CFTC Letter No. 97-83

September 5, 1997

Division of Trading & Markets

Re: Section 4m(1) -- Request for no-action relief from commodity pool operator (CPO) registration requirements for U and the members of the Board of Managers of the Fund in connection with the operation of the Fund

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Dear :

This is in response to your letter dated July 10, 1997, to the Division of Trading and Markets (the Division) of the Commodity Futures Trading Commission (the Commission), as supplemented by the July 18, 1997 telefacsimile transmission of H of your office and by telephone conversations with Division staff. By this correspondence, you request no-action relief from the requirement of Section 4m(1) of the Commodity Exchange Act (the Act[1]) to register as a commodity pool operator (CPO) for U which is a registered commodity trading advisor (CTA) and registered investment adviser, and for each of the members of the Board of Managers of (the Fund) in connection with the operation of the Fund.[2] Because the Fund will trade commodity interests, absent relief one or more of the members of the Board of Managers would be required to register as a CPO, and because extensive operational and management authority has been delegated by the Board of Managers to U as described below, U would also be required to register as a CPO.

Based upon the representations contained in the correspondence, we understand the pertinent facts to be as follows. The Fund is a Delaware limited liability company organized in the last quarter of 1996, and it was closed to new investors June 6, 1997. Its purpose is to provide diversification and professional investment management to persons who have substantial holdings of equity securities which have accrued relatively large unrealized capital appreciation or which are subject to transfer or disposition restrictions under the Securities Act of 1933 (the Securities Act).[3] Participants subscribe by contributing securities acceptable to U with an aggregate value of at least $1 million, in exchange for units of participation in the Fund.[4] The Fund has approximately $70 million in assets.

The units of interest in the Fund were offered and sold in a private placement to accredited investors as defined in Regulation D[5] under the Securities Act. The Fund entered into agreements with V and W pursuant to which V and W (both of which are registered as broker-dealers with t Securities and Exchange Commission (SEC)) would act as co-placement agents for the Fund.

Solicitation of participants in the Fund commenced in early 1997. Prospective participants were selected from among the existing clients of V and W and their respective affiliates in such a manner that the securities contributed to the Fund by the participants had characteristics similar to the basket of stocks upon which the Standard & Poor s 500 Composite Stock Price Index is based (the S&P 500).

The Fund s investment objective is to achieve long-term investment returns similar to the returns achieved by the S&P 500, while deferring recognition of capital gains on the securities contributed by the participants. In addition to the contributed securities, the Fund also purchases and holds shares of non-publicly traded preferred stock.[6] All dividends and additional securities (e.g., shares received as a result of stock splits) belong to the Fund and are reinvested.

The Fund may use various techniques intended to improve its tracking of the performance of the S&P 500, including purchase and sale of stock index futures contracts and options on such futures contracts, options on stock indices, options on baskets of stocks, options on individual stocks, and swap transactions. The Fund may also enter into what you describe as dividend and interest rate hedging arrangements in connection with preferred stock investments, including interest rate futures contracts, dividend and interest rate swaps, caps, floors and collars.[7] You state that the Fund s intention to trade commodity interests is disclosed to investors in the private placement memorandum.

The members of the Fund s Board of Managers are A , B , C , and D ,[8] are current and/or retired officers or directors of Fortune 500 corporations[9] and each serves as trustee on the board(s) of other fund(s) advised by U . No member of the Board of Managers is subject to statutory disqualification under Section 8a(2) or 8a(3) of the Commodity Exchange Act (the Act).[10] In accordance with the Fund s Limited Liability Company Agreement, the Board of Managers has delegated extensive authority to U , including the day-to-day management of the business, affairs, operation and assets of the Fund (subject to the overall direction of the Board of Managers). U provides advice and management with respect to the Fund s investment portfolio, furnishes all necessary office space, facilities, equipment and personnel for servicing the Fund s securities portfolio, and pays the salaries and fees of all U personnel who perform services relating to research, statistical and investment activities for the investment portfolio. U also provides facilities for maintaining the Fund s organization.

U receives a management fee on a quarterly basis in an amount equal to 0.75% per annum of average daily gross assets. Out of that management fee, V and W , each as co-placement agent of the Fund, receive a service fee based upon the aggregate contributions of the participants that V or W , respectively, brought into the Fund.

Each of the individuals who manages the Fund s portfolio is an officer of both U and Y) (both U

and Y are wholly-owned subsidiaries of Z[11]). E and F manage the Fund s equity portfolio and G manages the preferred securities portfolio.[12] F and E and G are Vice Presidents of U and Y .

During the first five years of the Fund s operation, any participant who withdraws from the Fund (subject to restrictions as to timing) will receive the securities that the participant contributed (together with any cash adjustment necessary to equate the value of the returned securities to the value of the redeemed units). After five years, a participant redeeming his units will receive the then current value of such units in the form of securities contributed by any or all of the Fund s participants (and not necessarily the same securities the redeeming participant originally contributed).

In support of your request you state that the Fund s commodity interest trading will be restricted as provided in Rule 4.5(c)(2)(i). You further state that U (as a Commission registrant) is willing to accept joint and several liability for any violation of the provisions of the Act or of Commission regulations applicable to CPOs by the members of the Board of Managers in connection with the operations and activities of the Fund.

Rule 4.5 was adopted by the Commission in response to a Congressional directive to provide relief from CPO regulation for certain otherwise regulated persons that use commodity interests to a limited extent in operating investment vehicles that are not marketed as commodity pools.[13] You have represented that U s commodity interest trading on behalf of the Fund will adhere to the investment restrictions set forth in Rule 4.5. U is subject to regulation as a CTA and as a registered investment adviser. Z and its subsidiaries (including U and Y) are variously subject to one or more of the regulatory frameworks established in the Securities Act, the Securities Exchange Act of 1934,[14] the Investment Advisers Act of 1940,[15] the federal banking laws and other statutory provisions. Moreover, and as noted above, but for banking law restrictions, the Fund could have been structured as a Rule 4.5 qualifying entity and managed as a separate unit of investment for which Y was acting as a fiduciary (as described in Rule 4.5(b)(3)) by placing Y personnel in control of the Board of Managers. Finally, persons who are dual officers of both U and Y (F and G and E) manage the Fund s portfolio.

Subject to the condition set forth below and based upon the foregoing representations, specifically that: (1) U is and will remain registered as a CTA with the Commission and as an investment adviser with the SEC for the duration of the Fund; (2) that only existing clients of Z and V were solicited to participate in the Fund; (3) the Fund is closed to new participants; (4) participants contributions consisted of equity securities encumbered by transfer restrictions or with substantial unrealized capital appreciation; (5) the Fund is constructed to mirror the performance of the S&P 500 by assembling the stocks comprising the S&P 500; and (6) commodity interest trading is restricted in the manner set forth in Rule 4.5(c)(2)(i), the Division will not recommend that the Commission take any enforcement action against U or any of the members of the Fund s Board of

Managers solely on the basis of their failure to register as CPOs in connection with the operation of the Fund.[16] This position is, however, subject to the condition that within thirty days of the date hereof U provides the Division with a written acknowledgment whereby U agrees to be jointly and severally liable for any violation of the Act or the Commission s rules by any of the members of the Fund s Board of Managers committed in connection with the operation of the Fund.

This letter does not excuse U or the members of the Fund s Board of Managers from compliance with any other applicable requirements contained in the Act or in the Commission s regulations issued thereunder. For example, each remains subject to the antifraud provisions of Sections 4b and 4o of the Act,[17] to the reporting requirements for traders set forth in Parts 15, 18 and 19 of the Commission s rules, and to all otherwise applicable provisions of Part 4.

This letter is based upon the representations made to us. Any different, changed or omitted facts or circumstances might require us to reach a different conclusion. In this connection, we request that you notify us immediately in the event that the operations or activities of U , the Board of Managers or the Fund (including the Fund s membership composition) change in any respect from those as represented to us. Further, the no-action position taken in this letter represents the views of this Division only and does 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 Christopher W. Cummings, an attorney on my staff, at (202) 418-5450.

Very truly yours

Susan C. Ervin

Chief Counsel

[1] 7 U.S.C. § 6m(1) (1994).

[2] You request, alternatively, that the Division treat U and the Fund as eligible for the relief made available to certain otherwise regulated entities by Commission Rule 4.5. In light of the position taken herein, it has been unnecessary for us to consider separately the merits of this request. Commission rules referred to herein are found at 17 C.F.R. Ch. I (1997).

[3] 15 U.S.C. § 77a et seq. (1994). You state that, in the case of restricted securities, legal opinions from counsel to the issuers have been obtained to the effect that contribution of such securities to the Fund by the holders thereof is not a violation of the Securities Act or the regulations promulgated thereunder. The Division expresses no opinion with respect to the application or effect of relevant securities or tax law provisions or requirements to the facts presented.

[4] This minimum subscription amount may be waived by U in its sole discretion.

[5] 17 C.F.R. § 230.501-230.508 (1997).

[6] Preferred stock will be purchased with borrowed funds, and repayment of such borrowings will be made out of dividends received on the Fund s portfolio and from returns on the Fund s investment activities.

[7] You state that such techniques will be employed as part of non-speculative strategies that come within the meaning and intent of the term bona fide hedging transactions and positions in Rule 1.3(z)(1).

[8] The members of the Board of Managers were selected initially by U in the course of the Fund s formation. Members of the Board of Managers may be removed only by vote of a majority of the members of the Fund.

[9] B is formerly an officer and director of Z and of Y .

[10] 7 U.S.C. §§ 12a(2) and 12a(3) (1994).

[11] Y is a commercial bank chartered under the laws of the State of New York. You state that but for restrictions imposed by banking law, the Fund could have been structured with a Board of Managers consisting of Y personnel, and the Fund could have been treated as a qualifying entity as defined in Rule 4.5(b). However, if the board were so structured, under the Bank Holding Company Act of 1956 (12 U.S. C. § 1841 et seq. (1994)) the Fund s securities and other positions would be treated as proprietary positions of Z . This and other restrictions would have made operation of the Fund unworkable.

[12] Both of E and F are registered as associated persons (APs) of U . Although G is not registered with Commission in any capacity, because he is expected to employ commodity interest trading strategies to manage interest rate risk in connection with managing the Fund s preferred securities portfolio, in support of the request U has represented that G will be registered as an AP of the firm prior to G employing such strategies for the Fund.

[13] In connection with enactment of the Futures Trading Practices Act of 1982 (Pub. L. 97-444, 96 Stat. 2294 et seq. (1983)) the Senate Committee on Agriculture, Nutrition and Forestry (the Committee) considered amending the Act to exempt such persons from the CPO definition. In lieu of adopting such an amendment to the CPO definition, the Committee directed the Commission to issue regulations that would accomplish the same purpose. A fuller discussion of the genesis of Rule 4.5 is set forth at 50 Fed. Reg. 15868-15869 (April 23, 1985).

[14] 15 U.S.C. § 78a et seq. (1994).

[15] 15 U.S.C. § 80b-1 et seq. (1994).

[16] In response to staff inquiry you state that the Fund is the only entity for which U performs the functions described in this letter involving commodity interest trading.

[17] 7 U.S.C. § 6b and 6o (1994).