90-4

UNITED STATES OF AMERICA
COMMODITY FUTURES TRADING COMMISSION
2033 K Street, N.W.
Washington, D.C. 20581

April 25, 1990

PUBLIC

Dear ____________:

This is in response to your March 2 and March 30, 1990 letters to the Commission's General Counsel on behalf of your clients, Company A ("A"), Company B ("B") and Company C ("C"). In your letters, you seek the Commission's staff's views concerning the light "sweet" crude oil ("crude oil") contracts (the "Contracts") described below; the execution and performance of the Contracts and related crude oil transactions by A, C, the Trustee, acting on behalf of the Trust, and the Adviser, as described below; and the offer and sale of, and secondary market transactions in, Trust units by B and others, as described below.

Based upon your letter, we understand the following.

The Parties

A is a . . . corporation. Through its subsidiaries, A provides worldwide diversified financial services to and trades with major corporations, governments, supranational organizations, central banks and other financial institutions. C and B are wholly-owned subsidiaries of A incorporated in the State of . . . .

C is, among other things, one of the world's largest international traders of energy-related commodities, including crude oil, oil products, petrochemicals, plastics, coal and coke.

B is a major securities broker/dealer registered with the Securities and Exchange Commission and a futures commission merchant registered with the Commission.

The Trustee for these transactions has not been selected at this time. However, the Trustee will be a U.S. bank or trust company with capital and surplus in excess of $ . . . million. The Trustee will not be affiliated with A, C or B.

The Trust

The trust (the "Trust") will be created under the laws of a state to be selected pursuant to a declaration of trust made by the Trustee. It is intended that the Trust be operated in a manner qualifying the Trust as a "grantor trust" for U.S. federal income tax purposes.

The Trust will issue certificates of beneficial interest ("Trust units") to investors in a public offering registered under the Securities Act of 1933, as amended (the "Securities Act").[1/] B will underwrite the offering of Trust units.[2/] It has not been determined at this time whether the Trust units will be listed for trading on a national securities exchange.

The proceeds of the offering will be delivered to C in exchange for the Contracts described below, which will be deposited in the Trust.[3/] The Contracts will be entered into by C and guaranteed by A or will be entered into by A in which case A will delegate its obligations thereunder to C but will remain liable therefor to the Trust. The Trust will not enter into any other contracts relating to the purchase or sale of a commodity, other than the Contracts and related transactions described herein, including without limitation, any futures contract or commodity option contract.

The Contracts

As noted above, the full purchase price of the crude oil to be delivered under the Contracts will be paid by the Trust at the time the Contracts are entered into from the proceeds of the sale of Trust units. There will be no variation margin payments made by either A or the Trust at any time.

A series of . . . separate Contracts will be entered into between C and the Trust each of which will provide for delivery of crude oil by C to the Trust during one of . . . consecutive . . . . Each Contract will require the delivery of the crude oil to the Trust on a . . . basis to be made at the . . . pipeline facility in . . . . The number of barrels of oil to be delivered during each . . . delivery month (each, a "Delivery Month") will be determined in accordance with the

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[1/] It is possible that the Trust units will be sold in a private placement under section 4(2) of the Securities Act.

[2/] It is possible that other registered broker/dealers will participate in the distribution of Trust units.

[3/] The deposit of the Contract in the Trust may take place through a special purpose subsidiary of A. The parties to the Contract held by the Trust will not be affected by this arrangement.

formula described below by reference to (1) the average of the future settlement prices (each such price, a "Settlement Price") of the New York Mercantile Exchange light "sweet" crude oil futures contract for the then . . . delivery month[4/] during the . . . (a ". . . Reference Period") commencing . . . months preceding the Delivery Month and (2) the average of the Settlement Prices during the . . . period (each a ". . . Reference Period") immediately following the . . . Reference Period. Very generally, the number of barrels of oil to be delivered during any Delivery Month will increase, within a range, in relation to increases in the average Settlement Price.

Subject to a minimum delivery of . . . barrels, the number of barrels of oil deliverable under each of the . . . Contracts during the Delivery Month for each of the . . . consecutive . . . will be equal to the product of (a) . . . barrels, multiplied by (b) a fraction, the numerator of which will equal the applicable . . . Reference Price minus $. . . , and the denominator of which will equal the product of the . . . Reference Price and the . . . Reference Price. Assuming the . . . Reference Price, the . . . Reference Price and the price at which the oil is sold by the Trust are equal, the operation of this formula will impose a maximum . . . delivery limitation of . . . barrels of crude oil per Contract.[5/]

Very generally, under the formula described above, decreases and increases in the price of crude oil above current market prices produce a decrease and increase, respectively, in the number of barrels of crude oil to be delivered under the Contracts. However, once a certain price level is reached ($ . . . per barrel under current market conditions), further increases in the price of crude oil result in corresponding decreases in the number of barrels of crude oil to be delivered at a rate which, in essence, progressively reduces the rate of increase in the return to the Trust.[6/]

4/ Alternative price determination mechanisms and sources will be utilized in the event that a settlement price for the New York Mercantile Exchange futures contract described above becomes unavailable for any reason.

5/ The number of barrels of crude oil used in the formulas and prices referenced in this letter are based on current market conditions and are used for illustrative purposes. The actual numbers used will be based on market conditions prevailing at the time of the offering of the Trust units.

6/ The relationship between the price of Crude Oil, the number
(Footnote Continued)

In addition, it is possible that, in order to increase the minimum return in the . . . years, the . . . Reference Price used in the formula to determine the number of barrels to be delivered during the . . . deliveries may be given a minimum value, currently expected to range between $ . . . and $. . . per barrel. The formula would operate identically to the original proposal, except that, if the . . . Reference Price were less than the minimum value at any time during the . . . years, the value of the . . . Reference Price for purposes of the formula would instead be deemed to be the minimum value.

The delivery of crude oil under the Contracts will be governed by . . . Tariff, effective . . . , as amended from time to time.

Delivery under the Contracts will be mandatory and neither C nor the Trust intend, or shall have the right to elect, cash settlement, offset, assignment or other alternative methods of discharging obligations under the Contract. Even in the case of events in the nature of force majeure beyond the control of the parties, the delivery obligation will be delayed without liability for damages, but will not be excused.

Operation of the Trust

The Trustee will engage an advisor (the "Adviser"), unaffiliated with A, C, B and the Trustee, that is experienced in dealings in crude oil to assist it in administering arrangements relating to the receipt and sale of crude oil delivered under the Contracts.

Immediately following each . . . Reference Period, A or C will notify the Advisor and the Trustee of the applicable . . . Reference Price, . . . Reference Price and the resulting number of barrels of crude oil to be delivered to the Trust during the applicable Delivery Month. The Advisor will assist the Trustee in soliciting bids from third-party crude oil traders and dealers (having satisfactory credit ratings) to purchase such crude oil from the Trust for delivery to the purchaser during such Delivery Month,[7] requesting quotes based on the average of the Settlement

(Footnote Continued)
of barrels delivered and the return to the Trust assume that the . . . Reference Price, . . . Reference Price and sale price for each Delivery month are equal. Variations in these prices will have differing effects based on the direction and magnitude of the differences.

[7] Delivery of crude oil through the . . . facility during any
(Footnote Continued)

Prices during the . . . period following the date of solicitation (The "Selling Period"). The Trustee will be required to sell the Trust's crude oil to the highest bidder and the adviser will assist the Trustee in arranging such sales and scheduling the delivery of such crude oil. Payment for crude oil sold on behalf of the Trust will be required on or about the 20th day of the calendar month following the Delivery Month.

If for any reason during any Selling Period the Trust does not receive a bid for the crude oil to be delivered during the following Delivery Month at a price equal to or greater than the average Settlement Price during the Selling Period less ten cents ($0.10) per barrel, then . . . will agree to purchase such crude oil from the Trust at that price for delivery during that Delivery Month.

The Advisor will receive a fee for its services, which will be negotiated prior to the creation of the Trust. In addition, the Trust will incur all of the normal costs and risks associated with taking and making delivery of crude oil.

Net proceeds from the sale of the crude oil on behalf of the Trust will be remitted to Trust unit holders shortly following the Trustee's receipt thereof, in accordance with the requirements of the declaration of trust.

Based on this information, it is the staff's view that the minimum price guarantee aspect of the Contracts creates the risk/return characteristics of a cash-settled call option by placing a floor on the Trust's return based on the sale of crude oil. That option characteristic, however, is embedded in the Contracts which require that the crude oil be delivered within normal commercial marketing channels. This delivery is required under all circumstances.

Although the Contracts require delivery of the crude oil, unlike a cash forward contract, the ultimate purchaser of the crude oil from the Trust is undetermined at the time the Contracts are entered into and is not itself a party to the Contracts. These features, among others, distinguish the Contracts from those instruments discussed in an Interpretative Statement of the Office of the General Counsel, "Characteristics

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(Footnote Continued)
month is scheduled over the course of the entire month, rather than on any particular day.

Distinguishing Cash and Forward Contracts and 'Trade' Options" (50 Fed. Reg. 3956 (September 30, 1987)).[8]

In light of the representations in your letter, and in particular the fact that under the Contracts, C will be obligated to deliver crude oil in normal commercial channels, the staff will not recommend to the Commission any enforcement action under Sections 4(a) or 4c of the Commodity Exchange Act, 7 U.S.C §§ 6(a), 6c, or Commission Rule 32.11, 17 C.F.R. §32.11 (1989), based upon the execution and performance of the Contacts and related crude oil transactions by A, C, the Trustee acting on behalf of the Trust, and the Advisor, as described above, and the offer and sale of, and secondary market transactions in, Trust units by B and others, as described above. This position does not excuse A, C, B, the Trustee or the Advisor from complying with any otherwise applicable provisions of the Commodity Exchange Act or Commission regulations, nor does it address any other proposed instrument. Any different, omitted or changed facts or conditions might require a different conclusion. It should also be noted that this position is that of the staff and is not binding upon the Commission.

Sincerely,

Joanne T. Medero

Andrea M. Corcoran
Co-Chairmen
Off-Exchange Task Force

8/ This interpretative statement explains, among things, that certain minimum price forward contracts which have certain characteristics of option contracts will be considered to be cash forward contracts where the contract requires actual delivery of the commodity in which the forward commitment is made in normal commercial channels.