



## U.S. COMMODITY FUTURES TRADING COMMISSION

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Division of Clearing and  
Intermediary Oversight

CFTC letter No. 05-19  
November 10, 2005  
Exemption  
Division of Clearing and Intermediary Oversight

Ananda Radhakrishnan  
Director

Re: Rules 4.21, 4.22 and 4.23  
“A” – Request for relief from certain Disclosure Document, recordkeeping and reporting requirements in connection with the operation of the “B”.

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Dear:

This is in response to your letter dated August 12, 2005, to the Division of Clearing and Intermediary Oversight (the “Division”) of the Commodity Futures Trading Commission (the “Commission”), as supplemented by your letters dated September 28, 2005 and October 4, 2005, August 29, 2005 presentation to Commission staff, e-mail messages, and telephone conversations with Division staff (the “correspondence”).<sup>1</sup> By the correspondence, you request, on behalf of “A”, a registered commodity pool operator (“CPO”), in connection with the operation by “A” of “B” (the “Fund”), certain relief from Commission Rules 4.21, 4.22 and 4.23<sup>2</sup> which concern, respectively, the disclosure, reporting and recordkeeping requirements applicable to registered CPOs.

The securities of the Fund (“Shares”) will be offered and sold to the public pursuant to an effective registration statement filed with the Securities and Exchange Commission (“SEC”) (the

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<sup>1</sup> The August 29, 2005 presentation included contributions from representatives of “C”, the “D”) and your law firm describing the proposed structure and operation of the Fund for the benefit of staff of the Division, as well as staff of the Division of Market Oversight.

<sup>2</sup> Commission rules referred to in this letter are found at 17 C.F.R. Ch. I (2005). They can be accessed through the Commission’s website: <http://www.cftc.gov/cftc/cftclawreg.htm>.

“Registration Statement”).<sup>3</sup> But unlike previous publicly-offered commodity pools, the Shares will be listed for trading on the “D”, and it is this fact that causes “A” to seek relief.<sup>4</sup>

### Background

Based upon the representations made in the correspondence, we understand the relevant facts to be as follows. The Fund is being structured, and will be offered and listed, in a manner substantially similar to an exchange-traded fund, or ETF.<sup>5</sup> The Fund will seek to track the performance of a futures index, the “E” (the “Index”), by trading the futures contracts that make up the Index, with the same proportionate weighting among contracts as is found in the Index. Shares will be issued in the first instance to “Authorized Participants” (certain registered broker-dealers who are also participants in the “F” in blocks of 200,000 Shares (“Baskets”), rather than directly to the public. Once the Registration Statement for Shares becomes effective, a retail investor will be able to purchase Shares from Authorized Participants or in the secondary market by placing an order with the investor’s own registered broker-dealer.

The initial public offering will involve the sale of Shares, on a maximum/minimum basis, to Authorized Participants. Consistent with customary practice in registered public offerings, during the period before the SEC declares the Registration Statement effective (the “pre-effective period”), Authorized Participants will have solicited interest and will have received purchase commitments from investors. Each of those investors will have acknowledged receipt of a preliminary prospectus, which will comply in full with the requirements for Disclosure

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<sup>3</sup> Prior to making the instant request, “A” filed the relevant offering materials for review with both the National Futures Association (“NFA”) and the SEC. By letter dated September 30, 2005, NFA stated that it had no further comments on the materials.

<sup>4</sup> In this regard, you have represented that “D” listing will not affect “A’s” obligation to comply with any other provision of the Commodity Exchange Act (the “Act”) or the Commission’s regulations issued thereunder applicable to CPOs in particular or to persons in general. The Act is found at 7 U.S.C. § 1, *et seq.* (2000), and also may be accessed through the Commission’s website: <http://www.cftc.gov/cftc/cftclawreg.htm>.

<sup>5</sup> Unlike a typical ETF, however, the Fund will trade indirectly through a second fund wholly-owned by the Fund and “A”. The purpose of this two-tiered structure is to permit the Fund, which as a commodity pool, would otherwise have to report its income to direct investors on a Form K-1, to provide information on a Form 1099 or substantially similar form, and thus in a format more akin to that given to ETF investors. This structure is not expected, however, to entail any material additional fees or costs for investors.

For the purpose of this letter the Division is treating both funds as a single commodity pool.

Documents in Part 4 of the Commission's rules,<sup>6</sup> and which "A" will update in accordance with Commission requirements.<sup>7</sup> Upon effectiveness of the Registration Statement, and assuming that purchase commitments have been obtained for the minimum number of Shares, Baskets will be issued to the Authorized Participants, who will sell the Shares comprising those Baskets to the investors who committed to purchase during the pre-effective period. "A" has informed the Division that the SEC considers the sale of Shares by the Fund to Authorized Participants and the resale of Shares by Authorized Participants to investors to be one offering by the Fund through the Authorized Participants, and that the Authorized Participants are acting as underwriters within the meaning of the federal securities laws. Accordingly, Authorized Participants selling Shares directly to investors under the foregoing scenario (*i.e.*, as underwriters) will be required to deliver a final prospectus in connection with each such sale.

To encourage the trading price of Shares to maintain a stable relationship with the Fund's net asset value, in the period following effectiveness of the Registration Statement, Authorized Participants are expected to create or redeem Baskets, depending upon whether purchasing or selling of Shares predominates in the secondary market. In addition, after effectiveness of the Registration Statement, investors will be able to buy and sell Shares freely on the "D".

Investors will be able to purchase Shares in three different contexts. First, during the pre-effective period, Investors who commit to purchase Shares will receive a preliminary prospectus and will acknowledge receipt thereof, all prior to actually purchasing their Shares. Second, upon effectiveness of the Registration Statement, if Authorized Participants decide to create additional Baskets, investors purchasing Shares from those Baskets will receive a prospectus, but after the purchase, at the time the investor receives a trade confirmation in accordance with usual custom in the securities industry pursuant to applicable provisions of federal securities laws and regulations. Third, an investor who purchases Shares on the "D" in the secondary market generally will not be provided a prospectus, but the same will be readily available.

## Discussion

### *Rule 4.21*

Rule 4.21(a) requires a registered CPO to deliver a Disclosure Document to prospective pool participants at or before the time the CPO delivers a subscription agreement for the pool. Rule 4.21(b) requires a CPO to obtain a signed and dated acknowledgment that a prospective

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<sup>6</sup> The Commission has stated that "[i]n those cases where a CPO chooses to provide a prospectus to prospective pool participants, the Commission will permit that prospectus to be supplemented to comply with the specific requirements of Rule 4.21." 44 Fed. Reg. 1918, 1922 (Jan. 8, 1979). You have represented that the Fund's preliminary prospectus will comply with the form and content requirements of Rule 4.21. Thus, for the purpose of this letter, the terms "preliminary prospectus," "prospectus" and "Disclosure Document" are equivalent.

<sup>7</sup> See, *e.g.*, Rule 4.26, which contains various Disclosure Document updating requirements.

pool participant has received a Disclosure Document before the CPO may accept money or other property in exchange for shares or other units of interest in the pool. The rule's purpose is "to protect pool participants – particularly those who are unsophisticated in financial matters – by ensuring that they are informed about the material facts regarding the pool before they commit their funds."<sup>8</sup>

The sale of Shares in the initial public offering will be conducted in compliance with Rule 4.21. To the extent, if any, that Authorized Participants may subsequently create additional Baskets and sell those Shares to investors, you claim that relief is required because investors purchasing Shares in these transactions will receive the Fund's prospectus/Disclosure Document after the actual purchase, at the same time that they receive the confirmation in accordance with usual custom in the securities industry pursuant to applicable provisions of federal securities laws and regulations. With respect to secondary market purchases on the "D", you conclude that "A" is not subject to Rule 4.21, a conclusion with which the Division agrees.<sup>9</sup>

In support of your request for relief from Rule 4.21, you state that the Internet websites maintained by "A", the Fund, the "D" and the SEC (the "Website Sources") will contain a current prospectus/Disclosure Document for the Fund.<sup>10</sup> Further in this regard, you state that virtually every prospective or actual investor is expected to utilize the services of a registered broker-dealer, who will direct them to the relevant website to access the current prospectus, or, upon request, will deliver a copy of the current prospectus.<sup>11</sup>

*Rules 4.22(a) and (b)*

Rule 4.22(a) requires a registered CPO to deliver to pool participants periodic unaudited Account Statements, which must include, among other information, Statements of Income (Loss) and of Changes in Net Asset Value. Rule 4.22(b) provides that Account Statements be delivered

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<sup>8</sup> 44 Fed. Reg. 1918, 1920 (Jan. 8, 1979).

<sup>9</sup> The CPO's obligation to deliver a Disclosure Document (and the requirement to obtain a signed acknowledgment of receipt) extends to the direct purchaser of units of participation, and not to persons who purchase from that purchaser. In this regard, the Commission has stated that, with respect to the transfer of a participation unit in a commodity pool, the CPO of the pool "is not required to provide a Disclosure Document (Rule 4.21) to a person who purchases a unit of participation or interest in the pool from a pool participant if the pool operator did not solicit the purchase." 44 Fed. Reg. 25658, 25659 (May 2, 1979).

<sup>10</sup> "A" similarly will comply with Rule 4.26 in connection with updating this prospectus/Disclosure Document.

<sup>11</sup> The only instances where the services of a registered broker-dealer would not be utilized would be where an investor has an account with a bank or trust company that is exempt from the requirement to register as a broker-dealer.

monthly for pools with net assets of more than \$500,000 and otherwise at least quarterly.<sup>12</sup> The purpose of these rules is to “ensure that participants have a reasonably current knowledge of the pool’s trading performance and operating costs.”<sup>13</sup>

An issuer of exchange-traded securities held in book-entry form through “F” (such as the Fund) usually does not readily know the identities of the investors who own those securities. You claim that it would be unduly burdensome and costly to require “A” to ascertain on a monthly basis the identities of purchasers of Shares in the secondary market in order to comply with the requirement under Rules 4.22(a) and (b) to deliver monthly Account Statements to shareholders in the Fund.<sup>14</sup> In this regard, you explain that, while publicly-offered commodity pools typically provide for redemption of shares no more frequently than monthly, because of the listing of the Fund’s shares on the “D”, ownership of the Fund’s shares is expected to change frequently on a daily basis.

In support of your request, you note that the same information that would otherwise be provided in the Fund’s monthly Account Statements, including the Fund’s net asset value and the certification required by Rule 4.22(h), will be readily available via the Website Sources, of which availability the Disclosure Document will advise participants.<sup>15</sup> You further state that the expense of delivering an Account Statement is about the same as the expense of delivering the Annual Report and that, if the requested relief is granted, the distribution expense of the Fund (an expense that is passed on to shareholders) will be approximately 1/12 of what it would be otherwise.

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<sup>12</sup> Rule 4.22(c) requires a registered CPO to distribute a certified Annual Report to pool participants. You have not requested any relief from Rule 4.22(c) in connection with the operation of the Fund, and, in fact, you represent that “A” will comply with Rule 4.22(c) in connection with its operation of the Fund. Delivery of the Annual Report is required once a year, whereas delivery of monthly Account Statements requires continuous monitoring of changes in ownership of shares.

<sup>13</sup> 44 Fed. Reg. at 1922.

<sup>14</sup> You make this request not only with respect to investors purchasing Shares in the secondary market, but also with respect to purchasers in the initial public offering. Once an investor has purchased Shares, whether directly from an Authorized Participant or on the “D”, they can be freely sold on the secondary market, and the same difficulties will be encountered in tracking the current owner.

<sup>15</sup> All information in the Fund’s Account Statements will be available on the Fund and “A” websites. The “D” website will link to the “A” and Fund websites for other financial information, including the Account Statements. Pursuant to Rule 4.22(h), a representative duly authorized to bind the CPO must sign an oath or affirmation that, to the best of the knowledge and belief of the individual making the oath or affirmation, the information contained in the Account Statement is accurate and complete. Each online equivalent of the Fund’s Account Statement will contain the oath or affirmation required by Rule 4.22(h).

*Rule 4.23*

Rule 4.23 specifies the types of books and records a CPO must make in the course of operating a pool, and requires that those books and records be kept at the CPO's main business address. The books and records must be available to pool participants for inspection and copying during normal business hours, and must be open and available for inspection by any representative of the Commission or the United States Department of Justice. The purpose of the rule is "to enable pool participants and the Commission to ascertain whether the CPO is dealing properly with pool funds."<sup>16</sup>

You have requested relief from the location requirement of Rule 4.23(a) such that books and records of the Fund may be kept by its administrator, the "G", a banking corporation subject to regulation by the "H" and the Federal Reserve Board, and, pursuant to delegation by "G", by "I", a registered broker-dealer that provides certain distribution-related services to the Fund (with respect to records related to Basket creations and redemptions and certain other functions).<sup>17</sup> You ask that "A" be permitted to comply with the location requirement of Rule 4.23 by having Fund books and records maintained at the offices of "G" and "I".<sup>18</sup>

You further ask for confirmation that neither "G" nor "I" will be deemed to be acting as a CPO solely by reason of keeping Fund records in the manner described in your correspondence, which the Division hereby so confirms. In this regard, the Division notes that neither firm will be acting in the manner contemplated by the statutory definition of a "commodity pool operator" – *e.g.*, neither will be promoting the pool by soliciting, accepting or receiving from others property for the purpose of commodity interest trading, and neither will have the authority to hire

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<sup>16</sup> 44 Fed. Reg. at 1922.

<sup>17</sup> Each of "G" and "I" has provided the Division with signed acknowledgments that Fund books and records may be inspected and copied by any representative of the Commission or the United States Department of Justice and may be inspected and copied during normal business hours by Fund participants. Included are schedules specifying the classes of books and records, by subparagraph of Rule 4.23, that each of "G" and "I" will be keeping.

<sup>18</sup> The full address of "G's" office at which Fund books and records will be kept is "J". The full address of "I's" office at which Fund books and records will be kept is "K". "G" will keep the books and records required by Rules 4.23(a)(2), (a)(3), (a)(4), (a)(5), (a)(6), (a)(7), (a)(8), (a)(10) and (a)(11). "I" will keep the books and records required by Rule 4.23(a)(9) and books and records of Basket creations and redemptions. You state that, for business continuity planning, security and general business planning reasons, these books and records may in the future be kept at different or additional "G" or "I" addresses. Disclosure of the "G" and "I" addresses at which Fund books and records are kept will be made to investors. "A" will keep the books and records required by Rule 4.23(a)(1).

(and to fire) the Fund's commodity trading advisor, and to select (and to change) the Fund's futures commission merchant.<sup>19</sup>

### Conclusion

Based upon the representations made in the correspondence, the Division believes that granting your request would not be contrary to the public interest and to the purpose of the rules at issue. Accordingly, pursuant to the authority delegated in Rule 140.93(a)(1), the Division hereby exempts "A" in connection with the operation of the Fund from: (1) the requirement of Rule 4.21(b) to obtain a signed acknowledgment of receipt of a Disclosure Document before accepting funds, securities or property from a prospective pool participant with respect to sales of Shares by Authorized Participants when Authorized Participants create additional Baskets, subsequent to effectiveness of the Registration Statement, provided that the information required to be contained in the Disclosure Document is maintained and kept current on the Website Sources; (2) the requirements of Rule 4.22 to deliver monthly Account Statements to purchasers of Shares, provided that the information that would otherwise be contained in such reports is maintained on the Fund and "A" websites; and (3) the requirement of Rule 4.23 to keep required books and records at "A's" main business office to the extent that such books and records are maintained at the offices of "G" or "I". Consistent with prior practice,<sup>20</sup> the exemption from the books and records location requirement of Rule 4.23 is subject to the conditions that: (1) "A" notify the Division if the location of any of the books and records required to be kept by Rule 4.23 changes from that as represented to the Division; (2) "A" remain responsible for ensuring that all books and records required by Rule 4.23 are kept in accordance with Rule 1.31 and for assuring the availability of such books and records to the Commission, NFA, and any other agency authorized to review such books and records in accordance with the Act and Commission regulations; (3) within forty-eight hours after a request by a representative of the foregoing, "A" will obtain the original books and records from "G's" offices in "J" or from "I's" offices in "K", as the case may be, and will provide them for inspection at "A's" main business office in "J"; (4) "A" discloses in the Fund's prospectus that its books and records required under Commission Rule 4.23 are kept at "G's" offices in "J" and at "I's" offices in "K", and further discloses which books and records are kept at each location; and (5) "A" remains fully responsible for compliance with Rule 4.23.

This letter exempts "A" from Rules 4.21, 4.22 and 4.23 as stated above. It does not excuse "A" from compliance with any other aspect of the Commission's disclosure, reporting

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<sup>19</sup> See, 49 Fed. Reg. 4778, 4780 (Feb. 2, 1984) (Commission acknowledged staff practice of employing these criteria in determining whether a person is, or is not, a CPO); and CFTC Staff Letter No. 98-04 [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶27,251 (February 21, 1997) (Co-CPOs were permitted to keep some of their pools' books and records with an administrator, and the administrator was not deemed to be acting as a CPO for those pools.)

<sup>20</sup> See, e.g., CFTC Staff Letter No. 04-30 [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶29,912 (Oct. 22, 2004).

and recordkeeping requirements, nor does it excuse “A” from compliance with any other applicable requirements contained in the Act or in the Commission’s regulations issued thereunder. For example, “A” remains subject to Rule 1.31, and the Commission maintains its right under that rule to inspect the required books and records of “A” at “G’s” offices in “J” and at “T’s” offices in “K”. Additionally, “A” also remains subject to all 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, and to all other applicable provisions of Part 4.

This letter is based upon the representations made to us and is subject to the conditions set forth above. Any different, changed or omitted material facts or circumstances, including the failure of the Shares to be listed for trading on the “D”, might render this letter and the exemptions granted herein void. In this connection, you must notify us immediately in the event that the operations of “A” or the Fund change in any material way from those represented to us.

If you have any questions concerning this correspondence, please contact me or Christopher W. Cummings, Special Counsel, at (202) 418-5445.

Very truly yours,

Ananda Radhakrishnan  
Director

CWC: cc