Y" for use in new "X" investment opportunities.[5] As guarantor of the "Z" apartment complex loan, "Y" must maintain a minimum net worth and liquidity. All of the limited partner interests in "Y" are owned by "X", and there are no other limited partners in "Y". No individual is permitted to invest directly in "Y". By reason of the structure of "X" and "Y", the exposure of "X" and its partners to liabilities (including loan guarantees) is significantly limited.

The general partner of each of "Y" and "X" is "W", and the sole shareholder and president of "W" is "A". "W" has been registered with the Commission as a CPO since March 1998, and "A" is registered as an associated person, and is listed as a principal, of "W".

"A's" commodity interest trading

In 1982 "A" began trading stock index futures contracts on the Kansas City Board of Trade, In 1984, he purchased a seat on the Chicago Board of Trade, specializing primarily in options trading. After selling his seat and moving to Texas, "A" continued to trade commodity interests for himself, friends and family.

"X" requires immediate access to cash for operating and capital needs in connection with its extensive investments in real estate, restaurants and other small companies. "X" uses "Y" for this reserve cash, and because of "A's" trading experience and expertise, "X" has concluded that having "A" trade commodity interests for the account of "Y" is in "X's" best interest. The commodity interest trading engaged in by "A" is incidental to the investment strategies of "X" and is for risk management purposes. If "A's" commodity interest trading expertise were not available to "X", "X" would not trade commodity interests but would simply invest its reserve cash in short-term equities or money market funds.

Restrictions on commodity interest trading

In support of your request, you state that commodity interest trading represents a very small and non-material portion of the investment activities of "X". Going forward, "X" would be willing to restrict the commodity interest trading in which "Y" engages, such that no more than 10 percent of the fair market value of all of "X's" assets may be used for initial and maintenance margin for commodity interest trading.[6]

Restrictions on investors and on initial investments

Also in support of your request, you state that "X" would agree to permit investment in "X" entities by new investors only if a new investor is (1) an immediate family member of "A" or an existing investor; or (2) a person who has had a business relationship in the last three years with "X", "W", "A" or you.[7] In addition, you state that no prospective investor in "X" will be permitted to make an initial investment of more than 10 percent of such person's net worth.

Analysis

Under the facts presented, as a collective investment vehicle that engages in commodity interest trading, "Y" is a pool within the meaning of Rule 4.10(d). Likewise, "X" as a participant in "Y" is also a pool. In addition, "W" is a CPO. The way in which "X" has developed from "A" and a small group of family and colleagues is not a pattern anticipated by the Commission's regulatory framework. The ordinary means of obtaining regulatory relief are either insufficient for your purposes, moot or unavailable.[8] Moreover, the facts of "X's" situation do not fit the Commission staff letters to which you refer in your correspondence, due to the varying levels of financial and business sophistication among the "X" partners and the several types of relationships between the partners and "A". Nor do the facts fit other letters that the Commission has issued, such as those involving real estate investment trusts.[9] Your request combines in a highly unusual manner aspects of several situations that the staff has considered in

the past, but in a way that does not permit the drawing of a clear standard that can provide guidance in other cases. Nevertheless, due to, among other factors, the anomalous history of "X", the fact that "W" is a registered CPO, the close (albeit varied) relationships among the partners and the restrictions on investor composition, commodity interest trading and investor contributions to which you have agreed, the Division does not believe that the full array of regulatory obligations applicable to CPOs is required.

Conclusion

Based upon the foregoing representations and the adoption by "X" of the investment and trading restrictions described above, the Division believes that it would be reasonable to provide relief to "W" from certain of the requirements otherwise applicable to it as a registered CPO. Accordingly, under the authority delegated to it by Rule 140.93(a), the Division hereby exempts "W" from the specific disclosure requirements of Rule 4.21, the financial reporting requirements of Rule 4.22, and the recordkeeping requirements of Rule 4.23(a)(10) and (a)(11) in connection with the operation of "Y" and "X". This exemption is conditioned upon implementation of the restrictions described above and is further conditioned upon "X" ensuring that if any offering memorandum or similar document is delivered to prospective investors, such memorandum includes all disclosures necessary to make the information contained therein, in the context in which it is furnished, not misleading.

This letter, and the exemption provided herein, are based upon the representations you have made to us and is subject to compliance with the conditions set forth above. Any different, changed or omitted material facts or circumstances might render this exemption void. You must notify us immediately in the event the activities or operations of "W", "X" or "Y" change in any material way from those represented to us. Further, this letter does not excuse "W" from compliance with any other applicable requirements contained in the Act, or in the Commission's regulations issued thereunder. For example, "W" remains subject to all antifraud provisions of the Act and the Commission's regulations, to the reporting requirements for traders set forth in Parts 15, 18 and 19 of the Commission's regulations and to all other applicable provisions of Part 4, including the recordkeeping requirements of Rule 4.23. Finally, this letter is applicable to "W" solely in connection with the operation of "X" and "Y".

If you have any questions concerning this correspondence, please contact Christopher W. Cummings, an attorney on my staff, at (202) 418-5445.

Very truly yours

John C. Lawton
Acting Director

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1 7 U.S.C. § 1a(4) (1994).

2 Commission rules referred to herein are found at 17 C.F.R. Ch. I *et seq*. (2000).

3 53 partners (owning 64 percent of "X") are officers of "W" and their immediate family members; 37 partners (owning 25 percent of "X") are longtime family friends; 12 partners (owning 3 percent) are longtime business associates; and 48 partners (owning 8 percent) are family and friends of original investors. During the last six years, new "X" partners have joined as a result of gifts by existing family members and accredited investors, small investments by business associates and partners with knowledge and expertise in an area in which "X" invests, or small investments by accredited investors who have known "A" for more than five years. Until December 1993 and the formation of "Y", there were only 33 investors, substantially all of whom were family and friends of "A".

4 When the real estate holdings of "Y" were distributed to other companies in order to set "Y" aside as the repository for the liquid assets of "X", it was not possible to transfer out of "Y" 526,800 shares of one of the restaurant development entities due to transfer restrictions on those shares imposed in connection with an initial public offering of the development entity's stock in July 1997.

5 For example, in April 2000, "X" lent $350,000 to "V" (a "X" subsidiary) for working capital and project costs, and made a $200,000 investment in an Internet mortgage company. In each case, "Y" was the source of funds. When property in Texas owned by another "X" subsidiary was sold, the proceeds were placed with "X". The persons responsible for carrying out the transactions involving "Y" are "A" and you.

6 During the calendar year 1999, the initial margin requirements for commodity interest trading as a percentage of the aggregate assets of "X" ranged from 0.49 percent to 6.0 percent.

7 For this purpose, a business relationship means a relationship that includes or will most likely include a business transaction that "A" in his best judgment determines has or will increase or contribute to the dollar value of "X". Further for this purspose, a business transaction means either (i) the purchase, sale or contribution of real or personal property or (ii) the provision of an expertise with respect to an investment opportunity. No person is or will be permitted to invest directly in "Y" (the entity in which all commodity interest trading is conducted).

8 For example, Rule 4.12(b), while available, would still require disclosure document delivery and periodic reporting. Rule 4.13(a) provides CPO registration exemption, but "W" is already registered, and Rule 4.7(a) is unavailable due to the participation as partners in "X" of persons who are not "qualified eligible participants."

9 *See, e.g.*, CFTC Staff Letter 00-49 [Current Transfer Binder] Comm. Fut. L. Rep (CCH) ¶28,101 (March 24, 2000); CFTC Staff Letter 00-50 [Current Transfer Binder] Comm. Fut. L. Rep (CCH) ¶28,102 (March 24, 2000); and CFTC Staff Letter 00-53 [Current Transfer Binder] Comm. Fut. L. Rep (CCH) ¶28,115 (March 24, 2000).