

CFTC Letter No. 00-01**November 30, 1999****Exemption****Division of Trading & Markets**

Re: Rule 4.7(b); -- Request to Treat Trust as a Qualified Eligible Client

Dear :

This is in response to the letter dated November 19, 1997 from "A",¹ to the Division of Trading and Markets ("Division") of the Commodity Futures Trading Commission ("Commission"), as supplemented by "A's" letter dated January 30, 1998, your letter dated January 20, 1999 and telephone conversations between "A" or you and Division staff. By this correspondence, on behalf of "P", a registered commodity trading advisor ("CTA"),² you request an exemption such that "P" may treat the "Trust" as if it satisfies the qualified eligible client ("QEC") criteria of Rule 4.7(b).³

Specifically, "P" seeks an exemption to permit it to treat the Trust as a QEC under Rule 4.7(b)(1)(ii)(B)(2)(xi). This rule provides for trusts and certain other collective investment vehicles to be QECs. Specifically, it requires that for a person to come within the QEC definition, the person must satisfy a portfolio requirement⁴ and four additional criteria: (1) the trust or other collective investment vehicle must have total assets in excess of \$5,000,000; (2) it must not have been formed for the specific purpose of opening an exempt account with the CTA; (3) its investment in the exempt account must be directed by a QEC or a QEP; and (4) all of its unit owners or participants in the trust, other than the CTA claiming relief, must be QEPs.⁵

Based upon the representations made in your correspondence, we understand the facts to be as follows. Pursuant to a claim for exemption filed under 4.7(b), "P", which comes within both the QEP and QEC definitions,⁶ provides commodity interest trading advice solely to QECs.⁷ "P" also provides securities trading advice to and manages, on a discretionary basis, the securities portfolio of the Trust. Though "P" has not yet invested any of the Trust's assets under its management in commodity interests, it would like to begin doing so primarily in order to manage the interest rate and foreign currency exposure arising from the securities investments of the Trust. "P" seeks confirmation that it may continue to claim an exemption under Rule 4.7(b) in connection with the

commodity interest trading advice it intends to provide to the Trust.

The Trust

The Trust was established in _____ as part of [a] plan of reorganization [arising from the] bankruptcy of the "Corporation". The Trust was established under the authority of the bankruptcy court and was assigned the liability for past and future claims against the Corporation. [Claimants], accordingly, were to be treated as "creditors" of the Corporation and were required to file claims with the Trust. One of the Trust's stated purposes was to enhance and preserve the Trust's estate in order to enable the trustees to provide for the payment of as many (present as well as future) claims as possible.

As of December 31, 1996, the Trust had total assets which exceeded _____.⁸

Administration of the Trust

The Trust is managed by a board of directors, the members of which have been selected for their ability to supervise prudently the Trust's investment and other activities and to select and oversee the Trust's financial advisors, including "P" * * *. The trustees are as follows:

(1) "B", who has been the chairman and managing trustee since 1992. "B" is an attorney with more than 25 years experience. Prior to his appointment as trustee, "B" worked in private practice specializing in corporate restructuring and the enhancement of shareholder value. Throughout his career, he has held executive positions and served as general counsel for several large multinational corporations.

(2) "C" who has been a trustee since December 1991. A law school graduate, "C" served as chairman and chief executive officer of a [commercial] firm. "C" also served as court-appointed trustee in the divestiture of several businesses pursuant to consent decrees or final orders involving the U.S. Department of Justice and the Federal Trade Commission.

(3) "D", who has been a trustee since 1992. "D", who holds a law degree and a Ph.D. in public law, is the former Chancellor of the "Q" public school system. He has taught law, business, political science and public administration on both the undergraduate and graduate levels. Currently, he is serving as the president of "R". Formerly, he was the dean

and a professor of law for “S”.

(4) “E”, a [former] California Superior Court Judge, who has been a trustee since the inception of the Trust. Prior to his appointment, “E” was the general counsel and vice president of the University of “T”. He has been a member of the Board of Regents of the University of “U”, and he has lectured and taught at the University of “T” and for various national and international institutes for the past 20 years.

The Claimants

* * * *

The [Trust] claimants have not been, and will not be, issued certificates of beneficial interest in the Trust nor are they referred to in the Trust Agreement as “beneficiaries” having an undivided *pro rata* (participatory) interest in the Trust. They do not make contributions or payments to the Trust, they do not directly or through a representative select the trustees or participate in the management of the Trust, and they have no direct rights in or claim to any incremental increases in the Trust’s corpus.⁹ Further, any investment income earned by the Trust can be dispensed in the sole discretion of the trustees and used to pay expenses and claims against the Trust. You thus assert that the claimants of the Trust are more like creditors of some portion of the Trust rather than “unit owners or participants” in the Trust.¹⁰ Accordingly, the Trust itself is not the type of collective investment vehicle referred to in Rule 4.7(b)(1)(ii)(B)(2)(xi).¹¹

The Trading

In support of your request, you represent that “P” will obtain the written consent of the Trust to be treated as a QEC and will provide the trustees with reasonable access to “P’s” management and to relevant financial records. In further support of your request, you assert that “P” will limit its trading of commodity interests in accordance with the following parameters:

(1) Trading in all cases by “P” will be solely incidental to the securities advisory services provided by “P” to the Trust. By way of example, “P” will use futures and futures options:

(a) for hedging and anticipatory hedging purposes;

(b) as surrogates for underlying cash market securities positions to enhance returns in situations where commodity interest trading is more cost-effective than trading the cash market securities; and

(c) to extend the duration of the Trust's portfolio. In this regard, you represent that the weighted duration of the managed portfolio may not vary by more than 1.5 years from the Trust's benchmark government bond index;¹²

(2) "P's" use of commodity interests will be restricted to unleveraged long positions in government bond and interest rate futures, such that the aggregate underlying commodity value of commodity interests will not exceed at any time 15% of the aggregate value of the Trust's assets under "P's" management; and

(3) "P's" use of commodity interests will comply with the aggregate margin and premium limitation set forth in the proviso to Rule 4.5(c)(2)(i).¹³

The Exemption

As discussed above, the Trust does not fit squarely within the definition of a QEC in Rule 4.7(b)(1)(ii)(B)(2)(xi), which includes non-business trusts and similar commingled vehicles.¹⁴ This is because of the unique characteristics of the Trust—*i.e.*, the fact that the claimants are not unit owners or participants *per se* in a collective investment vehicle.¹⁵ Unlike a conventional investment vehicle, the claimants have not invested in nor made contributions to the Trust. They do not select the trustees, they do not participate in the management of the Trust, and they have no right to participate in any decisions regarding the investment of the Trust *corpus*.

It is notable that "P", which provides securities trading advice and manages the Trust's securities portfolio, is both a QEP and a QEC. Additionally, the Trust is administered by a court-approved plan and managed by a board of directors, the members of which have been selected for their ability prudently to supervise the Trust's investment and other activities. Moreover, you have represented that "P" will obtain the written consent of the Trust to be treated as a QEC and will provide the Trust with reasonable access to "P's" management and to relevant financial records. We further note your representation that the

commodity interest trading will be solely incidental to the securities advisory activities on behalf of the Trust, and will comply with specified criteria concerning the aggregate underlying commodity value of all commodity interest positions and the aggregate initial margin and option premium limitation set forth in the proviso to Rule 4.5(c)(2)(i).

Based upon the foregoing representations, it appears that granting your request would not be contrary to the public interest or the purposes of Rule 4.7(b). Accordingly, by the authority delegated under Rule 140.93(a)(1), the Division hereby grants "P" an exemption permitting it to treat the Trust as a QEC and to continue to claim relief pursuant to Rule 4.7 (b) with respect to the Trust, notwithstanding its provision of commodity trading advice to the Trust.¹⁶ This relief, however, is granted on condition that "P" will limit its trading of commodity interests in accordance with the trading criteria set forth above, and, in particular, "P's" use of commodity interests will comply with the aggregate margin and premium limitation set forth in the proviso to Rule 4.5(c)(2)(i).

This letter does not excuse "P" from compliance with any otherwise applicable requirements contained in the Commodity Exchange Act (the "Act") or in the Commission's regulations issued thereunder. For example, "P" remains subject to all antifraud provisions of the Act and Commission regulations, the reporting requirements for traders set forth in Parts 15, 18, and 19 of the Commission's regulations, and all other provisions of Part 4. Moreover, this letter is applicable to "P" solely in connection with its providing commodity interest trading advice to the Trust, as discussed above.

This letter, and the exemption granted herein, are based upon the representations you have made to us and are applicable to "P" solely in connection with its serving as the CTA of the Trust. Any different, changed or omitted material facts or circumstances might render this exemption void. You must notify us immediately in the event the operations or activities of "P" and the Trust as stated above, including the amount committed by the Trust as initial margin and option premiums to establish commodity interest positions, change in any material way from those as represented to us.

If you have any questions concerning this correspondence, please contact Helene D. Schroeder, an attorney on my staff, at (202) 418-5450.

Very truly yours,

John C. Lawton

Acting Director

1 Subsequent to the filing of this letter, "A" ceased to be associated with your firm, and you assumed responsibility for pursuing this matter.

2 “P” also is registered as an investment adviser under the Investment Advisers Act of 1940.

3 While your letter was styled as a request for confirmation, we are treating it as a request for exemption under Rule 4.7(b). Commission rules referred to herein are found at 17 C.F.R. Ch. I (1999).

4 The portfolio requirement in Rule 4.7(b)(1)(ii)(B)(I)(i) is met with respect to any person who the CTA reasonably believes, at the time that person opens an exempt account with the CTA:

(i) owns securities (including pool participations) of issuers not affiliated with such client and other investments with an aggregate market value of at least \$2,000,000;

(ii) has had on deposit with a futures commission merchant, for its own account at any time during the six-month period preceding the date that person opens an exempt account with the commodity trading advisor, at least \$200,000 in exchange-specified initial margin and option premiums for commodity interest transactions;
or

(iii) owns a portfolio comprised of a combination of the funds or property specified in (i) and (ii) of this section in which the sum of the funds or property includable under (i), expressed as a percentage of the minimum amount required thereunder, and the amount of futures margin and option premiums includable under (ii), expressed as a percentage of the minimum amount required thereunder, equals at least one hundred percent. An example of a composite portfolio acceptable under this subparagraph (iii) would consist of \$1,000,000 in securities and other property (50% of (i) and \$100,000 in exchange-specified initial margin and option premiums (50% of (ii)).

The Commission adopted the portfolio requirement based in its belief that “investors who will not receive the specific disclosures required by Rule 4.21 should satisfy objective criteria that indicate a relatively high degree of investment acumen and resources.” 57 F.R. 34853, 34855 (Aug. 7, 1992).

5 This provision is derived from the definition of the term “accredited investor” in Rule 501 under the Securities Act of 1933, 17 CFR § 230.501 (1999), which defines an accredited investor as including “[a]ny trust, with total assets in excess of \$5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person as described in [17 C.F.R.] § 230.506(b)(2)(ii).” 17 C.F.R. § 230.501(a)(7). A sophisticated person under this provision includes each purchaser who “has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment.” In proposing Rule 4.7, the Commission noted that it was proposing a definition of QEP, and, by analogy, a definition of QEC, that was designed generally to include persons who qualify as accredited investors *and* who meet certain additional qualifications. 57 F.R. 3148, 3151 (Jan. 28, 1992).

6 “P” is a QEP under Rule 4.7(a)(1)(ii)(A)(4) because it is a registered CTA who has been registered and active as such for two years. Since “P” also acts for the account of QECs, it is a QEC under Rule 4.7(b)(1)(ii)(A).

7 Commission records indicate that “P” filed a Notice of Claim of Exemption on _____.

8 The Trust remains liable for the unpaid portion of the liquidated amount of each claim, only to the extent that assets will be available after paying all claimants the established 10% *pro rata* share of their claims.

9 Though the claimants do not participate in making the investment management decisions for the Trust, the Trust Agreement provides for a dispute resolution mechanism.

10 There is little likelihood that the Trust will have sufficient assets to pay all current and future claims in full. Upon receiving payment from the Trust, claimants are required to sign a release form that contains an acknowledgment that the claimant understands “it is very unlikely that [the claimant] will receive any additional settlement payments after the initial payment”

11 If the claimants were deemed to be the “unit owners or participants” of the Trust, instead of creditors, the Trust would not be a QEC under Rule 4.7(b)(1)(ii)(B)(2)(xi) because not all of the claimants are or will be QEPs.

As noted below, *infra* note 14, the Trust also is not a QEC under Rule 4.7(b)(1)(ii)(B)(2)(viii), the only other QEC category applicable to trusts, because it is not a business trust as specified thereunder.

12 It should be noted, that, in the context of the speculative limit rules, the Commission has observed that some or all of these particular trading strategies may qualify for an exemption from the speculative position limit rules as hedging or risk management activities. *See, e.g.*, 52 F.R. 34633 (Sept. 4, 1987) (“[I]f the fund manager intends to convert . . . funds into actual stock purchases, the position currently would be eligible for exemption from speculative limits as a hedge—in effect an anticipatory hedge”).

13 Rule 4.5(c)(2)(i), which provides an exclusion for certain otherwise regulated persons from the definition of the term CPO requires that commodity interests be used solely for *bona fide* hedging purposes within the meaning and intent of Rule 1.3(z)(1). In addition, with respect to positions in commodity interests that do not come within the meaning and intent of Rule 1.3(z)(1), the qualifying entity may represent that the aggregate initial margin and premiums required to establish such positions will not exceed five percent of the liquidation value of the qualifying entity’s portfolio, after taking into account unrealized profits and losses on any such contracts it has entered into.

14 You also claim that the Trust also does not fit within the definition of a QEC in Rule 4.7(b)(1)(ii)(B)(2)(viii), which includes corporations and business trusts, since beneficial interests in the Trust are not

divided into shares represented by certificates, and further, because the Trust, which was organized under “Q” law, is not operated for profit as is required of a business trust under “Q” law.

15 The claimants of the Trust are more like creditors of and not “unit owners or participants.”

16 In providing this exemption, we do not express any opinion concerning the appropriateness or the mix of the Trust’s investments, including the amount and purpose of commodity interest trading that “P” intends to engage in on behalf of the Trust.