

CFTC Letter No. 02-59

May 17, 2002

No-Action

Division of Trading and Markets

Re: Section 4m(1) of the Commodity Exchange Act

Dear :

This is in response to your letter dated June 21, 2000 to the Division of Trading & Markets (the “Division”) of the Commodity Futures Trading Commission (the “Commission”) on behalf of your client, the “Company,” as supplemented by additional correspondence^[1] and telephone conversations with Division staff.^[2] By your letter, you request an interpretation that the Company will be exempt from registration as a commodity trading advisor (“CTA”) pursuant to Rule 4.14(a)(1),^[3] based on the facts and circumstances described therein.

Facts

Based upon representations made in the aforementioned correspondence and conversations, as well as information provided by the Company to the Federal Energy Regulatory Commission (the “FERC”) in publicly available documents,^[4] we understand the facts to be as follows:

The Company was formed in 1998 by four electric generation and transmission cooperatives (“G&Ts”).^[5] The Company’s primary purpose is to act as an agent for the purchase and sale of power in the wholesale energy market.

The current members of the Company are “P”, “Q”, “R”, “S”, “T”, “U”, and “V”. Each member is a wholesale G&T that provides the electric requirements of the distribution cooperatives that it serves. The Company is organized as a for-profit company, with its profits divided among its members according to their proportion of ownership.

By order of [], the FERC accepted the Company’s rate schedule for filing, thereby authorizing the Company to act as a registered power marketer. As such, the Company is authorized to sell to its members, to sell to third parties at negotiated rates and terms, and to market, third-party capacity and energy. The Company does not, itself, own any generation or transmission facilities.

To assist member and non-member customers in managing their portfolios and enhancing reliability, the Company offers a full range of services, including contract management, scheduling, portfolio modeling, and energy execution services.^[6] The Company primarily markets its services to G&Ts and

retail distribution electric cooperatives that may or may not be affiliated with a G&T. While cooperative owned, cooperative focused, and cooperative principled, the Company also may provide its services to non-cooperative entities such as municipalities, public power agencies, investor-owned utilities, energy marketers, and other commercial or industrial customers.^[7] Each of its customers is or would qualify as an “eligible contract participant” as defined under Section 1a(12) of the Commodity Exchange Act (the “Act”).^[8] The Company does not, and does not plan to, provide or market its services to any commodity pool, passive collective investment vehicle, or any other entity not involved in electricity commerce.

With each of its members, the Company executes a “Bilateral Agreement” that governs the contractual relationship between the parties. For non-member customers, the Company executes a uniform “Service Agreement.” The services offered under both agreements are similar; however, the Company generally charges higher fees to non-member customers. Under both the Bilateral and the Service Agreements, a customer may select from among three different packages of services offered by the Company: Standard, Premium, and Energy Execution Services. Among the services offered in the Standard Services package are contract monitoring and compliance, credit analysis, portfolio modeling and settlement services. The Premium Services package includes consulting, commodity contract review and negotiation, and scheduling. The Energy Execution Services package includes short-term and long-term power transaction execution (potentially including transactions in energy futures) and short-term and long-term natural gas transaction execution and scheduling.

Within each package, each customer may designate the particular services that it wishes the Company to perform on its behalf. The Company will charge separate fees depending on how many service packages and which services within each package are selected. However, the Company will not perform Energy Execution Services for a customer that has not also contracted for Standard Services. Each fee will generally be a fixed fee, payable monthly; however, a customer may elect to pay a transaction-related, variable monthly fee for Energy Execution Services.^[9]

As noted above, the Standard Services package includes a portfolio modeling service. If a customer chooses to have the Company provide this service, the Company will create a custom-designed computer model of the customer’s energy portfolio, which takes into account the customer’s aggregate load, generation and contract positions. Using this model, the Company will determine the financial impact of various physical and financial events on the customer’s costs and risks. Through the capture, analysis, interpretation, and distribution of market information utilizing highly technical software applications, the Company will then develop specific hedge strategies for each customer, which may include recommendations to purchase or sell commodity options and/or electricity futures contracts.

The Company also may provide Energy Execution Services upon request, utilizing the hedging strategies developed through the portfolio modeling process to conduct power purchases and sales in the electricity forward and futures markets as agent for its customers. Any such transactions will be conducted pursuant to a power-of-attorney that gives the Company authority to make such trading decisions on the customer’s behalf. The Company will not take title to any electricity that it purchases on a customer’s behalf. Although the Company intends to primarily make power purchases and sales in

the forward electricity markets or through bilateral commodity option contracts, it may, in the future, also establish hedge positions in the energy futures markets for customers.^[10]

However, the Company would not buy or sell futures contracts on behalf of a customer unless explicitly authorized to do so by the customer. In this regard, the Company has explained that a futures or options trade for a customer would be executed based on a transaction request from the customer specifying pricing levels and stops. The Company would immediately report to the customer each trade made on its behalf. The Company would not hold customer funds to support any commodity interest orders placed on behalf of a customer. The customer would be expected to transfer any required funds to its futures commission merchant (“FCM”).^[11]

The Company has represented that any transactions involving electricity futures and options contracts would be incidental to the Company’s cash market activities. The Company has further represented that:

[The Company] does not offer trading services independent of [its] other services Any trading, cash or future, is directly linked to the overall strategic recommendations derived from the full mix of services performed. [The Company] is not a stand alone trading adviser. The commodity trading services are optional to a member and non-member, and must be selected before [the Company] will perform the service. As an example, a member of [the Company] could use all of the other services without electing, at its option, to use the commodity trading services. [The Company] does not advertise or market its commodity trading services separate from the other services it performs. Specifically, the commodity trading services are only one product in a basket of products being offered, all intended to stabilize and hedge the price of the electric product being offered.^[12]

Statutory and Regulatory Background

By developing unique hedging strategies tailored to the needs of its customers, as well as engaging in power purchases and sales involving commodity options or exchange-traded futures or options contracts on behalf of such customers, for a fee, the Company will be providing commodity interest trading advice to its customers for compensation or profit. Consequently, the Company will be a CTA.^[13] Section 4m (1) of the Act generally requires each person that comes within the CTA definition to register as such with the Commission.^[14] However, Rule 4.14(a)(1) provides an exemption from registration as a CTA for any person who is “a dealer, processor, broker, or seller in cash market transactions of any commodity (or product thereof) and the person’s commodity trading advice is solely incidental to the conduct of its cash market business.”^[15] The Company has requested an interpretation that it is exempt from registration as a CTA pursuant to Rule 4.14(a)(1).

This exemption, as originally issued in 1978 and then designated as Rule 1.71,^[16] exempted cash market dealers, processors, brokers, and sellers from the CTA registration requirement that was then applicable to persons rendering advice concerning the trading of cash commodities.^[17] In 1982, the statutory

definition of “commodity trading advisor” was amended to include only persons rendering advice with respect to trading in commodity futures contracts.^[18] Since that time, the Commission has applied the exemption to cash market dealers, processors, brokers, and sellers that come within the CTA definition currently set forth in the Act.

In a Statement of Agency Interpretation (the “Interpretation”) addressing registration requirements for certain feedlot operators, the Commission, applying the current CTA definition, stated that it believed that “the exemption [in Rule 4.14(a)(1)] may appropriately be applied to custom feedlot operators who in conjunction with their business activities as processors of cash commodities provide limited futures trading advice that is solely incidental to the conduct of such processing activities in the circumstances [described in the Interpretation].”^[19]

The Commission enumerated six criteria that were material to its determination that the “solely incidental” test had been met. Specifically, the Commission considered the commodity trading advice provided by the feedlot operator to be incidental to its cash market business, so long as such advice was:

- (1) [p]rovided solely to hedge the customer’s cattle being fed at such feedlot operator or to hedge grain purchases for the purpose of feeding such cattle;
- (2) not provided to customers other than customers employing the feedlot operator’s processing services;
- (3) provided at *de minimis* cost to the feedlot operator;
- (4) provided at no extra charge to any of its customers, *e. g.*, there should be no difference in the amount paid to the feedlot operator by different customers having the same volume of cattle processed through the feedlot if one customer uses advisory services of the feedlot operator and another customer does not;
- (5) provided without the feedlot operator soliciting customers for its advisory services or holding itself out generally to the public as a CTA; and
- (6) provided without restriction as to the customer’s choice of FCM.^[20]

Discussion

A determination as to whether the Company may claim an exemption from CTA registration under Rule 4.14(a)(1) requires a two-prong analysis. First, the Company must qualify as a “dealer, processor, broker or seller in cash market transactions of any commodity (or product thereof).” Second, the Company’s commodity trading advisory services must be “solely incidental to the conduct of its cash market business.”

Based upon representations made by the Company, the Division understands that the Company offers its customers a variety of services to assist them in providing electric power to end-users. Among the cash market services that the Company provides are reviewing and assisting in the negotiation and implementation of electricity contracts, analyzing the creditworthiness of counterparties, and scheduling and tracking electricity for delivery. The Company also may engage in the purchase and sale of electricity in the forward market as agent for its customers. The Division believes that these activities would qualify the Company as a “dealer, processor, broker or seller in cash market transactions” involving electric power.

Along with the various cash market services described herein, the Company also may provide commodity trading advice by developing specific hedging strategies for each customer. To implement those hedging strategies, the Company also may enter into commodity option contracts and/or exchange-traded futures and options contracts against its customers' forward power contract positions, pursuant to a power-of-attorney granted by the customer to the Company. These commodity trading advisory services are not offered independent of other services offered by the Company.

In analyzing whether the Company's CTA activities are "solely incidental" to its cash market activities, it is appropriate to consider the criteria set forth in the Interpretation within the broader context of the purpose and function of the Company.

Consistent with the criteria set forth in the Interpretation, the Company will provide commodity trading advice for the purpose of implementing specific hedging strategies for individual customers in connection with the cash market services provided by the Company. Transactions in exchange-traded futures and options contracts will be facilitated through an FCM of the customer's choice.

Notwithstanding these similarities, there are material facts that distinguish the Company's CTA activities from those of the feedlot operator discussed in the Interpretation. The Division notes that the various services offered by the Company are integrated so as to provide what is effectively "one-stop shopping" for cash market and related hedging services. In this regard, the Company describes itself in its marketing literature as "the nationally recognized energy marketing and risk management company for generation and transmission cooperatives . . . preserving the energy value chain by implementing balanced hedging strategies through the collection, analysis, interpretation, and distribution of market information."^[21] The Company also charges separate fees to customers that choose to utilize its Portfolio Modeling and Energy Execution services, rather than providing these services at no cost to the customer. Moreover, while the Company does not seek retail customers for its commodity trading advisory services, it nonetheless solicits customers for its advisory services and holds itself out generally to the public as a business that provides commodity trading advice.^[22]

The Division believes that the Company's commodity trading advisory services are distinguishable from those of the feedlot operator in that they are not offered merely as a limited, complimentary convenience to customers.^[23] Rather, the Company's commodity trading advisory services are an integral part of the multi-faceted services that are marketed by the Company. Thus, it is difficult to characterize the Company's commodity trading advisory activities as "solely incidental" to its cash market business in the same way as the feedlot operator's limited advisory activities were "solely incidental" to its cash market business.

Taking into consideration all of the facts and circumstances, the Division is unable to conclude that the Company's commodity trading advisory activities are "solely incidental to the conduct of its cash market business" within the meaning of Rule 4.14(a)(1). Consequently, the Division believes that the

Company is not eligible for the Rule 4.14(a)(1) exemption from CTA registration requirements.

Nevertheless, in view of all of the facts and circumstances presented, the Division believes that it is appropriate to take a no-action position with respect to the Company's failure to register as a CTA. This no-action position is based upon, in particular, the increased use of market-based pricing in newly deregulated wholesale and retail electricity markets, the corresponding increase in the need for risk management strategies to hedge cash market transactions, the Company's status as a FERC-regulated entity, and the representation that the Company's exchange-traded futures and options activities will be limited to hedging transactions on behalf of commercial entities that would qualify as eligible contract participants. The Division also has received documentation representing that none of the principals of the Company or any persons providing commodity trading advice to customers are subject to any of the statutory disqualifications from registration listed in Section 8a(2) or 8a(3) of the Act, 7 U.S.C. § 12a(2) or 12a(3). Accordingly, the Division will not recommend that the Commission commence any enforcement action against the Company based solely upon the Company's failure to register as a CTA under Section 4m(1) of the Act in connection with providing commodity trading advice to its customers, as described above.

Other Matters

This letter is applicable to the Company solely in connection with its provision of Portfolio Modeling and Energy Execution Services to entities involved in electricity commerce. It does not excuse the Company from compliance with any other applicable requirements contained in the Act or in the Commission's regulations issued thereunder. For example, the Company remains subject to all of the antifraud provisions of the Act and the Commission's regulations, to the reporting requirements for traders set forth in Parts 15, 18 and 19 of the Commission's regulations to the extent applicable, and to all otherwise applicable provisions of Part 4.

This letter and the no-action position taken herein are based upon the representations made by the Company. Any different, changed, or omitted material facts or circumstances might render this letter void. You must notify us immediately in the event that the operations or activities of the Company, including the range of services offered or the type of customer served, change in any material way from those represented to the Division. Moreover, this letter represents the position of the Division only and does not necessarily represent the views of the Commission or those of any other division or office of the Commission.

If you have any questions concerning this correspondence, please contact Phyllis Dietz, an attorney on my staff, at (202) 418-5430.

Very truly yours,

John C. Lawton
Acting Director

[1] The Division has received information by correspondence dated April 22, 2002, April 17, 2002, March 25, 2002, September 4, 2001, May 14, 2001, May 11, 2001, February 2, 2001, December 8, 2000, and October 30, 2000. In addition to your correspondence, the Division has received correspondence from “A”, the Company’s general counsel.

[2] Division staff have talked with you and “A”.

[3] Commission rules referred to herein are found at 17 C.F.R. Ch. 1 (2001).

[4] The Company is a public utility subject to FERC jurisdiction.

[5] A G&T is owned by its member distribution cooperatives and operates generating plants and transmission lines to supply power to the member cooperatives. A distribution cooperative is a non-profit, customer-owned electric company that purchases electric power at wholesale and distributes it to customers. There are currently 865 distribution and 60 G&T cooperatives in the United States that serve 35 million people in 46 states. *See* National Rural Electric Cooperative Association, “Facts About Electric Cooperatives” (visited April 29, 2002) <<http://www.nreca.org/coops/elecoop3.html>>.

[6] “Energy Execution Services” were originally called “Term Trading” in your letter dated June 21, 2000. The letter included a complete list of services provided by the Company to its customers and descriptions of each service.

[7] The Company currently provides limited services to one retail access electric services provider.

[8] 7 U.S.C. 1a(12).

[9] Specifically, the variable fee for Energy Execution Services will be based upon either 1) the lesser of a percentage of transaction notional amount or a percentage of transaction margins/savings realized, or 2) a rate per volume applied to the amount of volume transacted in excess of an annual volume threshold.

[10] It is the policy of the Company not to enter into hedging transactions on behalf of customers, without providing Standard Services under which controls and processes relating to trading, credit, contracts, and risk modeling are established.

[11] To date, one member of the Company has opened accounts with two FCMs and has given the Company trading authority; however, no trading activities related to that account have occurred.

[12] *See* letter dated October 30, 2000, at 3.

[13] Section 1a(6) of the Act, 7 U.S.C. § 1a(6), defines a CTA generally as any person who engages in the business of providing advice to others about the value or advisability of trading or using commodity futures or option contracts for compensation or profit.

[14] 7 U.S.C. § 6m(1). Section 4m(1), however, exempts from registration any CTA who, during the course of the preceding twelve months, has not furnished commodity trading advice to more than 15 persons and who does not hold himself out generally to the public as a CTA. In your letter of June 21, 2000, you state that because the Company has up until now provided services only to a small number of customers and has not publicly held itself out as a CTA, it has been exempt from registration under Section 4m(1). For the purposes of this no-action letter, we have not made any independent determination as to the validity of this claim.

[15] Rule 4.14(b) explains that “[f]or purposes of this section, ‘cash market transactions’ shall not include transactions involving contracts for the purchase or sale of a commodity for future delivery or transactions subject to Commission regulation under section 4c or 19 of the Act.”

[16] *See* 43 Fed. Reg. 32,291 (July 26, 1978). The following year, Rule 1.71 was amended and renumbered as Rule 4.13. *See* 44 Fed. Reg. 1918 (Jan. 8, 1979). In 1981, Rule 4.13 was amended and reorganized into Rule 4.13 (relating to commodity pool operators) and Rule 4.14 (relating to CTAs). *See* 46 Fed. Reg. 26,004 (May 8, 1981). The 1981 formulation of paragraph (a)(1) remains in effect today.

[17] *See* 43 Fed. Reg. at 32,291. To qualify for relief from CTA registration, the person's advice had to be “(a) directed solely to cash commodity transactions (as distinguished from commodity futures, commodity option or leverage transactions) and (b) incidental to the person’s business.” *Id.* At the time the Commission issued Rule 1.71, the definition of “commodity trading advisor” under section 2(a)(1) (A) of the Act included

any person who, for compensation or profit, engages in the business of advising others, either directly or through publications or writings, as to the value of commodities or as to the advisability of trading in any commodity for future delivery on or subject to the rules of any contract market....

[18] *See* Futures Trading Act of 1982 § 201, Pub. L. No. 97-444, 96 Stat. 2294 (1982). More specifically, the amendment deleted the phrase, “the value of commodities.” *Id.*

[\[19\]](#) See Statement of Agency Interpretation, 55 Fed. Reg. 3205, 3207 (Jan. 31, 1990).

[\[20\]](#) 55 Fed. Reg. at 3207. In construing the term “solely incidental,” the Commission has elsewhere stated:

There is no abstract numerical standard or percentage of business that defines the meaning of “solely incidental.” In analyzing this issue, the Commission looks to the nature of the business and the factual context in which the advisory services are rendered.

CFTC Staff Letter No. 94-29, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,020 at 41,288 (Mar. 15, 1994). See also CFTC Staff Letter No. 97-97, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,216 at 45,883, n.4 (Nov. 18, 1997) (citing CFTC Staff Letter No. 76-1, [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,135 at 20,907 (Feb. 26, 1976)).

[\[21\]](#) A marketing brochure was provided to the Division by letter dated May 14, 2001.

[\[22\]](#) See, e.g., CFTC Staff Letter No. 97-26 [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,026 (Mar. 26, 1997); CFTC Staff Letter No. 95-36 [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,377 (Nov. 23, 1994); CFTC Staff Letter No. 91-9 [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,189 (Dec. 26, 1991). In those letters, the Division staff expressed the view that “hold[ing] himself out generally to the public as a commodity trading advisor” includes such conduct as promoting advisory services through mailings, directory listings, and stationery, or otherwise initiating contacts with prospective clients. Unless a CTA restricts his clients to family, friends, and existing business associates, a CTA will generally be viewed as holding himself out to the public as a CTA.

[\[23\]](#) See generally CFTC Staff Letter No. 93-22 [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,698 (Mar. 3, 1993) (finding that a cotton warehouse that offered a program for delivering producers’ cotton against short cotton contracts on the New York Cotton Exchange “to attract cotton to Company’s facilities” qualified for an exemption from CTA registration under Rule 4.14(a)(1)).