COMMODITY FUTURES TRADING COMMISSION
2033 K Street, NW, Washington, DC 20581
(202) 254 - 8955
(202) 254 - 8010 Facsimile

DIVISION OF
TRADING AND MARKETS

95-66

July 19, 1995

Re: Rule 4.7(a)(1)(ii)(B)(2)(xi) -- Request for Relief from 10% Limit on Assets Invested in Exempt Pools by a Qualified Eligible Participant

Dear :

This is in response to your letter dated November 11, 1994 to the Division of Trading and Markets (the "Division") of the Commodity Futures Trading Commission (the "Commission"), as supplemented by letters of "A" dated November 23, 1994 and June 12, 1995, your memoranda dated December 14, 1994 and June 21, 1995 and by telephone conversations with Division staff ("the Correspondence"). By the Correspondence, you request relief from the restriction in Rule 4.7(a)(1)(ii)(B)(2)(xi)[1/] on the percentage of assets that a pool may invest in Rule 4.7 exempt pools where the investor pool is intended to constitute a qualified eligible participant ("QEP") but where some of the participants in the investor pool are not QEPs. You request this relief in connection with participation by "X" in "Y".[2/] The Correspondence also seeks confirmation that "Z", in operating "X" pursuant to a claim of exemption under Rule 4.12(b) (a "Rule 4.12(b) Pool"), may continue to multiply "X's" investment in "Y" by ten percent in

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1/ Commission rules referred to herein are found at 17 C.F.R. Ch. 1 (1994).

2/ By his November 23, 1994 letter "A" stated:

> "Y" and each of its general partners hereby concur in "X's" request for relief from the 10% ceiling. Please be advised, however, that neither "Y" nor its general partners (i) have received a copy of "X's" request to the CFTC seeking such relief, or (ii) make any representation regarding the accuracy or completeness of any statements contained in "X's" request.

determining whether "X" meets the ten percent commodity interest investment criterion of Rule 4.12(b)(1)(i)(C)[3/] notwithstanding the fact that "Y" currently is being operated as a Rule 4.7 exempt pool.

Based upon the representations made in the Correspondence, we understand the relevant facts to be as follows. "Z" operates "X" as a Rule 4.12(b) Pool.[4/] Approximately twelve percent of the assets of "X" are invested in "Y", which previously had been operated as a Rule 4.12(b) pool[5/] but, effective January 1, 1995, is being operated as a Rule 4.7 exempt pool. "Y's CPO"[6/] has stated its intention to require any partner of "Y" that does not qualify as a QEP to withdraw from participation in "Y". As is explained below, "X" does not qualify as a QEP because non-QEPs participate in "X" and more than ten percent of "X's" assets are invested in a Rule 4.7 exempt pool.[7/]

3/ Rule 4.12(b)(1)(i)(C) generally provides that the pool for which relief is being sought may not commit more than ten percent of the fair market value of its assets to establish commodity interest trading positions.

4/ Commission records indicate that "Z" filed a Rule 4.12(b) claim of exemption with respect to its operation of "X" on October 24, 1990.

5/ Commission records indicate that a Rule 4.12(b) claim of exemption for "Y" was filed on December 19, 1988, and a Rule 4.7 notice of a claim for exemption for "Y" was filed on December 5, 1994 (to be effective January 1, 1995). The filing of the Rule 4.7 notice supersedes the Rule 4.12(b) claim.

6/ "W" and "B" are the general partners of "Y". Both "W" and "B" are registered CPOs and they are collectively referred to herein as "Y's CPO."

7/ Nevertheless, "Y's CPO" has permitted "X" to continue to participate in "Y" at a level in excess of ten percent on the assumption that the relief requested in the Correspondence would be granted. Nothing herein excuses, or in any way limits the Commission's ability to proceed against "Y's CPO" for, any past violation of the Commodity Exchange Act (7 U.S.C. § 1 et seq. (1994), referred to herein as the "Act") or the Commission's regulations thereunder.

Request for Relief from Rule 4.7

"Y's CPO" has claimed exemption pursuant to Rule 4.7(a)(2), which requires that participations be offered or sold only to QEPs. A pool that meets the portfolio requirements of Rule 4.7(a)(1)(ii)(B)(1) may qualify as a QEP either pursuant to Rule 4.7(a)(1)(ii)(D), if all of its participants are QEPs, or pursuant to Rule 4.7(a)(1)(ii)(B)(2)(xi), if its assets exceed $5,000,000, it was not formed for the specific purpose of participating in Rule 4.7 exempt pools, its participation in Rule 4.7 exempt pools is directed by a QEP and no more than fifteen percent of its assets are used to purchase participations in Rule 4.7 exempt pools.

Approximately one-third of the participants in "X" are not QEPs, and more than ten percent of "X's" assets are invested in a Rule 4.7 exempt pool. Absent relief, then, "Y's CPO" may not treat "X" as a QEP because Rule 4.7(a)(1)(ii)(B)(2)(xi) restricts to ten percent the portion of the fair market value of a pool's assets which may be invested in Rule 4.7 exempt pools, if any of the participants in such pool are not QEPs.

"X" has seventy-seven participants. All but two of the non-QEP participants are accredited investors within the meaning of Regulation D under the Securities Act of 1933. The two non-accredited investors are relatives of "X" participants who are accredited investors. Each non-QEP investor in "X" has invested at least $100,000 in the fund, has been a participant in "X" for at least two years and has consented to the requested relief.

The purpose of the ten percent limitation in Rule 4.7 is, among other things, to preclude non-QEPs who could not invest in Rule 4.7 exempt pools based on their own qualifications from using QEP entities to access Rule 4.7 exempt pools.[8/] In support of the requested relief you contend that because "X's" non-QEPs were participants prior to any notice that a Rule 4.7 exemption claim would be made with respect to "Y", it appears clear that those participants did not invest in "X" to gain access to a Rule 4.7 exempt pool.

Based upon the representations you have made to us, it appears that granting the requested relief would not be contrary to the public interest. Accordingly, based upon compliance with the conditions set forth below, the Division will not recommend that the Commission take any enforcement action against "Z" or "Y's CPO" if "Z" fails to reduce "X's" participation in "Y" to ten percent or less of "X's" assets. This position is subject to the conditions that "Z": (1) notifies "X's" participants who are not QEPs that

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8/ See 57 Fed. Reg. 3148 at 3152 (January 28, 1992).

"Y" has become an exempt pool within the meaning of Rule 4.7 and that "Z" intends to maintain "X's" participation in "Y" at a level in excess of ten percent of "X's" assets; and (2) within ten days of the date of this letter gives such non-QEP participants an opportunity to redeem their interests in "X" within three months of their receipt of such notification.[9/]

Confirmation of Relief under Rule 4.12(b)

As a Rule 4.12(b) pool whose trading of commodity interests is limited to investing in another Rule 4.12(b) pool, "X" has relied upon the relief previously granted by the Division in Interpretative Letter 91-6 ("Letter 91-6").[10/] In Letter 91-6 the Division stated:

> [w]here a pool for which relief is sought under Rule 4.12(b) intends to trade commodity interests through investing in a (previously qualified) Rule 4.12(b) pool, then the (investing) pool may multiply its intended investment by ten percent and add that amount to whatever other commodity interest trading investments it intends to make (e.g., directly or indirectly under Rule 4.12(b)) in determining whether [the pool has complied with the restrictions in Rule 4.12(b) with respect to aggregate initial margin and option premiums].

The effect of Letter 91-6 is to permit a Rule 4.12(b) pool to invest more than ten percent of its assets in another pool, provided that the investee pool's commodity futures and options

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9/ In response to an inquiry by Division staff, you have stated that while "X" cannot represent that "Z" would not in the future admit any non-QEPs into "X", it represents that:

> the Fund's disclosure document will be expanded to fully disclose to all prospective investors that the Fund invests slightly more than 10% of its assets in "Y"; that the Fund has been granted relief to exceed the 10% ceiling; and the regulatory significance of exceeding the 10% ceiling [i.e., that "X" would be investing more of its assets in "Y" than it could without the relief].

10/ Division of Trading and Markets Interpretative Letter 91-6, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,069 (June 13, 1991).

trading is restricted such that the investor pool has effectively exposed less than ten percent of its assets to the risks involved in futures and options trading. The limitation on the investee pool's trading may be either the result of a claim of exemption as a Rule 4.12(b) pool, or a contractual restriction (e.g., a provision in the pool's partnership agreement).

In determining whether "X" qualifies for exemption under Rule 4.12(b), "Z" has multiplied "X's" investment in "Y" (approximately twelve percent of "X's" assets) by ten percent, with the result that for the purpose of Rule 4.12(b), "X" is committing 1.2 percent of its assets to establish commodity interest trading positions. However, the conversion of "Y" to a Rule 4.7 exempt pool from a Rule 4.12(b) pool has raised an issue as to whether "Z" may continue to rely on Letter 91-6 in connection with its investment in "Y".

If, for example, "Y" were contractually bound to limit to ten percent the fair market value of its assets to be committed to establishing commodity interest trading positions, then under Letter 91-6 "X" would continue to qualify for exemption under Rule 4.12(b), notwithstanding "Y's" Rule 4.7 exemption claim. Although there is no contractual restriction limiting "Y's" aggregate initial margin and option premiums to ten percent of the fair market value of its assets, because "Y" intends to continue to comply with the Rule 4.12(b) exemption requirements, you contend that "Z's" claim of exemption for "X" under Rule 4.12(b) should not be vitiated by "Y's" status as a Rule 4.7 "exempt pool." Further, "A" has represented that "Y's" "level of its commodity futures trading activity will be such that if not for its Rule 4.7 status, ["Y"] would fall within the level required by Rule 4.12(b)."

Based upon the foregoing representations, we confirm to you that "Z" may continue to multiply by ten percent "X's" investment in "Y", for the purpose of determining "X's" compliance with the trading limits of Rule 4.12(b)(1)(i)(C). You should be aware that the no-action position taken by this letter relieves "Z", "W" and "B" solely from certain requirements of Rule 4.7 and does not excuse them from compliance with any otherwise applicable requirements contained in the Act or in the Commission's regulations thereunder. For example, each remains subject to Section 4o of the Act,[11] to the reporting requirements for traders set forth in Parts 15, 18 and 19 of the Commission's regulations, and to all other provisions of Part 4. In addition, the Division notes that it is not excusing or in any way limiting the Commission's authority to proceed against "Z", "W" or "B" for any past viola-

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11/ 7 U.S.C. §6o (1994).

tions of the Act or the Commission's rules thereunder. The positions taken herein are prospective in nature only.

This letter is based on the representations that have been made to us and is subject to compliance with the conditions set forth above. Any different, changed or omitted facts or conditions might require us to reach a different conclusion. In this connection, we request that you notify us immediately in the event that the participant composition or commodity interest trading activities of "X" or "Y" change in any way from those as represented in the Correspondence. Further, this letter represents the position of the Division of Trading and Markets only. It does not necessarily reflect the views of the Commission or of any other division or office of the Commission. If you have any questions concerning this letter, please contact me or Christopher W. Cummings, an attorney on my staff, at (202) 254-8955.

Very truly yours,

Susan C. Ervin
Chief Counsel