



# U.S. COMMODITY FUTURES TRADING COMMISSION

RECORDS

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DIVISION OF  
TRADING & MARKETS

95-98

November 15, 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 July 6, 1995, to the Division of Trading and Markets ("Division") of the Commodity Futures Trading Commission ("Commission"), as supplemented by letters dated July 21, 1995, August 3, 1995, August 15, 1995, August 22, 1995, and October 11, 1995, and telephone conversations with Division staff. By your July 6, 1995 letter, as supplemented, you request on behalf of your client, "Q", that the Division grant "R", "S", and "T" relief from the commodity pool operator ("CPO") registration requirement of Section 4(m)(1) of the Commodity Exchange Act ("Act")<sup>1/</sup> in connection with certain commodity interest trading activities in which "Q" intends to engage, as described more fully below. You also request that the Division grant "R" and "S" relief from the commodity trading advisor ("CTA") registration requirement of Section 4(m)(1) of the Act<sup>2/</sup> in connection with providing commodity trading advice to "Q".

Initially, the Division notes that "Q" is structured as a special purpose limited liability company organized under the laws of the State. As structured, three entities hold "common membership interests" in "Q": "R", "S" and "T" (collectively the "Common Members" and individually a "Common Member"), each of whom has made capital contributions to "Q". Under the provisions of the "Operating Agreement" dated April 4, 1995, among "R", "S" and "T", "R" is designated as the "Controlling Common Member" and "Manager" and "S" and "T" are designated as the "Non-Controlling Common Members." From the facts as represented, it appears that all three entities may be analogous to general partners of a limited partnership and, as such, would be required to register as CPOs

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<sup>1/</sup> 7 U.S.C. § 6m(1) (1994).

<sup>2/</sup> Id.

under the Act<sup>3/</sup> absent the relief requested herein. Thus, although your request sought relief on behalf of "Q", the Division has determined that under the organizational structure of this limited liability company, "Q" would be a commodity pool and relief should be sought on behalf of the three Common Members as the operators thereof.<sup>4/</sup>

Based upon the representations made in your letter, as supplemented, we understand that the facts are as follows. "Q's" primary business is the issuance of guaranteed investment contracts ("GICs")<sup>5/</sup> to trustees, municipalities or other governmental and related nongovernmental entities that are engaged in municipal finance transactions.<sup>6/</sup> "Q" is exempt from registration as an investment company pursuant to section 3(c)(1) of the Investment Company Act of 1940, which provides an exemption from the definition of an investment company for "any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities."

"R" is a Delaware special purpose corporation organized specifically for the purpose of owning an interest in, and acting as a Common Member of, "Q". Pursuant to the terms of the Operating Agreement, "R" is the manager of "Q" and may, in its sole discretion, enter into agreements on behalf of "Q", appoint officers and perform other tasks in connection with the capitalization of "Q",

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<sup>3/</sup> 7 U.S.C. § 1 et seq. (1994). See CFTC Interpretative Letter No. 75-16, [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,104 (October 15, 1975). As explained more fully below, the holders of certain securities issued by "Q" would appear to be analogous to limited partners.

<sup>4/</sup> As explained more fully below, "Q" appears to be a commodity pool as a consequence of its pooling funds and commodity interest trading activities for the benefit of holders of its securities.

<sup>5/</sup> GICs are a form of investment vehicle introduced in the early 1970's. The most basic form of a GIC is a contract characterized by a single deposit, earning interest at a guaranteed rate of return until maturity, at which time the principal is returned.

<sup>6/</sup> Typically, a GIC is purchased in connection with a bond offering by a municipality and serves as a source of security for the municipality's bonds or an investment of bond proceeds. The GICs issued by "Q" are secured obligations of "Q". Under the terms of each GIC, "Q" pays each GIC holder a guaranteed fixed or variable rate of return determined through a bidding process or through negotiations.

the issuance of GICs, and all incidental or related matters. All of the capital stock of "R" is owned by the Trust, a charitable trust established under a Trust Agreement dated January 30, 1995. "Q's" distributions to "R"<sup>7/</sup> will become net income of the Trust and will be distributed at least annually to one or more charitable organizations described in Section 170(c) of the Internal Revenue Code of 1986 ("IRC").<sup>8/</sup>

"S" and "T" are both special purpose Delaware corporations organized for the purpose of owning an interest in, and acting as Common Members of, "Q". Both are wholly-owned subsidiaries of "U", which is the parent company of several companies engaged in the investment and financial services business and which is a wholly-owned subsidiary of "V".<sup>9/</sup> "V", an indirect wholly-owned subsidiary of "W", is a diversified financial services company.

You represent that additional Common Members will not be added and that Common Member interests are non-assignable, non-transferable and may not be encumbered. You also state that certain officers of "Q" are currently and are expected to be employees of one or more of "S" affiliates.

In addition to the proceeds from issuing GICs, "Q" also will derive funds from the sale of preferred membership interests ("Preferred Interests") which will be equity interests in "Q".

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<sup>7/</sup> "Q's" distributions to its Common Members are determined in accordance with a specific formula embodied in the Operating Agreement.

<sup>8/</sup> Section 170(c) of the IRC provides generally that such charitable organizations include states (where the funds are used for public purposes); corporations, trusts or other such entities created under U.S. law and organized for religious, charitable, scientific, literary or educational purposes; or other similar types of entities organized for similar purposes.

<sup>9/</sup> Subsidiaries of "U" include "X", a company whose principal business is the issuance of insurance coverage for municipal bonds and whose statutory capital base for its 1994 fiscal year was XXX million. The volume of insurance written in 1994 by "X" for municipal bonds in the primary market was YYY billion and in the secondary market was ZZZ billion. Other wholly-owned companies of "U" are "Y" and "Z". In 1994, "Y" had outstanding municipal investment contracts (similar to "Q's" GICs) with more than 100 state and local governments and agencies with a total value of TTT billion. "Z" committed more than TTT billion in liquidity facilities to municipal issuers of variable-rate obligations, all guaranteed by "V", also in 1994.

Preferred Interests will be issued to no more than fifteen accredited investors not otherwise affiliated with "Q" ("Preferred Members"), all of whom will be "accredited investors" within the meaning of Rule 501(a)(1), (2), (3), or (7) of Regulation D of the Securities Act of 1933.<sup>10/</sup> All Preferred Members are or will be unaffiliated with "V" or its subsidiaries. None of the Preferred Members is or will be an entity formed for the purpose of purchasing Preferred Interests in "Q" or otherwise participating in any exempt commodity pool. Three hundred and fifty Preferred Interests have or may be issued at a purchase price of \$100,000 each, representing between one and ten percent of "Q's" total capitalization.<sup>11/</sup> Pursuant to the terms of the private placement memorandum, Preferred Members are expected to receive a return comprised of a fixed-rate monthly distribution, and the return of their principal at maturity or redemption.

Under the provisions of "Q's" Operating Agreement, and as described in its private placement memorandum, "Q" will establish a segregated non-interest bearing trust account into which it will deposit amounts received from the GICs, the Preferred Interests and other sources. "Q" will use such proceeds to purchase a portfolio of securities and other investments that are within specified categories and that, taken together, satisfy specified portfolio composition requirements. Specifically, for capital appreciation

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<sup>10/</sup> As defined by such provisions of Regulation D, Preferred Interests will be issued to institutional entities and will not be issued to any natural persons. Rule 501(a)(1) defines accredited investor generally to include banks, registered brokers or dealers, insurance companies, licensed small business investment companies and certain employee benefit plans. Rules 501(a)(2), (3) and (7) of the Regulation define accredited investor generally to include private business development companies, certain charitable organizations, business trusts, partnerships and other trusts generally with assets in excess of \$5 million.

<sup>11/</sup> To date, Preferred Interests have been sold in blocks worth \$10 million. The first Preferred Member that purchased a \$10 million block of Preferred Interests was a technology corporation with over \$20 billion dollars in capital. This Preferred Member determined to divest itself of its Preferred Interests, which were then purchased in a \$10 million block by a registered investment adviser that has in excess of \$1 billion under management on behalf of certain institutional accredited investors. For prudent business reasons, "Q's" placement agent anticipates continuing the practice of offering and selling Preferred Interests in blocks of \$10 million, although "Q" may sell Preferred Interests in less than \$10 million blocks should market conditions and business acumen dictate.

purposes, "Q" is permitted to (1) invest its funds in a portfolio of securities, debt obligations and money market investments ("Permitted Investments") within certain credit quality parameters; (2) enter into repurchase agreements and reverse repurchase agreements; and (3) enter into, among other transactions, financial futures contracts and options on financial futures contracts ("commodity interest transactions") for the sole purpose of hedging any or all of its investment risk exposure in connection with its issuance of GICs and investing in Permitted Investments.<sup>12/</sup>

With respect to "Q's" intended commodity interest trading transactions, you represent that "Q" intends to trade interest rate futures contracts and options thereon for the purpose of hedging its GICs and Permitted Investments through bona fide hedging transactions and positions as defined in Commission Rule 1.3(z)(1).<sup>13/</sup> The commodity interest contracts that "Q" intends to trade include eurodollar time deposit rates, LIBOR, thirty-day interest rates, U.S. Treasury bills and notes and U.S. Treasury strips, and options on the foregoing. You also represent that "Q" will not deposit as initial margin or premiums for its commodity interest transactions an aggregate amount of funds greater than three percent of the liquidation value of "Q's" outstanding GIC contracts (which should be equal to the aggregate principal dollar amount of "Q's" obligations to holders of its GIC contracts) computed in accordance with generally accepted accounting principals, after taking into account unrealized profits and unrealized losses on such transactions. You state that "Q's" intended use of commodity interests as a hedging tool is fully disclosed in its private placement memorandum furnished to offerees of Preferred Interests and its confidential memorandum furnished to offerees of GICs.

You represent that the Preferred Interests and GICs have and will be offered and sold in compliance with Section 4(2) of the Securities Act of 1933. To that end, you represent that the offer

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<sup>12/</sup> Specifically, the summary to "Q's" private placement memorandum provides:

To establish a hedged position with respect to Investments, ["Q"] may also enter into contracts for interest rate swaps, forward deliveries, options, futures and other financial assets or interests in financial assets commonly referred to as "derivative instruments". . . .

<sup>13/</sup> Commission rules referred to herein are found at 17 C.F.R. Ch. I 1995, as amended by 60 Fed. Reg. 38146 (July 25, 1995).

and sale of "Q's" Preferred Interests and GICs are subject to compliance with the antifraud provisions of the federal securities laws. You also state that "Q" has informed you that, for prudent business reasons and as a matter of business practice, "Q's" private placement memorandum, which describes "Q" and the Preferred Interests, and its confidential memorandum which is furnished to offerees of GICs, contain all material disclosures, sufficient to enable a Preferred Member or a GIC offeree to make an informed and knowledgeable decision as to whether it should acquire "Q's" Preferred Interests or a GIC.

In support of the requested relief, you also state that "Q" represents that neither "Q", "R", "S", nor "T", nor any of their principals or officers is subject to a statutory disqualification under Sections 8a(2) or 8a(3) of the Act.<sup>14/</sup> In addition, as noted above, for prudent business reasons, "Q's" placement agent anticipates continuing the practice of offering and selling Preferred Interests in blocks of \$10 million, although "Q" may sell Preferred Interests in less than \$10 million blocks should market conditions and business acumen dictate. You also represent that "Q" understands that the Commission, or its representatives, may exercise its appropriate regulatory authority to examine "Q's" relevant books and records or exercise other appropriate authority, at such time as the Commission deems necessary, to assure compliance with the Act, the regulations promulgated thereunder, and any regulatory relief that the Division may grant. You state that "Q" is not intended to be a commodity pool and that the use of commodity interest contracts will be incidental to its business of issuing GICs. You ask the Division to grant, among other things, "R", "S", and "T" no-action relief from CPO registration requirements, such that they need not register as CPOs, notwithstanding "Q's" commodity interest trading transactions.

Section 4m(1) of the Act<sup>15/</sup> requires all CPOs to be registered as such. Section 1a(4) of the Act<sup>16/</sup> 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 . . . property for the purpose of trading in [commodity interests]."<sup>17/</sup> It appears that, as a consequence of "Q's" pooling funds and issuing Preferred Interests and GICs, and

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<sup>14/</sup> 7 U.S.C. § 1 et seq. (1994).

<sup>15/</sup> 7 U.S.C. § 6(m) (1994).

<sup>16/</sup> 7 U.S.C. § 1 (1994).

<sup>17/</sup> 7 U.S.C. § 1 (1994).

engaging in commodity interest transactions with such pooled funds, "Q" would be a commodity pool. Consequently, absent an applicable exemption or other relief, "R", "S" and "T" would be required to be registered as CPOs.

The Division believes that your request for CPO registration relief has merit in light of your representations, among others, that: (1) "Q" is a special purpose vehicle whose primary business is the issuance of GICs to trustees, municipalities or other governmental and nongovernmental entities that are engaged in municipal finance transactions; (2) "Q" will not have additional Common Members; (3) "Q's" Preferred Interests and GICs have been and will be offered and sold pursuant to section 4(2) of the Securities Act of 1933; (4) "Q's" Preferred Interests have been and may be sold to no more than fifteen unaffiliated accredited investors within the meaning of Rule 501(a)(1), (2), (3) or (7) of Regulation D, all of which are institutional entities as described herein; (5) capital from Preferred Members will represent ten percent or less of "Q's" total capitalization; (6) "Q" will engage in commodity interest transactions solely for bona fide hedging purposes, as defined in Rule 1.3(z)(1), with respect to its Permitted Investments and GICs; (7) "Q's" intended use of commodity interest transactions is fully disclosed in its private placement memorandum furnished to offerees of Preferred Interests and its confidential memorandum furnished to offerees of GICs; (8) "Q" will not deposit as initial margin or premiums for its commodity interest transactions an aggregate amount of funds greater than three percent of the liquidation value of "Q's" outstanding GIC contracts (which should be equal to the aggregate principal dollar amount of "Q's" obligations to holders of its GIC contracts) computed in accordance with generally accepted accounting principals, after taking into account unrealized profits and unrealized losses on such transactions; and (9) neither "Q", "R", "S", "T", nor any of their principals or officers is subject to a statutory disqualification under sections 8a(2) or 8a(3) of the Act.<sup>18/</sup>

Accordingly, the Division will not recommend that the Commission take any enforcement action against "R", "S", or "T", nor any of their principals or officers, for failure to register as CPOs in connection with their operation of "Q" with respect to the commodity interest transactions as described herein.<sup>19/</sup>

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<sup>18/</sup> 7 U.S.C. § 8a(2) or 8a(3) (1994).

<sup>19/</sup> Cf. Rule 4.5, which provides relief from CPO registration for an otherwise regulated investment company in connection with the operation of the investment company as a "qualifying entity" pursuant to specified criteria, including the use of commodity  
(continued...)

You also ask the Division to grant "R" and "S" relief from CTA registration in connection with commodity interest trading advice rendered to "Q". As noted, under the provisions of the Operating Agreement, "R" has sole discretion to control the agreements entered into on behalf of "Q". Pursuant to such discretion, "R" has delegated to "S" the authority to make investment decisions on behalf of "Q", including its commodity interest transactions. To the extent that "R" has the authority to select "Q's" trading advisors and, as provided above, is not required to register as a CPO, it would appear that both "R" and "S" would be required to register as CTAs, notwithstanding that "R" is delegating such authority to "S".

In support of the request for relief from CTA registration, you further represent that neither "R" or "S" provides commodity interest trading advice to any other persons or holds itself out generally to the public as a CTA. Based upon the representations you have made to us, the Division will not recommend that the Commission take any enforcement action against "R" or "S" for failure to register as a CTA in connection with providing commodity interest trading advice to "Q" as described herein.<sup>20/</sup>

You should be aware that the positions taken in this letter do not excuse "Q", "R", "S" or "T" from compliance with any otherwise applicable requirements contained in the Act or in the Commission's regulations issued thereunder. For example, each remains subject to the antifraud provisions of Section 40 of the Act,<sup>21/</sup> to the reporting requirements for traders set forth in Parts 15, 18, and 19 of the Commission's regulations, and to the operational provisions of Rules 4.20 for CPOs and 4.30 for CTAs and the advertising requirement of Rule 4.41 for both CPOs and CTAs.

This letter is based upon the representations provided to us and is strictly limited to those representations. Any different, changed or omitted facts or circumstances might require us to reach

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<sup>19/</sup> (...continued)

futures or options contracts for bona fide hedging purposes, with an allowance of up to five percent of the liquidation value of the qualifying entity's portfolio for other than bona fide hedging purposes.

<sup>20/</sup> Cf. Rule 4.14(a)(5), which provides that a person is not required to register as a CTA where it is exempt from registration as a CPO and where "the person's commodity trading advice is directed solely to, and for the sole use of, the pool or pools for which it is so exempt."

<sup>21/</sup> 7 U.S.C. § 60 (1994).



a different conclusion. In this connection, we request that you notify us immediately in the event the operations of "Q", including the restrictions on the use of commodity interest contracts as described herein, change in any way from those as represented.

The views expressed herein are those of the Division only and do not necessarily represent the views of the Commission or of any other office 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) 418-5450.

Very truly yours,

Susan C. Ervin  
Chief Counsel