CFTC Letter No. 99-27

July 14, 1999

No-Action; Exemption

Division of Trading & Markets

Re: Request for Exemption from the QEP Criteria of Rule 4.7

Dear :

This is in response to your letter dated February 24, 1998 to the Division of Trading and Markets (the "Division") of the Commodity Futures Trading Commission (the "Commission"), as supplemented by your letters dated March 30, 1998, September 24, 1998, January 29, 1999 and May 24, 1999, your facsimile transmission dated February 12, 1999 and telephone conversations with Division staff. By your correspondence you request an exemption from the "qualified eligible participant" ("QEP") criteria of Rule 4.7[1] such that "X", a registered commodity pool operator ("CPO"), may claim the relief available under Rule 4.7 in connection with its operation of the "Partnership".

Based upon the representations made in your correspondence, we understand the facts to be as follows. "X" serves as the general partner and registered CPO of the Partnership, which is a limited partnership that invests primarily in a diversified portfolio of large capitalization common stocks that are publicly traded and registered under the Securities Act of 1933 ("'33 Act") and the Securities Exchange Act of 1934.[2] As of December 31, 1998, "X" had a net equity of $13,072,132 and the Partnership had capital of $88,395,802. All participants in the Partnership are "accredited investors" as that term is defined under Regulation D of the '33 Act. In addition, as of December 31, 1998, 93.6 percent of the capital of the participants in the Partnership was attributed to persons who are QEPs.

"X" would now like to have the Partnership trade commodity interests and would like to operate the Partnership pursuant to Rule 4.7. However, as noted above, not all of the participants in the Partnership are QEPs. In support of your request you represent the following:

> As a prerequisite to investment in commodity interests by the Partnership, the limited partners of the Partnership will approve an amendment to the Partnership's limited partnership agreement and consent to the creation of a

> Memorandum Account within the Partnership for purposes of allowing limited partners who are QEPs to participate in commodity interest transactions. At that time, the limited partners will be given the option of withdrawing from the Partnership. The Memorandum Account will be accounted for separately from other Partnership investments and will, in effect, create the equivalent of two classes of interests in the Partnership, to wit: partners who are prohibited from participating in commodity interest transactions ("Non-Commodity Partners") and partners who may participate in commodity interest transactions ("Commodity Partners"). Only limited partners who are QEPs will be permitted to become Commodity Partners or purchase Commodity Partner interests. Limited partners who do not qualify as QEPs will become Non-Commodity Partners. Non-Commodity Partners and Commodity Partners will have identical rights and obligations, with the exception that only Commodity Partners may participate in investments by the Partnership in commodity interests and, in turn, share in any profits or losses attributable to such investments.

To insulate the assets of the Fund that are allocable to the Non-Commodity Partners from any losses that may be incurred in connection with any commodity interest trading in which the Partnership may engage, "X" has negotiated an arrangement (the "Arrangement") with "Z", a registered futures commission merchant ("FCM"),[3] whereby in connection with the Partnership opening up a commodity interest trading account with "Z", the FCM will agree to limit its recourse against the Partnership with respect to this account to an amount no greater than the value of the assets of the Partnership that are allocable to partners who are QEPs.[4] To ensure that the Arrangement will be maintained, "X" will agree that no new commodity interest trading will be done in the Memorandum Account (other than for the purpose of closing out existing positions) if and for so long as the percentage of the capital of the Partnership that is attributable to those limited partners who are QEPs falls below 75 percent.[5]

In further support of your request, you represent that if the exemption is granted, "X" will prepare: (1) an amendment to the Partnership's Limited Partnership Agreement to create the Memorandum Account; and (2) a revised Private Placement Memorandum. Among other things, the Private Placement Memorandum will contain the following: (1) the disclosures required by Rule 4.7; (2) a discussion of the risks involved in trading commodity interests, along with a statement that the Partnership may use commodity interests solely for hedging and risk management purposes; (3) a discussion of the types of limited partners -- *i.e.*, QEPs -- who will be entitled to participate in the Partnership's

commodity interest trading; and (4) a description of the Memorandum Account and the Arrangement. "X" will then send these revised documents, along with an amendment to the Subscription Agreement that addresses QEP requirements, to all of the limited partners of the Partnership. A cover letter will explain the purposes of the changes. The cover letter also will request each limited partner to complete and return the Subscription Agreement and to indicate its acceptance as a limited partner of the revised Limited Partnership Agreement. Finally, the cover letter will provide each limited partner with the opportunity to withdraw from the Partnership as of the business day prior to the effective date of the changes.

In light of the foregoing, we believe that it would not be contrary to the public interest or the purposes of Rule 4.7 to grant your request.[6] This is because, taken together, the terms of the Memorandum Account and the Arrangement mean that the Non-Commodity Partners (*i.e.*, those participants who are not QEPs): (1) will not participate in investments by the Partnership in commodity interests; (2) will not share in any profits or losses attributable to such investments; and (3) will not have any Partnership assets allocable to them subject to claim by the Partnership's FCM. Accordingly, the Division confirms that "X" may claim the relief available under Rule 4.7 in connection with its operation of the Partnership and, under the authority delegated to it by Rule 140.93(a)(1), hereby exempts "X" from the requirement in Rule 4.7 that all participants in the Partnership be QEPs. This exemption is, however, subject to the condition that "X" comply with the disclosure, reporting and recordkeeping requirements of Rule 4.7 with respect to each participant in the Partnership.

This letter, and the exemption provided herein, are based upon the representations you have made to us and are subject to compliance with the condition set forth above. Any different, changed or omitted material facts or circumstances might render this exemption void. You must notify us immediately in the event the activities or operations of "X" or the Partnership change in any material way from those represented to us.[7] Further, this letter does not excuse "X" from compliance with any other applicable requirements contained in the Commodity Exchange Act (the "Act") or the Commission's rules issued thereunder. For example, it remains subject to all antifraud provisions of the Act and the Commission's rules, to the reporting requirements for traders set forth in Parts 15, 18, and 19 and to all other applicable provisions of Part 4.[8] Finally, this letter is applicable to "X" solely in connection with its operation of the Partnership.

If you have any questions concerning this letter, please contact Barbara S. Gold, Assistant Chief Counsel, at (202) 418-5450.

Sincerely,

I. Michael Greenberger

Director

[1] Commission rules referred to herein are found at 17 C.F.R. Ch. I (1999).

[2] "Y" serves as the Partnership's investment adviser. "X", "Y" and their affiliates serve as general partner and/or investment adviser to partnerships, mutual funds and separate accounts having aggregate gross assets in excess of $4 billion.

[3] With your May 24, 1999 letter you enclosed a copy of the Arrangement.

[4] This valuation will be done by "Y".

[5] Rule 1.56 prohibits an FCM from representing in any way that it will guarantee a customer against loss, limit the loss of a customer or not call for or attempt to collect margin from a customer. The Commission proposed and adopted Rule 1.56 in order to stop the practice of FCMs offering and entering into agreements that provided that the customer would not be responsible for *any* sums that exceeded the initial margin payments of a futures contract. The rule was based upon the Commission's belief that this practice threatened the safety of customer funds, created an incentive for the FCM to misuse customer funds and might be inherently deceptive. *See* 46 Fed. Reg. 11668 (February 10, 1981). Moreover, commenters on proposed Rule 1.56 noted that FCMs who engaged in this practice were in constant jeopardy of becoming undercapitalized and of being forced into bankruptcy as a result, unless they were extremely well-capitalized. They further noted that the FCMs likely to engage in this practice generally were the less-capitalized firms.

In contrast, with respect to the instant request, you have represented that "X" itself sought out the FCM with whom to enter into the Agreement; the FCM may use all of the assets of the Partnership that are allocable to limited partners who are QEPs to meet all of the margin calls in the Memorandum Account; as of December 31, 1998, 93.6 percent of the capital of the Partnership was attributable to QEP participants; "X", as the Partnership's general partner, remains responsible to the FCM for any deficits in the Memorandum Account; and as of December 31, 1998, "X" had a net equity of more than $13,000,000. We also note that the FCM with which the "X"commodity interest account, "Z", has been registered as an FCM since June 20, 1991 and as of December 30, 1998, had excess net capital of over $1 billion. Accordingly, while the arrangement might implicate Rule 1.56, based upon the terms of the Arrangement, the Division will not recommend that the Commission commence any enforcement action against "Z" for failure to comply with Rule 1.56.

[6] *See*, *e.g.*, CFTC Staff Letter No. 98-83, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶27,506 (December 14, 1998; CFTC Staff Letter No. 96-81, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶26,910 (November 1, 1996).

[7] In particular, if the percentage of capital in the Partnership attributable to persons who are QEPs materially decreases, the Partnership transacts business with a different futures commission merchant or the nature of the agreement between "Z" and "X" changes, the exemption granted herein likely would be void.

[8] Similarly, the no-action position taken herein is based upon the representations you have made to us. Any different, changed or omitted material facts or circumstances might render this position void and you must notify us immediately in the event the terms of the Arrangement change in any material way from those represented to us. Further, this letter does not excuse "Z" from compliance with any other applicable requirements contained in the Act and the Commission's rules and it is applicable to "Z" solely in its capacity as the FCM of the Partnership.