U.S. COMMODITY FUTURES TRADING COMMISSION
Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581
Telephone: (202) 418-5260
Facsimile: (202) 418-5527
www.cftc.gov

Division of
Market Oversight

CFTC letter No. 06-19
September 6, 2006
No-Action
Division of Market Oversight

Re: Request for No-Action Relief with Regard to Commodity Exchange Act Section 4a and Commission Regulation 150.2, Speculative Position Limits for Certain Soybean and Wheat Futures Positions

Dear :

As you know, pursuant to Section 4a(a) of the Commodity Exchange Act (the "Act"), the Commission establishes and enforces speculative position limits for futures and option contracts on a limited group of agricultural commodities, including corn, soybeans and wheat traded on the Chicago Board of Trade ("CBOT"). Those limits are set out at § 150.2 of the Commission's regulations.

By letter dated June 13, 2006, supplemented by an amended letter dated July 14, 2006, you have requested, on behalf of your client, X, no-action relief with respect to certain positions in CBOT corn, soybeans and wheat futures, to be held pursuant to P, a proprietary commodity investment program created by X.[1] Specifically, you have asked that the Division of Market Oversight ("Division") confirm that it will not recommend to the Commission that enforcement action be taken with respect to such corn, soybean and wheat futures positions if the positions (in any month other than the spot month) are in excess of the applicable speculative position limits. For the reasons, and subject to the conditions, described in the remainder of this letter, the Division hereby grants the no-action relief you have requested.[2]

Factual Background

The P Investments

As described in your letter, X's clients can invest in the P program in several ways. X is a registered commodity pool operator ("CPO") and commodity trading advisor ("CTA"). A client can invest in P through a separate account with a futures commission merchant ("FCM"), managed by X in its CTA capacity. A client can also invest in P through a fund that could be

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[1] In addition to your June 13 and July 14 letters, including Exhibit A, "New 2006 P Weights," and Exhibit B, a copy of a "Confidential Private Placement Memorandum," dated December 2005, you have provided the Division with additional information through various e-mail and telephone contacts.

[2] As you know, the CBOT has adopted speculative position limit rules that mirror the limits set out in Commission regulation 150.2. This letter does not provide relief with respect to those CBOT rules. Therefore, X will have to secure relief from the CBOT's speculative position limits directly from the exchange.

operated by X in its CPO capacity. Finally, a client can invest in P through a fund operated by a third party, which is advised or sub-advised by X in its CTA capacity. Such a fund could be offered in accordance with the Commission's Part 4 rules or pursuant to an exemption from certain provisions of the Part 4 rules, such as, for example, Rule 4.7, Rule 4.13(a)(3) or Rule 4.13(a)(4) (a "Rule 4.7 pool," a "Rule 4.13(a)(3) pool," or a "Rule 4.13(a)(4) pool").[3]

X manages these various funds and individual and pool accounts pursuant to P. X currently manages over $1 billion of assets pursuant to P. The no-action relief you have requested would apply to the aggregate of all positions managed or traded in accordance with P.

The P Strategy

You have stated that P's rules require investments in three commodities in each of the following six tangible commodity groups: agricultural (grains and grain byproducts); livestock (meats and animals); energy (the petroleum complex and natural gas); precious metals (gold, silver, and the platinum complex that are primarily held for investment or used in jewelry); industrial metals (copper, aluminum, zinc, nickel, tin and lead that are used almost exclusively for industrial purposes); and soft commodities and foods (coffee, sugar, cocoa and orange juice, as well as cotton and lumber). P's rules require further that investments in no one of these tangible commodity groups constitute more than 35% of P and that no single commodity constitute more than 70% of its respective tangible commodity group. These tangible commodity group weightings and individual commodity weightings are calculated in accordance with a mathematical formula that blends two-thirds of five-year global production and one-third of five-year trading volume of futures contracts traded in U.S. dollars. Both production and trading volume are valued using the average commodity prices during the preceding year. Weightings of each commodity group and of each commodity are reset at the beginning of each year, and each commodity is rebalanced to its target weighting if its actual weighting deviates from the target weighting by more than 10% of its intended weight. X reserves the right to assign different bands to each commodity, but historically has used this single band (+/-10%) to quantify acceptable deviation for all commodities in all cases.

You note that, during 2005, the percentage of corn, soybean or wheat futures contracts was rebalanced a total of ten times, in each case in accordance with P's predetermined rebalancing threshold, *i.e.*, when the actual weighting of the respective commodity deviated from the target weighting relative to all other commodities by more than 10%. You point out that rebalancing never reflects a view that a position in a particular commodity is trading at a discount to its fair value or that a position in a particular commodity will be more profitable than a position in another commodity. As described in Exhibit A to your letter, since the most recent reset early in

[3] In the case of a Rule 4.13(a)(4) pool, one such investment structure is described in Exhibit B, the Confidential Private Placement Memorandum that accompanied your letter. According to that Memorandum, Y, Inc. serves as the Investment Manager to (the "Fund") and (the "Master Fund"), with responsibility for the day-to-day management of the Fund's investments and administrative affairs, while X serves as the sub-advisor to the Fund and the Master Fund. Subject to the general supervision of the Investment Manager, X has complete discretion and responsibility with respect to the Fund's and the Master Fund's investments. Investors purchase membership interests in the Fund and all of the capital of the Fund is, in turn, invested in the Master Fund. The assets of the Master Fund consist of a long-only portfolio of exchange-traded, U.S. dollar-denominated futures and forward contracts in tangible commodities.

2006, corn futures contracts account for 3.94% of P, soybean futures contracts account for 4.84% and wheat futures contracts account for 4.72%.

You have stated that X's clients are furnished with a level of disclosure and transparency about P appropriate for the product, based upon the provisions of the Act and the CFTC's Part 4 rules. For example, X provides each prospective separate account client with a CTA disclosure document, even if the client is a "qualified eligible person" as defined in Rule 4.7. A separate account client also receives account statements no less frequently than monthly from the FCM carrying the account. In the case of an offering that is not subject to an exemption from the Part 4 rules, prospective participants receive a pool disclosure document containing the information required under the Commission's Part 4 rules, as well as periodic statements and a certified annual report of the fund's financial condition. In the case of a Rule 4.7, Rule 4.13(a)(3), or Rule 4.13(a)(4) fund, prospective participants receive a private placement memorandum (*see* Exhibit B), periodic statements, and a certified annual report of the fund's financial condition, even if not required under the relevant rules.

Trading Activities

You have stated that P is a long-only, diversified tangible commodity futures trading program that is designed to maintain consistent, fully collateralized exposure to tangible commodities as an asset class. P is intended to provide diversification for traditional portfolios of equities and fixed income instruments, as well as some protection from inflation risk. To implement P, X enters into long positions in a diversified basket of U.S. dollar-denominated futures and forward contracts on tangible commodities that have an annual trading volume in excess of 250,000 contracts. These contracts are traded on both U.S. and non-U.S. exchanges. In connection with managing accounts pursuant to P, X does not seek to incur any additional price exposure for itself in the futures markets, but rather seeks to offset the exposure it incurs in the course of offering P investments to its clients, by entering into exchange-traded transactions in the futures markets. P does not seek to generate speculative profits by predicting price trends.

You further state that P requires all futures positions to be rolled into later contract months prior to the last trading day or first notice of delivery day, whichever is earlier. You note that, to prevent the market from front running any of the roll orders, there has not been any fixed roll date and time. Rather, X has exercised its judgment in determining the precise timing of the roll, as well as the subsequent contract month to which the positions will be rolled. In that regard, you note that X evaluates such factors as liquidity, prevailing prices and spreads, and other market conditions. Nonetheless, you represent that positions in front month futures contracts are typically rolled during the week before the earlier of the last trading day or the first notice of delivery day, and that positions are never held into the delivery month.

Maximum Size of Corn, Soybean and Wheat Futures Positions

You have stated that, in view of the growth of interest in P and the development and marketing of new products, X anticipates that the amount of assets it manages pursuant to P could reach $4.5 billion over the next 12 months. At that level, the corn, soybean and wheat positions held pursuant to P could exceed the Commission's speculative position limits.[4] Given the foregoing considerations, and X's critical need to use futures contracts to offset its exposure, you have requested that X be allowed to hold: (1) in CBOT corn futures, a net long position of, (a) up to 17,500 contracts for a single month (other than the spot month) and (b) up to 27,000 contracts for all months combined (with no change in the spot month limit); (2) in CBOT soybean futures, a net long position of, (a) up to 9,000 contracts for a single month (other than the spot month) and (b) up to 15,000 contracts for all months combined (with no change to the spot month limit); and (3) in CBOT wheat futures, a net long position of, (a) up to 11,000 contracts for a single month (other than the spot month) and (b) up to 13,000 contracts for all months combined (again, with no change to the spot month limit). You have stated that these limits reflect a conservative estimate of X's reasonably anticipated requirements for meeting its risk management needs for the near future.

Analysis

You note that the P strategy, and the relief you have requested, are similar to the index trading program described, and the relief granted, in CFTC Letter 06-09.[5] First, as in the program described in CFTC Letter 06–09, P is a long-only, fully collateralized trading strategy. Thus, the value of the long futures positions will not exceed the aggregate amount of cash or cash equivalents (such as cash deposited in a money market mutual fund) set aside in an identifiable manner in respect of such futures positions plus any accrued profits on such futures positions held at the FCM. The unleveraged nature of the strategy is indicative of the absence of speculative intent and also minimizes any risk that these futures positions could be subjected to a forced liquidation due to adverse market movements.

Second, you point out that the cash market underlying the CBOT's corn, soybean and wheat futures contracts has a high degree of demonstrated liquidity relative to the size of X's anticipated futures positions. The Commission has traditionally recognized in its market oversight activities that the liquidity of the underlying cash market and the potential for substantial arbitrage positions between the cash and futures markets mitigate the influence that large futures positions may have on futures prices.

Third, you state that P's rules-based, non-speculative trading methodology is no more conducive to market manipulation or disruption than other currently recognized non-speculative strategies. As described, P utilizes a predetermined set of mathematical rules and criteria for calculating the weightings for tangible commodity groups and individual commodities and for the annual reset and any rebalancings. Thus, X resets the weightings annually based upon the economic significance and liquidity of each tangible commodity group in relation to all other tangible commodity groups, and of each commodity within a particular tangible commodity group in

[4] Under Rule 150.2, the speculative position limit in CBOT corn futures contracts, separately or in combination, net long or short, is 600 contracts for the spot month, 13,500 contracts for a single month other than the spot month, and 22,000 contracts for all months combined. The speculative position limit in CBOT soybean futures contracts, separately or in combination, net long or net short, is 600 contracts for the spot month, 6,500 contracts for a single month other than the spot month, and 10,000 contracts for all months combined. The speculative position limit in CBOT wheat futures contracts, separately or in combination, net long or net short, is 600 contracts for the spot month, 5,000 contracts for a single month other than the spot month, and 6,500 contracts for all months combined.
[5] CFTC No-Action Letter No. 06-09, 2006 WL 1419389 (CFTC), May 5, 2006.

relation to all other commodities in such group, not on the basis of speculative market views, price targets, or price trends. Similarly, any periodic rebalancing is implemented in accordance with a predetermined numerical threshold and not on the basis of speculative market views, price targets, or price trends.

Fourth, you note that, as with the program described in CFTC Letter 06–09, implementing the P strategy should not pose any concerns about trading activity in the spot month because X rolls all long futures positions into later contract months prior to the last trading day or first notice of delivery day, whichever is earlier. Thus, X is not requesting any increase in the spot month limit.

Finally, you state your belief that granting this request is supported by, and consistent with, the Division's no-action position in CFTC Letter No. 06–09 and that the facts and circumstances presented in your request are analogous to those presented in that recent no-action letter.[6] Consistent with the relief granted in CFTC Letter No. 06–09, you have also requested that, in the event of subsequent growth in the amount of assets under management pursuant to P requiring additional long futures positions, X be permitted to notify the Division in reliance on the no-action relief granted in this letter. Upon receipt of such a request, the Division could either confirm that the increased position size is permissible pursuant to the relief granted herein or is not permissible unless X requests and receives additional no-action or other relief. In either event, X would be able to learn the Division's decision through a simple notice filing and would not be required to reapply for no-action relief *de novo*.

Conclusion

For the reasons, and subject to the conditions, described in this letter, the Division has determined that it will not recommend to the Commission that enforcement action be taken for violation of Commission regulation 150.2 with respect to the corn, soybean and wheat futures trading activity conducted by X, and the futures positions held in connection with the P strategy, if those positions (in any month other than the spot month) are in excess of the applicable speculative position limits. In particular, the conditions governing this no-action relief include:

- The futures trading activity passively tracks the P strategy;

- The P strategy continues to reflect a broadly diversified basket of tangible commodities, calculated and rebalanced based on an objective, predetermined mathematical formula, as described in your letter;

- The futures trading activity is unleveraged;

- The futures trading does not result in price exposure for X (*i.e.*, the price exposure is passed on to the individual account holders or the various pool participants, including investors in funds subject to, or exempt from, the Part 4 rules, as the case may be);

[6] Also, consistent with the no-action request that gave rise to CFTC Letter 06-09, your request does not constitute a request pursuant to Commission regulation 1.47 to classify the positions in question as *bona fide* hedging under Commission regulation 1.3(z)(3).

- As noted, positions in excess of the speculative limits are not carried into the spot month;

- X's clients are provided with at least the level of disclosure and transparency described in your letter; and

- The maximum long CBOT corn, soybean and wheat futures positions held pursuant to the no-action relief do not exceed 17,500 contracts for a single non-spot month (27,000 contracts for all months combined) in corn, 9,000 contracts for a single non-spot month (15,000 contracts all months combined) in soybeans, and 11,000 contracts for a single non-spot month (13,000 contracts all months combined) in wheat.

The position taken herein is based upon the representations you have made to the Division. Any different, changed or omitted facts or conditions, including revisions to the legal requirements applicable to speculative position limits and exemptions thereto, might require the Division to reach a different conclusion. The relief granted in this letter applies only with respect to regulation 150.2 and does not excuse X from complying with any otherwise applicable provisions of the Act or Commission regulations. You must notify the Division immediately in the event that there is any significant change from the facts presented to us concerning the activities of X, or the Funds, as described in your letter. Further, this letter represents the position of the Division of Market Oversight only and does not necessarily represent the views of the Commission or any other division or office of the Commission.

If you have any questions concerning this correspondence, please contact Donald H. Heitman, an attorney on my staff, by email at dheitman@cftc.gov, or by phone at (202) 418-5041.

Very truly yours,

Richard A. Shilts
Director
Division of Market Oversight