

CFTC Letter No. 97-86**September 15, 1997****Division of Trading & Markets**

Re: Rule 4.7(a); Request for no-action relief to permit the CPO of a Rule 4.7(a) exempt pool to accept as a participant an entity comprised of knowledgeable employees.

Rules 4.21-4.26; Request for relief from CPO disclosure, reporting and recordkeeping requirements where the pool is an employee collective investment vehicle.

Dear :

This is in response to your letter dated June 10, 1997, to the Division of Trading and Markets (the Division) of the Commodity Futures Trading Commission (the Commission), as supplemented by your letters dated July 14, 1997 and August 5, 1997 and by telephone conversations with Division staff. By your correspondence, you request no-action relief permitting the Company as the commodity pool operator (CPO) of O , a pool as to which the Company has claimed exemption under Rule 4.7(a)),¹ to accept as a participant in O an investment vehicle that is not a qualified eligible participant (QEP) as set forth in Rule 4.7(a). You further request that the Division determine that such investment vehicle, P , is not itself a pool within the meaning of Rule 4.10(d)(1).²

Based upon the representations contained in your correspondence, we understand the pertinent facts to be as follows. The Company is registered with the Commission as a CPO, and its sole associated person (AP) and principal is A³ The Company operates O pursuant to a claim of exemption under Rule 4.7(a).⁴ Although the assets of O are principally invested in securities, it is expected that a portion of those assets will also be used to trade commodity interests for hedging or risk management purposes.

As set forth in your correspondence, P is to be formed as a limited liability company for the principal purpose of enabling employees of the Company to participate in the profits of the Company in a manner that results in favorable tax treatment from the employees perspective. The manager of P will be A and its members will be five designated employees of O (the Employees⁵). You represent that each of the Employees is a knowledgeable employee as defined in Rule 3c-5(a)(4),⁶ adopted by the Securities and Exchange Commission (SEC) under the Investment Company

Act of 1940 (the ICA⁷).

P will be admitted as a special general partner of O⁸ and substantially all of P's assets will be invested in O. As the managing general partner of O, the Company is entitled to receive as an incentive fee a portion of O's profits⁹. The Company intends to allocate a portion of that incentive fee to P and, as a result, the Employees will receive a participation in the incentive fee.¹⁰ Each employee participation has tax advantages to the extent that some or all of such participation is characterized as long term gain or unrealized appreciation.

You represent that participation in P is entirely voluntary and is not a condition of continued employment. Each member of P may contribute a maximum of \$1,000 as initial capital. Members will not be permitted to invest additional amounts; any increase in the value of a member's interest will be solely the result of appreciation in P's interest in O and the allocation of part of the Company's incentive fee, if any, to P, as described above. Upon formation, P will have total assets of \$5,000.

Because (1) P is not expected to have total assets in excess of \$5 million, (2) P is being formed for the purpose of investing in a Rule 4.7(a) exempt pool, and (3) not all of the members of P will be QEPs, absent relief, the Company's claim for exemption under Rule 4.7(a) with respect to O would be invalidated by the proposed admission of P.¹¹

You represent that pursuant to Section 3(c)(7) of the ICA¹² O is excluded from regulation as an investment company under the ICA, inasmuch as the Company has a reasonable belief that all of the investors in O are qualified purchasers (as that term is defined in ICA Section 2(a)(51)).¹³ You believe that O's eligibility for the Section 3(c)(7) exclusion will not be affected by the proposed participation of P in O because ICA Rule 3c-5 provides that securities beneficially owned by a knowledgeable employee (or a group of knowledgeable employees who form an entity to invest in a private investment fund) are not to be considered when determining whether the outstanding securities of a private investment company are owned exclusively by qualified purchasers.¹⁴ Thus, although neither P nor any of the Employees is a qualified purchaser, O may accept P as proposed and still use the exclusion provided by ICA Section 3(c)(7).

When it added the Section 3(c)(7) exclusion to the ICA, Congress provided for investment by knowledgeable employees in companies excluded from ICA regulation by that exclusion. In Section 209(d)(3) of NSMIA, Congress directed the SEC within one year to:

prescribe rules pursuant to the [SEC's] authority under section 6 of the Investment Company Act of 1940 to permit the ownership of securities by knowledgeable employees of the issuer of the securities or an affiliated person without loss of the

exception of the issuer under paragraph (1) or (7) of section 3(c) of that Act from treatment as an investment company under that Act.¹⁵

Accordingly, effective June 9, 1997, the SEC adopted Rule 3c-5, which defines knowledgeable employee with respect to a company that would be an investment company but for the exclusion provided by ICA Section 3(c)(7) (a Section 3(c)(7) Company).

In addition to executive officers, directors, trustees, general partners, advisory board members or persons serving in similar capacities, the term knowledgeable employee includes an employee of a Section 3(c)(7) Company (or of an affiliated person who manages the Section 3(c)(7) Company s investment activities), who, in connection with his or her regular duties, participates in the investment activities of the Section 3(c)(7) Company, other Section 3(c)(7) Companies, or investment companies which are advised by an affiliated person of the Section 3(c)(7) Company. Such an employee must have been performing such functions and duties (or substantially similar functions or duties for another company) for at least twelve months. An employee performing solely clerical, secretarial or administrative functions is not a knowledgeable employee.¹⁶

Each of the Employees is employed by O , the Rule 4.7(a) exempt pool in which P seeks to become a participant, and (with the exception of B) until June 1997 each was employed by Q , another investment fund of which A is a general partner and the registered CPO.¹⁷ You have provided the following information concerning the name, business background and professional experience of each of the Employees:

1. C is engaged in equity, options and futures trading for O . She was employed in the same capacity by Q from December 1991 to June 1997. From June 1989 to November 1991, C was employed by R where she traded listed equities. She was employed by and traded listed securities and options for S from March 1976 to June 1989, and from November 1972 to March 1976 she was employed by and traded options on behalf of T . C has an MBA in Finance from RR.
2. D is engaged in management of foreign exchange risk exposure for O through the use of derivatives and cash instruments. He was employed in the same capacity by Q from January 1994 to June 1997. Before joining Q , D worked for U from June 1990 to December 1993 as a senior options trader managing portfolios in energy products and foreign exchange, and for V from September 1983 to June 1990 as a Vice President and Options Trader. He has a J.D. from SS .
3. E is employed by O to trade cash, futures and derivatives in foreign exchange and related markets. From May 1997 to June 1997, he was employed by Q in the same

capacity. From May 1993 until May 1997, E was employed by X, a hedge fund manager with \$100 million under management, as head of execution. His work was primarily focused on foreign exchange and related markets, trading cash, futures and derivatives. From 1991 to 1993 he was employed by U as an assistant trader and institutional salesman, and from 1988 to 1991, he was employed by Y as an analyst in the LBO group. E has an A.B. magna cum laude from TT.

4. F is employed by O as an equity research analyst, and he was employed by and worked for Q in that capacity from February 1996 to June 1997. From October 1993 to February 1996, he was employed as an analyst in the research department of Z, and from 1992 to 1993 he was employed by OO in the equity research department. F has a B.A. in Economics from UU and was the VV Scholarship winner.

5. B is employed by O as a research analyst. From June 1993 through June 1997 he was employed as an analyst for PP and from September 1988 through April 1991, he was employed as a commercial loan officer by QQ. Between leaving QQ and going to work for PP, B earned an M.B.A. degree from WW.

C and D are believed to be accredited investors, as defined in Regulation ¹⁸ D under the Securities Act of 1933.¹⁹ E, F and B are not believed to be accredited investors, but each has an annual income in excess of \$100,000.

You represent that the Company will distribute to P all information and reports required to be delivered to participants in O as a Rule 4.7 exempt pool. Copies of such information and reports will be provided separately to each Employee holding an interest in P. In addition, P will provide to each Employee Schedules K-1 and annual financial statements for P. Each of the Employees will consent to being treated as a QEP. No management or incentive fees will be charged to P on account of its participation in O, and no such fees will be charged to the participants in P.

Based upon your representations, the Division believes that granting the requested relief would not be contrary to the public interest or the purposes of Rule 4.7. Accordingly, subject to the condition set forth below, the Division will not recommend that the Commission take any enforcement action against: (1) the Company based solely upon the admission of P as a participant in O; or (2) A based solely upon his failure to comply with the specific requirements of Rules 4.21 through 4.26 in connection with the operation of P.²⁰ The no-action positions taken in this letter are subject to the condition that no additional members be admitted to P without the prior approval of the Division.²¹

This letter does not excuse A or the Company 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 4c of the Act,²² 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 and is subject to compliance with the condition set forth above. 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 A, the Company, P or O (including the membership composition of P) change in any respect from those as represented to us. Further, the no-action positions taken in this letter represent the views of this 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 Christopher W. Cummings, an attorney on my staff, at (202) 418-5450.

Very truly yours

Susan C. Ervin

Chief Counsel

¹ Commission rules referred to herein are found at 17 C.F.R. Ch. I et seq. (1997).

² Although your June 10, 1997 letter seeks confirmation that the Commission will not take or recommend enforcement against A, if he does not file a Section 4.7 notice and comply with the specific requirements of the [Commodity Exchange Act] not waived by Section 4.7 with respect to P, we are treating that request as a request on behalf of A for relief from the specific disclosure, reporting and recordkeeping requirements of Part 4 of the Commission's rules that would otherwise be applicable to A as the manager of P.

³ A is also registered individually as a sole proprietor CPO.

⁴ The notice of claim for exemption was filed with the Commission on May 27, 1997. O was formed in April 1997, and its first offering of limited partnership interests closed June 9, 1997.

⁵ It is contemplated that in the future participation in P may be offered to additional employees who meet the knowledgeable employee definition described below. A will not be a member of, or a participant in, P.

⁶ 17 C.F.R. § 270.3c-5(a)(4) (1997).

⁷ 15 U.S.C. § 80a-1 et seq. (1994).

⁸ O's partnership agreement provides for a class of general partner designated "special general partner" and further provides that a "special general partner" may not (1) vote on any decision or action a general partner is required or permitted to take; (2) manage or participate in management of the partnership's business or property; or (3) act on behalf of or bind the partnership. Although a "special general partner" is subject to the same liabilities as any other general partner of O, the partnership agreement provides that general partners are not personally liable for distribution or return of limited partner capital contributions (which distributions or returns are to be made solely from assets of O). The partnership agreement also provides for indemnification of general partners for any act or omission pursuant to the authority of the agreement that does not involve bad faith or willful misconduct. Moreover, you explain that because P is organized as a limited liability company (LLC), the maximum potential liability of an Employee for losses incurred by the LLC, will be the amount of the Employee's capital account in the LLC.

⁹ O's partnership agreement provides that net profits are allocated (a) to general partners and Group C limited partners based on 100% of the ratio of their capital accounts to the total partnership capital; (b) to Group A limited partners based on 90% of the ratio of their capital accounts to the total partnership capital; and (c) to Group B limited partners based on 80% of the ratio of their capital accounts to the total partnership capital. The remaining net profits are then distributed among the general partners (including P) in a manner determined by the Company on a purely discretionary basis. (Losses are shared by all partners on a straight pro rata basis.)

¹⁰ As manager of P, A will determine in his sole discretion the manner in which each of the Employees will share in such amount.

¹¹ See Rule 4.7(a)(1)(ii)(B)(2)(xi), which sets forth the criteria that a pool must satisfy to qualify as a QEP.

¹² Section 3(c)(7) was added to the ICA by the National Securities Markets Improvement Act of 1996 (NSMIA).

¹³ Generally, a "qualified purchaser" is an individual or a family-owned company that owns at least \$5 million in investments (as defined in ICA Rule 2a51-1(b)), or a person who owns and invests on a discretionary basis \$25 million or more in investments. A trust can be a qualified purchaser if the trustee and the settlor are qualified purchasers and the trust was not formed specifically to acquire securities of Section 3(c)(7) exempt entities. ICA Rule 2a51-1(h) provides that a "qualified purchaser" is a person who is within the definition or is reasonably believed by a Section 3(c)(7) company (or person acting on its behalf) to be within the definition. See 62 Fed. Reg. 17512, 17527-17528 (April 9, 1997).

¹⁴ ICA Rule 3c-5(b), 62 Fed. Reg. 17512, 17529.

¹⁵ As noted by the SEC, [t]he purpose of this provision appears to be to allow private funds to offer persons who participate in the funds management the opportunity to invest in the fund as a benefit of employment. 61 Fed. Reg. 68099, 68102 (December 26, 1996). Thus, unlike qualified purchasers, knowledgeable employees are not subject to any financial requirements.

¹⁶ Knowledgeable Employee is defined in ICA Rule 3c-5(a)(4) as follows:

(4) The term *Knowledgeable Employee* with respect to any Covered Company means any natural person who is:

(i) An Executive Officer, director, trustee, general partner, advisory board member, or person serving in a similar capacity, of the Covered Company or an Affiliated Management Person of the Covered Company; or

(ii) An employee of the Covered Company or an Affiliated Management Person of the Covered Company (other than an employee performing solely clerical, secretarial or administrative functions with regard to such company or its investments) who, in connection with his or her regular functions or duties, participates in the investment activities of such Covered Company, other Covered Companies, or investment companies the investment activities of which are managed by such Affiliated Management Person of the Covered Company, *provided that* such employee has been performing such functions and duties for or on behalf of the Covered Company or the Affiliated Management Person of the Covered Company, or substantially similar functions or duties for or on behalf of another company for at least 12 months.

Covered Company is defined in ICA Rule 3c-5(a)(2) as a Section 3(c)(1) Company or a Section 3(c)(7) Company.

Section 3(c)(7) Company is defined in Rule 3c-5(a)(6) as a company that would be an investment company but for the exclusion provided by section 3(c)(7) of the [ICA].

See 62 Fed. Reg. 17512, 17529.

¹⁷ As noted above, A also is the sole AP and principal of the Company, O's CPO, and the manager of P. As further noted above, O had its first closing and commenced operations in June 1997, at which time the Employees became employees of O.

¹⁸ 17 C.F.R. § 230.501-230-508 (1997).

¹⁹ 15 U.S.C. § 77a et seq. (1994).

²⁰ Although we do not address in this letter the specific disclosures required to be made to the participants in O , we note that the structural and compensation arrangements involving P and any potential conflicts of interest that may arise therefrom should, of course, be disclosed.

²¹ In light of this relief, it has not been necessary for the Division to consider separately your request that the Division determine that P is not a pool as defined in Rule 4.10(d)(1).

²² 7 U.S.C. § 6b and 6o (1994).