PROPOSED RULES

COMMODITY FUTURES TRADING COMMISSION

17 CFR Parts 3, 4 and 140

Commodity Pool Operators and Commodity Trading Advisors; Exemption From Registration and From Subpart B of Part 4 for Certain Otherwise Regulated Persons and Other Regulatory Requirements

Wednesday, February 8, 1984

***4778** AGENCY: Commodity Futures Trading Commission.

ACTION: Proposed rules.

SUMMARY: The Commodity Futures Trading Commission (the “Commission”) is proposing to exempt certain otherwise regulated persons from registration as a commodity pool operator (“CPO”) and from the provisions of Subpart B of Part 4 of the Commission's regulations upon the filing of a notice of eligibility with the Commission. To implement this proposal, certain other amendments would be made to the Commission's regulations. Similarly, and so that it may know the identities of all persons who are operating as a CPO pursuant to an exemption from registration as such, the Commission is proposing to require that each person who is exempt from registration as a CPO pursuant to § 4.13(a)—the operators of family, club and small pools—file with the Commission the prescribed statement of exemption that it currently is required to deliver to prospective participants pursuant to § 4.13(b)(1). The Commission also is proposing to ***4779** prohibit CPOs from receiving income generated from their pools' assets other than for the purpose of recovering actual organizational and offering expenses. Without specifying any proposed language at this time, the Commission further is considering the adoption of other amendments to the Part 4 regulations that would: exempt other persons from registration as a CPO or from certain provisions of Part 4; exempt certain persons registered as an investment adviser (“IA”) under the Investment Advisers Act of 1940 (the “IAA”) from registration as a commodity trading advisor (“CTA”); supplement the current format for presenting the actual past performance records of CPOs, and their principals; and establish financial requirements for CPOs.

DATE: Comments must be received by April 9, 1984.

ADDRESS: Comments should be sent to: Commodity Futures Trading Commission, 2033 K Street NW., Washington, D.C. 20581. Attention: Secretariat.

FOR FURTHER INFORMATION CONTACT: Barbara R. Stern, Special Counsel for Commodity Pool Operators and Commodity Trading Advisors, Division of Trading and Markets, 2033 K Street NW., Washington, D.C. 20581. Telephone: (202) 254-8955.

SUPPLEMENTARY INFORMATION:

I. Proposed Exemption for Certain Otherwise Regulated Persons from Registration as a CPO and From the Provisions of Subpart B of Part 4

A. Introduction

The term "commodity pool operator" is defined in section 2(a)(1)(A) of the Commodity Exchange Act, as amended (the "Act"), 7 U.S.C. 2 (1982), to mean:

[A]ny person engaged in a business which is of the nature of an investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in any commodity for future delivery on or subject to the rules of any contract market, but does not include such persons not within the intent of this definitionas the Commission may specify by rule or regulation or by order.

Section 4m(1) of the Act, 7 U.S.C. 6m(1)(1982), makes it unlawful for any person to engage in business as a CPO without being registered as such. Part 4 of the Commission's regulations, 17 CFR Part 4 (1983), as amended by 48 FR 35248 (August 3, 1983), governs the operations and activities of CPOs.[FN1] In particular, § 4.10(d) defines the term "pool" to mean "any investment trust, syndicate or similar form of enterprise operated for the purpose of trading commodity interests." 2

> FN1 Part 4 also governs the operations and activities of CTAs. For the purposes of this Federal Register release, references to a particular Part 4 regulation may be found in 17 CFR Part 4 (1983).
> While the Act provides the Commission with general authority to regulate both CPOs and commodity pools, it provides the Commission with specific authority only to register CPOs. With respect to the registration of commmodity pools and of units of participation therein, Section 4m(2), 7 U.S.C. 6m(2)(1982), states:
>
> Nothing in this Act shall relieve any person of any obligation or duty, or affect the availability of any right or remedy available to the Securities and Exchange Commission or any private party arising under the Securities Act of 1933 or the Securities Exchange Act f 1934 governing the issuance, offer, purchase, or sale of securities of a commodity pool, or of persons engaged in transactions with respect to such securities, or reporting by a commodity pool.
>
> FN2 The term "commodity interest" is defined in § 4.10(a) to mean:
>
> (1)Any contract for the purchase or sale of a commodity for future delivery; and
>
> (2) Any contract, agreement or transaction subject to Commission regulation under section 4c or 19 of the Act.

Whether a particular entity is operated 'for the purpose' of trading commodity interests, and thus is a pool within the scope of § 4.10(d), depends on an evaluation of all the facts relevant to the entity's operation. The Commission recognizes that in the past its staff has issued interpretations of the Part 4 rules. Consistent with that practice, the Commission invites interested persons to seek such staff interpretation of § 4.10(d) . . . . 46 FR 26004, 26006 (May 8, 1981).

Pursuant to this invitation certain interested persons have sought and have received staff interpretations [FN3]

that they would not be CPOs and that the entities they operated would not be pools within the scope of § 4.10(d).[FN4] The representations given in connection with the receipt of these "not a pool" letters typically stated that the entity in question (1) was subject to extensive Federal or State regulation; (2) would be using commodity interests for hedging purposes; (3) would commit only a small percentage of its assets—e.g., 5%—to its commodity interest trading; (4) would not be promoted as a commodity pool; and (5) would disclose, as appropriate, the purpose of and limitations on its commodity interest trading.[FN5]

> FN3 These interpretations have been issued by the Commission's Division of Trading and Markets, which is responsible for, among other things, administering and interpreting the Part 4 regulations.
>
> FN4 See, e.g., IDS Bond Fund, Inc. (available December 23, 1981); Harris Trust and Savings Bank (available November 13, 1981); Montgomery Street Income Securities, Inc. (available August 14, 1981).
>
> FN5 It should be noted that not all of the persons who requested such "not a pool" staff interpretations received them. Where one or more of these representations were absent, the Division of Trading and Markets has declined to issue such an interpretation. The Division has, however, afforded such persons certain relief from the Part 4 rules. The nature of this relief is discussed below in Part II of this Federal Register release.

In connection with the adoption of the Futures Trading Act of 1982, Pub. L. No. 97-444, 96 Stat. 2294 et seq. (1983) (the "1982 Act"), the Senate Committee on Agriculture, Nutrition, and Forestry (the "Committee") considered an amendment to the CPO definition which would have exempted the persons specified therein from the CPO definition. As the Committee Report states:

Chairman Helms then offered an amendment to clarify the definition of the term "commodity pool operator." In general, the amendment would exempt from the definition of "commodity pool operator" (1) any group of individuals less than five in number, (2) any person regulated under the Investment Company Act of 1940 or any insurance company or any trust department of a bank or trust company, each of which utilizes less than 10 percent of its pooled assets (as initial margins or options premiums) for futures trading and which was not established to conduct business as a commodity pool, (3) any benefit plan that is subject to the provisions of the Employee Retirement Income Security Act of 1974, and (4) any other person exempted by the Commission. . . . The Chairman indicated that adoption of the amendment would make it easier for commercial interests which pool funds for long-term investment in bonds and other long-term interest bearing vehicles to hedge the risk associated with fluctuation in interest rates. The Chairman further stated that, since virtually all the persons or entities to which the exception would apply are regulated by other Federal or State agencies, it is reasonable to take them out of this regulatory mechanism. S. Rep No. 384, 97th Cong., 2d Sess. 79-80 (1982).

In connection with the Committee's consideration of this amendment, the Commission made the Committee aware of the "not a pool" interpretations its staff previously had provided and of the representations upon which these interpretations had been based.[FN6]

> FN6 The Commission also advised the Committee that the staff had been proceeding very cautiously in issuing these interpretations in light of the recent expanded interest of institutional investors in commodity related pooled investment media.

After discussing whether the amendment may have been too broad and after noting the fact that the Commission intended to further review the issue of which entities should not be treated as commodity pools, the Committee declined to adopt the suggested amendment. Instead, the ***4780** Committee directed the Commission to issue regulations which would have the effect of exempting certain otherwise regulated persons from registration as a CPO. Specifically, the Committee Report states:

The Committee believes, consistent with the amendment offered by Chairman Helms, that certain entities are not within the intent of the definition of the term "commodity pool operator", as that term is defined in the Act, unless these entities have other attributes or features which would warrant their regulation as a commodity pool operator. Specifically, an entity regulated under the Investment Company Act of 1940 or an insurance company or a bank or trust company acting in its fiduciary capacity and subject to regulation by any State or the United States could ordinarily be excluded from the definition of the term "commodity pool operator," provided that (1) the entity uses commodity futures contracts of options thereon solely for hedging purposes; (2) initial margin requirements or premiums for such futures or options contracts will never be in excess of 5 percent of the fair maket value of the entity's assets (in the case of an investment company) or of the assets of any trust, custodial account or other separate unit of investment for which the entity is acting as a fiduciary; (3) the entity has not been and will not be, marketing participations to the public as or in a commodity pool or otherwise as or in a vehicle for trading in the commodities markets; and (4) the entity will disclose to each prospective participant the purpose of and limitations on the scope of the commodity futures or commodity option trading it conducts for such participants.

Also, a defined benefit plan that is subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA) and is insured by the Pension Benefit Guaranty Corporation, or any fiduciary thereof, ordinarily could be excluded from the definition of the term "commodity pool operator", provided that its commodity futures (or options on futures) trading activity is solely incidental to the conduct of its business as such a plan or as a fiduciary thereof. The Committee understands that such a plan and its fiduciaries are subject to extensive regulation under ERISA. Therefore, while the Commission should retain discretion in this area, the Committee believes that, unless otherwise inappropriate, exemption by rule, regulation, or order from commodity pool operator registration and related requirements, other than antifraud provisions, should generally be granted to these classes of entities. Id. at 80.

To implement this directive, by this Federal Register release the Commission is proposing § 4.5 and certain related amendments to its regulations.

B. Proposed § 4.5

Prior to discussing the mechanics of the proposed rule, the Commission believes that a general discussion of the relationship between a CPO and its pool would be helpful to persons who would be affected by the proposal.

Under the Commission's regulatory framework, a CPO and its pool generally must be organized as separate entities. Specifically, Rule 4.20(a) provides that, subject to exception in the case of certain corporations, a CPO must operate its pool as an entity cognizable as a legal entity separate from that of the pool operator.[FN7] The rule leaves to the discretion of the CPO the form of organization of its pool, so long as that form is one which would be recognized as a separate entity by a court of competent jurisdiction—e.g., a general partnership, a limited partnership, a trust or other form of association. Among other things, Rule 4.20(a) is intended to afford pool participants the maximum amount of protection in the event of the CPO's insolvency, to prohibt a CPO from so-

liciting or accepting orders from members of the public for the purchase or sale of commodity futures contracts without being registered as a futures commission merchant (“FCM”),[FN8] and to clarify the responsibility of the CPO for the activities and investment policies of its pool.

FN7 4.20(a) provides:
(a)(1) Except as provided in paragraph (a)(2) of this section, a commodity pool operator must operate its pool as an entity cognizable as a legal entity separate from that of the pool operator.

(a)(2) The Commission may exempt a corporation from the requirements of paragraph (a)(1) if:

(i) The corporation represents in writing to the Commission that each participant in its pool will be issued stock or other evidences of ownership in the corporation for all funds, securities or other property that the participant contributes for the purchase of an ownership interest in the pool;

(ii) The corporation demonstrates to the satisfaction of the Commission that it has established procedures adequate to assure compliance with paragraphs (b) and (c) of this section; and

(iii) The Commission finds that the exemption is not contrary to the public interest and the purposes of the provision from which the exemption is sought.

Pargarphs (b) and (c) of Rule 4.20 provide:

(b) All funds, securities or other property received by a commodity pool operator from an existing or prospective pool participant for the purchase of an interest or as an assessment (whether voluntary or involuntary) on an interest in a pool that it operates or that it intends to operate must be received in the pool's name.

(c) No commodity pool operator may commingle the property of any pool that it operates or that it intends to operate with the property of any other person.

FN8 Section 2(a)(1)(A) of the Act defines the term “futures commission merchant” to mean:

[Any person] engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market and that, in or in connection with such solicitation or acceptance of orders, accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom.

Section 4d(1) of the Acxt, U.S.C. 6d(1) (1982), makes it unlawful for any person to engage in business as a FCM without being reqisteredc as such.

The other prohibited activities specified in paragraphs (b) and (c) of Rule 4.20

> similarly are intended to insure that a CPO does not improperly commingle, convert or otherwise mishandle the property of its pool. See 45 FR 51600, 51604 (August 4, 1980) and 46 FR 34310, 34311 (July 1, 1981).

Frequently, Commission staff is called upon by members of the public to offer guidance on determing who, in fact, would be the CPO of a particular pool. In providing such guidance, the staff typically looks at such factors as who will be acting in the manner contemplated by the statutory definition of the term “commodity pool operator”—e.g., who will be promoting the pool by soliciting, accepting or receiving from others, property for the purpose of commodity interest trading—and who will have the authority to hire (and to fire) the pool's CTA and to select (and to change) the pool's FCM.

To be effective, then, any exemption under proposed § 4.5 must not only be applicable to a “ person” who could be deemed to be a CPO but also to the pool such person intended to operate—i.e., its “qualifying entity.,”Accordingly, paragraph (a) of the proposed rule pertains to the persons that would be eligible for exemption from CPO registration and from Subpart B and paragraph (b) specifies the corresponding qualifying entity for which such exemption would be available. The Commission has strictly followed the language of the Committee Report in specifying the persons and the qualifying entities eligible for the exemption. Since who the pool operator of a given entity would be might extend to operating officials, principals or employees, to clarify the scope of the exemption, paragraph (a) includes not only the person itself (e.g., a bank or trust company) but also “any principal or employee thereof.”[FN9] For similar reasons, paragraph (b) provides that a qualifying entity must be operated in a specified manner, which essentially is the manner specified in the Committee Report, discussed below.

> FN9 See § 4.20(a)(2), Supra n. 7, which allows for an entity to also be its CPO in certain cases.

To qualify for the exemption, a person would file a notice of eligibility with the Commission, as provided for in paragraph (c). The Commission is not now proposing that this notice be supported by any specific documentation. The Commission is, however, requesting comment on whether such documentation would be appropriate and, if so, what would be approrpiate.[FN10] (In this connection, the ***4781** Commission requests that the comments addressed to this issue, and to all other issues raised by proposed § 4.5, specifically identify the person and qualifying entity to which such comments are addressed.[FN11])

> FN10 For example, documentation that an entity is a registered investment company—and therefore is a qualifying entity—might include the most recent prospectus for the investment company.

> FN11 This request refers to generic identities—e.g., a bank subject to Federal regulation and the assets of any trust for which it is acting as a fiduciary—and not to actual identities—e.g., XYZ Bank, N.A. and the XYZ Bank, N.A. Collective Trust.

Under the proposal, the notice of eligibility would be required to contain the names of the person and the qualifying entity and the applicable provisions under paragraphs (a) and (b) pursuant to which they are eligible for exemption. The Commission is aware that an entity registered as an investment company under the Investment Company Act of 1940 (the “ICA”), which is one of the specified qualifying entities, may be accorded certain exemptions under the Federal securities laws concerning disclosure and financial reporting to participants and oth-

er matters.[FN12] The Commission is concerned that the nature and extent of such exemptions could be such that the investment company should not be treated as "an otherwise regulated entity" for purposes of proposed § 4.5.[FN13] Therefore, where the qualifying entity is a registered investment company, the notice of eligibility also would contain information on any such exemptions to which the company was subject or, if it was not so subject, a statement to that effect. The Commission is not aware that any of the other qualifying entities specified in the proposal may be accorded exemptions concerning disclosure and financial reporting to participants or other exemptions from their respective regulatory schemes sufficient to warrant reconsideration of the applicability of proposed § 4.5 to them and, therefore, the Commission has not proposed that the notice contain similar information with respect to any other qualifying entities. However, the Commission requests comments on this issue.

> FN12 For example, Section 6(c) of the ICA, 15 U.S.C. 80a-6(c)(1982), provides:
> The Commission by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this [Act] or of any rule or regulation thereunder, if an to the extent that such exemption is necessary or appropriate in the public intrerest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this [Act].
>
> FN13 As stated above, the Committee Report excludes from its scope otherwise qualifying entities having "attributes or features" which warrant their regulation by the Commission.

The notice of eligibility also would be required to contain certain representations ocncerning the standards by which the qualifying entity would be operated. As discussed more fully below, these standards—which are criteria for the exemption—generally would require the entity: (1) To trade commodity interests solely for hedging purposes; (2) to commit no more than 5% of its assets as margin or premiums for its commodity interest trading; (3) to not market itself as a commodity pool; (4) to disclose to its participants the purpose of and limitations on its, commodity interest trading; and (5) to submit to special calls for information by the Commission. With the exception of the representation concerning special calls, which is intended to permit the Commission to monitor the continued applicability of the exemption by verifying compliance with the terms and conditions of the exemption, these standards of operation are taken from the Committee Report. It should be noted that although this proposal has not itself gone beyond the specific langauge of the Committee Report to further define the meaning and scope of these criteria, the Commission specifically is requesting comments on the actual content of these representations which address specifically the differences in the other regulatory frameworks to which the qualifying entities set forth in the proposal are subject. The Commission expects that the final rules on these representations will more fully describe the parameters of such operating conditions. Moreover, the Commission expects to interpret the express criteria of the rule in accord with the specific standards contained in the staff interpretations of § 4.10(d) which have been issued to date. Absent comment which suggests further interpretation or modification of the rule itself, the Commission expects to continue to follow such interpretations and to consider requests for further delineation of the criteria based on specific fact situations.

The first representation concerning the standards by which a qualifying entity would be operated is that the entity must "use commodity futures or options contracts solely for bona fide hedging purposes."In this regard, the Commission believes that the definition of the term "bona fide hedging transactions and positions" contained in

§ 1.3(z)(1), 17 CFR 1.3(z)(1) (1983), should be controlling.[FN14] Among other things, this means that in using commodity futures and options contracts the qualifying entity must take into account the correlation in the fluctuations in the value of its futures or options positions relative to the value of its actual or anticipated cash positions. This also means that such futures or options positions must be entered into with the intent required by § 1.3(z)(1).

> FN14 Section 1.3(z)(1) states:
> Bona fide hedging transactions and positions shall mean transactions or positions in a contract for future delivery on any contract market, where such transactions or positions normally represent a substitute for transactions to be made or positions to be taken at a later time in a physical marketing channel, and where they are economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, and where they arise from:
>
> (i) The potential change in the value of assets which a person owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing, or merchandising,
>
> (ii) The potential change in the value of liabilities which a person owes or anticipates incurring, or
>
> (iii) The potential change in the value of services which a person provides, purchases or anticipates providing or purchasing.
>
> Notwithstanding the foregoing, no transactions or positions shall be classified as bona fide hedging for purposes of section 4a of the Act unless their purpose is to offset price risks incidental to commercial cash or spot operations and such positions are established and liquidated in an orderly manner in accordance with sound commercial practices and unless the provisions of paragraphs (z) (2) and (3) of this section and §§ 1.47 and 1.48 of the regulations have been satisfied.

In this connection, Commission staff has found that certain “anticipatory” or “long hedge” strategies do not, in fact, come within the scope of § 1.3(a)(1). With respect to futures contracts, a traditional anticipatory hedge is a transaction in which a futures contract is purchased to protect against an increase in the price of the commodity subject to the futures contract where there is a fixed commitment to purchase the underlying commodity at a later date. With respect to options, a so-called anticipatory hedge typically would involve the purchase of a call option to protect against an increase in the price of the commodity subject to the option where there is a fixed commitment to purchase such commodity. Where there is an anticipatory transaction but no fixed commitment to make a transaction at a later time in a physical marketing channel, the Commission is concerned that distinguishing between what is the anticipatory reduction of risk and speculation may be exceedingly difficult. This is particularly true in the case of pooled investment media where there is no independent business need generated by the commercial activities of the entity (other than the need to increase investment return) for using the ***4782** commodity markets to anticipate future commitments.

Nonetheless, the Commission believes that there may be situations where it would not be economically appropriate for such an entity to complete an anticipatory hedge.[FN15] In this connection, the staff has employed an intent test to determine whether an anticipatory hedge which is not in fact followed by the purchase of the com-

modity—i.e., "completed"—is outside the scope of § 1.3(z)(1). Accordingly, Commission staff previously has required that to receive a "not a pool" interpretation an entity must represent that it "will use commodity futures or options contracts solely for bona fide hedging purposes" and, further, that: (1) All transactions will be entered into with the intent required by § 1.3(z)(1); and (2) a substantial majority—i.e., 75%—of all anticipatory hedge transactions entered into each year will be completed.[FN16] The Commission proposes to continue to so interpret the hedging criteria for purposes of the exemption in § 4.5 but specially requests comments on whether additional or different standards should be set forth.

FN15 For example, if due to drastically changed market conditions since the purchase of a long futures contracts, the cash market for the commodity subject to the contract has declined and a further decline appears likely, the purchase of the commodity at the time of offset of the contract may not be prudent.

FN16 1 See Pension Hedge Fund Inc., Comm. Fut. L. Rep. (CCH) 21,908 (available November 3, 1983); SteinRoe Bond Fund, Inc., Comm. Fut. L. Rep. (CCH) 21,906 (available October 21, 1983); Prudential-Bache Option Growth Fund, Inc., Comm. Fut. L. Rep. (CCH) 21,905 (available September 13, 1983). See also Piedmont Income Fund, Inc., Comm. Fut. L. Rep. (CCH) 21,910 (available November 21, 1983).

Second, the qualifying entity must "not enter into commitments which require as deposits for initial margin for [its] futures or options contracts more than 5 percent of the fair market value of its assets."The reason for this criterion is that the exemption is not intended to be for pooled media primarily dealing in commodity interest trading but for qualifying entities that use commodity interests as risk reduction transactions as an adjunct to their other stated investment activities.

Third, the qualifying entity must be operated in a manner so that it "will not be, and has not been, marketing participations to the public as or in a commodity pool or otherwise as or in a vehicle for trading in the commodity futures or commodity options markets."' For purposes of this representation, the Commission proposes to interpret the term "marketing" to include oral, written and electronic promotional materials.[FN17] The Commission further proposes that an entity would be "marketing participations" in a manner inconsistent with the required representation if it was actively promoted as a hybrid—e.g., a securities and a commodities—trading vehicle or as an investment vehicle in which commodity futures and options trading was particularly significant and critical to the growth of its assets, as opposed to being incidental to protecting those assets against a decline in value. The Commission is aware, however, that the other regulatory agencies to which the qualifying entity is subject may prescribe the form and content of the entity's marketing materials.[FN18] The Commission therefore is requesting comment on whether "marketing" should be further interpreted in light of the prescriptions of such other regulatory agencies.[FN19]

FN17 This is consistent with the revised definition of the term "commodity trading advisor" in Section 2(a)(1)(A) of the Act and with the staff's "not a pool" interpretative letters. See Section 201(2) of the 1982 Act, 96 Stat. 2297-98 and supra n. 16, respectively.

FN18 1 See, e.g., Section 8(b)(5) of the ICA, 15 U.S.C. 80a-8(b)(5)(1982).

FN19 1 CF. Division of Trading and Markets Staff Intepretative Letter, Comm.

Fut. L. Rep. (CCH) 21,788 (available March 18, 1983).

Fourth, the qualifying entity must disclose in writing to each prospective participant the purpose of and limitations on its commodity futures and options trading. Again, in view of the differences in the other regulatory frameworks to which the entity may be subject and, in particular, any differences in applicable disclosure requirements, the Commission requests comment on whether further specificity as to how this criterion would best be met is needed.

Fifth, and finally, the qualifying entity must "submit to such special calls as the Commission shall make of it to demonstrate compliance with the requirements for exemption" specified in 4.5.[FN20] The Commission believes that it must be able to readily obtain such information as may be necessary to verify compliance with the terms and conditions of the exemption and would expect to make very limited use of this special call provision. Inasmuch as proposed § 4.5 would provide for exemption from the recordkeeping requirements of § 4.23, this provision would enable the Commission upon complaint to establish whether an entity operating under the exemption was in continued compliance with the exemption criteria. It may also help the Commission to further refine the hedging or other criteria required by the exemption or to expand such criteria by rendering data on commodity interest activity by such entities generally accessible.

FN20 The Commission is proposing in § 140.93(a)(5) to delegate to the Director of the Division of Trading and Markets the authority to make such special calls. This would be consistent with other delegations of authority under Part 4 that the Commission has made. See §§ 140.93(a)(1)-(4), 17 CFR 140.93(a) (1)-(4) (1983).

The Committee Report contemplated that any rule proposed by the Commission in response thereto would not require prior approval on a case-by-case basis to apply. The Commission therefore has proposed that the notice of eligibility under § 4.5 would be effective upon filing.[FN21] To continue the effectiveness of the exemption, the Commission has proposed in paragraph (d) that a supplemental notice be filed to render the information contained in the notice of eligibility accurate and complete. For example, a supplemental notice would be required to be filed in the event of a change in the name of the person as to whom the exemption was effective or the qualifying entity for which it was effective. Similarly, a supplemental notice would be required to be filed in the event the person as to whom the exemption was effective or the entity for which it was effective had ceased to come within the scope of paragraph (a) or (b), respectively—e.g., such entity had ceased to be registered as an investment company under the ICA or had ceased doing business as such. In the cases presented in this latter example, however, and as discussed below, the exemption would cease to be effective. The supplemental notice would be due fifteen business days after the occurrence of such event. This proposed requirement recognizes the continued importance of the Commission knowing who is operating under the exemption and, accordingly, compliance therewith would be essential to continue the effectiveness of the exemption.

FN21 Under proposed § 4.5(c)(3), the notice of eligibility would be required to be filed with the Commission "prior to the date upon which such person intends to operate the qualifying entity" (emphasis added).

As the representations given in connection with the receipt of the previously issued "not a pool" staff interpretative letters closely parallel the representations which would be required in connection with qualifying for the exemption contained in proposed § 4.5, the Commission does not believe that it should be necessary for the recipients of such interpretative letters to, in effect, "re-submit" an application for exemption—i.e., to file an initial

notice of eligibility—in the event the proposal is adopted. However, to insure that these persons (and entities) would ***4783** be in compliance with the requirements of the proposed rule, the Commission intends to take the position that such persons must file supplemental notices in the event that any of the representations they previously had made to the Commission changed or that, to the extent that the proposal would require any additional representations, they were not in compliance with them. This position would ensure equal treatment of all persons claiming exemption under the rule.

Under paragraph (e), an exemption effective under the rule would immediately cease to be effective upon the ineligibility of the person as to whom the exemption was effective or the entity for which it was effective for inclusion in paragraph (a) or (b), respectively, or upon the failure of the entity to be operated in the manner specified in paragraph (c)(2). The Commission emphasizes that failure to provide a supplemental notice of this information under paragraph (d) would not affect the fact that the exemption had ceased. (conversely, the providing of this information in a supplemental notice would not affect the fact that the exemption had ceased.) Under paragraph (e), the Commission also could terminate an exemption if it determined that: (1), The notice of eligibility was inaccurate or incomplete; (2) a person or qualifying entity thereof possesses other attributes or features which warrant CPO registration—e.g., in the event of substantial de-regulation of the person or qualifying entity; or (3) the continuance of the exemption would be contrary to the public interest. This termination authority was contemplated by the Committee Report, which states that “the Commission should retain discretion in this area.”It should be noted, however, that the Commission has not proposed to delegate its authority to terminate an exemption to the staff.

The final paragraph of the proposed rule, paragraph (f), specifies the requirements for each notice required to be filed under the proposal—i.e., it must be in writing, signed by a duly authorized representative, and filed at the address stated in § 4.2.

C. The Effects of Proposed § 4.5

The proposed rule would provide relief for the otherwise regulated persons specified therein in two ways. First, it would exempt them from registration as a CPO with the Commission. Therefore, unlike registered CPOs, these persons would not be required to file registration applications and fingerprint cards with the Commission nor would they be subject to any registration fees. See generally Part 3 of the Commission's regulations, 17 CFR Part 3 (1983), as amended by 48 FR 35248. In furtherance of this relief from registration, the Commission is proposing to amend § 3.16(a)(4) to provide that an associated person of a person exempt from CPO registration and from Subpart B under § 4.5 would, likewise, be exempt from registration with the Commission.[FN22]

> FN22 Section 1.3(aa), 48 FR 35248, 35279, defines the term “associated person” to mean in pertinent part: [A]ny natural person who (as provided in Section 4k of the Act) is associated in any of the following capacities with:
> * * * * *
>
> (3) A commodity pool operator as a partner, officer, employee, consultant, or agent (or any natural person occupying a similar status or performing similar functions), in any capacity which involves (i) the solicitation of funds, securities, or property for a participation in a commodity pool or (ii) the supervision of any person or persons so engaged * * *.

Second, the proposed rule would provide relief from all of the provisions of Subpart B of Part 4. This means re-

lief from the disclosure, reporting and recordkeeping requirements under §§ 4.21, 4.22 and 4.23, respectively, for each CPO who is "registered or required to be registered."This also means relief from the prohibited activities specified in § 4.20, discussed above, for each person that comes within the CPO definition and which apply regardless of whether that person is registered or required to be registered as a CPO.[FN23] As noted, the purpose of § 4.20 is to insure that pool participants' funds will not be improperly commingled, converted or otherwise mishandled by their pool's CPO. The Commission believes that the other regulatory frameworks to which the persons and qualifying entities specified in proposed § 4.5 are subject generally address the purposes of the prohibitions contained in § 4.20.[FN24] Therefore, the Commission believes that such relief is appropriate.[FN25] The Commission nonetheless requests comments on this matter.

> FN23 The Commission notes that by this Federal Register release it is proposing to amend § 4.20 to prohibit certain additional activities. This proposal is discussed later at Part II of this release.
>
> FN24 See, e.g., Section 17(f) of the ICA, 15 U.S.C. 8a-17(f) (1982).
>
> FN25 In this connection, it should be noted that if a person (or qualifying entity) was operating in a mannner inconsistent with the purpose of § 4.20, under proposed § 4.5(e) the Commission would have the authority to terminate the person's exemption.

Pursuant to the directive of the Committee Report, the Commission also is proposing to amend § 4.15. This proposal would exclude from the reparations provisions of setion 14 of the Act, 7 U.S.C. 18 (1982), any person exempt from registration as a CPO under Part 4—e.g., under § 4.5.[FN26] Although such person would continue to be subject to the anti-fraud provisions of section 4o of the Act, 7 U.S.C. 6o (1982), the Commission is declining at this time to exercise its authority to subject such person to the reparations provisions of section 14. Moreover, with respect to the persons specified in proposed § 4.5, this exclusion would be consistent with the Committee Report language that "exemption . . . other than [from] antifraud provisions . . . should generally be granted."In contrast, and for this same reason, the Commission has not proposed to amend § 4.41, which prescribes certain advertising standards for all CPOs, to exclude therefrom any person who would be exempt from CPO registration under § 4.5.[FN27] N Therefore, § 4.41 would continue to apply to each person who comes within the CPO definition, whether or not such person is required to register as a CPO with the Commission.

> FN26 This proposal also would apply to persons exempt from registration as a CPO under § 4.13, which currently is the only section of Part 4 which provides for such an exemption and to persons exempt from registration as a CTA under § 4.14.
>
> FN27 Section 4.41 provides:
>
> (a) No commodity pool operator, commodity trading advisor, or any principal thereof, may advertise in a manner which:
>
> (1) Employs any device, scheme or artifice to defraud any participant or client or prospective participant or client; or
>
> (2) Involves any transaction, practice or course of business which operates as a

fraud or deceit upon any participant or client or any prospective participant or client.

(b)(1) No person may present the performance of any simulated or hypothetical commodity interest account, transaction in a commodity interest or series of transactions in a commodity interest of a commodity pool operator, commodity trading advisor, or any principal thereof, unless such performance is accompanied by the following statement: "Hypothetical or simulated performance results have certain inherent limitations. Unlike an actual performance record, simulated results do not represent actual trading. Also, since the trades have not actualy been executed, the results may have under-or-over compensated for the impact, if any, of certain market factors, such as lack of liquidity. Simulated trading programs in general are also subject to the fact that they are designed with the benefit of hindsight. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown."

(2) If the presentation of such simulated or hypothetical of such simulated or hypothetical performance is other than oral, the prescribed statement must be prominently disclosed.

(c) The provisions of this section shall apply:

(1) To any publication, distribution or broadcast of any report, letter, circular, memorandum, publication, writing, advertisement or other literature or advice, including the texts of standardized oral presentations and of radio, television, seminar or similar mass media presentations, and

(2) Regardless of whether the commodity pool operator or commodity trading advisor is exempt from registration under the Act.

***4784** II. Other Proposals

A. Introduction

The Part 4 regulations were issued by the Commission on January 2, 1979 and they became effective April 1, 1979, See 44 FR 1918. Based upon the significant growth in CPO and CTA activity and the Commission's experience in monitoring the implementation of and compliance with these original regulations, revisions to the Part 4 regulations were issued on May 8, 1981, and they essentially became effective on August 24, 1981. See 46 FR 26004; 46 FR 34799 (July 6, 1981). Based upon the continuing growth of CPO and CTA activity and experience with these revisions, the Commission today is proposing further amendments to the Part 4 regulations.

B. Proposed Amendments to Existing Regulations

Section 4.13: Exemption from registration as a CPO. Section 4.13 exempts the operators of family, club and small pools from registration as a CPO.[FN28] Under paragraph (b)(1) of this rule, a persons who qualifies for and operates pursuant to such exemptions must deliver a prescribed statement to each prospective participant in its pools. This statement essentially advises the prospective participant that the CPO is not registered as such

with the Commission and therefore that the CPO is not required to comply with the disclosure and reporting requirements applicable to registered CPOs under §§ 4.21 and 4.22, respectively. The statement must also describe the exemption pursuant to which the CPO is not registered.

> FN28 See 44 FR 1918, 1919. Specifically, § 4.13(a) provides in pertinent part:
> A person is not required to register under the Act as a commodity pool operator if:
>
> (1)(i) It does not receive any compensation or other payment, directly or indirectly, for operating the pool, except reimbursement for the ordinary administraative expenses of operating the pool;
>
> (ii) It operates only one commodity pool at any time;
>
> (iii) It is not otherwise required to register with the Commission and is not a business affiliate of any person required to register with the Commission; and
>
> (iv) Neither the person nor any other person involved with the pool does any advertising in connection with the pool (for purposes of this section, advertising includes the systematic solicitation of prospective participants by telephone or seminar presentation); or
>
> (2)(i) The total gross capital contributions it receives for units of participation in all of the pools that it operates of that it intends to operate do not in the aggregate exceed $200,000; and
>
> (ii) None of the pools operated by it has more than 15 participants at any time.

Currently, § 4.13(b)(1) does not require that this prescribed statement be filed with the Commission. Because it is critical to the Commission's oversight of the operations and activities of CPOs to know the identities of all persons who are acting as a CPO, the Commission is proposing to amend § 4.13(b)(1) to require that the statement specified therein be filed with the Commission.[FN29] It should be noted that this proposal is in no way intended to affect who is eligible for exemption from registration as a CPO under § 4.13 or to delay the effectiveness of any such exemption.[FN30]

> FN29 This proposal would parallel proposed § 4.5(c), discussed above.
>
> FN30 Section 4.14 exempts certain persons from registration as a CTA. That rule does not, however, require the delivery of any prescribed statement such as that specified in § 4.13(b)(1) for CPOs.

Section 4.20: Prohibited activities for CPOs. The Commission believes that a CPO has a fiduciary duty to its pool participants to use the assets of its pool for a program of commodity interest trading which can result in gain—that is, to use assets for purposes for which they were contributed.[FN31] The Commission further believes that the current regulatory framework for CPOs under Part 4 may not contain adequate provisions to ensure tha this fiduciary duty is fulfilled. Specifically, the Commission is concerned that, absent any prohibition, a CPO may not commit sufficient assets of its pool to commodity interest trading but, instead, may keep those assets our of the commodity interest markets to permit the § 4.21 to receive the income generated therefrom.[FN32] This would not be permitted if properly disclosed under § 4.21(a)(9).

FN31 For example, if a CPO were to place but a minimal amount of is pool's assets at risk in the commodity interest markets, the CPO might be in breach of its fiduciary duty to afford its pool participants the opportunity of achieving their objective of profiting from their participation in the pool. See also Stewart v. Decade Management Co., Com. Fut. L. Rep. (CCH) 20,664 (Initial Decision Aug. 29, 1978), wherein it was stated the a CPO assumes a fiduciary obligation to its pool participants by accepting the participants' funds and receiving the power of attorney to trade those funds.
In making this statement, however, the Commission is not unmindful of the fact that for prudent business pruposes, a CPO typically does not commit all the assets of its pool for initial margin and premiums on futures and options contracts but maintains a reserve of pool assets for the payment of such items as additional margin and legal and accounting fees. This statement, then, is in now way intended to impair the ability of a CPO to maintain a reserve of pool reserve of pool assets for such purposes or other purposes related to the prudent management of pool assets or to affect the propriety of such activity. Rather, this proposal is intended to remove any incentive for personal gain on the part of the CPO related to the form of investment of the pool's assets.

FN32 Thus, if only small portion of the assets it collected from its pool participants were placed into the commodity interest markets, the CPO, although deriving income from such assets in its own behalf, would virtually assure that the participants would not profit from their investments in the pool. This is because in order for a pool participant to profit from his investment, a sufficient percentage of the pool's assets must be deposited as initial margin. Otherwise, the pool would have to generate a virtually unattainable rate of return.

Accordingly, the Commission is proposing in § 4.20(d) to prohibit a CPO from receiving income generated by its pool's assets other than for the sole purpose of offsetting the actual organizational and offering expenses of the pool which have been incurred by the CPO. The term “organizational and offering expenses” would be defined in § 4.20(d)(2)(ii) to include legal and accounting fees, printing expenses, escrow charges, and filing, registration and recording fees. The Commission specifically requests comment on this proposed definition.

C. Notice of Further Rulemaking

In addition, the Commission also is considering the adoption of certain other amendments to Part 4 of its regulations. Set forth below is a narrative discussion of these other amendments that the Commission is considering as well as a discussion of certain issues related thereto on which the Commission seeks comment. The Commission has not yet formulated specific language to implement these proposals and, accordingly, no such language is reflected in the text of the proposals reprinted at the end of the notice.

Exemptions for other CPOs. As noted, the Commission has strictly followed the Senate Report in specifying the persons and qualifying entities who would be eligible for exemption under proposed § 4.5. The Commission does, however, request comments on which other persons and entities, if any, are subject to such pervasive Federal or State regulation so as to make the availability of the proposed exemption appropriate as to them. Of course, such other persons and entities would still be required to meet the criteria specified in § 4.5 to be eligible

for the exemption.

The Commission wishes to make clear that it does not believe that the mere liability of a person or entity to its participants under such other Federal or State regulation would be sufficient to make the proposed exemption appropriate.[FN33] Rather such person or ***4785** entity must be subject to ongoing regulation of its activities with respect to its participants in a manner generally equivalent to the regulation of a CPO's activities as provided for under the Part 4 regulations.[FN34]

> FN33 Compare, for example, the regulatory requirements applicable to a company that is registered as an investment company unde the ICA ans whose securities have been registered under the Securities Act of 1933 with those applicable to a company that has sold its securities in reliance upon the availablility of an exemption from such registration in Regulation D issued under such Act. 17 CFR 230.501-230-506 (1983).
>
> FN34 As noted above, among other things Part 4 provides for disclosure, reporting and recordkeeping requirements for CPOs.

In this connection, the Commission is aware that in the course of administering Part 4, its staff has issued certain exemptions from the disclosure requirements of Rule 4.21 and the reporting requirements of Rule 4.22 to persons and entities who would not be eligible for exemption under proposed § 4.5. 35 36e.g., 10%—as initial margin and option premium deposits; (3) the entity had not been, and would not be, marketed as a commodity pool; (4) the entity would disclose the purpose of and limitations on its commodity interest trading to its participants; and (5) the entity was required by its enabling documents to furnish certified financial statements to its participants on an annual basis.[FN37] Upon such representations, the staff has exempted these persons from the specific requirements of Rules 4.21 and 4.22 and has accepted in lieu thereof the disclosure and reporting documents that they intended to provide to their participants under the regulations which address the primary purpose of the entity's operation.[FN38] The staff required such persons, however, to remain subject to the recordkeeping requirements of § 4.23.

> FN35 These exemptions have been issued pursuant to Rule 140.93(a)(1), which delegates to the Director of the Division of Trading and Markets the authority to issue exemptions from the Part 4 regulations.
>
> FN36 Typically, such documents have been limited partnership agreements.
>
> FN37 See, e.g., Division of Trading and Markets Staff Interpretative Letters available May 24, 1983 and January 28, 1983.
>
> FN38 Typically, these documents have included, with respect to Rule 4.21, confidential offering memoranda prepared in accordance with Regulation D and, with respect to Rule 4.22, a certified annual report containing Statement of Financial Condition, Income (Loss), Changes in Financial Position and Changes in Ownership Equity.

The Commission is considering adopting a rule that would codify both the relief accorded under these exemptions and the representations upon which such relief was based. The Commission requests comments on this pro-

posal and, in particular, on the representations that would be required to be made thereunder.

Exemption from registration as a CTA for certain persons registered as an IA. In connection with the recent amendments to the Act, the CTA definition was amended to, among other things, exclude additional persons thereform. Specifically, Section 2(a)(1)(A) of the Act now defines the term "commodity trading advisor" to mean:

[Any person who, for compensation or profit, engages in the business of advising others, either directly or through publications, writings or electronic media, as to the value of or the advisability of trading in any contract of sale of a commodity for future delivery made or to be made on or subject to the rules of a contract market, any commodity option authorized under section 4c, or any leverage transaction authorized under section 19, or who, for compensation or profit, and as part of a regular business, issues or promulgatets analyses or reports concerning any of the foregoing; but such term does not include (i) any bank or trust company or any person acting as an employee thereof, (ii) any news reporter, news columnist, or news editor of the print or electronic media, or any lawyer, accountant, or teacher, (iii) any floor broker or futures commission merchant, (iv) the publisher or producer or any print or electronic data of general and regular dissemination, including its employees, (v) the fiduciary of any defined benefit plan which is subject to the provisions of the Employee Retirement Income Security Act of 1974, (vi) any contract market, and (vii) such other persons not within the intent of this definition as the Commission may specify by rule, regulation, or order; Provided, that the furnishing of such services by the foregoing persons is solely incidental to the conduct of their business or profession* * * . (Emphasis added.)

As a result of this amendment, it appears that many of the persons who would be providing advice on commodity interest trading to persons and entities who have qualified for exemption under proposed § 4.5 would, themselves, be excluded from the CTA defintion—i.e., banks, trust companies and employees thereof, and the named fiduciary of any defined benefit plan subject to ERISA or any fiduciary whose sole business is to advise that plan.[FN39]

> FN39See the definition of the term "commodity trading advisor" contained in § 1.3(bb), 48 FR 35248, 35279.

Section 2(a)(1)(A) was not amended to exclude from the CTA definition a person registered as an IA under the IAA.[FN40] The Commission is aware that there may be situations in which a person registered as an IA would desire to provide advice on both securities and commodity interest trading to persons and entities who have qualified for exemption under proposed § 4.5. Since Section 2(a)(1)(A) does not exclude a person registered as an IA from the CTA definition, absent an exemption such person would be required to register as a CTA with the Commission.[FN41]

> FN40 Section 202(a)(11) of the IAA, 15 U.S.C. 80b-2(a)(11)(1982), defines the term "investment adviser" to mean:
> [A]ny person who, for compensation, engages in the business of advising others, either directly or through publications or writing, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities; but does not include [certain specified persons].
>
> Section 203(a), 15 U.S.C. 80b-3(a)(1982), generally makes it unlawful for a per-

son to engage in business as an IA without being registered as such.

FN41 In this connection, the Commission notes that the staff of the Division of Investment management of the Securities and Exchange Commission has stated that it would not recommend that that Commission take any enforcement action under:

the Investment Advisers Act, if, without registering under such Act, [certain commodity pools'] trading advisers provide the [pools] with advice concerning approved futures and CFTC options, provided that such advisers are not otherwise investment advisers as defined in the Investment Advisers Act who are required to register under the Investment Advisers Act. Peavey Commodity Futures Fundings I, II and III, Fed. Sec. L. Rep. (CCH) 77,511 at 78,652 (available June 2, 1983).

Section 4m(1) of the Act provides in general for registeration as a CTA. Section 4m(1) does, however, exempt from registration as CTA certain persons who come within the statutory definition, by providing in pertinent part:

[T]he provisions of this section shall not apply to any commodity trading advisor who, during the course of the preceding twelve months, has not furnished commodity trading advice to more than fifteen persons and who does not hold himself out generally to the public as a commodity trading advisor. (Emphasis added.)

In furtherance of the purpose of the Committee Report, but in light of the limits of Section 4m(1), the Commission is considering adopting a rule that would exempt from registration as a CTA a person who is registered as an IA and who was formed for the sole purpose of and whose sole business is to provide investment advice to a person and an entity who have qualified for exemption under proposed § 4.5. The Commission wishes to emphasize that this rule would not apply to a registered IA who advised two or more persons and entities who had qualified under proposed § 4.5—because that IA would be "[holding] himself out generally to the public as a commodity trading advisor."Moreover, a person exempted ***4786** from registration as a CTA under this rule would continued to be subject to the anti-fraud provisions of Section 4o of the Act and to the advertising standards for CTAs specified in Rule 4.41, discussed above.[FN42]

FN42 In making this proposal, the Commission is not seeking to define the term "person" for purposes of the exemption from registration as a CTA in Section 4m(1) but, as stated above, is acting in furtherance of the purposes of the Committee Report. In this regard, the Commission notes that the Court of Appeals for the Ninth Circuit has held that a person who furnishes trading advice to a futures commission merchant which "incorporate[s] that advice directly into actual transactions" for its discretionary account customers who number more than fifteen people is thus furnishing trading advice to more than fifteen people. CFTC v. Savage, 611 F. 2d 270, 281 (9th Cir. 1979).

Prohibited activities of CPOs. As stated above, the Commission believes that a CPO has a fiduciary duty to its pool participants to use the assets of its pool for a program of commodity interest trading which can result in gain. In this connection, the Commission further believes that a CPO has a fiduciary duty to its pool participants to serve as the pool's CPO until either another CPO assumes responsibility for operating the pool or until the pool's assets are liquidated.

The current Part 4 rules, however, contain no specific provisions to ensure that this fiduciary duty is fulfilled. Accordingly, the Commission also is considering the adoption of an additional provision in § 4.20 that would prohibit a CPO from abandoning its pool. The Commission requests comments on this proposal.

Presentation of actual past performance of CPOs, CTAs, and their principals. Sections 4.21(a) and 4.31(a) respectively require each CPO who must register under the Act and certain CTAs who must register[FN43] to furnish a Disclosure Document to prospective customers. In particular, §§ 4.21 (a)(4) and (a)(5) and § 4.31(a)(3) require the Disclosure Document to contain information on the actual past performance of CPOs, CTAs, and their principals in a specified format.

> FN43 Section 4.31(a) only applies to those CTAs who must register and who seek to direct or to guide a client's commodity interest account.

As originally adopted, this format included an annual rate of return (compounded annually) and a table of periodic net asset values. 44 FR 1918, 1925-1926 and 1928. The Commission adopted this format to require that past performance be presented in an understandable and meaningful manner to prospective customers and in a uniform format that would enable members of the public to compare the performance of different commodity interest accounts and to compare those accounts with other financial investments. See 44 FR 1918, 1921. Experience with this format indicated that it was not, however, completely fulfilling its purposes. Therefore, the Commission determined to revise the format by adopting “a less complex approach to the presentation of past performance, which may sacrifice comparability but which is more readily understood.”45 FR 51600, 51602.

This revised format, which currently is in effect, requires that actual past performance must be displayed in a table showing at least quarterly the following information: (A) Beginning net asset value; (B) all additions; (C) all withdrawals and redemptions; (D) net performance; (E) ending net asset value; and (F) the rate of return, calculated by dividing net performance by beginning net asset value. Specifically, this format is required by §§ 4.21 (a)(4)(ii) and (a)(5)(ii) for CPOs and by § 4.31(a)(3)(ii) for CTAs.[FN44] Based upon its experience with this current format for the presentation of actual past performance the Commission believes that certain further revisions may be appropriate and seeks comments thereon as discussed below.

> FN44 In addition, under § 4.21(a)(4)(ii)(G) a CPO must also include in the prescribed table the number of units outstanding at the end of each period for which performance is disclosed.

The Commission's experience with the current format indicates that the format does not specifically take into account when additions or withdrawals occurred during a particular performance period in arriving at the net performance for such period.[FN45] This is because the format assumes that any such additions or withdrawals occurred at the end of the performance period. Therefore, when there have been net additions—i.e., more additions than withdrawals—during the period, the specified format may produce a higher percentage of gain than that which would be produced under a format that takes the timing of such additions into account. Conversely, when there have been net withdrawals—i.e., more withdrawals than additions—during the period, the specified format may produce a lower percentage of loss than that which would be produced under a format that takes the timing of such withdrawals into account. Accordingly, the Commission seeks comment on whether the past performance format for CPOs, CTAs, and their principals should be revised to take the timing of additions and withdrawals into accounts and, if so, how this revision would best be made.

> FN45 Of course, under the current rules a CPO or a CTA could supplement the

specified format so as to take this information into account. As the Commission stated:

[T]he format the Commission has adopted for the presentation of past performance is a minimum disclosure standard which CPOs and CTAs must meet. More comprehensive or more frequent disclosure could thus be made as needed—e.g., where the format potentially could mislead prospective customers. 46 FR 26004, 26008.

See also §§ 4.21(h) and 4.31(g).

The current format also does not specifically account for situations where commodity interests have been traded for hedging—as opposed to speculative—purposes. The Commission is aware that a growing number of CPOs and, in particular, CTAs are seeking to trade in such instruments as financial and stock index futures and options contracts for hedging purposes in managing customers' assets which include the instruments underlying these contracts. Accordingly, the Commission seeks comments on whether the past performance format should be supplemented to take the results of such trading for hedging purposes into account and, if so, how this revision would best be made.

The Commission's experience with the current format further indicates that the format might best serve it purposes if it were to also require past performance to be presented on an annual basis. As noted above, currently performance must only be presented “at least quarterly.” However, the Commission's experience indicates that for performance to be presented in a meaningful manner and in a manner capable of ready comparison with other investment vehicles, it also should be presented on an annual basis. Therefore, the Commission seeks comments on whether the past performance format for CPOs, CTAs, and their principals should be revised to require, in addition to the current information called for at least quarterly, an annual rate of return and, if so, how this rate of return should be computed.

Financial requirements for CPOs. The framework of the Act and the Commission's regulations thereunder allows three categories of registrants to have direct access to customer funds committed for the purpose of trading commodity interests: FCMs, introducing brokers (“IBs”) and CPOs.[FN46] For FCMs and IBs, the Commission has established certain minimum financial and related reporting requirements [FN47] to ***4787** ensure that they meet their obligations as registrants and “to guarantee accountability and responsible conduct.” [FN48] For CPOs, however, the Commission has not established such requirements to date.

FN46 Section 4.30 generally prohibits a CTA from receiving customers funds committed for the purpose of trading commodity interests.

FN47 See §§ 1.10, 1.12, 1.16, 1.17 and 1.18, 17 CFR 1.10, 1.12, 1.16, 1.17 and 1.18 (1983), as amended by 48 FR 35248.

FN48 See S. Rep. No. 384 at 41.

Section 1.17(a) prescribes these minimum financial requirements. For an FCM, who may receive customer funds directly in its own name, this requirement basically is an adjusted net capital of $50,000. For an IB who, like a CPO, may not receive customer funds directly in its own name but who must transmit those funds to an FCM,[FN49] this requirement basically is an adjusted net capital of $20,000.

FN49 See the discussion of § 4.20, supra, for CPOs and § 1.57(c), 48 FR 35248, 35291 for IBs.

In proposing minimum financial requirements for IBs, the Commission stated:

[R]equiring a registered intorducing broker to have a permanent capital base not only would establish a benchmark of economic viability, but would also be an important element of customer protection. 48 FR 14933, 14942 (April 6, 1983).

The Commission believes that financial requirements for CPOs similarly would serve these vital functions. The Commission further believes that because CPOs, like IBs, must transmit their customers' funds to an FCM, financial requirements for CPOs similar to those for IBs would be appropriate. In this connection, the Commission requests comments on the actual dollar amounts and the method of computing of such amounts as they should apply to CPOs.[FN50]

FN50 The Commission intends that such financial requirements would be applicable only to CPOs registered or required to be registered under the Act. This would be consistent with the purposes of exemption from registration as a CPO—whether that exemption be for an "otherwise regulated entity" under proposed § 4.5 or for the operator of a "family, club or small pool" under § 4.13(a).

III. Related Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act ("RFA"), 5 U.S.C. 601 et seq. (1982), requires that agencies, in proposing rules, consider the impact of those rules on small business. The Commission has already established certain definitions of "small entities" to be used by the Commission in evaluating the impact of its rules on such small entities in accordance with the RFA.[FN51]

FN51 47 FR 18618-18621 (April 30, 1982).

These definitions do not address the persons and qualifying entities set forth in proposed § 4.5 because, by the very nature of the proposal, the operations and activities of such persons and entities generally are regulated by Federal and State authorities other than the Commission.[FN52] Assuming, arguendo, that such persons and entities would be "small entities" for purposes of the RFA, the Commission does not believe that proposed § 4.5 would have a significant economic impact on them because it merely would require the filing of a notice with the Commission, the documentation for which should be pre-existing. Moreover, the proposal would relieve these persons (and entities) from the requirement to register as a CPO and from the disclosure, reporting and recordkeeping requirements applicable to registered CPOs is required. With respect to persons exempt from registration as a CPOs. As for other persons who may come within the CPO definition, the Commission has determined that registered CPOs are not small entities for purposes of the RFA.[FN53] Thus, no economic analysis of these proposals as they relate to registered CPO pursuant to § 4.13(a), however, such analysis may be required. The proposals that would affect such exempt CPOs are found in §§ 4.13(b)(1) and 4.20(d).[FN54] The Commission does not believe that these two proposals should have a significant economic impact on such exempt CPOs because, in the case of the revision to § 4.13(b)(1), the proposal would merely require the CPO to provide the Commission with a copy of an already required statement of exemption and, in the case of § 4.20(d), the propos-

al would affect only the manner in which the CPO could be compensated but not the amount of such compensation. Thus, with respect to CPOs, pursuant to Section 3(a) of the RFA, 5 U.S.C. 605(b), the Chairman, on behalf of the Commission, certifies that these proposed rules will not have a significant economic impact on a substantial number of small entities. The Commission nonetheless invites comments from any CPO which believes that these rules would have a significant impact on its operations.[FN55]

FN52 For example, a registered investment company is regulated by the Securities and Exchange Commission.

FN53 47 FR 18619-18620.

FN54 Section 4.20(d) would also apply to CPOs who are registered or required to be registered with the Commission.

FN55 Proposed § 3.16(a)(4) would exempt from registration as an AP of a CPO an AP of a person exempt under § 4.5. An AP must be an individual: See Section 4k of the Act, 7 U.S.C. 6k (1982). Because the RFA does not apply to "individuals," no economic analysis of proposed § 3.16(a)(4) is required.

B. Paperwork Reduction Act

The Commission has submitted to the Director of the Office of Management and Budget ("OMB"), pursuant to the provisions of the Paperwork Reduction Act, 44 U.S.C. Chapter 35, an explanation and details of the information collection and recordkeeping requirements which would be necessary to implement these proposals. Since all of the information collection proposals contained herein consist of proposed amendments to Part 4, which has already been assigned an OMB control number, the Commission understands that these proposals will be assigned the same OMB control number.[FN56]

FN56 The OMB control number for Part 4 is 3038-0005.

Interested members of the public may obtain a complete copy of the information collection proposals relating to the proposed rules contained herein by contacting Joseph Salazar at (202) 254-9735. Persons wishing to comment on the Paperwork Reduction Act implications of these proposals are asked to send a copy of their comments to Mr. Salazar at the Commodity Futures Trading Commission, 2033 K Street, NW., Washington, D.C. 20581, and to the OMB Desk Officer for the agency, Katie Lewin, Office of Information and Regulatory Affairs, Office of Management and Budget, Washington, D.C. 20503.

List of Subjects

17 CFR Part 3

Registration, Associated persons, Commodity futures.

17 CFR Part 4

Commodity pool operators, Commodity trading advisors, Commodity futures.

17 CFR Part 140

Authority delegation (Government agencies), Commodity futures.

In consideration of the foregoing and pursuant to the authority contained in the Commodity Exchange Act and, in particular, Sections 2(a)(1), 4k, 4l, 4m, 4n, 4o, 8a and 14 thereof, 7 U.S.C. 2, 6k, 6l, 6m, 6n, 6o, 12a and 18 (1982), and in 5 U.S.C. 552 and 552b (1982), the Commission hereby proposes to amend Chapter I of Title 17 of the Code of Federal Regulations as follows:

PART 3—REGISTRATION17 CFR § 3.16

1. Section 3.16(a)(4) is proposed to be revised to read as follows:

[Note.—Paragraph (a) is not proposed to be amended but is included solely for the convenience of the reader inasmuch as it does not at this time appear in the Code of Federal Regulations]:

17 CFR § 3.16

***4788** § 3.16 Registration of associated persons of commodity trading advisors and commodity pool operators.

(a) Registration required. Except as otherwise provided in § 3.12(f) or in paragraph (e) of this section, it shall be unlawful for any person to be associated with a commodity trading advisor or with a commodity pool operator as an associated person unless that person:

* * * * *

(4) Is exempt from registration as a commodity pool operator pursuant to the provisions of § 4.5 or 4.13 of this chapter or is associated with a person who is so exempt from registration: Provided, That the provisions of this paragraph (a)(4) shall not apply to the solicitation of funds, securities, or property for a participation in a commodity pool, or the supervision of any person or persons so engaged, by, for, or on behalf of a commodity pool operator (i) which is not exempt from registration pursuant to the provisions of § 4.5 or 4.13 of this chapter or (ii) which is registered as a commodity pool operator notwithstanding the availability of any such exemption;

* * * * *

PART 4—COMMODITY POOL OPERATORS AND COMMODITY TRADING ADVISORS17 CFR § 4.5

2. Section 4.5 is proposed to be added to read as follows:

17 CFR § 4.5

§ 4.5 Exemption for certain otherwise regulated persons from registration as a commodity pool operator and from the provisions of Subpart B.

(a) The following persons, and any principal or employee thereof, shall be eligible for exemption from registration as a commodity pool operator and from the provisions of Subpart B with respect to the operation of a qualifying entity specified in paragraph (b) of this section:

(1) An investment company registered as such under the Investment Company Act of 1940;

(2) An insurance company subject to regulation by any State;

(3) A bank or trust company subject to regulation by any State or the United States; and

(4) A trustee or named fiduciary of a defined benefit pension plan.

(b) For the purposes of this section, the term “qualifying entity” means:

(1) With respect to any person specified in paragraph (a)(1) of this section, an investment company registered as such under the Investment Company Act of 1940;

(2) With respect to any person specified in paragraph (a)(2) of this section, assets of any trust, custodial account or other separate unit of investment for which it is acting as fiduciary;

(3) With respect to any person specified in paragraph (a)(3) of this section, the assets of any trust, custodial account or other separate unit of investment for which is is acting as a fiduciary; and

(4) With respect to any person specified in paragraph (a)(4) of this section, a defined benefit pension plan that is subject to the provisions of the Employee Retirement Income Security Act of 1974 and is insured by the Pension Benefit Guaranty Corporation;

Provided, however, that such entity will be operated in the manner specified in paragraph (c)(2) of this section

(c) Any person who desires to qualify for exemption pursuant to this section shall file with the Commission a notice of eligibility.

(1) The notice of eligibility must contain the following information:

(i) The name of such person;

(ii) The applicable subparagraph of paragraph (a) of this section pursuant to which such person is eligible for exemption;

(iii) The name of the qualifying entity which such person intends to operate pursuant to the exemption; and

(iv) (A) The applicable subparagraph of paragraph (b) of this section pursuant to which such entity is a qualifying entity.

(B) If such qualifying entity is an investment company registered as such under the Investment Company Act of 1940, the notice of eligibility must specify and fully describe each exemption concerning disclosure and financial reporting to participants to which such entity is subject under said Act or under the Securities Act of 1933 or the Securities Act of 1934. If such entity is not subject to any such exemption, the notice of eligibility must contain a statement to that effect.

(2) The notice of eligibility must contain representations that such person will operate the qualifying entity specified therein in a manner such that the qualifying entity:

(i) Will use commodity futures or commodity options contracts solely for bona fide hedging purposes;

(ii) Will not enter into commitments which require as deposits for initial margin or premiums for such futures or options contracts more than 5 percent of the fair market value of its assets;

(iii) Will not be, and has not been, marketing participations to the public as or in a commodity pool or otherwise as or in a vehicle for trading in the commodity futures or commodity options markets;

(iv) Will disclose in writing to each prospective participant the purpose of and the limitations on the scope of the commodity futures and commodity options trading in which the entity intends to engage; and

(v) Will submit to such special calls as the Commission shall make of it to demonstrate compliance with the requirements for exemption specified in this section.

(3) The notice of eligibility must be filed with the Commission prior to the date upon which such person intends to operate the qualifying entity pursuant to the exemption provided by this section.

(4) The notice of eligibility shall be effective upon filing.

(d)(1) Each person as to whom an exemption has become effective hereunder must, in the event that any of the information contained or representations made in the notice of eligibility becomes inaccurate or incomplete, file a supplemental notice with the Commission to that effect which, if applicable, includes such amendments as may be necessary to render the notice of eligibility accurate and complete.

(2) The supplemental notice required by paragraph d(1) of this section shall be due within fifteen business days after the occurrence of such event.

(e)(1) An exemption effective hereunder shall cease to be effective upon any change which would render:

(i) A person as to whom such exemption is effective ineligible under paragraph (a) of this section;

(ii) The entity for which such exemption is effective ineligible under paragraph (b) of this section; or

(iii) Either the representations made pursuant to paragraph (c)(2) of this section inaccurate or the continuation of such representations false or misleading.

(2) The Commission may terminate an exemption effective hereunder by providing written notice of such termination to a person as to whom such exemption is effective if the Commission determines that:

(i) The notice of eligibility is inaccurate or incomplete in any respect;

(ii) A person as to whom such exemption is effective, or the qualifying entity for which it is effective, possesses other attributes or features which would make the treatment of such person as a commodity pool operator more consistent with the definition of and regulations applicable to a commodity pool operator; or

***4789** (iii) The continued effectiveness of the exemption would be contrary to the public interest.

(f) Any notice required to be filed hereunder must be:

(1) In writing;

(2) Signed by a duly authorized representative of a person specified in paragraph (a) of this section as follows: if such person is a corporation, by the chief executive officer, chief financial officer or counterpart thereto; if a partnership, by a general partner; and if a sole proprietorship, by the sole proprietor; and

(3) Filed with the Commission at the address specified in § 4.2.

17 CFR § 4.13

3. Section 4.13 is proposed to be amended by revising paragraph (b)(1) to read as follows:

17 CFR § 4.13

§ 4.13 Exemption from registration as a commodity pool operator.

* * * * *

(b)(1) No person who is exempt from registration as a commodity pool operator under paragraphs (a)(1) or (a)(2) of this section and who is not registered as such pursuant to that exemption may, directly or indirectly, solicit, accept or receive funds, securities or other property from any prospective participant in a pool that it operates or that it intends to operate unless, on or before the date it engages in that activity, the person delivers or causes to be delivered to the prospective participant a written statement that must disclose this fact as follows: "The commodity pool operator of this pool is not required to register, and has not registered, with the Commodity Futures Trading Commission. Therefore, unlike a registered commodity pool operator, this commodity pool operator is not required by the Commission to furnish a Disclosure Document, periodic Account Statements, and an Annual Report to participants in the pool."The person must:

(i) Describe in the statement the exemption pursuant to which it is not registered as a commodity pool operator;

(ii) Provide its name, main business address and main business telephone number on the statement;

(iii) Manually sign the statement as follows: if such person is a corporation, by the chief executive officer, chief financial officer or counterpart thereto; if a partnership, by a general partner; and if a sole proprietorship, by the sole proprietor; and

(iv) File two copies of the statement with the Commission at the address specified in § 4.2 within seven business days after the date the statement is first delivered to a prospective participant.

* * * * *

17 CFR § 4.15

4. Section 4.15 is proposed to be revised to read as follows:

17 CFR § 4.15

§ 4.15 Continued applicability of antifraud section.

The provisions of section 4o of the Act shall apply to any person even though such person is exempt from registration under this Part 4, and it shall continue to be unlawful for any such person to violate section 4o of the Act.

17 CFR § 4.20

5. Section 4.20 is proposed to be amended by adding paragraph (d) to read as follows:

17 CFR § 4.20

§ 4.20 Prohibited activities.

* * * * *

(d)(1) Except as provided in paragraph (d)(2) of this section, no commodity pool operator may receive any income generated from the assets of any pool that it operates or that it intends to operate.

(2)(i) A commodity pool operator may receive income generated from the assets of any pool that it operates or that it intends to operate provided that such income is received for the sole purpose of recovering the organizational and offering expenses of such pool which have been incurred by the commodity pool operator and that such income is limited to the actual amount of such organizational and offering expenses.

(ii) For purposes of this paragraph (d)(2) of this section, the term “organizational and offering expenses” may include legal and accounting fees, printing expenses, escrow charges, and filing, registration and recording fees.

PART 140—ORGANIZATION, FUNCTIONS AND PROCEDURES OF THE COMMISSION17 CFR § 140.93

6. Section 140.93 is proposed to be amended by adding paragraph (a)(5) to read as follows:

17 CFR § 140.93

§ 140.93 Delegation of Authority to the Director of the Division of Trading and Markets.

(a) * * *

(5) All functions reserved to the Commission in § 4.5(c)(2)(v) of this Chapter.

* * * * *

Issued in Washington, D.C. on February 2, 1984, by the Commission.

Jane K. Stuckey,

Secretary of the Commission.

[FR Doc. 84-3341 Filed 2-7-84; 8:45 am]

BILLING CODE 6351-01-M

49 FR 4778-02, 1984 WL 127828 (F.R.)
END OF DOCUMENT