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COMMODITY FUTURES TRADING COMMISSION

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DIVISION OF  
TRADING AND MARKETS

July 10, 1995

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

Dear :

This is in response to your letter dated April 20, 1995 to the Division of Trading and Markets ("Division") of the Commodity Futures Trading Commission ("Commission"), as supplemented by letters dated May 16, 1995 and May 31, 1995, and telephone conversations with Division staff. By your letter, as supplemented, you request that the Division grant: (1) the directors of (the "Fund"), a Puerto Rico commodity pool, relief from registration as commodity pool operators ("CPOs"); and (2) (the "Adviser"), the Fund's investment adviser, relief from registration as a commodity trading advisor ("CTA").

Based upon the representations made in your letter, as supplemented, we understand the pertinent facts to be as follows. The Fund is a non-diversified, open-end management investment company. At least seventy-five percent of the Fund's directors will have their principal residence in Puerto Rico and none of the Fund's directors will be subject to a statutory disqualification under Section 8a(2) or 8a(3) of the Commodity Exchange Act (the "Act").<sup>1/</sup> The Fund will be registered under the laws of the Commonwealth of Puerto Rico pursuant to the Puerto Rico Investment Companies Act (the "P.R. Act").<sup>2/</sup> In addition, you represent

<sup>1/</sup> 7 U.S.C. § 12a(2) or 12a(3) (1994). The Fund contemplates that it will have five directors. You represent that citizens of the United States who are not residents of Puerto Rico will comprise no more than twenty-five percent of the Fund's directors. Currently, the Fund's one director who is a resident of the United States is also an officer of the Adviser. A second director, a Puerto Rico resident, is an officer of the Fund's underwriter.

<sup>2/</sup> Our understanding of the operative provisions of the P.R. Act has been set forth in letters to you dated May 24, 1995 and February 8, 1995 (the "Letters"), wherein we issued relief from CPO

(continued...)

that the Fund is exempt from registration as an investment company under Section 6(a)(1) of the Investment Company Act of 1940 ("ICA").<sup>3/</sup>

The Fund is organized, has its principal place of business and maintains its books and records in Puerto Rico. The Fund will offer stock and debt securities. Shares of 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>4/</sup> You also represent that the Fund's debt securities will be offered and sold to corporations organized in the United States that qualify for tax credit under Section 936 of the Internal Revenue Code ("936 corporations"),<sup>5/</sup> entities organized in Puerto Rico or elsewhere outside of the United States

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<sup>2/</sup> (...continued)

and CTA registration to certain other of your clients in connection with their operation of Puerto Rico investment companies similar to the one at issue here.

<sup>3/</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 Act, 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 May 26, 1995, the Division of Investment Management of the Securities and Exchange Commission ("SEC") provided you with written assurance that it would not recommend enforcement action if the Fund did not register under the ICA in reliance upon Section 6(a)(1).

<sup>4/</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>5/</sup> Our understanding of Section 936 and 936 corporations was also set forth in the Letters.

that have their principal places of business in Puerto Rico, or other Puerto Rico residents, including natural persons.<sup>6/</sup>

The Fund's investment objective is to achieve a high level of current income that is exempt from United States Federal and Puerto Rico income taxes. In order to achieve its objective, the Fund intends to invest at least sixty-seven percent of its total assets in a portfolio of investment grade obligations, including securities issued by the Commonwealth of Puerto Rico and its political subdivisions and Puerto Rico mortgage-backed securities ("Obligations"). The Fund also may invest the remainder of its total assets in securities issued or guaranteed by the United States government, its agencies and instrumentalities and in municipal securities of issuers in the United States. Consistent with the SEC no-action position discussed above, the Fund is not registered as an investment company under the ICA and, thus, it is neither an "otherwise regulated entity" nor a "qualifying entity" specified in Rule 4.5.<sup>7/</sup> Consequently, the Fund does not qualify for exclusion from the definition of the term CPO under Rule 4.5 and the Adviser is not exempt from CTA registration under Rule 4.14(a)(8). Nonetheless, the Fund seeks to use commodity interest contracts and the Adviser seeks to provide commodity interest trading advice in a manner consistent with eligibility status under Rules 4.5 and 4.14(a)(8).

The Fund's underwriter is the Puerto Rico branch office of (the "Underwriter"), a Delaware corporation. The Underwriter is

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<sup>6/</sup> Puerto Rico is a possession of the United States. Thus, the Fund is one which is organized within the "United States," and will be offered to and whose directors will be "United States persons." The Division has defined the term "United States" to mean the United States, its states, territories or possessions, or an enclave of the United States government, its agencies or instrumentalities. The term "United States person" has been defined to include: (1) a natural person who is a resident of the United States; (2) a partnership, corporation or other entity organized under the laws of the United States or which has its principal place of business in the United States; (3) any estate or trust, the income of which is subject to United States income tax regardless of source; or (4) any entity organized principally for passive investment such as a commodity pool, investment company or similar entity which has significant investment by United States persons. See CFTC Interpretative Letter 92-3, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,221, at 38,627 (January 29, 1992); See also Rule 4.7(a)(1)(ii)(C).

<sup>7/</sup> Commission rules referred to herein are found at 17 C.F.R. Ch. I (1994).

registered with the P.R. Commissioner as a broker-dealer under the Uniform Securities Act (the "P.R. Sec. Act").<sup>8/</sup> In lieu of the Underwriter, the Fund may utilize in the future other entities organized in Puerto Rico, and registered as broker-dealers under the P.R. Sec. Act, to distribute the Fund's shares and debt securities.<sup>9/</sup>

The Adviser is registered with the SEC as an investment adviser under the Investment Advisers Act of 1940 ("IAA"). It is a Delaware limited partnership and its principal office is in New Jersey. Neither the Adviser nor any of its directors is subject to a statutory disqualification under Sections 8(a)(2) or 8(a)(3) of

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<sup>8/</sup> You represent that Section 201(a) of the P.R. Sec. Act provides that, "It shall be unlawful for any person to transact business in Puerto Rico as broker-dealer or agent unless he is registered under this chapter." 10 L.P.R.A. § 861(a). The P.R. Sec. Act defines the term "person" as "an individual, a corporation, a partnership, an association, a joint stock company, a trust where the interests of the beneficiaries are evidenced by a security, an unincorporated organization, a government, or a political subdivision of a government." 10 L.P.R.A. § 881(i). You state that this definition does not recognize a branch of a corporation as a distinct separate entity, and, therefore, the registration requirement is applicable to a corporation organized in the United States since it would be the "person" transacting business in Puerto Rico as a broker-dealer. Once a person is registered as a broker-dealer under the P.R. Sec. Act, the applicable regulations are the same regardless of the form of organization. Thus, the P.R. Sec. Act does not differentiate a corporation organized in the United States that transacts business in a Puerto Rico as a broker-dealer through a branch office from a Puerto Rico corporation that transacts business in Puerto Rico as a broker-dealer and is affiliated with a corporation organized in the United States.

<sup>9/</sup> Consistent with the Commission's prior statements in this area, it does not appear that the Underwriter is acting in the capacity of a CPO. The Commission, when adopting Rule 4.5, was requested to clarify whether a registered investment company's underwriter came within the definition of the term CPO and, if so, to also provide relief from regulation as a CPO for such persons equivalent to the relief provided for the investment company. 50 Fed. Reg. 15871 (April 23, 1985). The Commission responded that it did not believe that the activities in which such persons typically engage are the activities in which a CPO typically engages. The Commission stated that such persons are outside the CPO definition and, therefore, relief from regulation as a CPO was not necessary. Id.

the Act. The Underwriter and the Adviser are affiliated companies. The roles of the Underwriter and the Adviser are fully disclosed in the Fund's prospectus.

In support of your request, you represent that the Fund will be operated in a manner consistent with Rule 4.5(c)(2) and, specifically, will use commodity futures and commodity option 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 the Adviser, in accordance with certain requirements of Rule 4.14(a)(8): (1) will provide commodity interest trading advice to the Fund in a manner that is solely incidental to its furnishing of securities advice to the Fund; (2) will employ only strategies as are consistent with eligibility status under Rule 4.5; and (3) will not otherwise hold itself out as a CTA.

Based upon the foregoing, the Division will not recommend that the Commission take any enforcement action against the directors of the Fund based solely upon their failure to register as CPOs in connection with the Fund's operation.<sup>10/</sup> In addition, the

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<sup>10/</sup> As noted above, the Fund is exempt from registration as an investment company under Section 6(a)(1) of the ICA, and, thus, the Fund does not qualify for exclusion from the definition of the term CPO under Rule 4.5. However, the Division believes that granting the Fund's directors relief from CPO registration is consistent with prior Commission statements and Division precedent in this area. See 50 Fed. Reg. 15868, 15870-71 & n. 28 (April 23, 1985) (Commission stated that Rule 4.5 did not provide an exclusive means for relief from regulation as a CPO, that it expected Commission staff to continue to issue such interpretations of Rule 4.5 as may be necessary and appropriate to fulfill the purposes of the rule, and that the scope of Rule 4.5 relief includes the principals or employees of such persons). See also CFTC Interpretative Letter 85-8, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,728, at 31,062 (February 8, 1985) (Division granted CPO registration no-action relief with respect to an "employees' security company" and its principals where the company was exempt from registration as an investment company under the ICA but otherwise complied with Rule 4.5); CFTC Interpretative Letter 91-5, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,063, at 37,974 (May 28, 1991) (Division granted CPO registration no-action relief with respect to the board of trustees of a fund which,

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Division will not recommend that the Commission take any enforcement action against the Adviser based solely upon its failure to register as a CTA in connection with its providing commodity interest trading advice to the Fund.<sup>11/</sup> These positions are, however, subject to the condition that the Fund, its directors, and the Adviser 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) at least seventy-five percent of the directors of the Fund will have their principal residences in Puerto Rico; (2) shares of stock in the Fund will be sold solely to persons who have their principal residences or places of business in Puerto Rico; (3) the Fund is registered as an investment company under the P.R. Act and, thus, is exempt from registration as an investment company under the ICA; (4) the Fund will be operated in a manner consistent with Rule 4.5(c)(2); and (5) the Adviser, which is registered as an investment adviser under the IAA, 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 the Fund, its directors or the Adviser 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 applicable

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10/ (...continued)

although not a pension fund eligible for relief under Rule 4.5, was sufficiently similar to such funds to warrant relief); CFTC Interpretative Letter 95-30, Comm. Fut. L. Rep. (CCH) ¶ 26,371, at 42,715 (February 10, 1995) (Division granted CPO and CTA no-action relief in connection with an SEC registered broker-dealer's operation of an investment management company registered and regulated under the P.R. Act and to be operated in a manner consistent with Rule 4.5(c)(2)).

11/ See CFTC Interpretative Letter 89-2, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,405, at 35,770 (March 1, 1989) (Division granted relief from CTA registration where registered investment adviser would be eligible for relief under Rule 4.14(a)(8) but for the fact it proposed to provide commodity interest trading advice to the general account of an insurance company client rather than a separate account offered by such client as contemplated by the exemptive criteria of Rules 4.14(a)(8) and 4.5(b)).

provisions of Part 4. Further, this relief is applicable to the Fund's directors solely in connection with their activities as CPOs of the Fund and to the Adviser solely in connection with its acting as the CTA of the Fund.

This letter is based on the representations you have made to us and is subject to compliance with the condition 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.

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

Very truly yours,

Susan C. Ervin  
Chief Counsel