CFTC letter No. 02-113
November 19, 2002
Interpretation
Division of Clearing and Intermediary Oversight

Re: Rule 4.7 – Request to Permit Additional Non-QEPs in Certain Commodity Pools

Dear :

This is in response to your letter dated January 24, 2002, to the Division of Trading and Markets (the "Division")[1] of the Commodity Futures Trading Commission (the "Commission"), as supplemented by your letters dated April 15, 2002 and July 9, 2002, by your e-mail messages dated August 14, 2002, September 10, 2002 and November 5, 2002, and by telephone conversations with Division staff. By your correspondence, you request certain relief on behalf of "S" (successor to "T"), "U" and their affiliates (collectively, "V").[2]

By letter dated September 17, 1997 ("Staff Letter 97-95")[3] the Division had permitted "W", a registered commodity pool operator ("CPO") affiliated with "V", to admit certain persons not within the definition of "qualified eligible person" ("QEP") under Commission Rule 4.7[4] to participate in investment funds with respect to which "W" claimed (or another registered CPO, in the future would claim) relief under Rule 4.7(b) ("Employee Funds"). That relief was based upon, among others, representations that: (1) participation in, and contribution to, the Employee Funds would be entirely voluntary; (2) Employee Funds would not charge any fees to the participants, although they would pass along fees charged by any investee funds; (3) a small percentage of an Employee Fund's assets could be allocated to direct commodity interest trading; and (4) the purpose of the Employee Funds would be to reward and retain key personnel of "V" and to attract talented professionals.

"V" now seeks to permit additional persons to participate in these Employee Funds. For purposes of this request, we are incorporating by reference the representations made in support of the relief issued by Staff Letter 97-95.

Based upon the representations made in the instant correspondence, we understand the facts giving rise to this request to be as follows. In addition to the representations made in connection with Staff Letter 97-95, you state "V" believes that additional facts warrant expanding the class of persons eligible to participate in Employee Funds, so that participation in Employee Funds that engage in commodity interest trading will be available to all employees to whom "V" currently may privately offer employee investment funds that invest in securities or real estate. Besides the existing categories of managing directors and limited partners, the expanded class of potential participants ("Eligible Participants")

would include the categories of persons specified in your correspondence. Generally they include employees, retired employees and consultants of "V" and their family members, each of whom (in his or her own right) would be an "accredited investor" as defined in Regulation D under the Securities Act of 1933,[5] and would be prohibited from making an annual investment in Employee Funds of more than 15 percent of that person's previous year's gross income on an annualized basis (including salary and bonus as well as awards of shares of restricted stock and stock options). Moreover, the Employee Funds are designed to be invested alongside funds that "V" offers to its clients, in order to give eligible employees exposure to the same type of investments that are offered to "V" clients without charging those employees the normal fees paid by clients.[6]

In support of the instant request, you note the following: (1) an Employee Fund would be organized as a limited liability entity and would limit the amount that could be committed as initial margin and premiums for direct trading of commodity interests to 10 percent of its assets; (2) one of "V's" affiliates (in each case a registered CPO) would serve as each Employee Fund's CPO;[7] (3) each Eligible Participant who invests in an Employee Fund would receive a detailed offering memorandum that would generally comply with the information and disclosure requirements under Rule 4.12(b);[8] (4) each participant would receive an annual statement regarding the Employee Fund and containing financial statements certified by an independent certified public accountant; and (5) no fees would be charged to participants, except that fees paid by the Employee Fund to pools in which it invests would be borne by the Employee Fund's participants *pro rata*. In addition, "V" will undertake to: (1) obtain from each investor written confirmation of the investor's understanding that the Employee Fund will be operated pursuant to relief granted by the Division; and (2) obtain from each investor written confirmation of the investor's understanding of the risks inherent in investing in an Employee Fund.

In support of your request, you claim that the attributes and qualifications of the expanded range of persons eligible to participate in Employee Funds provide "sufficient indications of the level of investment acumen and resources envisioned by the Commission" in adopting Rule 4.7. This is because in addition to providing proof of accredited investor status, the prospective investor will be required to represent, *inter alia*, that he or she has adequate means of providing for current needs and financial ability to withstand loss of the entire investment in the Employee Fund.[9]

The rationale for providing relief under Rule 4.7 is that the pool participants or advisory clients with whom the CPO or CTA deals all possess a certain minimum level of sophistication, evidenced by specified attributes such as portfolio size, relevant employment experience, and actual involvement in the CPO's or CTA's investment decision-making process. In Staff Letter 97-95, the Division permitted participation in Employee Funds by certain non-QEPs, all of whom were managing directors of "V" operating companies or active or retired limited partners of "T" and their trusts or family investment vehicles. In each case there was a connection between the participant and the management or ownership of the business. Here, the breadth of the requested expansion of Eligible Participants criteria for the Employee Funds is outside the scope of the QEP concept and the Commission's intent in adopting Rule 4.7. Nevertheless, because "V" has undertaken to provide significant safeguards and protections to the

Eligible Participants (including, without limitation, access to books and records, annual investment limits, and restrictions on direct commodity interest trading by an Employee Fund), and the purpose of the Employee Funds is to provide a completely voluntary opportunity to invest alongside the products "V" offers to its clients, the Division believes that relief is appropriate.

Finally, we note that your correspondence sought confirmation of continuing effectiveness of the position taken in Staff Letter 97-95 if the range of Eligible Participants in Employee Funds were expanded. One aspect of the relief granted in Staff Letter 97-95 was to eliminate the requirement to provide quarterly reports to Employee Fund participants (as would otherwise be required by Rule 4.7). While that relief may have been warranted in the case of the managing directors and limited partners who were the subject of Staff Letter 97-95, you have agreed to provide to Eligible Participants such periodic reports as Rule 4.7 requires.

Based upon the representations contained in your correspondence, the Division believes that granting your request would not be contrary to the public interest and the purposes of the Commodity Exchange Act (the "Act")[10] or the Commission's rules. Accordingly, subject to the conditions set forth below, the Division will not recommend that the Commission commence any enforcement action against the CPO of any Employee Fund solely on the basis that it admits participants described in the categories set forth in your correspondence and otherwise complies with the requirements of Rule 4.7(b) with respect to those investors. The foregoing no-action position is subject to the condition that each Eligible Participant has reasonable access to the books and records of the Employee Fund in which such Eligible Participant participates or seeks to participate, with the opportunity to ask questions and receive answers concerning the operation and investment activities of such Employee Fund. In addition, as you have requested, the Division will not recommend that the Commission take any enforcement action against the CTA advising an Employee Fund that complies with the foregoing conditions, solely on the basis that the CTA treats the Employee Fund as a QEP.

Furthermore, the Division confirms that portion of the no-action position taken in Staff Letter 97-95 as regards the failure to provide quarterly reports to managing directors and limited partners. The periodic reports specified in Rule 4.7(b)(2) must be provided to all other Eligible Participants.

This letter, and the no-action positions taken herein, are based upon the representations made to the Division and are applicable to "V" and to the CPO or CTA of any Employee Fund, solely in connection with the operation and advising of Employee Funds currently in existence or organized in the future. Any different, changed or omitted facts or circumstances might render the no-action positions taken herein void. You must notify the Division immediately in the event the operations or activities of "V" or the Employee Funds change in any material way from those represented to the Division. Furthermore, this letter and the no-action positions taken herein 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.

This letter does not excuse "V" or any CPO or CTA of an Employee Fund from compliance with any other applicable requirements contained in the Act or in the Commission's rules thereunder. For

example, each remains subject to the antifraud provisions of Sections 4b and 4o of the Act,[11] to the reporting requirements for traders set forth in Parts 15, 18 and 19 of the Commission's rules, and to all other provisions of Part 4.

If you have any questions concerning this correspondence, please contact me or Christopher W. Cummings, an attorney on my staff, at (202) 418-5445.

Very truly yours,

Jane Kang Thorpe
Director

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[1] As of July 1, 2002, a reorganization of Commission staff became effective. Accordingly, for purposes of this letter, the term "Division" includes the Division of Clearing and Intermediary Oversight and its predecessor, the Division of Trading and Markets, as the context requires.

[2] By "affiliates" you mean direct or indirect subsidiaries of "S" in which "S" holds 100 percent of the beneficial interest.

[3] CFTC Staff Letter No. 97-95 [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶27,199 (September 7, 1997).

[4] Commission rules referred to herein are found at 17 C.F.R. Ch. I (2002). The non-QEPs were certain managing directors and limited partners of "V" and trusts and family investment vehicles wholly owned or controlled by those managing directors and limited partners. Each of the managing directors and limited partners either participated in the profits of "V", received a fixed rate of return on their capital invested in "V", or earned at least $600,000 in salary and bonus compensation in the most recent calendar year preceding the issuance of Staff Letter 97-95.

[5] They would be accredited investors by virtue of satisfying either the income test (*i.e.*, $200,000 in income in each of the two most recent fiscal years or joint income with the person's spouse of $300,000 in each of those years, with a reasonable expectation of reaching the same income level in the current year) or the net worth test, all as set forth in Regulation D.

[6] You state that permitting former employees and their family members to remain invested in an Employee Fund advances "V's" goal of attracting and recruiting new employees by providing that certain benefits of employment will continue even subsequent to a departure.

[7] Again, by "affiliate" you mean a direct or indirect subsidiary of "S" in which "S" holds 100 percent of the beneficial interest.

[8] The offering memorandum would not include a "break-even" analysis, information about major investee pools or major CTAs, and the sort of detailed disclosure concerning fees as is called for in Rule 4.24(i)

[9] You further claim that your request is supported by CFTC Staff Letter 00-67, [1999-2000 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶28,162 (May 26, 2000), in which a CPO was permitted to claim Rule 4.7 relief for a pool that admitted accredited investors as well as non-accredited investors who received reportable income of $100,000 or more in the most recent year and reasonable expectation of income of at least $140,000 in subsequent years, and who met certain minimum educational and professional experience targets. You also refer the Division to CFTC Staff Letter 00-92, [1999-2000 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶28,277, (September 20, 2000), in which an offshore CPO that chose to register with the Commission was permitted to claim relief under Rule 4.7 while retaining as pool participants certain investment professionals substantially responsible for managing the pool and their family members, and private personal and charitable trusts or foundations created by them. Your request goes somewhat further than either of these letters.

[10] 7 U.S.C. § 1 *et seq.* (2000)

[11] 7 U.S.C. §6b and 6o (2000).