CFTC Letter No. 99-07

January 25, 1999

Interpretation

Division of Trading & Markets

Re: Section 4(d) of the Act -- Registration Requirements Applicable to Proposed Hedging Vehicle

Dear:

This is in response to your letter dated January 15, 1997, as supplemented by letters dated March 6, 1997 and February 16, 1998, to the Division of Trading and Markets ("Division") of the Commodity Futures Trading Commission ("Commission"), as well as by telephone conversations with Division staff, by which you requested the Division's opinion concerning the applicability of the Commodity Exchange Act[1] ("Act") to a business venture proposed by "X".

Based upon your correspondence, we understand the pertinent facts to be as follows. "X" is an Iowa-based corporation that provides consulting services to country grain elevators. "X" is not currently registered with the Commission in any capacity. It wishes to establish a new corporate division to provide grain producers with a means to market grain and to hedge price risks.[2] While you referred to this new division as "the hedging vehicle," you also stated that the hedging vehicle "will be synonymous with "X". Thus, we will refer to the hedging vehicle as "X" throughout this response.

Under the proposed program, "X" will market specific quantities of corn or soybeans on behalf of producers, as stipulated in the grain marketing agreement between the producer and "X". "X" will have authority to market the grain in any manner that it deems appropriate, including use of exchange-traded futures and option contracts, deferred delivery contracts, cash sales or other means. "X" will utilize marketing strategies that it believes are best suited for an individual client, and such strategies may vary from client to client.

"X's" grain-producer client will hold title to any grain assigned to "X" for marketing under the marketing agreement until such time that the grain is sold to a grain dealer and the title is transferred. However, you represent that the producer will provide "X" with a lien on any grain subject to the marketing agreement. You further state that "X" will perfect this security interest in the grain under applicable law and maintain such security interest until such time as "X" receives full payment from the grain producer for any costs incurred by "X" on behalf of the producer and for fees due it under the marketing agreement. Such settlement will occur after the grain is sold and has been delivered by the producer. Payment for any transaction made under the marketing agreement will be received in the name of "X". After such payment is received, "X" will reconcile its strategy costs, service fees and other transaction

expenses, which will be invoiced to and deducted from gross receipts received. The balance of any funds received on behalf of the producer will then be issued to the producer. Any balance due to "X" after settlement, or incurred or paid by "X" after settlement, will be billed directly to the producer and due in full in thirty days.

"X" may in some instances hedge the price risk for its producer-clients by using exchange-traded futures or option contracts. In such instances, "X" will place trades through an account opened in "X's" name at a futures commission merchant ("FCM"). "X" will have authority to initiate and terminate such hedging positions on behalf of a client. "X" does not, nor does it intend to, trade commodity futures or options contracts for its own account.

> "X" will finance such commodity futures or option positions, *i.e.*, "X" initially will be responsible for any margin or premium payment needed to open and maintain such positions. "X" will, however, maintain a settlement sheet for each of its clients on which "X" will post the costs (and profits) associated with any futures or options position opened on behalf of a client. Any costs associated with a position opened on behalf of a client will be invoiced to that client at the time of settlement. (Any profits associated with such position likewise will be credited to the client at the time of settlement.) "X" may use a single futures or options contract to hedge the grain of more than one client. In such cases, it appears that the costs or profits associated with the hedge would be assigned to each client on a per bushel basis.

"X" will keep on file a record of any marketing transactions undertaken on behalf of a client.[3] The record will detail the date of the transaction, the quantity and commodity involved, the type of transaction, the price and expiration date of the transaction, and the strategy costs, service fees or other transaction expenses incurred. "X" will provide each client with a monthly statement summarizing details of activity undertaken on behalf of the client and disclosing the status of marketed and unmarketed grain. The monthly report will "mark-to-market" transactions undertaken by "X" on behalf of clients.

The Act provides the Commission with "exclusive jurisdiction . . . with respect to accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an 'option', 'privilege', 'indemnity', 'bid', 'offer', 'put', 'call', 'advance guaranty', or 'decline guaranty'), and transactions involving contracts of sale of a commodity for future delivery . . . ."[4] To the extent that "X" intends to advise other parties on the use of commodity futures or options to hedge price risk or to engage in such transactions on behalf of its clients, it could be subject to numerous provisions of the Act or Commission rules. The following information provides only general guidance.[5] Therefore, we strongly recommend that, if you decide to pursue this matter further, you first consult with knowledgeable private counsel concerning these activities.

> Based upon the information provided to us, it appears that "X" would be required to register as an FCM to engage in commodity futures or options trades on behalf of clients

as described above. Section 1a(12) of the Act[6] defines an FCM as:

> . . . an individual, association, partnership, corporation, or trust that is engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market, and in or in connection with such solicitation or acceptance of orders, accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom.

By promoting its hedging services and trading futures or options on behalf of its clients, "X" would be promoting the use of futures and options by its clients and soliciting persons to trade futures or options contracts.[7] In addition, although "X" will initially be responsible for all margin and premium payments required to establish or maintain futures or options positions, "X's" customers ultimately bear the liability for the costs of such transactions. "X", therefore, would be extending credit to its clients in connection with its solicitation of futures or options orders. Thus, "X's" proposed activities would clearly bring it within the statutory definition of an FCM.[8] In turn, Section 4d of the Act[9] requires any person acting as an FCM to register as such. "X" would also be required to comply with all regulations applicable to FCMs including requirements that it maintain adequate levels of net capital, properly segregate customer funds, maintain accounts in the name of the customer and provide required risk disclosure statements to customers.[10]

Section 4k(1) of the Act[11] further requires that any persons associated with an FCM register as an "associated person" ("AP"). Commission Rule 1.3(aa) defines an associated person of an FCM as "a partner, officer or employee (or other natural person occupying a similar status or performing similar functions) [who is involved in] the solicitation or acceptance of customers' or option customers' orders (other than in a clerical capacity) or the supervision of any person or person so engaged." [12] Therefore, persons soliciting clients for "X's" hedging service or supervising such persons would be required to register as an AP of "X".

> We note that, even if "X" did not solicit discretionary authority to trade on behalf of clients but limited its activities to providing advice or guidance on using futures or commodity option contracts to hedge client price risks, "X" could still be required to register as a commodity trading advisor ("CTA") under the Act. Section 1a(5) of the Act[13] defines a CTA, *inter alia*, as "any person who for compensation or profit, engages in the business of advising others, either directly or through publications, writings, or electronic media, as to the value of or the advisability of trading in any contract of sale of a commodity for future delivery made or to be made on or subject to the rules of a contract market; any commodity option authorized [under the Act] . . . ." By advising clients on

strategies which use commodity futures or options contracts to hedge price risks, "X" would be engaged in activities within the statutory definition of a CTA.[14] In turn, Section 4m(1) of the Act[15] requires any person acting as a CTA to register as such.

"X's" proposed hedging services may raise other regulatory issues. For example, "X's" proposal to allow its customers to buy partial interests in exchange-traded futures or commodity option contracts presents questions as to whether "X" would be offering non-approved futures or commodity options contracts to these clients in violation of the Act and Commission rules. In the alternative, if "X" opened a joint account in the names of all its clients holding an interest in the same futures or option contracts (or carried such joint account itself if it were to register as an FCM), "X" may be required to register as a commodity pool operator ("CPO"). We also note that farm managers who have received discretionary authority from farm owners to contract directly with "X" to hedge farm production may be required to register as CTAs, or alternatively as FCMs, depending upon how the transactions are handled.[16]

This response is based upon the representations made to us. Any different, changed or omitted facts or circumstances might require us to reach a different conclusion. This response represents the views of this Division only and not necessarily the views of the Commission or any other office or division of the Commission. This letter provides general guidance only. It does not relieve you or "X" from any applicable requirements under the Act or Commission rules. Further, this letter does not provide any information or make any findings concerning the applicability of any law or regulation administered by any other federal agency, department or commission or of any provision of state law to your proposed business dealings. If you have any questions on this correspondence, please contact Thomas E. Joseph, an attorney on my staff at (202) 418-5450.

Very truly yours,

I. Michael Greenberger

Director

[1] 7 U.S.C. § 1 *et seq.* (1994).

2 The term "grain producers' would include farm management groups, which may manage any or all aspects of a farm's operations pursuant to a power of attorney from the farm owner, as well as individual producers of grain.

[3] "X's" marketing agreement states that "the word `transaction' includes any contract or commitment executed and/or entered into by "X" to facilitate marketing the grain pledged within this Agreement." The marketing agreement further indicates that "X" intends to charge a per bushel fee for each transaction undertaken on behalf of a client. (The amount of the fee is not specified in the sample agreement provided.) Thus, it appears that "X" will charge a fee for each futures or options position

entered into on a client's behalf.

[4] 7 U.S.C. § 2(i)(1994). Section 4c(b) of the Act, 7 U.S.C. § 6c(b) (1994), further provides the Commission with plenary authority to regulate commodity option transactions.

[5] This response addresses your questions concerning "X's" use of exchange-traded commodity futures or options contracts. It does not address the applicability of the Act or Commission rules to any other type of transaction that may be contemplated by "X".

[6] 7 U.S.C. § 1a(12)(1994).

[7] *See, e.g.*, CFTC Interpretative Letter No. 84-17, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,373 at 29,725 (October 2, 1984)("By advising its clients of the benefits of hedging in the futures markets and by trading the accounts of its clients who elect to hedge, the Company is both soliciting and accepting orders for the purchase and sale of contracts for future delivery.").

[8] Commission Rule 33.3 would require "X" to register as an FCM in order for it to solicit and maintain accounts for customers engaging in exchange-traded commodity option transactions. *See* 17 C.F.R. Part 33 (rules governing exchange-traded commodity options).

[9] 7 U.S.C. § 6d (1994).

[10] Commission Rule 170.15, 17 C.F.R. § 170.15, also states that each person required to register as an FCM must also be a member of at least one futures association registered under Section 17 of the Act, 7 U.S.C. § 21 (1994). Currently, the National Futures Association ("NFA") is the only such registered association. Therefore, "X" would also be required to become a member of NFA before offering the proposed hedging services.

[11] 7 U.S.C. § 6k(1)(1994).

[12] 17 C.F.R. § 1.3(aa)(1997).

[13] 7 U.S.C. § 1a(5)(1994). The Act provides an exclusion from the definition of a CTA for any FCM whose advisory services are offered in a manner solely incidental to its brokerage business. Thus, it does not appear that "X" would be required to register as a CTA if it were to register as an FCM.

[14] *See, e.g.*, CFTC Interpretative Letter No. 98-07, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,254 (January 22, 1998)(service which teaches farmers methodology for hedging would be a CTA).

[15] 7 U.S.C. § 6m(1)(1994).

[16] *See* CFTC Interpretative Letter No. 84-17, *supra* n.7. A farm manager who has authority to allocate its client's resources to a third party who will then engage in futures or options trading would be acting in a capacity similar to that of a "trading manager" for a commodity pool. The Commission has stated that "trading managers [for commodity pools] are CTAs." 60 Fed. Reg. 38146, 38153 (July 25, 1995) (discussing definition of "trading manager").