

CFTC Letter No. 97-53

June 24, 1997

## Division of Trading &amp; Markets

Re: Section 4m(1) of the Act -- Request for Relief from CPO and CTA Registration for Two State-Regulated Insurance Companies and a State-Regulated Trust Company.

Rule 4.7(a) -- Request To Treat Insurance Company Separate Account and Limited Liability Trading Vehicle Sub-Account as Rule 4.7(a) Exempt Pools, and for Relief from Ten Percent Restriction of Rule 4.7(a)(1)(ii)(B)(2)(xi).

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Dear :

This is in response to your letter dated April 23, 1997, to the Division of Trading and Markets (the Division ) of the Commodity Futures Trading Commission (the Commission ), as supplemented by facsimile transmissions dated May 8 and May 27, 1997 from A of your firm and by telephone conversations with Division staff. By your correspondence, you request certain relief on behalf of: (1) R , a registered commodity pool operator ( CPO ); (2) S , a limited purpose trust company; (3) T , a chartered bank and trust company; and (4) Y and Z , each a state-regulated insurance company (collectively U ). Your request pertains to an estate planning device designed jointly by U , S and R involving the offering of variable life insurance policies (the Contracts<sup>1</sup>) to certain trusts (the Trusts ) established by persons who are qualified eligible participants ( QEPs ) and qualified eligible clients ( QECs ) as defined in Commission Rule 4.7<sup>2</sup>.

Specifically, you request that the Division take a no-action position with respect to S , T and U for failure to register as commodity trading advisors ( CTAs ) or as CPOs as required by Section 4m(1) of the Commodity Exchange Act (the Act<sup>3</sup>). You further request that R be allowed to claim relief pursuant to Rule 4.7(a) from certain requirements of Part 4 of the Commission's rules with respect to: (1) the U separate account (the Separate Account ) into which Contract premiums received from the Trusts will initially be placed; and (2) a sub-account (the LP Subaccount ) that may invest all or part of the funds placed in the Separate Account in limited liability trading vehicles, including limited partnerships and limited liability companies, some of which will be commodity pools.<sup>4</sup> Finally, you request relief from Rule 4.7(a)(1)(ii)(B)(2)(xi) (the Ten Percent Restriction ) with respect to R and the CPO of any Rule 4.7(a) exempt pool in which the LP Subaccount invests, notwithstanding the presence of non-QEPs in the LP Subaccount.

Based upon the representations contained in your correspondence, we understand the pertinent facts to be as follows. R is a wholly-owned subsidiary of V, which is, in turn, a wholly-owned subsidiary of W<sup>5</sup>. R has been registered as a CPO since January 26, 1994, and has operated several commodity pools. S is also a wholly-owned subsidiary of V. S and T will act as co-trustees of each Trust.<sup>7</sup>

R, consistent with its mission to structure and implement investment opportunities for its clients, initiated discussions with U concerning the Contracts.<sup>8</sup> The Contracts are variable life insurance policies and variable joint and last survivor insurance policies. The parties propose that the Contracts will be offered by U on a private placement basis pursuant to Section 4(2) of the Securities Act of 1933<sup>9</sup> or pursuant to Regulation D thereunder<sup>10</sup> through W, a registered broker-dealer which has entered into a selling agreement with X, a registered broker-dealer affiliate of U.

The Contracts to which your request applies will be offered exclusively to the Trusts. Each Trust will be established by one or more grantors, each of whom will be an executive officer or client of W meeting the definitions of QEP and QEC.<sup>11</sup> However, by reason of limitations on the amount of the exemption under Section 2631 of the Code, none of the Trusts will possess total assets in the amount required by Rule 4.7(a)(1)(ii)(B)(2)(xi).<sup>12</sup> In order to receive the desired estate tax treatment, the grantor must relinquish control over the assets placed in the Trust. Accordingly, subsequent to the grantor's decision to place funds in a Trust, S as a co-trustee will have full discretion over the Trust's assets and the manner in which the assets are invested.

As a co-trustee of each Trust, S has the power to direct the investments of the Trusts, including the power to decide whether to purchase the Contracts. If S fails to exercise this power, then T has the right to invest the assets of the Trust. U will issue the Contracts in accordance with state insurance regulations. The insured under a Contract will be either the grantor of the Trust, the grantor's spouse or the grantor's child. The beneficiary of a Trust generally will be a descendant of the grantor (including those born after formation of the Trust) during the duration of the Trust.<sup>13</sup>

The premiums paid on account of the Contracts purchased by the Trusts will be invested by means of the Separate Account. S, as co-trustee, will determine the manner in which the funds in the Separate Account will be allocated among three subaccounts, including the LP Subaccount. Each Trust, therefore, will hold a Contract and an interest in the Separate Account.

Each Trust that is the owner of a Contract may allocate, through S, premiums or cash value to one or more of the subaccounts that comprise the Separate Account: (1) a subaccount that invests in registered investment company shares; (2) a subaccount that invests in individual equity and debt securities; and (3) the LP Subaccount which invests in limited partnership and limited liability

company interests. Only the Trusts may participate in the Separate Account. Each of the subaccounts will have its own investment objective and the minimum investment amount will vary from one subaccount to another. The LP Subaccount will invest only in privately offered investment limited partnerships and limited liability companies, some of which will be commodity pools.<sup>14</sup> The other subaccounts (1) will be prohibited from investing directly in commodity interests or participating in commodity pools; and (2) will not be permitted to share in profits or losses attributable to investments in the LP Subaccount.

R will serve as the investment manager for the LP Subaccount and will recommend to U a list of investment vehicles (including commodity pools) for investment of LP Subaccount funds.<sup>15</sup> U will approve some or all of the listed investment vehicles as available investments for the LP Subaccount and R will determine whether and to what extent LP Subaccount funds are allocated among the approved investment vehicles. R, therefore, will be managing the LP Subaccount.

Before a Trust invests in the LP Subaccount, the co-trustees will receive a private offering memorandum detailing all of the subaccounts and containing information that U and R deem to be material to a decision to invest in the LP Subaccount. Each Trust also will be required to consent to being treated as a QEP before it invests in the LP Subaccount.

Upon the death of the named insured under a Contract, the Trust will be paid a death benefit as provided by the Contract. You represent that the program is structured so that there will be no cash surrender rights or withdrawal rights prior to the named insured's death.<sup>16</sup> The Trust will continue to operate for the benefit of the beneficiary, and payments will be made to the beneficiary in accordance with the terms of the Trust instrument.

You have requested that U be granted relief from the requirement to register as a CPO and CTA with respect to the Separate Account and the LP Subaccount. In support of your request, you represent that R has been responsible for the design of the investment components of the Contracts with respect to the LP Subaccount (such as how investee funds will be selected and how funds will be allocated among investee funds), while U has been responsible for the design of the insurance features of the Contracts, such as the provisions controlling transfer and withdrawal and the death benefit. Consistent with these roles, the portion of the private offering memorandum for the Separate Account relating to the investments comprising the LP Subaccount is being prepared by R, while the portion relating to the life insurance features of the Contracts is being prepared by U. R will be appointed investment manager of the LP Subaccount and will be responsible for the investment-related activities of the LP Subaccount. Pursuant to its responsibilities under state insurance laws, U will act as the issuer of the Contracts, will act as custodian of the assets of the LP Subaccount, and will be responsible for, among other things, the valuation of the assets of the entire Separate Account (relying for the LP Subaccount upon valuation information provided by R). U will also be responsible for the preparation and distribution of the Separate Account's annual reports and the maintenance of books and records.

With regard to the offering of the Contracts, U will initially inform the Trusts that the Contracts are available. Consistent with its selling agreement with X, W will provide the Separate Account offering memorandum to those Trusts on behalf of which the co-trustees (or either of them) have expressed an interest in the Contracts. We also note your representation, stated above, that the conceptual framework of the proposed program originated with R, which sought the assistance of U in structuring the insurance component of the Contracts.

The Division considers a number of factors in determining whether relief from CPO and CTA registration is appropriate. In the case of U, we believe that the following factors support granting CPO and CTA registration relief to U: (1) R, a registered CPO, will act as investment manager in connection with the selection and replacement of commodity pools in which the LP Subaccount participates and the allocation of LP Subaccount funds to such commodity pools; (2) U, as a state-regulated life insurance company, is subject to regulation under state insurance law and X and W, as registered broker-dealers, are subject to regulation under the federal securities laws; (3) U will design the insurance features of the proposed program and will not participate in the management of commodities-related investments; (4) the LP Subaccount will not invest directly in commodity interests but will only invest through limited liability trading vehicles; and (5) participation in the Contracts will be limited to Trusts established by persons meeting the QEP and QEC criteria of Rule 4.7.

With respect to S, its role in this program will be limited to acting as a co-trustee for the Trusts. While it will control, in the first instance, for each Trust whether a Contract is purchased and, if purchased, whether any premiums will be allocated to the LP Subaccount, it does not participate in the selection and replacement of commodity pools in which the LP Subaccount will participate, and it does not participate in deciding the amount of LP Subaccount funds to be used to purchase interests in such pools. All such decisions will be made by R, a registered CPO, and an affiliate of S.<sup>17</sup>

Based upon your representations, the Division believes that your request for relief from CPO and CTA registration requirements for U, S and T has merit.<sup>18</sup> Accordingly, subject to the conditions set forth below, the Division will not recommend that the Commission take any enforcement action against U or S (together with T when acting as co-trustee with S) for failure to register as CPO or CTA pursuant to Section 4m(1) of the Act in connection with the proposed offering and operation of the Contracts. This relief is subject to compliance by R, S, T and U, as applicable, with the following conditions:

1. R continues to be an affiliate of S, to be registered with the Commission as a CPO and to act as the investment manager for the LP Subaccount;
2. U and/or R will deliver to each Trust, before the Trust invests in the LP

Subaccount, an offering memorandum for the Separate Account that describes possible investments that may be made by the LP Subaccount and the material risks of such investments;

3. Each Trust consents to being treated as a QEP;

4. U provides the Division with written notice of the name or other designation under which each of the Separate Account and the LP Subaccount are carried on the books of U within ten days after the selection of such names or other designations; and

5. U, S, T and R will comply with the requirements of the Act and the Commission's rules except to the extent granted relief therefrom, as provided below.

Further, this relief is being granted in part upon the understanding that in participating in the proposed program U and W are subject to liability under applicable securities and/or insurance law provisions.

With respect to your requests (1) that R be allowed to claim relief pursuant to Rule 4.7(a) for the Separate Account and the LP Subaccount, and (2) that the Division exempt R and the CPO of any Rule 4.7(a) exempt pool in which the LP Subaccount participates from the Ten Percent Restriction notwithstanding participation of non-QEPs in the Contracts, we note that the Division has previously granted similar relief in connection with similar pooled investments.<sup>19</sup> Here, as in those cases, you represent that each Trust participating in the Contracts will be established by a grantor meeting the QEP and QEC definitional criteria and each such Trust will consent to being treated as a QEP.

In light of the foregoing, it appears that granting the requested relief would not be contrary to the public interest or the purposes of Rule 4.7(a). Accordingly, subject to the conditions set forth above, the Division will not recommend that the Commission take any enforcement action against: (1) R for failure to comply with Rule 4.7 based solely upon R claiming relief pursuant to Rule 4.7(a) notwithstanding investment in the LP Subaccount by non-QEP Trusts and treating such Trusts as QEPs; or (2) R or the CPO of any Rule 4.7(a) exempt pool in which the LP Subaccount participates for failure to comply with Rule 4.7(a) based solely upon the LP Subaccount investing more than ten percent of the fair market value of its assets in Rule 4.7 exempt pools.

This letter does not excuse R, S, T or U from compliance with any other applicable requirements contained in the Act or in the Commission's regulations issued thereunder. For example, each remains subject to the antifraud provisions of Sections 4b and 4c of the Act,<sup>20</sup> to the reporting requirements for traders set forth in Parts 15, 18 and 19 of the Commission's rules, and to all

otherwise applicable provisions of Part 4.

This letter is based upon the representations made to us. Any different, changed or omitted facts or circumstances might require us to reach a different conclusion. In this connection, we request that you notify us immediately in the event that the operations or activities of R , S , T , U , the Trusts, the Separate Account or the LP Subaccount change in any respect from those as represented to us. Further, the no-action positions taken in this letter represent the views of this Division only and do not necessarily represent the views of the Commission or of any other office or division of the Commission. Finally, the Division is expressing no opinion with respect to the application or effect of relevant tax, securities or insurance law provisions or requirements.

If you have any questions concerning this correspondence, please contact me or Susan C. Ervin, the Division s Chief Counsel, at (202) 418-5450.

Very truly yours

Andrea M. Corcoran

Director

<sup>1</sup> As a general rule, the insured under a Contract will be either (i) the Trust s grantor and, if applicable, his or her spouse; or (ii) one or more of the grantor s children.

<sup>2</sup> Commission rules referred to herein are found at 17 C.F.R. Ch. I et seq. (1996). The Trusts will be organized as generation-skipping trusts in accordance with relevant provisions of the Internal Revenue Code of 1986 (26 U.S.C. § 1 et seq. (1994), the Code ), in order to permit deferral of the obligation to pay generation skipping transfer tax on the distributions from the Trusts.

<sup>3</sup> 7 U.S.C. § 6m(1) (1994).

<sup>4</sup> Because neither the Separate Account nor the LP Subaccount will be operated pursuant to the criteria of Rule 4.5(c), an exclusion from the CPO definition pursuant to Rule 4.5 is not available to U .

<sup>5</sup> Commission records indicate that W is listed as a principal of Q , a registered introducing broker. A subsidiary of W , O is registered as a futures commission merchant.

<sup>6</sup> Thus, S and R are affiliated entities.

<sup>7</sup> In this regard, you explain that T will act as co-trustee only to the extent necessary (i) to comply with a requirement under Delaware insurance law that a trust owned life insurance policy issued (and

delivered) in the State of Delaware to a Delaware trust must have a trustee with its principal place of business in Delaware, and (ii) to ensure that the Trusts are governed by Delaware law including the Delaware rule against perpetuities. You state that the use of a Delaware co-trustee will satisfy these requirements. You ask the Division to grant T, as co-trustee, the same relief you seek on behalf of S (i.e., relief from CPO and CTA registration).

<sup>8</sup> You indicate that in addition to acting as CPO for three pools, R also develops new products, such as this program developed in collaboration with U.

<sup>9</sup> 15 U.S.C. § 77d(2) (1994).

<sup>10</sup> 17 C.F.R. § 230.501 *et seq.* (1996).

<sup>11</sup> A grantor may establish a Trust jointly with the grantor's spouse. Existing and future W clients and executive officers will be eligible to establish Trusts. You represent that once V educates its marketing personnel so that they understand the product, all marketing will be done on a one-on-one basis with current W clients and executive officers. Marketing efforts will not be extended to prospective clients (or prospective executives).

<sup>12</sup> Accordingly, as noted above, absent relief, R would not be able to claim relief pursuant to Rule 4.7(a).

<sup>13</sup> S and T, as co-trustees, generally will have discretion to pay or apply the income and principal of the Trust to and among the one or more members of a class of beneficiaries set forth in the agreement between the grantor and the co-trustees creating the Trust (for example, the descendants of the grantor living from time to time).

<sup>14</sup> You represent that it is intended that the LP Subaccount will principally invest in securities investment vehicles, many of which also are pools for which exemption is claimed pursuant to Rule 4.12 (b) or Rule 4.7.

<sup>15</sup> As noted above, the LP Subaccount will invest in limited liability trading vehicles, such as limited partnerships and limited liability companies. It also may invest in other private investment vehicles with limited liability if such are developed in the future.

<sup>16</sup> You indicate that the Contracts must be structured consistent with Code criteria to permit the Trusts to be treated as generation skipping trusts.

<sup>17</sup> As stated above, S and R are both wholly-owned subsidiaries of W.

<sup>18</sup> See CFTC Interpretative Letter 97-12, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,985

(March 7, 1997).

<sup>19</sup> See CFTC Interpretative Letter No. 97-12 (cited above); CFTC Interpretative Letter No. 96-30, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,671 (March 29, 1996); and CFTC Interpretative Letter No. 95-107, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,578 (November 22, 1995).

<sup>20</sup> 7 U.S.C. § 6b and 6c (1994).