86-5A

COMMODITY FUTURES TRADING COMMISSION
2033 K STREET, N.W., WASHINGTON, D.C. 20581

DIVISION OF
TRADING AND MARKETS

November 6, 1985

Re: Application of Commission Rule 4.5 to a Separate Account Comprised of Single Employer Pension Plans

Dear :

This is in response to your letter dated August 16, 1985, in which you seek our views concerning the application to "X" of Commission rule 4.5, 50 Fed. Reg. 15868 (April 23, 1985), and the definition of the term "commodity trading advisor" in Section 2(a)(1)(A) of the Commodity Exchange Act ("Act"), 7 U.S.C. 2 (1982).

Rule 4.5 provides an exclusion from the definition of the term "commodity pool operator" ("CPO"). The rule specifies the persons who are eligible for that relief, the qualifying entities for which they are so eligible and the criteria pursuant to which those qualifying entities are required to be operated. That relief is effective upon the filing of a notice of eligiblity with the Commission.

Ir particular, rule 4.5 provides:

> (a) Subject to compliance with the provisions of this section, the following persons, and any principal or employee thereof, shall be excluded from the definition of the term "commodity pool operator" with respect to the operation of a qualifying entity specified in paragraph (b) of this section:
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> (2) An insurance company subject to regulation by any State; and
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> (4) A trustee or named fiduciary of a pension plan that is subject to Title I of the Employee Retirement Income Security Act of 1974; Provided, however, That

for purposes of this §4.5 the following pension plans shall not be construed to be pools:

(i) A noncontributory plan, whether defined benefit or defined contribution, covered under Title I of the Employee Retirement Income Security Act of 1974;

(ii) A contributory defined benefit plan covered under Title IV of the Employee Retirement Income Security Act of 1974; Provided, however, That with respect to any such plan to which an employee may voluntarily contribute, no portion of an employee's contribution is committed as margin or premiums for futures or options contracts; and

(iii) A plan defined as a governmental plan in Section 3(32) of Title I of the Employee Retirement Income Security Act of 1974.

(b) For the purposes of this section, the term "qualifying entity" means:

* * *

(2) With respect to any person specified in paragraph (a)(2) of this section, a separate account established and maintained or offered by an insurance company pursuant to the laws of any State or territory of the United States, under which income gains and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account, without regard to other income gains or losses of the insurance company;

* * *

(4) With respect to any person specified in paragraph (a)(4), and subject to the proviso thereof, a pension plan that is subject to Title I of the Employee Retirement Income Security Act of 1974;

Provided, however, That such entity will be operated in the manner specified. . . .

From the representations made in your letter, we understand the facts to be as follows:

"X" is a [State] life insurance company licensed as such in all 50 states and the District of

Columbia. . . .

A major portion of of "X"'s business is issuing group pension contracts to the trustee or plan sponsor of employee pension benefit plans. . . . Such plans are of two types, defined benefit plans and defined contribution plans. A defined benefit plan specifies the benefits at retirement but not the contributions; a defined contribution plan does the opposite.

The plan sponsor or trustee purchases a group pension contract to obtain from the insurer one or both of two types of services for the plan: (i) investment facilities for contributions to the plan, and (ii) the right to purchase annuities to pay retirement benefits. This letter is concerned only with "X"'s investment facilities for contributions, not with the funds set aside for the purchase of annuities.

The investment facility under a group pension contract is an unallocated fund. Amounts directed to it are not allocated for the purchase of annuities. Under the terms of the group pension contract, the trustee or plan sponsor directs how the unallocated fund is to be invested: in "X"'s general account and/or in one or more separate accounts.

"X"'s general account is its corporate account. The separate accounts are established in accordance with Sections . . . of the [State] General Statutes. Investment performance of a separate account's portfolio is isolated or accounted for separately from that of all other accounts, and may be guaranteed in whole or in part, or not guaranteed, by "X".

State law provides that the plan sponsor or trustee has no legal or beneficial interest in the assets of the general account portfolio or of any separate account portfolio, and that "X" owns the assets allocated to its general or separate accounts and is not a trustee with respect to those assets. The trustee or plan sponsor, through its contract, is a creditor of "X".

Separate accounts are of two types, "pooled" accounts and "non-pooled" or "single-customer" accounts. The assets of a single-customer separate account support "X"'s obligations under a contract issued to fund the plan or plans of a single employer or an affiliated group of employers. Pooled separate accounts hold

> assets supporting contracts issued to fund the plans of more than one employer or affiliated group. . . .

Essentially, you seek our concurrence in your contention that "X"'s operation of one or more single-customer separate accounts, each of which is used solely to fund "X"'s investment obligations under a contract issued to pension plans described in Commission rule 4.5(a)(4)(i), (ii) or (iii), should not be characterized as the operation of a commodity "pool" and, therefore, would not necessitate compliance with the operative requirements of rule 4.5.

In support of your position, you have stated the following:

> Although [rule 4.5] does not address the CPO status of a life insurance company operating one or more separate accounts each of which is used solely to fund "X"'s obligations to a single [pension] plan [described in Commission rule 4.5(a)(4)(i), (ii) or (iii)], the explanatory release strongly suggests that if there is no commingling of assets relating to different pension plans, there are no "pool" concerns at the pension plan level or at any other level:
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> > ". . . this ["pool"] exclusion is only applicable at the pension plan level itself and not at any subsequent level where the assets of any such pension plan are commingled with the assets of any other person in trading commodity interests. . . ." 1/
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> "X"'s view is that each such single-customer separate account takes the "not a pool" status of the plan whose contract is funded through the separate account, that operating "not a pool" separate accounts does not require "X" to register as a CPO or to comply with the "qualifying entity" requirements of paragraphs (c) through (f) of the Rule as to those separate accounts to be [excluded] from CPO [regulation]. . . .

We initially note that you have not elected to seek exclusion from the CPO definition pursuant to Commission rules 4.5(a)(2), (b)(2) and (c) which, if available, would require "X" to file a notice of eligibility and to operate each separate account pursuant to certain specified criteria -- e.g., the purposes for which commodity interests may be traded. Instead, you

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1/ 50 Fed. Reg. at 15873.

contend that the rationale for excluding certain pension plans from the definition of "pool" should be extended by analogy to "X"'s single-customer separate accounts which fund similar pension plans. In this regard, we note that the Commission has confirmed that rule 4.5 is a "safe harbor" and does not provide the exclusive means for relief from CPO regulation. 2/ Moreover, the Commission has directed the staff to continue to issue such interpretations of rule 4.5 as may be necessary and appropriate to fulfill the purposes of the rule. 3/ Accordingly, notwithstanding the absence of an express rule provision that addresses your particular situation, the Division is authorized to consider the relief requested.

As we have made clear in two previous interpretative letters concerning rule 4.5, 4/ where the assets of multiple pension plans are commingled under a separate trading vehicle, it is the separate trading vehicle that is the qualifying entity. Accordingly, a determination of whether action is required or not required under rule 4.5 must be based upon an evaluation of the structure and trading activities in commodity interests of the trading vehicle as a single entity. Such an evaluation would include not only a consideration of the characteristics of each pension plan under the trading vehicle, but also an analysis of how the assets of all such plans are commingled and invested, the manner in which gains and losses from trading in commodity interests are allocated to each plan and the purposes for which the trading vehicle was formed.

This is because the Commission has made clear that even though a rule 4.5(a)(4) exclusion from the pool definition may be applicable to an individual pension plan, it does not necessarily follow that the rule 4.5(a)(4) exclusion will be available to a different entity (such as a master trust or a separate account) which commingles such a pension plan's assets with the assets of other persons for trading in commodity interests. Specifically, the Commission has stated that the rule 4.5(a)(4) exclusion from the pool definition in rule 4.10(d) may not be applicable: 5/

> where the assets of any such pension plan [i.e., a plan described by rules 4.5(a)(4)(i)-(iii)] are commingled with the assets of any other person in trading commodity interests and gains and losses are not

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2/ 50 Fed. Reg. at 15870.

3/ Id.

4/ Division of Trading and Markets Interpretative Letters 85-13, Comm. Fut. L. Rep. (CCH) ¶22,734 (August 2, 1985) and 85-15, Comm. Fut. L. Rep. (CCH) ¶22,736 (August 15, 1985).

5/ 50 Fed. Reg. at 15873.

> separately accounted for. For example, in the event that the assets of two or more such plans are commingled in a trust account or other type of investment vehicle which intends to trade in, among other things, commodity interests, the Commission, in appropriate cases where that vehicle was not subject to an effective exclusion under §4.5, would deem the operation of such vehicle as the operation of a commodity pool and such plans as its pool participants. In such event, with respect to such vehicle, compliance with the provisions of §4.5 --- or regulation as a CPO --- would be required. (Emphasis added.)

Thus, the Commission has expressed concern that a person who operates a trading vehicle which is not subject to an exclusion from the pool definition but who solicits or accepts investors' funds for the purpose of trading in commodity interests not evade regulatory requirements applicable to CPOs merely by including an otherwise excluded entity in its commingled trading vehicle.

We believe that the concerns noted above are not raised where a separate account is funded solely by assets of a single-customer's pension plans which are all excluded from the pool definition by Commission rule 4.5(a)(4)(i), (ii) or (iii), the insurance company is "otherwise regulated" by State law and there are no other indicia that would warrant characterization as a commodity pool, such as marketing or operating the separate account primarily as a vehicle for trading in the commodity interest markets. 6/ Under such circumstances, we believe that the rationale noted by the Commission for excluding certain individual pension plans in rules 4.5(a)(4)(i) and (ii) from the pool definition --- i.e., they do not involve

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6/ As made clear by the Division in Interpretative Letters 85-13 and 85-15 concerning rule 4.5, the purposes for which the trading vehicle was formed constitute an essential element in deciding whether to extend a rule 4.5(a)(4) exclusion from the definition of pool to different levels of trading vehicles. See n.4, above. This is because the relief from regulation as a CPO was intended for entities which, inter alia:

> [have] not been, and will not be, marketing participations to the public as or in a commodity pool or otherwise as or in a vehicle for trading in the commodities markets. . . .

S. Rep. No. 384, 97th Cong., 2d Sess. 80 (1982).

the placement of investors' funds at risk in commodity interest trading 7/ -- similarly applies and that such a single-customer separate account itself generally should be excluded from the pool definition. Similarly, since the Commission has stated that governmental pension plans are not appropriate subjects for Commission regulation, 8/ we believe that a single-customer separate account funded solely by assets derived from governmental pension plans described in rule 4.5(a)(4)(iii) also generally should be excluded from the definition of "pool."

Accordingly, based upon the foregoing representations and subject to the conditions set forth above, we believe that "X" would not be required to file a notice of exclusion under rule 4.5 -- or to take any other action -- to claim the exclusion from the pool definition available under rule 4.5(a)(4)(i), (ii) or (iii) in connection with the operation of the single-customer separate accounts described above. 9/

You further contend that "X" should not be characterized as a commodity trading advisor ("CTA") with respect to providing trading advice on commodity interests to the single-customer separate accounts described above. In support of this position, you have stated the following:

7/ As noted by the Commission in 50 Fed. Reg. at 15873:

> [A] non-contributory plan, i.e., one in which all contributions are solely made by an employer, can never be a commodity pool, because no funds are solicited from participants and only the employer bears the funding responsibility of the plan if there are losses. Similarly, defined benefit plans are not likely to be commodity pools, even if contributions are permitted, because such plans normally require the employer to cover losses and permit the employer to benefit from excess earnings not needed to fund the benefit.

8/ 50 Fed. Reg. at 15873.

9/ Consistent with our views as expressed above, however, we believe that where a single-customer separate account is funded not only by the assets of plans which are excluded from the pool definition by rule 4.5(a)(4)(i), (ii) or (iii), but also of other pension plans which are not similarly excluded, the exclusion from the pool definition generally should not be available to such a separate account. In such a case, a notice of eligiblity must be filed with respect to the separate account to claim the relief available under rule 4.5. This is so even if these other plans were operated pursuant to the requisite criteria specified in rule 4.5(c). See n.4., above.

> The term "commodity trading advisor" is defined . . . as:
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> > "any person who, for compensation or profit, engages in the business of advising others. . . as to value of or the advisability of trading in any contract of sale of a commodity for future delivery. . . ."
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> In our view, in the management of its own separate accounts, "X" is not engaged in the business of advising others. The assets of those accounts are "X"'s own. . . .
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> [Moreover,] in Rule 4.14(a)(5), the Commission provides relief from the CTA registration requirements for any person "exempt from registration as a CPO and [whose] commodity trading advice is directed solely to, and for the sole use of, the pool or pools for which it is so exempt. . . ." [emphasis ours].

Although State law may characterize the assets placed in a special or general account as assets belonging to the insurance company, we believe that the economic reality of a transaction should control our analysis of the applicability of the Commodity Exchange Act to the discretionary management activities of "X". Clearly, "X"'s "investment facilities" under its pension contracts constitute the offer of discretionary investment management in commodity interests to pension plan sponsors and subjects those plans' assets to possible gain or loss in the commodity interest markets. This is precisely the type of activity intended to be encompassed by the CTA definition in Section 2(a)(1)(A) of the Act.

Rule 4.14, 17 C.F.R. §4.14 (1985), provides for an exemption from registration as a CTA for the persons specified therein. As you have noted, rule 4.14(a)(5) exempts a person from registration as a CTA if:

> It is exempt from registration as a commodity pool operator and the person's trading advice is directed solely to, and for the sole purpose of, the pool or pools for which it is so exempt. . . .

Since "X" would not be required to register as a CPO with respect to the operation of single-customer separate accounts described above which, inter alia, include assets derived from pension plans described in rule 4.5(a)(4)(i), (ii) or (iii), you essentially contend that the rationale underlying rule 4.14(a)(5) should be applied by analogy to "X" when acting solely in such capacity.

The Division notes that rule 4.14(a)(5) applies solely to persons who, inter alia, are exempt from registration as a CPO. Rule 4.14(a)(5) thus does

not expressly apply to persons who are excluded from the definition of CPO by rule 4.5 or to persons whose non-CPO status is premised upon the fact that the entities under their control are excluded from the definition of "pool" under rule 4.5(a)(4). Clearly, the mere fact that an entity is not a commodity pool does not mean that its adviser is not a CTA.

Nonetheless, rule 4.14(a)(5) does reflect a general Commission intent to eliminate any unnecessary costs and burdens of regulation. 10/ Consistent with that intent, the Division believes that adoption of a "no-action" position with respect to a person's CTA registration would be appropriate under other circumstances not specified in rule 4.14(a) where the costs and burdens of CTA registration would appear to outweigh any regulatory benefit. Furthermore, adoption of such a position would be consistent with the general policy of rule 4.5, which essentially reflects a Congressional and Commission intent to avoid, where appropriate, unnecessary and duplicative CPO regulation for certain "otherwise regulated" persons. 11/

In this regard, the Division notes that the single-customer separate accounts which are funded by the assets of pension plans described in rules 4.5(a)(4)(i)-(iii) are excluded from the definition of "pool" because, in the case of rule 4.5(a)(4)(i) and (ii) plans, they are subject to the Employee Retirement Income Security Act of 1974, insured by the Pension Benefit

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10/ The practical effect of rule 4.14(a)(5) is to exempt from CTA registration persons who operate and advise essentially family, club and small, unsolicited commodity pools, as specified in rule 4.13, 17 C.F.R. §4.13 (1985). Cf. 44 Fed. Reg. 1918 at 1919 (January 8, 1979), wherein the Commission stated that those exemptions were adopted because "the costs of compliance with the Part 4 rules outweigh the benefits to be gained from regulating family, club and small pools."

11/ S. Rep. No. 384, 97th Cong., 2d Sess. 79-80 (1982), which directed the Commission to adopt rule 4.5, explains in pertinent part:

> [S]ince virtually all of the persons or entities to which this exception would apply are regulated by other Federal or State agencies, it is reasonable to take them out of this regulatory mechanism. . . .
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> . . . Therefore, while the Commission should retain discretion in this area, the Committee believes that, unless otherwise inappropriate, exemption by rule, regulation or order from [CPO] registration and related requirements . . . should generally be granted to these classes of entity. (Emphasis added.)

Guaranty Corporation and the participants' assets are not subject to risk of loss in commodity interest trading; in the case of rule 4.5(a)(4)(iii) governmental plans, considerations of state and local sovereignty argue for non-interference by the Commission. 12/ Moreover, in the instant case, rule 4.5 recognizes that "X" -- who will be serving as both the "CPO" and the "CTA" of each single-customer separate account -- is "otherwise regulated" under State law. Under such circumstances, then, the Division believes that relief from regulation as a CTA would be appropriate provided that the commodity interest advisory activities of "X" with respect to the single-customer accounts described above are essentially incidental to the conduct of its business of offering investment management facilities for contributions to those accounts. 13/

Accordingly, the Division will not recommend that the Commission take any enforcement action against "X" if it does not register as a CTA solely in connection with providing advice on commodity interest trading to the single-customer separate accounts under its management described above and such advice is incidental to the other investment management facilities

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12/ 50 Fed. Reg. at 15873. Of course, participants' assets would not be at risk in commodity interest trading if such governmental plans also were noncontributory plans or defined benefit plans of the type specified in rule 4.5(a)(4)(ii). Of course, the sponsors of all such plans bear the risk of loss from commodity interest trading.

13/ In this regard, we note that with respect to the assets of a "separate unit of investment for which it is acting as a fiduciary and for which it is vested with investment authority," a bank or trust company is both eligible for relief from regulation as a CPO under rule 4.5 and is excluded from the CTA definition pursuant to section 2(a)(1)(A) of the Act, provided that the furnishing of advice is solely incidental to the conduct of its business. Cf. Division of Trading and Markets Interpretative Letter 83-2, Comm. Fut. L. Rep. (CCH) ¶21,788 (March 18, 1983), wherein the Division determined that a bank would be acting "solely incidental" to the conduct of its business and therefore would be excluded from the CTA definition in offering a financial futures advisory service limited as follows: (1) the service would be offered solely in connection with the bank's rendition of other commercial banking services and to such persons as correspondent banks, savings and loan associations and commercial and industrial corporations which had existing relationships with the bank and which used various other services of the bank -- i.e., they were not merely depositors; (2) the service would be limited to hedging programs using financial futures; (3) the bank would not actively market the service; and (4) revenues from the service would constitute a minimal percentage of the bank's consolidated revenue and also of its banking revenue, as separately stated.

offered for such separate accounts -- i.e., the trading of commodity interests in the separate accounts is solely incidental to those accounts' investment activities in the underlying cash markets. For example, in the event "X" holds itself out to prospective or existing single-customer separate accounts of the type described above as (capable of) providing special commodity interest advice and expertise, this position would no longer obtain. 14/

This letter addresses the application of rule 4.5 and the CTA definition in Section 2(a)(1)(A) of the Act to a single-customer separate account which is funded solely from the assets of pension plans which are all excluded from the definition of commodity pool by Commission rule 4.5(a)(4)(i), (ii) or (iii) and is not marketed or operated primarily as a vehicle for trading in commodity interests. 15/ In the event that "X" (or any other person) operates the assets of such a separate account in such a manner that assets from the separate account are commingled in another trading vehicle with the assets of other customers' separate accounts, persons or entities and are traded in commodity interests, we believe that it would be appropriate to view that other trading vehicle as a separate trading vehicle for the purposes of determining the applicability of rule 4.5. As previously noted, that determination would depend upon the facts of each case. Similarly, our conclusion with respect to "X"'s CTA registration requirements would not automatically apply to the operation of such commingled accounts.

The opinions we have expressed above are based upon the facts and circumstances stated in your letter and on our understanding of those representations as set forth above. Any different, changed or omitted facts or conditions might require us to reach a different conclusion.

14/ Cf. Division of Trading and Markets Interpretative Letter 85-10, Comm. Fut. L. Rep. (CCH) ¶22,730 (July 22, 1985), wherein the Division concluded that a bank was unable to claim relief under rule 4.5 because, inter alia, the Division found that the trading of commodity interests would be essential -- not incidental -- to the conduct of a fund the bank intended to operate. Further in this regard, the Division stated that it did not believe the bank could make such statements as "The Fund's use of stock index futures is not a critical, or even a particularly significant, component of its overall performance" and that "The Fund's use of stock index futures is merely incidental to its activities in the cash equities markets."

15/ See n.6, above.

If you have any questions on this matter, please do not hesitate to contact Barbara R. Stern, Esq., Assistant Chief Counsel, or Robert H. Rosenfeld, Esq., Division staff attorney, at (202) 254-8955.

Very truly yours,

Andrea M. Corcoran
Director