CFTC Letter No. 01-35
March 12, 2001
Other Written Communication
Division of Trading and Markets

Re: Section 4m(1) of the Act and Rule 4.14(a)(9) -- Questions Concerning the Operation of an Internet Website Providing Commodity Interest Trading Advice and Management of Commodity Interest Accounts.

Dear:

This is in response to your telefacsimile letter dated January 30, 2001, to the Division of Trading and Markets (the "Division") of the Commodity Futures Trading Commission (the "Commission"), as supplemented by telephone conversations with Division staff. By your correspondence, you request, on behalf of your company "X", the Division's views regarding the potential registration and regulatory compliance requirements under the Commodity Exchange Act (the "Act")[1] and the Commission's rules [2] applicable to "X" if it proceeds to operate a proposed Internet website that would provide investment advice, initially in an impersonal context, and subsequently in the course of managing customer accounts.

Based on the representations made in your correspondence, we understand the facts to be as follows. "X's" proposed activities may be viewed in two general areas: (1) operation of an informational Internet website concerning financial instruments; and (2) managing customer accounts.

"X's" Internet website

"X" proposes to operate its Internet website on two levels. Level One would be open to the general public at no cost, and would present an opinion on the 25 most highly capitalized non-tech stocks and the 25 most highly capitalized tech stocks, updated at least weekly. "X" plans to promote its website using a combination of investor e-mail lists and Internet banner advertising on financial websites.

Access to Level Two would require payment of a monthly subscription fee. Level Two would monitor what you describe as a "model hypothetical hedge-type account, valued at $100,000." The model hypothetical account portfolio would potentially include futures contracts, foreign exchange, derivative instruments, stocks, money market instruments and mutual funds. E-mail notices would be sent directly to Level Two subscribers alerting them to changes and possible changes in the model portfolio. Level Two service would be entirely impersonal. Subscribers would be responsible for their own brokerage arrangements and trading decisions, and "X" would not make any attempt to modify the model portfolio to meet the needs of any subscriber or group of subscribers.

A hypothetical track record would be posted as part of the Level Two service, and you state that full compliance would be made regarding disclaimers required by regulatory agencies on the use of a hypothetical track record and the risks inherent in the model portfolio's investment approach.[3] The Level Two service would be actively promoted on "X's" website, and it also could be promoted through direct mail and Internet banner advertising.

"X's"Contemplated Money Management Activities

Beginning June 2001, "X" intends to accept a "limited number" of "unsolicited" accounts from "qualified/accredited" investors. Late in 2001, "X" plans to become a member of the National Futures Association ("NFA") and to register with the Securities and Exchange Commission ("SEC") as an investment adviser ("IA") and with the Commission as a commodity trading advisor ("CTA"). Having so registered, "X" intends to begin soliciting "non-accredited/non-qualified" trading accounts. The approach that "X" would use to trade its clients' managed accounts would be highly similar, if not identical, to the approach taken by the Level Two service on the website.

Your Particular Questions

In your correspondence, you pose several specific questions regarding the applicability of regulatory requirements to the proposed business activities discussed above. Each of your numbered questions has been copied and indented below, followed in each case by the Division's response.

1. How many qualified/accredited investors can ["X"] handle within a managed account context without registering with the SEC as an IA/the CFTC as a CTA? Does ["X"] need to file for an exemption from registration in order to manage the limited number of accredited investors?

Section 4m(1) of the Act would exempt from CTA registration requirements any CTA that gives commodity interest trading advice to no more than 15 clients during any twelve-month period, *and* who does not otherwise hold itself out generally as a CTA to the public. Your company would probably not qualify to use this provision of the Act due to the Internet website activity, which would clearly constitute holding "X" out to the public as a CTA. Accordingly, "X" would be required to register as a CTA regardless of the sophistication level of the clients whose accounts it managed, although the regulatory burdens would be reduced if "X" solicited and advised exclusively "qualified eligible persons" or "QEPs" and filed a notice of claim of exemption under Rule 4.7.

2. If a subscriber to ["X]'s Level Two web service who is a qualified/accredited investor contacts "X" regarding the management of an account, is this considered a "solicited" account?

A meaningful answer to this question would require more facts than are presented in your letter. For instance, does the Level Two website text imply or infer that "X" is equipped and willing to manage accounts? Does it indicate that "X" may do so in the future? Does it leave that question open? Would the

general context of a website that demonstrates a trading strategy be expected to draw potential advisory clients for the site's operator?

3. When ["X"] becomes registered as an IA and CTA in order to accept non-qualified/accredited investors, to what extent can managed accounts be promoted on the web site? The issue here is the interrelationship of the web site (technically an activity exempt from registration) to money management activities (an activity subject to registration if non-accredited investors or more than a specified number of accredited investors are involved).

Given the proposed website activity, "X" should register as a CTA before managing any accounts. Promoting managed accounts on the web site would remove it from the coverage of Rule 4.14(a)(9). The web site would no longer be exempt from registration, but would be considered to be a part of the managed account program. Accordingly the Commission's guidance provided for delivery of required Disclosure Documents in the context of web sites and other electronic media, as set forth in *Interpretation Regarding Use of Electronic Media by Commodity Pool Operators and Commodity Trading Advisors for Delivery of Disclosure Documents and Other Materials,*[4] would apply. Further, the premise of your question is inaccurate. As indicated in our answer to question #1, the statutory CTA registration exemption, in addition to requiring that a person not hold itself out as a CTA, restricts the number of clients without reference to the nature of those clients.

4. When ["X"] becomes registered as an IA and CTA for the purpose of controlling the accounts of investors, will the CFTC and SEC claim that Levels One and/or Two of the web site will automatically fall under the registration?

It is not clear from the context what you mean by "automatically fall under the registration." Nevertheless, once "X" begins managing client accounts, the basis for exemption from CTA registration requirements that "X" previously would have been relying upon in offering Level One and Level Two (*i. e.*, that "X" was providing generalized, non-tailored information about commodity markets generally) would probably be unavailable. Most likely, the web site activity would lend itself to being seen as a means of finding and drawing clients for the managed account program. It is possible that additional facts not presented in your correspondence could alter this result.

5. Prior to registration as an IA and CTA, can the web site announce that ["X"] is in the process of registering as a money manager in order to accept managed accounts? Such an announcement would clearly state that a managed account is contingent upon ["X"]'s pending registration and the execution of the appropriate disclosure/offering documents.

Section 4m(1) of the Act forbids use of the mails or any means or instrumentality of interstate commerce in connection with one's business as a CTA "unless registered under this Act." Accordingly, soliciting clients before "X" was registered would not be permitted under the Act.

6. "A", the Chief Investment Officer of ["X"], managed the commodity trading accounts of a

number of investors from about 1985 through 1993. "A" managed the commodity trading account of an offshore account during 1994. "A" has not held trading authority over any account since and withdrew his NFA membership and CTA registration in 1995. The records of these accounts were discarded in 1995. CFTC Regulation §4.35(b) requires that a trading advisor must disclose the actual performance of all accounts, or disclose that the trading advisor has not directed any accounts. In preparing the disclosure document, how should ["X"] handle this matter?

Rule 4.35 requires disclosure of actual performance for the five years immediately preceding the date of the Disclosure Document. Disclosure of performance data pre-dating that five-year period is voluntary, and is considered supplemental information for purposes of the CTA's Disclosure Document. Since "A" has not managed accounts for more than five years, he would not be required to disclose performance. Since he cannot provide documentation to back up any performance he might otherwise be entitled to include as supplemental information in a Disclosure Document, he may not characterize the performance of the accounts he managed when he was registered with the Commission. He may, however, indicate that he was previously registered, in what capacity he was registered, and the time period(s) of such registration. Any such disclosure must include any Commission or self-regulatory organization disciplinary or administrative actions against "A" during the same period.

7. Will ["X"] be able to utilize a single unified disclosure document (covering stocks, mutual funds, commodity futures, etc.), or will separate documents be required by the CFTC and SEC?

The Commission does not object to dual CFTC/SEC registrants using a single Disclosure Document, provided that the document complies with the requirements set forth in the Commission's rules. The review of Disclosure Documents for CTAs has been delegated to the National Futures Association ("NFA"), and you should contact NFA's compliance department for assistance if you have any questions regarding simultaneous compliance with SEC and Commission rules.

This letter is based upon the representations made to us. Any different, changed or omitted facts or circumstances might require us to reach a different conclusion. Please note that we express no opinion with respect to the application or effect of relevant securities law provisions or requirements.[5]

If you have any questions concerning this correspondence, please contact me or 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. § 2 (1994), as amended by the Commodity Futures Modernization Act of 2000 ("CFMA"), Pub. L. No. 106-554, 114 Stat. 2763 (to be codified as amended in scattered sections of 7 U.S.C.).

[2] Commission rules referred to herein are found at 17 C.F.R. Ch. I (2000).

[3] Presumably, you are referring, at a minimum, to the requirements of Commission Rule 4.41 regarding the presentation of hypothetical trading results.

[4] *See* 62 Fed. Reg. 39104 (July 22, 1997).

[5] You may present your IA questions to the Division of Investment Management of the SEC.