COMMODITY FUTURES TRADING COMMISSION
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DIVISION OF
TRADING AND MARKETS

94-23

February 15, 1994

Re: Request for Relief from Commodity Pool Operator Regulation

Dear :

This is in response to your letter dated October 11, 1993, 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 and by correspondence dated November 3, 1993, November 23, 1993 and December 13, 1993. By your letter, as supplemented, you request, on behalf of "X" that the Division not recommend that the Commission take any enforcement action against "X" for failure to register as a commodity pool operator ("CPO") in connection with the operation of two real estate partnerships, "Y" and "Z" (collectively the "Partnerships").

Based upon the representations made in your letter, as supplemented, we understand that the facts are as follows. "Y" and "Z" are California limited partnerships formed in 1989 and 1984, respectively. They were formed for the purpose of, and are engaged in the business of, acquisition, development, improvement, management and leasing of real estate rental properties and other real estate related activities. "Y"'s real estate holdings consist of three apartment complexes, one valued at "F" million, one valued at "G" million and one valued at "H" thousand. The outstanding loan amounts owing on such properties are approximately "I", "J" and "K", respectively. "Z"'s real estate holdings consist of a unit apartment complex located in state valued at "L" million, with an outstanding loan balance of approximately "M".

"X" is a California corporation incorporated in 1973, and is the general partner of the Partnerships. "X" has two shareholders, you, the president of the corporation, and "A", the vice president. Neither you or "A" is subject to a statutory disqual-

ification under Section 8a(2) or 8a(3) of the Commodity Exchange Act (the "Act").[1/]

The limited partners of the Partnerships consist of your immediate family members, your personal friends and business associates. "Y" has 36 limited partners and "Z" has 26 limited partners. The interests of the Partnerships are exempt from registration with the Securities and Exchange Commission ("SEC") as a private offering under Section 4(2) of the Securities Act of 1933. The interests of the Partnerships have restrictions on transfer and may not be sold, transferred, pledged or hypothecated unless they have first been registered with the SEC and pursuant to applicable state law, or unless an opinion of counsel reasonably satisfactory to the Partnerships is received that registration is not required.

The partnership agreements for the Partnerships (the "Agreements") authorize the general partner to hedge the risk from interest rate fluctuations on mortgage loans with commodity interest contracts. The Partnership Agreements also state that the general partner of the Partnerships must reimburse the Partnerships for any losses in excess of $25,000.00 sustained from hedging activities. Specifically, Section 7.21 of the Agreement for "Y" provides:

Prepayment of Loans, Hedging of Mortgages and Unsecured Loans

> The General Partner shall have the right to establish futures positions in Treasury Bills or to be short or long Puts or Calls on Government Bonds, Treasury Notes, Euro-Dollars or similar financial securities and option positions in order to hedge existing loan positions of the Partnership. Said bond positions cannot exceed the face value of loans or accrued interest due in the three years following the establishing of a position, and cannot exceed a cost of $25,000.00. During the life of the Partnership should any net losses from hedging activity exceed net gains by $25,000.00, the General Partner shall reimburse the Partnership for such losses in excess of $25,000.00.[2/]

[1/] 7 U.S.C. §§ 12a(2) or 12a(3) (1988).

[2/] Although this provision of the Agreement states that "Said bond positions . . . cannot exceed a cost of $25,000.00," it was

(continued...)

All limited partners receive a copy of and are required to execute their respective Agreement.

"X" seeks to open commodity interest trading accounts as provided for under the Agreements for each Partnership in order to hedge the interest rate exposure that the Partnerships encounter as a consequence of the mortgage loans on the real estate property held by the Partnerships. You represent that these commodity interest trading accounts will be the only trading accounts of the Partnerships (i.e., one account for each Partnership) and that the purpose of the trading accounts will be strictly limited to bona fide hedging, as defined in Commission rule 1.3(z).[3/] In addition, you state that the Partnerships will limit the commodity interest contracts to the purchase of options, puts and calls on the instruments authorized by the terms of the Agreements and that the amount of funds that will be deposited as original margin or option premiums for such contracts will be limited to a maximum of $25,000.00 for each Partnership.[4/] You contend that the Partnerships are not intended to be commodity pools and that the opening of commodity interest accounts on behalf of the Partnerships is incidental to the real estate business of the Partnerships.

Section 1a(4) of the Act defines the term CPO, as "any person engaged in a business which is in the nature of an investment trust, syndicate, or similar form of enterprise and who, in connection therewith, solicits, accepts, or receives from others

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[2/] (...continued)
represented during the course of a telephone conversation with Division staff that the $25,000.00 limit applies for purposes of all commodity interest contract positions. The Agreement for "Z" contains a similar provision but allows for hedging in Treasury Bills only.

[3/] Commission rules referred to herein are found at 17 C.F.R. Ch. I (1993). For the purpose of the position we are taking herein, we are presuming that the Partnerships' commodity interest trading will be solely for "bona fide hedging" as defined in Rule 1.3(z)(1), a copy of which is enclosed.

[4/] We note that it appears that some of the contracts that the Partnerships seek to purchase may be options on securities, which may be excluded from the Commission's jurisdiction pursuant to Section 2(a)(1)(B)(1) of the Act. Such contracts, however, may be subject to the jurisdiction of the Securities and Exchange Commission pursuant to Section 2 of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. § 78(b) (1988) and Section 9(g) of the 1934 Act, 15 U.S.C. § 78i(g) (1988).

. . . property . . . for the purpose of trading in [commodity interests]."[5/] Rule 4.10(d) defines the term "commodity pool," (closely following the definition of a CPO) as "any investment trust, syndicate or similar form of enterprise operated for the purpose of trading commodity interests." In explaining this definition, the Commission stated that all the facts relevant to an entity's operation must be reviewed for purposes of determining whether a particular entity is operated "for the purpose" of trading commodity interests.[6/]

Based upon your representations, among others, that: (1) the Partnerships were formed for a business purpose unrelated to the trading of commodity interests (i.e., real estate transactions); (2) the commodity interest accounts of the Partnerships will be traded solely for bona fide hedging purposes, as defined in Rule 1.3(z); and (3) the amount of funds that may be deposited as original margin or option premiums for commodity interest contracts on behalf of each Partnership is limited to $25,000.00, we believe that relief from CPO registration is appropriate in this instance. Accordingly, the Division will not recommend that the Commission take any enforcement action against "X" for failure to register as a CPO in connection with its operation of the Partnerships.

You should be aware that the position taken in this letter does not excuse "X" from compliance with any otherwise applicable requirements contained in the Act[7/] or in the Commission's regulations promulgated thereunder. For example, "X" remains subject to the antifraud provisions of Section 4o of the Act,[8/] to the reporting requirements for traders set forth in Parts 15, 18, and 19 of the Commission's regulations, and to the operational and antifraud provisions of Rules 4.20 and 4.41, respectively.

This letter is based upon the representations that you have made to us and is strictly limited to those representations. Any different, changed or omitted facts or conditions might require us to reach a different conclusion. In this connection, we request that you notify us immediately in the event the operations or activities of the Partnerships, including their restrictions on commodity interest trading, change in any way from those

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5/ 7 U.S.C. § 1 (Supp. IV 1992).

6/ 46 Fed. Reg. 26004, 26006 (May 8, 1981).

7/ 7 U.S.C. § 1 et seq. (1988 & Supp. IV. 1992).

8/ 7 U.S.C. § 6o (1988).

as represented to us. Further, this letter is applicable to "X" solely in connection with its operation of the Partnerships.

The "no-action" position taken herein represents the position of the Division of Trading and Markets only. It does not necessarily represent the views of the Commission or of any other unit or division of the Commission.

If you have any questions concerning this correspondence, please contact me or Tina Paraskevas Shea, an attorney on my staff, at (202) 254-8955.

Very truly yours,

Susan C. Ervin
Chief Counsel