



COMMODITY FUTURES TRADING COMMISSION

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DIVISION OF  
TRADING AND MARKETS

95-30

February 10, 1995

Re: Section 4m(1) -- Request for Relief from Commodity Pool Operator and Commodity Trading Advisor Registration for Certain Entities

Dear :

This is in response to your letter dated September 8, 1994, to the Division of Trading and Markets ("Division") of the Commodity Futures Trading Commission ("Commission"), as supplemented by letters dated October 6, 1994, November 1, 1994, December 22, 1994, January 17, 1995, and February 3, 1995 and telephone conversations with Division staff. By your letter you request that the Division grant relief from: (1) commodity pool operator ("CPO") and commodity trading advisor ("CTA") registration requirements on behalf of "T"; and (2) CTA registration requirements on behalf of "U", in connection with the operation of (the "Fund").

Based upon the representations made in your letter, as supplemented, we understand that the facts are as follows. "T" is incorporated in Puerto Rico, has its principal office and place of business in Puerto Rico, and is the underwriter for the Fund. Although "T" is not registered with the Commission in any capacity, it is registered as a broker-dealer with the Securities and Exchange Commission ("SEC"). "T" is not registered as an investment adviser pursuant to an exemption provided by Section 203(b)(3) of the Investment Advisers Act of 1940 ("IAA").<sup>1/</sup> Puerto Rico is the principal residence of the members of the board of directors of "T" and of "T's" principals and officers. You represent that neither "T" nor any of its principals, officers and members of its

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<sup>1/</sup> Section 203(b)(3) of the IAA provides an exemption from registration to an investment adviser who, during the preceding twelve months, has had fewer than fifteen clients and who does not hold himself out generally to the public as an investment adviser nor act as an investment adviser to any registered investment company. An investment adviser claiming this exemption remains subject to the antifraud provisions of Section 206 of the IAA.

board of directors is subject to a statutory disqualification under Sections 8a(2) or 8a(3) of the Commodity Exchange Act ("Act").<sup>2/</sup>

"U" is a financial institution chartered and having its principal office and place of business in Puerto Rico. "U" is a banking institution whose deposits are insured by the Federal Deposit Insurance Corporation ("FDIC")<sup>3/</sup> and which is excluded from the definition of "investment adviser" pursuant to Sections 202(a)(2) and 202(a)(11) of the IAA. Puerto Rico is the principal residence of "U's" board of director members, principals and officers. You represent that neither "U" nor any of its principals, officers, or members of its board of directors is subject to a statutory disqualification under Section 8a(2) or 8a(3) of the Act.<sup>4/</sup>

The Fund is a non-diversified, closed-end management investment company. At least a majority of the directors of the Fund will have their principal residence in Puerto Rico and none of the directors of the Fund will be subject to a statutory disqualification under Sections 8a(2) or 8a(3) of the Act.<sup>5/</sup> The Fund is registered under the laws of the Commonwealth of Puerto Rico pursuant to the Puerto Rico Investment Companies Act (the "P.R. Act")<sup>6/</sup> and is exempt from registration as an investment company

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<sup>2/</sup> 7 U.S.C. § 12a(2) or 12a(3) (1988 & Supp. IV 1992).

<sup>3/</sup> The Division notes that, under Section 19 of the Federal Deposit Insurance Act, principals of a bank insured by the FDIC are subject to a fitness examination in that the bank effectively is prohibited from employing any person who has been convicted of a crime involving dishonesty or breach of trust without the prior consent of the FDIC. 12 U.S.C. § 1829 (1988 & West Supp. 1994).

<sup>4/</sup> Id.

<sup>5/</sup> Id. It is contemplated that the Fund will have between three and five directors, one of whom may be a United States person. You represent that not more than twenty-five percent of the Fund's board of directors will be comprised of citizens of the United States who are not residents of Puerto Rico.

<sup>6/</sup> Act No. 6 of October 19, 1954, as amended 10 L.P.R.A. 661. Based upon your representations, the Division understands that the applicable laws of Puerto Rico with respect to the regulation of the Fund are as follows. In order for an investment company to operate in Puerto Rico, it must be registered with the Office of the Commissioner of Financial Institutions for the Commonwealth of Puerto Rico (the "P.R. Commissioner") under the P.R. Act. The P.R.

(continued...)

pursuant to Section 6(a)(1) of the Investment Company Act of 1940 ("ICA").<sup>7/</sup>

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<sup>6/</sup> (...continued)

Commissioner requires an investment company to submit a series of periodic reports and any information the P.R. Commissioner requests that is not part of the periodic reports. 10 L.P.R.A. 671(a)(2). An investment company must file investment reports at least quarterly with the P.R. Commissioner and must submit semi-annual and annual reports to the investors. The annual report must contain the following information: a balance sheet, a statement of securities owned, a statement of income, a statement of surplus, and a statement of aggregate remuneration to directors, members of the advisory board, officers, and persons affiliated with officers or directors. 10 L.P.R.A. 671(b).

In addition, the P.R. Act imposes other requirements upon investment companies registered in Puerto Rico, including: (1) that all documents filed with the P.R. Commissioner by the investment company must be available for public examination and reproduction; (2) that the investment company maintain certain ties with the economy of Puerto Rico, for example, the investment company's annual stockholders' meeting must be held in Puerto Rico and the principal office of the investment company must be located in Puerto Rico; and (3) certain requirements with respect to the capitalization of the investment company and certain limitations on the investment practices which are intended to protect stockholders from the risks associated with the lack of portfolio diversification.

<sup>7/</sup> Specifically, Section 6(a)(1) of the ICA provides an exemption from registration for:

Any company organized or otherwise created under the laws of and having its principal office and place of business in Puerto Rico, the Virgin Islands, or any other possession of the United States; but such exemption shall terminate if any security of which such company is the issuer is offered for sale or sold after the effective date of this title, by such company or an underwriter therefor, to a resident of any State other than the State in which such company is organized.

In this regard, by letter dated, the Division of Investment Management of the Securities and Exchange Commission has provided you with written assurance that it would not recommend enforcement action if the Fund does not register under the ICA.

The Fund will be organized and have its principal place of business in Puerto Rico and interests in the Fund will be offered and sold solely to residents of Puerto Rico. The Fund will offer common stock and commercial paper and other short-term debt securities ("debt securities"). Shares of common stock will be offered and sold exclusively to individuals who have their principal residence in Puerto Rico and to persons, other than natural persons, whose principal offices and principal places of business are located in Puerto Rico.<sup>8/</sup> You also represent that the Fund's debt securities will be offered and sold only to U.S. corporations that qualify for tax credit under Section 936 of the Internal Revenue Code ("936 corporations"),<sup>9/</sup> entities organized in Puerto Rico or elsewhere outside of the U.S. that have their principal place of business in Puerto Rico, or other Puerto Rico residents.

The Fund's investment objective is to achieve a high level of current income that, for eligible Puerto Rico investors as described in the Fund's prospectus,<sup>10/</sup> is exempt from U.S. Federal and Puerto Rico income taxes. In order to achieve its objective, the Fund intends to invest at least seventy percent of its total assets in a portfolio of investment grade Puerto Rico obligations, including securities issued by the Commonwealth of

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<sup>8/</sup> You represent that the governing documents of the Fund will prohibit ownership of the Fund's shares by anyone other than a resident of Puerto Rico.

<sup>9/</sup> Puerto Rico's status as a United States possession entitles qualifying corporations organized under the laws of a state of the United States to elect a special tax credit under Section 936 of the U.S. Internal Revenue Code, which was enacted by Congress to induce United States companies to expand their operations to Puerto Rico in efforts to reduce unemployment and contribute to the stability of the economy. A "936 corporation" must conduct an active trade or business in Puerto Rico, must have earned at least eighty percent of its gross income for the preceding three-year period from sources within Puerto Rico and, for such three-year period, must have earned at least seventy-five percent of its gross income from the active conduct of a trade or business in Puerto Rico. Under Section 936, all the investments of a 936 corporation must be made in Puerto Rico (for use in Puerto Rico) and must comply with the provisions of Section 2(j) of the Acts, and Regulation 3582 promulgated on February 28, 1984 by the Commissioner of Financial Institutions of Puerto Rico.

<sup>10/</sup> You have represented that the Fund's prospectus is typical of those that would be issued in connection with the offering of a mutual fund under the ICA.

Puerto Rico and its political subdivisions and Puerto Rico mortgage-backed securities ("Puerto Rico Obligations"). The Fund also may invest up to thirty percent of its total assets in securities issued or guaranteed by the U.S. government, its agencies and instrumentalities and in municipal securities of issuers in the United States. In this regard, the Fund seeks to use commodity interest contracts in a manner consistent with Commission Rule 4.5(c)(2), although, consistent with the SEC exemption discussed above, the Fund is not registered as an investment company under the ICA. Thus, the Fund is not a "qualifying entity" under Rule 4.5(b)(1), and an exemption from CTA registration pursuant to Rule 4.14(a)(8) is unavailable to "U".

"T" and "U" will jointly manage the Fund's investment portfolio.<sup>11/</sup> "U" also will act as the Fund's administrator, transfer agent and custodian. "U" will share with "T" the authority to make investment decisions relating to the trading of Puerto Rico Obligations and other investments, including commodity interest trading for the Fund. You represent that neither "T" nor "U" will hold itself out to the public as a CTA and that "U's" role as a co-advisor to the Fund will be fully disclosed in the Fund's prospectus.

In support of your request, you represent that "T" will operate the Fund in a manner consistent with Rule 4.5(c) and, specifically, will use commodity futures or commodity options contracts solely for bona fide hedging purposes within the meaning and intent of Rule 1.3(z)(1), or to the extent that such positions do not come within the meaning and intent of Rule 1.3(z)(1), the aggregate initial margin and premiums required to establish such positions will not exceed five percent of the liquidation value of the Fund's portfolio, after taking into account unrealized profits and losses on any such contracts it has entered into. You also represent that both "T" and "U" will comply with the requirements of Rule 4.14(a)(8) in connection with providing commodity interest trading advice to the Fund.

Based upon the foregoing, the Division will not recommend that the Commission take any enforcement action against "T" based solely upon its failure to register as a CPO in connection with its operation of the Fund. In addition, the Division will not

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<sup>11/</sup> It is contemplated that "T" and "U" will enter into an advisory agreement with a U.S. subadviser but that the advice provided by the subadviser will not be binding on "T", "U" or the Fund. Any such subadviser retained for the purpose of advising the Fund for trading commodity interest contracts will be registered with the Commission in the appropriate capacity or exempt from such registration.

recommend that the Commission take any enforcement action against either "T" or "U" based solely upon "T's" or "U's" failure to register as a CTA in connection with its providing commodity interest trading advice to the Fund. These positions are, however, subject to the condition that "T" and "U" will submit to such special calls as the Division, or other representative of the Commission, may make to demonstrate compliance with the terms and conditions of these "no-action" positions. The views stated herein are based, in part, upon your representations that: (1) Puerto Rico is the principal place of business of "T", "U" and the principal residence of all directors, officers and principals thereof; (2) at least seventy-five percent of the directors of the Fund will have their principal residence in Puerto Rico;<sup>12/</sup> (3) shares of stock in the Fund will be sold solely to persons who have their principal residence or place of business in Puerto Rico; (4) the Fund is registered and regulated under the P.R. Act; (5) "T" will operate the Fund in a manner consistent with Rule 4.5(c)(2); and (6) "T" and "U" will comply with the requirements of Rule 4.14(a)(8) with respect to the manner in which commodity interest trading advice is rendered to the Fund.

The positions taken herein do not excuse "T" or "U" from compliance with any otherwise applicable requirements contained in the Act or the Commission's regulations thereunder. For example, each remains subject to the antifraud provisions of Section 40 of the Act, 7 U.S.C. § 60, to the reporting requirements for traders set forth in Parts 15, 18 and 19 of the Commission's regulations, and to all other provisions of Part 4. Further, this relief is applicable to "T" solely in connection with its acting as the CPO of the Fund and to "T" and "U" solely in connection with their acting as the CTAs of the Fund.

This letter is based on the representations you have made to us and is subject to the conditions stated above. Any different, changed or omitted facts or conditions might require us to reach a different conclusion. In this regard, we request that you notify us immediately in the event the facts change in any way from those represented to us. Finally, the positions taken herein represent the views of the Division of Trading and Markets only and do not necessarily reflect the views of the Commission or any other office or division of the Commission.

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<sup>12/</sup> As noted, it is contemplated that the Fund will have between three and five directors, one of whom may be a United States person.

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

Very truly yours,

Susan C. Ervin  
Chief Counsel