Washington and Lee Law Review

Volume 42 | Issue 3 Article 3

Summer 6-1-1985

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HEDGING THE VALUE OF COLLECTIVE ASSETS: FINANCIAL INSTITUTIONS EXCLUDED FROM REGULATION AS COMMODITY POOL OPERATORS UNDER THE COMMODITY EXCHANGE ACT

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I. INTRODUCTION

Financial institutions including mutual funds, commercial banks, pension funds and insurance companies increasingly have sought to use financial futures in reducing interest rate and market risk of investment portfolios. Financial futures can be used for hedging purposes to protect against adverse

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changes in the market value of securities that a financial institution owns or intends to acquire. These hedging instruments are available in a wide spectrum including interest rate futures contracts on United States Treasury Bonds, bills and notes, and bank certificates of deposit. Public markets currently exist for stock index futures contracts on the Standard and Poor's 500 and 100 stock indexes, the New York Stock Exchange Composite Index, and the Value Line Stock Index.[1] Innovative financial futures contracts are rapidly evolving to provide additional hedging tools for financial institutions in performing investment management. For example, on April 16, 1985, the Commodity Futures Trading Commission (CFTC) approved an application

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1. An extensive technical description of the mechanics and theory employed by institutions to reduce interest rate and market risk of investment portfolios with financial futures is beyond the scope of this article. A brief, generalized explanation, however, may provide helpful background to this subject matter. The term "futures" designates the standaridzed contracts covering the sale of commodities for future delivery on a commodity exchange. *See Glossary of Trading Terms,* Commodity Futures Trading Commission 13 (1983). A futures contract is a firm commitment to deliver or to receive a specified quantity and grade of a commodity during a designated month with price being determined by public auction among exchange members. *Id.*

Financial futures markets facilitate hedging by institutional investment managers by providing a liquid mechanism to protect against changes in interest rate and market risk of investment portfolios or assets. Essentially, hedging involves establishing a position in one market opposite that in another market, so that the losses (or gains) in one will be at least partially offset by the gains (or losses) in another, regardless of subsequent price or market movements. In this way, the value of an investment portfolio is maintained by reducing exposure to adverse market or interest rate fluctuations.

Financial futures hedges provide a risk-management tool that is specifically designed to transfer interest rate or market risk. A financial futures hedge transaction involves the establishment of a position in the futures market that will offset current or anticipated transactions in the cash market. The cash market is the market for immediate delivery of and payment for commodities. *Id.* at 4. In essence, a futures transaction acts as a substitute for a cash market transaction. In this manner, institutions can execute cash market transactions in the present while establishing advantageous spreads between asset yields and liability costs in the future. Consequently, the unpredictable price or market risk in a cash transaction can be replaced by a more predictable and more stable price relationship between the cash market and the futures market.

The probability of a successful hedge depends on the degree of statistical or price movement correlation between the hedged issue and the financial instrument underlying the futures contract. "Pure" hedges occur where the correlations between the hedged instrument and that underlying the futures contract are the same. Significant similar features include instrument type, term, and duration. Simple examples of "pure" hedges include (i) hedges of long-term treasury bonds with treasury bond futures contracts or (ii) hedges of 9-month treasury bills with 9-month treasury bill futures contracts.

Financial institutions are most likely to employ financial futures to hedge investment portfolios, and to manage the matching of assets of liabilities. In pursuit of these goals, financial institutions may implement "anticipatory" or "long-hedge" strategies in which the hedger does not own, but expects to acquire, the underlying commodity at the time of the financial futures transaction. This "advance" hedge protects the entity against increases that may occur in the cash instrument before its acquisition. For example, a lender may execute an anticipatory hedge to protect against fluctuations in the market value of a loan to which it is committed, but which will be executed in the future.

of the Coffee, Sugar and Cocoa Exchange for designation as a contract market to trade futures contracts on the consumer price index for urban wage earners and clerical workers.[2]

For some commentators, 1982 is viewed as the watershed year for the acceptability of financial futures as a legitimate, innovative development in the world's capital markets.[3] This contrasts with the attitude of financial institutions that long had refrained from using financial futures because they were viewed to be too risky to acquire.[4] Many institutional portfolio managers are now finding it too risky *not* to invest in financial futures to hedge against interest rate and market risk.[5] Indeed, some financial institution analysts have encouraged the use of financial futures with an almost religious fervor.[6]

More technical explanation and analysis of institutional hedging with financial futures contracts is available in various sources. *See* Figlewski, *Hedging with Financial Futures for Institutional Investors—From Theory to Practice* (1985); Merrick and Figlewski, *An Introduction to Financial Futures* (Solomon Brothers Center for the Study of Financial Institutions) (1984); Loosigian, *Interest Rate Futures—A Market Guide for Hedgers and Speculators* (1980); Little, *Financial Futures Hedging Guide* (1979); Schwarz, *How to Use Interest Rate Futures* (1979); Clayton Brokerage Co. of St. Louis, Inc., *Hedge Guide for the Interest Rate Futures Market—A Guide For the Management of Risk Associated with Fluctuations in Interest Rates* (1979); Arthur Andersen & Co., *Interest Rate Futures Contracts: Accounting and Control Techniques for Banks* (1978); Winikates, *GNNA Mortgage Futures Market: A Financial Manager's Guide* (1977) (Financial Managers' Society for Savings Institutions); Economic Index Market of Coffee, Sugar and Cocoa Exchange, Inc., *An Introduction to Inflation Futures* (1985); Angell, *A Technical Approach to Trading Interest Rate Futures Markets,* 6(6) Commodities (1977); Angrist, *How to Hedge Interest Rate Risks,* Forbes, Dec. 15, 1976; Bohnsack, *The "Ultimate Commodity" and the Bottom Line,* 31(2) U. MICH. BUS. REV. (1979).

2. *See* Commodity Futures Trading Commission News Release No. 2339-85 (April 15, 1985). Similarly, the CFTC approved applications to trade futures contracts on the NASDAQ-100 Index, and the Standard and Poor's Over-the-Counter Industrial Stock Price Index, respectively on October 24, 1985. *See* SEC. REG. L. REP. (BNA) at 1943 (Nov. 1, 1985). The NASDAQ-100 Index is composed of 100 large non-financial common stocks that are quoted on NASDAQ's National Market System. The S&P OTC Index comprises 250 domestic industrial National Market System common stocks. Futures contracts on these two indices will serve as hedging instruments for institutional investors with portfolios that correlate statistically or in kind with instruments on the indices.

3. Reich, *Futures: Ready or Not Here They Come,* 17(3) INSTITUTIONAL INV., March 1983, at 51.

4. Blanton and Hemmerick, *Fund Activity Brightens Futures,* PENSIONS & INV. AGE, March 5, 1984, at 3.

5. *See* Reich, *supra* note 3 at 54; *see also* Zoller, *Commodities: An Investment Opportunity with Growing Appeal for Money Management,* 16(11) INSTITUTIONAL INV., March 1983, at 143.

6. Gottlieb, *Hedging Opportunities for Insurance Companies,* WORLD LAW, Jan. 1985, at 41 (in volatile economic markets, insurers should manage risk of asset-liability mismatches, especially in products such as guaranteed investment contracts); Nadler, *Financial Futures and the Commercial Bank,* 10(7) BANKER'S MONTHLY, July 1984, at 4 (for bank, futures market is like buying fire insurance: it expects no profit, but hopes to eliminate any loss even if there is a fire); Koppenhaver, *Selective Hedging of Bank Assets with Treasury Bill Futures Contracts,* 7(2) J. FIN. RESEARCH, Summer 1984, at 105 (simulates interest rate futures contracts in theory of bank behavior to illustrate prudent hedging of bank loans and government securities); Victor

Financial institutions are clearly becoming bigger players in the rapidly growing financial futures markets.[7]

The regulatory constraints faced by financial institutions present an important consideration in using financial futures for hedging portfolio instruments. As recently as two years ago, many regulatory structures strictly prevented financial institutions from acquiring financial futures.[8] A recent shift in the stance of regulators, however, has given financial futures new respectability, and opened the gates for prudent portfolio hedging with these instruments.[9] This trend is likely to continue in light of a study conducted

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and Brewer, *Financial Futures . . . the Causes of "Richness" and "Cheapness" in the Fixed Income Market,* 12(9) PENSIONS & INV. AGE, Sept. 1984, at 44 (fixed income financial futures contracts' richness and cheapness compared to underlying cash markets, offers pension funds chance to increase returns from fixed income portfolios); Hershman, *The Boom in Financial Futures and Options,* 52(3) DUN'S BUS. MONTH, Sept. 1984, at 56 (importance of phenomenal growth in financial futures extends to banks and brokerage houses); Koch, *Financial Futures as a Risk Management Tool for Banks and S&Ls,* 67(9) ECON. REV., Sept. 82, at 4; Petrucello, *What the Thrifts Can Do,* 165(3) BANKER'S MAG., May 1982, at 72; Worthy, *Big New Players in Financial Futures,* FORTUNE, Sept. 17, 1984, at 109 (small banks, thrift institutions, and nonfinancial corporations with large pension funds can reduce concerns about ruinous zigs and zags in interest rates, foreign currencies, and stocks through use of financial futures); Powers, *Are There Futures in Your Future?* 60(5) J. NAT'L A. BANK WOMEN, July 1984, at 14 (interest rate futures instrumental in era of financial institution deregulation that emphasizes successful bank asset and liability management); Freeman, *Why Not Price Loans Using Financial Futures?* 76(3) A.B.A. BANKING J., Mar. 1984, at 173; Picou, *Hedging GNMA Pass-Throughs,* 45(5) MORTGAGE BANKING, Feb. 1984, at 54.

7. *See* Booth and Smith, *Use of Interest Rate Futures by Financial Institutions,* 15(1) J. BANK RESEARCH, Spring 1984, at 151; *see also* Worthy, *supra* note 6, at 109. One study, which notes that the most numerous category of new traders attracted to the growing financial futures markets are financial institutions, estimates that during 1984, financial futures accounted for nearly 74 million contracts, or approximately 50% of total volume in United States futures markets. *See* Imel, Hobson and Tosini, *The CFTC's Hedging Definition—Development and Contemporary Issues* (October 1985) at 1 and 34; *see also* SEC. REG. L. REP. (BNA) (Nov. 15, 1985) at 2020 (summarizing report of Imel, Hobson and Tosini). A listing of institutional money managers using fixed-income or stock index futures is set forth in PENSIONS & INV. AGE, June 10, 1985 at 51.

8. Markham and Gilberg, *Federal Regulation of Bank Activities in the Commodities Markets,* 39 BUS. LAW. 1719 (1984); *Futures Investments Slowed by Legal Hurdles,* PENSIONS & INV. AGE, Oct. 11, 1982, at 45.

9. For example, several states recently expanded the investment provisions of their state insurance codes or regulations specifically to authorize insurance companies to acquire financial futures in bona fide hedging transactions. *See, e.g.,* CAL. INS. CODE §121 (1984) (insurers may hedge up to 5% of admitted assets with interest rate futures, plus 100% of investments in notes or banks secured by first mortgage lien upon real property); Connecticut Ins. Bull. No. FS-14 (Apr. 24, 1984) (permits use of interest rate futures for bona fide hedging as defined by the Commodity Futures Trading Commission); N.Y. Ins. Reg. No. 111 (1984) and N.Y. INS. CODE §80 (Supp. 1985) (permitting futures contracts in amount not to exceed 2% of insurers' total admitted assets). The New York modification has profound implications because most states closely follow New York's standards in insurance regulation. *See* Maidenberg, *Bill Lets Life Insurers Use Futures as Hedge,* New York Times, June 28, 1983, at D1, col. 3; *see also* Grala and Osborn, *Hedging with Options and Commodity Futures Under the Revised New York State Insurance Law,* 16 CONN. L. REV. 477 (1984).

by three federal financial institution regulators in response to a congressional directive, which concluded that the new financial futures markets are adequately regulated to afford necessary investor protections, and serve a useful economic purpose that does not appear to impair capital formation.[10]

In addition to the regulatory scheme of their primary regulators, financial institutions may also trigger statutes and regulations administered by the CFTC under the Commodity Exchange Act[11] (CEA) involving the activities of commodity pools and commodity pool operators. This results by virtue of the collective or "pooled" nature of the assets that financial institutions

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The Labor Department recently issued an opinion letter effectively opening the door for pension funds to acquire financial futures, which concluded that initial and maintenance margins held by a futures commission merchant (FCM) on behalf of a pension plan acquiring financial futures were not "plan assets" for purposes of ERISA. This facilitated pension plans' involvement in financial futures because the FCM would not be a plan fiduciary subject to stringent regulations. *See* Opinion No. 82-49(A) (Sept. 21, 1982); *see also* 9 PENSION REP. (BNA) 1394 (1982) (discussing opinion letter of Labor Department). *See generally* Bromslaw and Bossman, *Pension Plan Trading in Commodities Futures,* 2 COMM. L. LETTER 10 (1982); Pianko and Selig, *Investment of Pension Fund Assets in Financial Instrument Futures, Tax Management* (BNA) #80-1 (1980); Teberg, *Options and Financial Futures,* 12 REV. SEC. REG. 906 (1979).

Three federal banking regulators published a joint policy statement urging banks to insure that interest rate futures are used to reduce risk exposure in view of an entity's asset liability mix. These statements set forth guidelines governing the use of interest rate futures. *See* 45 Fed. Reg. 18116 (1980) (policy statement of FDIC); 45 Fed. Reg. 18120 (1980) (policy statement of Federal Reserve Board); Banking Circular 79 (2d. Rev.) (Mar. 19, 1980) (views of Comptroller). On April 19, 1983, the Comptroller revised the Banking Circular a third time, relaxing detailed reporting requirements but retaining previous internal control requirements. On August 11, 1982, the Federal Home Loan Bank Board adopted regulations permitting federally insured savings & loans to trade in all financial futures, 12 C.F.R. §563.17-5 (1985).

On October 16, 1981, the Comptroller issued a revised Trust Banking Circular No. 14 which updated minimum guidelines that bank trust departments must follow when engaging in financial futures. Among other things, the revised circular recommends the adoption of specific written procedures, detailed recordkeeping, individualized trust position limits, market valuation, and internal controls.

Beginning in 1983, the Securities and Exchange Commission (SEC) began issuing no-action letters to registered investment companies that provided interpretive relief from several sections of the Investment Company Act of 1940. 15 U.S.C. §§80a-1 - 80a-64 (1982). *See, e.g.,* Pension Hedge Fund Inc. (available Jan. 20, 1984); SteinRoe Bond Fund, Inc. (available Jan. 17, 1984); IDS Bond Fund, Inc. (available April 11, 1983). These no-action letters principally concerned prohibitions against the creation of a senior security by virtue of margin obligations in financial futures contracts, and requirements that assets, including margins, be maintained under prescribed custodial arrangements usually involving banks. For further discussion, *see* Lauerman, *Agencies Eye Investment Company Hedging Strategies,* Legal Times, May 7, 1984, at 14.

On August 23, 1984, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 80, which clarified that unlike speculative futures positions, futures contracts qualifying as hedges against price or interest rate risk need not trigger recognition of gain or loss when a change occurs in the market value of the futures contract. *See* 16 SEC. REG. L. REP. (BNA) 1463 (1984) (discussing implications of accounting standard).

10. *See A Study of the Effects on the Economy of Trading in Futures and Options* (Dec. 1984) by the Board of Governors of the Federal Reserve, Commodities Futures Trading Commission, and the Securities and Exchange Commission. An independent study on some of these issues reached similar conclusions. *See* Gaffee, *The Impact of Financial Futures and Options on Capital Formation,* 4 J. FUTURES MARKETS 3, 417 (1984).

11. 7 U.S.C. §2 (1982).

the collective or "pooled" nature of the assets that financial institutions manage on behalf of depositors, investors, pension plan participants, trust beneficiaries, and variable insurance contract holders.[12] After more than a year of intense analysis, however, the CFTC adopted a complex exemptive rule that would significantly eliminate regulatory and compliance burdens for heavily regulated financial institutions that acquire a limited number of financial futures to hedge interest rate and market risks in portfolio management. This article will trace the historical antecedents to this new rule, and analyze its substance, applicability and effectiveness.

II. Background

A. *Statutory and Regulatory Underpinnings*

The Commodity Exchange Act (CEA), defines the term *commodity pool operator* 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 definition as the Commission may specify by rule or regulation or by order.[13]

Section 4n(1) of the CEA[14] requires a commodity pool operator (CPO) to register with the CFTC, unless specifically exempted by rule, regulation or order.[15] Ordinarily, an individual or entity becomes a CPO by organizing and operating a commodity pool which invests the collective assets of other individuals in commodity interests, including financial futures. Because the CFTC has exclusive and plenary authority over commodity trading firms and professionals,[16] financial institutions that acquire financial futures in the

12. Regulations under the Commodity Exchange Act define the term "pool" for purposes of commodity pool operator (CPO) regulations to mean "any investment trust, syndicate or similar form of enterprise operated for the purpose of trading commodity interests." 17 C.F.R. §4.10(d) (1985); *see* 46 Fed. Reg. 26004 (May 8, 1981) (concerning adoption of this regulation).

13. 7 U.S.C. §2 (1982).

14. 7 U.S.C. §6m(1) (1982).

15. *See* Rosen, *Regulation of Commodity Pool Operators Under the Commodity Exchange Act*, 40 Wash. & Lee L. Rev. 937 (1983) (discussing CPO registration and means of exclusion). Part 4 of the Commodities Futures Trading Commission's (CFTC) regulations governs the operations and activities of CPOs, through certain operational, disclosure, reporting and recordkeeping requirements set forth in subpart b thereof. 17 C.F.R. §§4.20 - 4.23 (1985).

16. 7 U.S.C. §2a (1982); *see* Tendick and Gaine, *Introducing the Regulator: The CFTC*, 35 Bus. Law. 751 (1980). Before 1982, jurisdictional disputes existed between the CFTC and the SEC concerning the regulation of commodity pools. In adopting rules governing the

management of collective assets may trigger the CFTC's jurisdiction notwithstanding the network of their primary regulators. The definition of the term "commodity pool" is instrumental to this regulatory overlap.

The term "commodity pool" is not specifically defined in the CEA. The Commodity Futures Trading Commission Act of 1974 introduced the term "commodity pool" indirectly through the definition of commodity pool operator. Pursuant to its statutory rulemaking authority, the CFTC first issued CPO regulations in 1979 which defined a commodity pool as "any investment trust, syndicate, or similar form of enterprise that trades commodity interests."[17] In 1981, the CFTC narrowed the definition of commodity pool by specifying that a pool is "any investment trust, syndicate or similar form of enterprise *operated for the purpose of* trading commodity interests."[18] According to the CFTC release adopting the modifications, whether a particular entity is operated "for the purpose" of trading commodity interests depends upon "an evaluation of all the facts relevant to the entity's operation."[19] In resolution of this analysis, the CFTC encouraged interested

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operations of commodity pool operators in 1977, the CFTC stated that it had not yet taken a position on what effect the grant to the CFTC of "exclusive jurisdiction," set forth in Section 2(a)(1) of the CEA, has on the relationship of the federal securities laws to the formation of commodity pools. *See* Adoption of Rules Concerning Commodities Pool Operators and Commodity Trading Advisors, [1977-1980 Transfer Binder] COMMODITY FUT. L. REP. (CCH) ¶ 20,725 at 22,974 n.19 (Jan. 8, 1979); *see also* CFTC Interpretive Letter No. 77-14, *id.* at 20,486 (Sept. 16, 1977). In contrast, the SEC asserted that the activities of a commodity pool or a company (its formation, capital-raising and continuing corporate existence) are subject to the federal securities laws. *See* Joint Explanatory Statement of CFTC and SEC [1980-1982 Transfer Binder] COMMODITY FUT. L. REP. (CCH) ¶ 21,332 at 25,605 (Feb. 2, 1982). *Contra,* Gravois v. Fairchild, Arabatzis, [1977-1980 Transfer Binder] COMMODITY FUT. L. REP. (CCH) ¶ 20,706 at 22,875 (E.D. La., Nov. 9, 1978) (holding that CEA preempted registration and antifraud provisions of federal securities laws regarding commodity pools). These jurisdictonal ambiguities were resolved in the SEC-CFTC (or "Shad-Johnson") accords which determined that the federal securities laws applied to solicitations for investments in a commodity pool. Recent amendments to the CEA reflect these positions. *See* Securities Commodities Accord Amendments of 1982, Pub. L. No. 97-303, 96 Stat. 1409 (1982); *see also* S. REP. No. 390, 97th Cong., 2d Sess. (1982).

17. 17 C.F.R. §4.10(d) (1980).

18. 46 Fed. Reg. 26004, 26014 (1981) (emphasis added). The term "commodity interest" is defined in 17 C.F.R. §4.10(a) as:

(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.

19. 46 Fed. Reg. 26004, 26006 (1981). Commentators on the definition suggested that an entity whose assets committed to trading commodity interests did not exceed a specified percentage—such as 10%—should be outside the definition of the term "pool." The CFTC viewed this approach to be deficient because it failed to take into account the fact that such an entity might, nonetheless, be marketed and sold as a commodity pool, so that the participants in the pool would be denied protections of the Commodity Exchange Act and its regulations. Alternatively, other persons suggested that the term "pool" be defined as "an entity organized and operated for the principal purpose of acquiring or trading commodity interests." The CFTC found this suggestion to be unsatisfactory because it did not recognize that an entity may commence operations in one line of business and subsequently may engage in another line of

persons to seek interpretations under the new rule from the CFTC.[20]

The few courts that have considered the definition of a commodity pool have been consistent in their approach. The United States District Court for the District of Columbia in *Meredith v. Conti-Commodity Services, Inc.*,[21] held that to be a commodity pool, investors' assets must be pooled in a single account, and the pool must execute transactions for the benefit of the entire account. The court stated that in a commodity pool, individual investors' profits and losses are allocated by shares to individual investors based on their contribution to the fund.[22] Similarly, in *International Cattle Systems v. Parsons*,[23] the United States District Court for the District of Kansas held that a determinative characteristic of a commodity pool was the common sharing of profits or losses by investors in pooled enterprises.[24]

In *Savino v. E.F. Hutton & Co.*[25] the court explained that a commodity pool was an enterprise:

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business—that is, a commodity pool. In addition, the CFTC believed the phrase "principal purpose" was too narrow. *Id.*

20. The CFTC recently granted interpretive relief to an insurance company separate account funding a group annuity contract that will be offered to single employer corporate retirement plans, which was determined not to be a "pool" under Rule 4.10(d). CFTC Interpretive Letter No. 85-16 [Current Binder] COMMODITY FUT. L. REP. (CCH) at ¶ 22,737 (Aug. 15, 1985). According to the letter, the annuity contract owners would have a contract with the insurance company, and any proceeds to the annuity holders would not depend on the results of the futures or options trading by the insurance company. Rather, all futures or options trading would be done merely to hedge the company's liability to contract holders.

Under the subject letter, a retirement plan would deposit money with the insurance company, and the company would contractually agree that return to the plan participant will be equal to the increase in the S&P 100 stock index or zero, whichever is greater. The return will be measured by comparing the index on either the contract's anniversary date, at contract termination, or the date of a partial withdrawal. The insurance company then hedges its contractual commitment against market increases by, in most cases, purchasing call options on an index traded on a securities exchange. Under an alternative in the investment strategy, the insurance company would purchase futures contracts on a stock index, or purchase call options on such a futures contract. Some observers characterized this type of a vehicle to be trading in "synthetic" instruments because an interest in the actual underlying instruments is not obtained. *See* Burr, *Commission OK's CPO Rule Exclusion for Pensions Funds*, PENSIONS & INV. AGE, June 10, 1985, at 51.

Significantly, the CFTC specifically distinguished this type of insurance company separate account from insurance company separate accounts funding variable insurance contracts which fluctuate according to the investment experience of the separate account. CFTC Interpretive Letter No. 85-16, *id.* at 31,038. The CFTC emphasized that in the subject separate account, the return to a contract owner did not depend on the results of the futures and options trading by the insurance company, and that the trading was practiced simply to hedge the company's liabilities to contract holders. *Id.* Rule 4.5 provides an exclusion for state regulated insurance companies with respect to the operation of insurance company separate accounts. *See infra* note 91 and accompanying text.

21. [1980-1982 Transfer Binder] COMMODITY FUT. L. REP. (CCH) ¶ 21,107 (D.D.C. 1980).

22. *Id.* at 24,462.

23. [1980-1982 Transfer Binder] COMMODITY FUT. L. REP. (CCH) ¶ 21,367 (D. Kan. 1982).

24. *Id.* at 25,756.

25. [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,850 (S.D.N.Y. Jan. 30, 1981).

in which investors' funds are placed in a single account and transactions are executed on behalf of the entire account rather than being attributed to any particular subsidiary account. The profit or loss shown by the account as a whole is ultimately allocated to each investor according to the relative size of his or her contributions to the fund. Each investor's rate of return is thus entirely a function of the rate of return shown by the entire account.[26]

It is interesting to note that none of the courts which have construed the term commodity pool have referred to or discussed the CFTC's definition contained in section 4.10(d).[27] Nevertheless, the judicial authority construing the term commodity pool comports with the CFTC's regulatory definition and interpretive opinions. When read together, the court interpretations define the term commodity pool as any enterprise in which investor funds are combined, placed and traded in a single account for the purpose of trading commodities, and in which the profits and losses are allocated on a pro rata basis to all participants.[28]

B. *Financial Institutions as Commodity Pool Operators: Regulatory Implications*

The statutes and regulations confronting financial institutions deemed to be operating commodity pools are numerous and detailed. The first act triggered by CPO status is registration pursuant to sections 4m(1)[29] and 4n[30]

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26. *Id.* at 90,251; *accord,* Milnarik v. M-S Commodities, Inc., 457 F.2d 274, 277-78 (7th Cir.), *cert. denied,* 409 U.S. 887 (1972); Meredith v. Conti-Commodity Services, Inc. [1980-1982 Transfer Binder] COMMODITY FUT. L. REP. (CCH) ¶ 21,107 at 24,462 (D.D.C. 1980).

27. Instead, these cases have relied upon a functional analysis to interpret the term commodity pool, which focuses upon: (i) the structure of the collective commodity trading vehicle; (ii) the methods employed to distribute profits and losses to participants in the collective vehicle; and, (iii) the extent to which individual investor's rates of return were uniform or disparate. *See, e.g.,* Meredith v. Conti-Commodity Services, Inc., [1980-1982 Transfer Binder] COMMODITY FUT. L. REP. (CCH) ¶ 21,107 (D.D.C. 1980); Commodities Futures Trading Commission v. Heritage Capital Advisory Services, Inc., [1980-1982 Transfer Binder] COMMODITY FUT. L. REP. (CCH) ¶ 21,367 (D. Kan. 1982).

28. *See* Rosen, *supra* note 15, at 947. Some commentators have suggested that what is now called a commodity pool was previously called a commodity mutual fund or a commodity trading fund, often involving the issuance of a separate equity security. *See* Note, *The 1981 Revisions in the CFTC's Commodity Pool Operator Regulation,* 7 J. CORP. L. 627, 630 (1982); *accord,* Saitlin, *Exclusive CFTC Jurisdiction of Commodity Trading Vehicles May Depend upon Form over Substance; or, Everyone into the Pool,* 35 BUS. LAW 241, 243 n.7 (1977).

29. 7 U.S.C. § 6m(1) (1982). This provision requires a CPO using the mails or any means or instrumentality of interstate commerce in connection with a CPO business to register with the CFTC. Section 9c of the CEA, 7 U.S.C. § 13c (1982), establishes a misdemeanor offense for CPO's who fail to so register and who use the mails and interstate commerce. Section 2a(1) of the CEA, 7 U.S.C. § 2a(1) (1982), provides the CFTC with authority to exclude from CPO registration individuals or entities not within the intent of the CPO definition. Under this authority, the CFTC has exempted from registration CPOs operating pools beneath a specified size and number of participants in Rule 4.13. 17 C.F.R. § 4.13 (1985).

30. 7 U.S.C. § 6n (1982). This section provides that a CPO may register under the CEA

of the CEA on Form 7-R.[31] CPO principals must disclose detailed biographical information on Form 8-R[32] under the CEA, and file fingerprint cards. For large financial institutions such as banks or insurance companies, this compliance obligation could be mechanically complex and burdensome.

Commodity pool operators also must become members of the National Futures Association, a designated self-regulatory organization for the futures industry, and comply with all of its standards of conduct and rules of operation.[33] Individuals deemed "associated persons" of the commodity pool

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by filing an application disclosing information stipulated by the CFTC's regulations. The categories of information required pursuant to this provision include (i) the names and addresses of all principals of the firm; (ii) the education and business affiliations for the past 10 years; (iii) the nature of the CPO applicant's business; (iv) the nature and scope of the applicant's authority concerning client's funds and accounts; (v) the basis of CPO compensation; (vi) the location of the CPO's principal and branch offices; and, (vii) the name and form of the CPO's form of organization and capital structure.

31. Form 7-R and accompanying instructions are set forth in COMMODITY FUT. L. REP. (CCH) (1985) at ¶ 3515. Form 7-R serves as a uniform registration form for CPOs, commodity trading advisors, futures commission merchants, and newly registered brokers. Schedules B and C of Form 7-R require detailed disclosure concerning the operation of each commodity pool, such as the pool's name, form of organization, dates of operation, and net asset value. *Id.* at ¶ 3612. Schedules B and C also require disclosure of any reciprocal business affiliations of the CPO applicant or any principal involving commodity pools that the CPO applicant operates, with any other commodity pool or entity registered with the CFTC. *Id.*

32. *See id.* at ¶ 3521. Form 8-R requires essential background information parallel to that stipulated in Form 7-R such as education, business background, and a 10 year employment and residential record. *See supra* note 30. Form 8-R does not elicit disclosure unique to CPO principals; principals of commodity trading advisors, principals of futures commission merchants, registered floor brokers and associated persons also must complete and file the same form.

33. The National Futures Association (NFA) was approved by the CFTC as a registered futures association pursuant to Section 17 of the CEA, 7 U.S.C. § 21 (1982), in 1981. *See* SEC. REG. L. REP. (BNA) No. 621, at E-1 (Sept. 23, 1981) (Registration Approval Order). NFA Bylaw 1101 indirectly requires any CPO actively engaged in operating and soliciting interests in commodity pools to join the NFA, by prohibiting other NFA members, such as futures commission merchants, from handling transactions on behalf of non-members of the NFA. This indirect membership requirement is permitted by Section 17m of the CEA. 7 U.S.C. § 21m (1982).

In 1982, Congress added Seciton 8a(10) to the CEA, 7 U.S.C. § 12a (10) (1982), which authorizes the CFTC to delegate registration functions under the CEA to registered futures associations, such as the NFA. Congress also indicated in 1982 that a capable and stable NFA could, in the future, acquire certain other CFTC regulatory functions, including specific scrutiny of CPOs. H.R. REP. No. 565, Part I, 97th Cong., 2d Sess. 41 (1982). The CFTC must prepare a report for Congress by January 1, 1986 on the regulatory proficiency of the NFA for the period between January 1, 1983 and September 30, 1985. *See* Pub. L. No. 97-444 § 237(2), 96 Stat. 2294, 2325 (1982). This process of reporting will establish a foundation for the NFA to, assume a larger regulatory role.

The NFA has created a broad pattern of administrative and regulatory guidance. *See NFA Rules Governing the Business Conduct of Members Registered with the Commission* (1985). For example, NFA Rules 2-1 through 2-11 establish minimum sales practice standards. CPOs are governed by a detailed anti-fraud provision that prohibits the conversion of any assets received from a pool participant. NFA Rule 2-2. NFA Rule 2-3 prohibits members from sharing operator, such as officers, employees, consultants or agents of the financial institution, must register pursuant to section 4k(2)[34] of the CEA on Form 8-R thereunder.[35]

CFTC regulations require CPOs to deliver disclosure documents to prospective pool participants containing, among other things, information about the CPO and trading adviser, conflicts of interest in the pool's activities, three year performance records of the pool operator, fees and expenses, restrictions on transferability, and tax ramifications of the investment.[36] The CPO disclosure provisions also require dissemination of a "risk disclosure statement" that may represent unfamiliar information to financial institution customers.[37] This statement requires rather ominous warnings that, under certain market conditions it may be impossible to liquidate a position, that market conditions may prevent the limitation of losses, that some pools are subject to substantial administrative or transactional charges, and that participants' liability may be unlimited in some cases.[38]

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directly or indirectly in the profits or losses resulting from futures trading without a customer's written authorization.

Several NFA rules parallel CFTC regulations and initiatives. NFA Rule 7-13 incorporates CFTC Rule 4.21(a)(9), 17 C.F.R. § 4.21(a)(9) (1984), which requires CPOs to disclose the manner in which the pool will fulfill its margin requirements and the form in which pool funds not deposited will be held after trading commences. The NFA drafted a proposed rule to conform to a proposed amendment to CFTC Rule 4.21(a)(9), 49 Fed. Reg. 4778 (Feb. 8, 1985), that would set forth disclosure for CPOs concerning income generated from assets of a commodity pool that is used by the CPO for additional compensation, and to recover organizational and operating expenses of the pool. *See* NFA Releases I-85-20 (July 3, 1985). In sum, the administrative and regulatory scrutiny of the NFA is detailed, extensive, and likely to continue.

34. 7 U.S.C. § 4(k)(2) (1982).

35. *See* 17 C.F.R. §3.16 (1985).

36. 17 C.F.R. §4.21 (1985).

37. *See* 17 C.F.R. § 4.21(a)(17)(i) (1985) (setting forth required substance of risk statement).

38. 17 C.F.R § 4.21(a)(17)(i) (1984). This provision requires the following statement to be prominently displayed on the first page of the disclosure statement:

RISK DISCLOSURE STATEMENT

YOU SHOUD CAREFULY CONSIDER WHETHER YOUR FINANCIAL CONDITION PERMITS YOU TO PARTICPATE IN A COMMODITY POOL. YOU MAY LOSE A SUBSTANTIAL PORTION OR EVEN ALL OF THE MONEY YOU PLACE IN THE POOL.

IN CONSIDERING WHETHER TO PARTICPATE IN A COMMODITY POOL, YOU SHOULD BE AWARE THAT TRADING COMMODITY CONTRACTS CAN QUICKLY LEAD TO LARGE LOSSES AS WELL AS GAINS. SUCH TRADING LOSSES CAN SHARPLY REDUCE THE NET ASSET VALUE OF THE POOL AND CONSEQUENTLY THE VALUE OF YOUR INTEREST IN THE POOL. ALSO, MARKET CONDITIONS MAY MAKE IT DIFFICULT OR IMPOSSIBLE FOR THE POOL TO LIQUIDATE A POSITION.

IN SOME CASES, COMMODITY POOLS ARE SUBJECT TO SUBSTANTIAL CHARGES FOR MANAGEMENT, ADVISORY AND BROKERAGE FEES. IT MAY BE NECESSARY FOR THOSE POOLS THAT ARE SUBJECT TO THESE CHARGES TO MAKE SUBSTANTIAL TRADING PROFITS TO AVOID DEPLE-

CFTC regulations also require commodity pools to maintain detailed records of all transactions,[39] and to make either monthly or quarterly reports to participants depending upon the size of the pool.[40] The regulations also direct commodity pools to file periodic reports with the CFTC or the National Futures Association. Compliance with the CPO recordkeeping and reporting requirements may present burdensome logistical problems for financial institutions that communicate with participants indirectly, on different timetables, and with different types of information. For example, insurance companies that operate group annuity contracts to fund large tax qualified retirement plans do not file this type or quantity of information with plan participants. Rather, under provisions of the Employee Retirement Income Security Act of 1974 and the regulations thereunder, disclosure goes to plan administrators in recognition of practical considerations.[41]

TION OR EXHAUSTION OF THEIR ASSETS. THIS DISCLOSURE DOCUMENT CONTAINS A COMPLETE DESCRIPTION OF EACH EXPENSE TO BE CHARGED THIS POOL.

THIS BRIEF STATEMENT CANNOT DISCLOSE ALL THE RISKS AND OTHER SIGNIFICANT ASPECTS OF PARTICIPATING IN A COMMODITY POOL. YOU SHOULD THEREFORE CAREFULLY STUDY THIS DISCLOSURE DOCUMENT AND COMMODITY TRADING BEFORE YOU DECIDE TO PARTICPATE IN A COMMODITY POOL. *Id.*

In addition, if the participant's potential liability in the pool is greater than the amount of the participant's contribution for purchase of a pool interest, the following paragraph must be included in the last paragraph of the risk disclosure statement:

ALSO, BEFORE YOU DECIDE TO PARTICIPATE IN THIS POOL, YOU SHOULD NOTE THAT YOUR POTENTIAL LIABILITY AS A PARTICIPANT IN THIS POOL FOR TRADING LOSSES AND OTHER EXPENSES OF THE POOL IS NOT LIMITED TO THE AMOUNT OF YOUR CONTRIBUTION FOR THE PURCHASE OF AN INTEREST IN THE POOL AND ANY PROFITS EARNED THEREON. A COMPLETE DESCRIPTION OF THE LIABILITY OF A PARTICIPANT IN THIS POOL IS EXPLAINED MORE FULLY IN THIS DISCLOSURE DOCUMENT. 17 C.F.R. § 4.21(a)(17)(ii) (1984).

39. 17 C.F.R. §4.23 (1985). Under this provision, CPOs must keep itemized daily records of all transactions, receipts, disbursements, participants' names and addresses, copies of all distributed literature, monthly FCM statements, and all financial statements.

40. 17 C.F.R. §4.22 (1985). Pools with greater than $500,000 in assets must provide participants with material data about the pool, its net asset values, fees, adviser trading information, commissions and expenses monthly. Pools with less than $500,000 in assets report quarterly. An annual report certified by a certified public accountant must be sent to participants and the CFTC, although pools with less than $50,000 and 15 participants are excluded from this requirement.

41. The administrator of an employee benefit plan, and not the plan's funding vehicle, is responsible for satisfying reporting and disclosure duties mandated by ERISA. *See, e.g.*, §§ 104(b) and 105 of Title I, Subpart B, of the Employee Retirement Security Income Act of 1974, 29 U.S.C. 1001 *et seq.* (1982), Pension Plan Guide (CCH) ¶ 14,240 and ¶ 14,250 respectively, (1985). Under those provisions, the administrator must furnish to each plan participant copies of the plan and plan summary. *See* Section 104(b)(1) of Title I, Subpart B, of the Employee Retirement Security Income Act of 1974, 29 U.S.C. 1001 *et seq.* (1982). Updated summary plan descriptions must be furnished in five year intervals. *Id.* Upon written request, the plan administrator must provide, for a reasonable charge, copies of the latest updated summary, latest annual report, and instruments under which the plan was established. *Id.* Section

Section 4o of the CEA contains a general anti-fraud provision prohibiting CPOs from engaging in fraudulent or deceptive acts against pool participants or prospective participants.[42] Regulations implementing this statutory provision require CPOs to operate pools as a separate entity, and prohibit the commingling of funds.[43] This proscription may be troublesome for banks, trust departments, insurance companies or pension plans. The CFTC also enforces CPO advertising restrictions that are dissimilar to those customarily governing financial institutions in their principal activities.[44]

This brief summary of the regulatory network governing CPOs highlights a number of significant regulatory incongruities facing financial institutions that may invoke the definition of commodity pool operator.[45] For these reasons, financial institutions that sought to hedge interest rate and market risks of their investment portfolios through the limited use of financial futures, attempted to obtain relief from the statutory and regulatory constraints facing CPOs.

C. Administrative Response to Requests for Interpretive Relief

In the past, the CFTC had taken the position that a financial institution, such as a mutual fund, that commits even a small part of its assets to futures contracts and options may be a "commodity pool operator" as defined by section 2a(1) of the CEA and, together with the entity's administrator and sponsor, required to register as a CPO.[46] In a series of interpretive letters addressing financial institutions, however, the CFTC concluded that under certain conditions such entities were not commodity pools, and that CPO registration would not be required.[47] In order to obtain these interpretive

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105 of ERISA requires administrators to furnish a participant, upon written request, total benefits accrued and nonforfeiture benefits which have accrued. *Id.* The general pattern and timetable of disclosure under ERISA is incompatible with the CFTC's periodic reporting requirement.

42. *See* CFTC v. Savage, 611 F.2d 270, 281-85 (9th Cir. 1980)(discussing antifraud principles applicable to CPOs).

43. 17 C.F.R. §4.20 (1985).

44. 17 C.F.R. §4.21 (1985).

45. These principally involve advertising standards and antifraud provisions of the CEA. For a more expansive discussion of the regulatory structures confronting CPOs, see Schneider, *Commodity Pool Operators and Commodity Trading Advisors,* Commodity Futures, 441 P.L.I. 63 (1984); Selig and Schroeder, *Regulation of Market Professionals,* Options and Financial Futures, 394 P.L.I. 311, 341-46 (1982).

46. CFTC Interpretive Letter No. 75-17, [1975-1977 Transfer Binder] COMMODITY FUT. L. REP. (CCH) ¶ 20,112 (Nov. 4, 1975).

47. *See, e.g.,* CFTC Interpretive Letter No. 83-8, [1982-1984 Transfer Binder] COMMODITY FUT. L. REP. (CCH) ¶ 21,908 (Nov. 3, 1983); CFTC Interpretive Letter No. 83-6, *id.* at ¶ 21,906 (Oct. 21, 1983). These letters held that the subject entities were not "pools" within the meaning and intent of 17 C.F.R. §4.10(d). As a result, these entities were excluded from most of the statutory and regulatory provisions confronting CPOs, such as registration, disclosure and recordkeeping. The CEA's general antifraud, and large trader reporting requirements would, however, continue to apply.

opinions, financial institutions were required to make specific undertakings. In sum, 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 (such as, five percent) 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.[48]

In developing the Futures Trading Act of 1982,[49] the Senate Committee on Agriculture, Nutrition and Forestry (the Committee) considered an amendment to the CEA which would have exempted certain institutional entities, such as banks, insurance companies, and investment companies, from the definition of commodity pool operator.[50] In response to this development, the CFTC informed the Committee of the "not a pool" interpretive letters it had issued under section 4.10(d) of its regulations to financial institutions.[51] In substitution of a statutory amendment to the CPO definition, therefore, the Committee directed the CFTC to issue regulations which would provide relief from the CPO regulatory structure for financial institutions that were deemed to be sufficiently "otherwise regulated." Following these recommendations, the Committee's report stated that:

> [C]ertain 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 or 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 market 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)

48. *See, e.g.*, IDS Bond Funds, Inc. (available Dec. 23, 1981); Harris Trust and Savings Bank (available Nov. 13, 1981); Montgomery Street Income Securities, Inc. (available Aug. 14, 1981).

49. Pub. L. No. 97-444, 96 Stat. 2294 (1983).

50. *See* S. Rep. No. 384, 97th Cong., 2d Sess. 80 (1982).

51. *See* 16 Fed. Reg. 253, 254 (1984).

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.[52]

In answer to the Committee's directive, the CFTC published proposed Rule 4.5 under the CEA on February 8, 1984, which would have made available for certain otherwise regulated persons an exemption from registration as a CPO and from the provisions of subpart B of part 4 of the Regulations.[53] Following the publication of proposed Rule 4.5, the CFTC changed the nature of its response to "not a pool" interpretive requests. Rather than issuing opinions that entities were not "pools" within the meaning and intent of section 4.10(d) as it had done previously,[54] the CFTC began to issue no-action letters stating that the Division would not recommend that the Commission take any enforcement action against the entity for failure to register as a CPO or to comply with the provisions of subpart B of part 4.[55] This practice has continued following the adoption of Rule 4.5.[56]

The CFTC sought to maximize public participation in this rulemaking by extending the comment period beyond its initial deadline and by sending letters requesting comments on the proposal to financial institutions' primary regulators, industry trade associations, and to committees of the American Bar Association. The CFTC's noteworthy efforts elicited over 100 individual comment letters, demonstrating the significance and complexity of the Rule

52. *See* S. REP. No. 384, 97th Cong., 2d Sess. 80 (1982).

53. 49 Fed. Reg. 4778, 4788-89 (1984).

54. *See supra* note 47 (discussing CFTC's expansive interpretive letters).

55. *See, e.g.*, CFTC Interpretive Letter No. 84-5, [1982-1984 Transfer Binder] COMMODITY FUT. L. REP. (CCH) ¶ 22,023 (Feb. 24, 1984); CFTC Interpretive Letter No. 84-4, *id.* at ¶ 22,022 (Feb. 24, 1984).

56. *See, e.g.*, CFTC Interpretive Letter No. 85-10, [Current Binder] COMMODITY FUT. L. REP. (CCH) ¶ 22,730 (July 22, 1985); CFTC Interpretive Letter No. 85-9, *id.* at ¶ 22,729 (July 16, 1985). The CFTC, however, has determined to issue "not a pool" interpretive positions in limited circumstances in which the subject entity does not trigger the meaning of "pool" based on analogous exclusions in the Rule 4.5 release. *See* CFTC Interpretive Letter No. 85-16, *id.* at ¶ 22,737 (Aug. 15, 1985) (insurance company separate account funding retirement plan where participant's return does not depend on futures and options trading by company); CFTC Interpretive Letter No. 85-15, *id.* at ¶ 22,736 (Aug. 15, 1985) (multiple pension plan master trust which did not place investor's funds at risk in commodity interest trading).

4.5 proposal. On April 15, 1985, the CFTC adopted a final version of Rule 4.5, dubbed the "not a pool rule," that clearly reflects the CFTC's careful reconsideration of its proposal, responds to the concerns voiced by commentators, and applies the CFTC's interpretation of the Committee's report. The discussion below will evaluate the principal features of new Rule 4.5, comparing the proposal with the final version, and analyzing the substance of the CFTC's action.

III. Rule 4.5 Excludes Financial Institutions from the Definition of Commodity Pool Operator

A. *Overview*

New Rule 4.5 provides an exclusion from the definition of the term "commodity pool operator" for specified financial institutions that are subject to extensive regulatory structures. The rule relieves these entities and the collective assets, or "pools", that they are deemed to operate from the various regulatory, compliance, recordkeeping, and disclosure requirements governing commodity pool operators subject to the CEA. Section 4.5 entities must file a notice of eligibility specifying the persons and entity to be excluded and containing certain representations about operating criteria. In addition, Rule 4.5 entities must submit to special calls for information by the CFTC to verify compliance with the operating criteria.

B. *Scope of Relief Available Under Rule 4.5*

Proposed Rule 4.5 would have provided extensively regulated financial institutions with an exemption from *registration* as a CPO and from the provisions of subpart B of the part 4 regulations.[57] Significantly, this proposal would have continued to include these financial institutions within the definition of "commodity pool operator," and, therefore, these entities would have remained subject to much of the particularized regulatory structure governing CPOs.[58] Although most commentators supported the proposed rule's goal to eliminate unnecessary and duplicative regulatory burdens, many suggested that the exemptive scope of the rule needed refinement.[59] Because proposed Rule 4.5 provided only an exemption from CPO registration, it would have necessitated the acknowledgement of an inapplicable regulatory status as a precondition to obtaining exemptive

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57. 49 Fed. Reg. 4780, 4788-89 (1984).

58. *See supra* text accompanying notes 35-45 (discussing regulatory requirements affecting CPOs); *see also* Rosen, *supra* note 15.

59. *See, e.g.,* Comment Letters of: Colonial Advisory Services, Inc.; Investment Company Institute; Prudential Insurance Company of America; Securities and Exchange Commission. These comment letters and all those referenced hereinafter are contained in CFTC Comment File No. 84-6.

relief.[60] Instead, these commentators recommended that the Rule should provide exemption from the *definition* of the term "commodity pool operator," and argued that this comported with the intent of the Senate Committee's Report.[61]

The legislative history contains repeated statements that certain entities are not within the intent of the commodity pool operator definition and should be exempt from CPO regulation.[62] This view is buttressed by the Committee's decision not to adopt a statutory amendment in deference to the CFTC's "not a pool" interpretive positions at that time, which held that certain entities were not commodity pools for purposes of the CPO regulations. Stated differently, the CFTC's letters essentially held that the subject entities had not triggered the definition of the term commodity pool as set forth in section 4.10(d).[63] The influence of the CFTC's interpretive letters on the Committee's deliberations and the Report's references to definitional exclusions demonstrates that Congress did not intend that financial institutions must confess commodity pool or operator status to obtain the regulatory relief of Rule 4.5.

In response to the views of commentators, the CFTC determined to expand the scope of Rule 4.5 so that it made "available an exclusion—not merely an exemption—for certain otherwise regulated persons from the definition of the term 'commodity pool operator.' "[64] This revision implements congressional intent more closely[65] and enhances the utility of Rule 4.5. Eligible financial institutions that are extensively regulated will be relieved of the unnecessary obligation to comply with CPO provisions of dubious applicability.

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60. Comment Letter of the American Council of Life Insurance at 16.

61. *See, e.g., id.* at 17; Comment Letter of American Bar Association Subcommittee on the Federal Regulation of Securities at 4; Comment Letter of Comptroller of the Currency at 2.

62. *See* S. REP. No. 384, 975th Cong. 2d Sess. 79-80 (1982). Generally, the Committee Report exempted from the definition of "commodity pool operator," groups of less than 5 persons; persons regulated by the Investment Company Act of 1940; any insurance company or trust department using less than 10% of its pooled assets for futures trading; and benefit plans covered by ERISA. *Id.* The report later states that "the Committee believes . . . that certain entities are not within the intent of the *definition* of the term commodity pool operator. . . . [a]n insurance company . . . could ordinarily be excluded from the definition of the term. . . ." *Id.* at 80 (emphasis added). *But see* a single comment in the legislative history which states that ". . . while the Commission should retain discretion in this area, the Committee believes that . . . exemption by rule, regulation, or order from commodity pool operator registration and related requirements . . . should generally be granted to these classes of entities." *Id.* When balanced against the frequent references to a definitional exemption, this statement is internally consistent only if viewed in a generic descriptive sense, rather than in a literal light.

63. *See, e.g.,* St. Paul Securities, Inc. (available January 31, 1982); INA Investment Securities Inc. (available February 10, 1982); Montgomery Street Income Securities, Inc. (available August 14, 1981).

64. 50 Fed. Reg. 15868, 15870 (1985).

65. It should be noted that the legislative history principally concerns a reauthorization hearing, rather than explaining a specific statutory change that has been enacted. This is particularly true regarding CPO exemptions.

The CFTC established another important refinement to Rule 4.5 by clarifying that it provides a regulatory "safe harbor" and is not the exclusive means for relief from regulation as a CPO. This action responded to commentators' concerns that proposed Rule 4.5 appeared to suggest that entities unable to satisfy the conditions of the rule would be prima facie commodity pool operators.[66] As commentators had recommended, the CFTC confirmed that entities unable to satisfy the literal language of Rule 4.5 could continue to seek interpretive relief on the issue of whether the entity was operated "for the purpose of trading commodity interests" based upon an evaluation of all the facts relevant to its operation.[67]

In reponse to one commentator[68] the CFTC clarified that entities which had received "not a pool" or "no-action" letters premised on more stringent operating criteria than Rule 4.5 would be able to comply with the rule's less stringent criteria.[69] In addition, the CFTC indicated that section 4o of the CEA,[70] which prohibits fraudulent activities by CPOs, would not be applicable to recipients of "no-action" letters that merely refrained from enforcement action but deemed the entities to be CPOs subject to section 4o of the CEA.[71] This accommodation eliminates unwarranted regulatory disparities among similar entities.

C. *Entities to Which the Exclusion Applies*

Under the CFTC's regulatory framework, a CPO and its pool generally must be organized as separate legal entities.[72] To be effective, therefore, Rule 4.5 pertains not only to the institutions that could be deemed CPOs, but also to the corresponding pooled assets or *qualifying entity* involved. The release proposing Rule 4.5 noted that the rule's intended scope of relief included principals and employees of exempt entities and persons.[73] One commentator suggested that the phrase "principal or employee" should be expanded to include persons who functionally, but not literally, come within that phrase.[74] Another comment recommended that the phrase be expanded to include "such other fiduciaries that fall within the intent" of Rule 4.5.[75]

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66. *See* Comment Letter of American Council of Life Insurance at 19 (analogizing Rule 4.5 to the safe harbor provided in Regulation D under the Securities Act of 1933, an exception for limited securities offerings); Comment Letter of National Association of Futures Trading Advisors at 6; Comment Letter of Goldman, Sachs & Co. at 2.

67. 50 Fed. Reg. 15868, 15870 (1985).

68. *See* Comment letter of American Council of Life Insurance at 18 n.34; *see also supra* note 47 and accompanying text (discussing distinction between "not a pool" and "no-action" letters).

69. 50 Fed. Reg. 15868, 15870 (1985).

70. 7 U.S.C. §60 (1982).

71. 50 Fed. Reg. 15868, 15870 (1985).

72. 17 C.F.R. §4.20(a) (1985).

73. 49 Fed. Reg. at 4780 (1984).

74. Comment Letter of American Council Life Insurance at 24.

75. Comment Letter of Goldman, Sachs & Co. at 6.

Based upon a strict adherence to the Committee Report,[76] the CFTC declined to incorporate these recommendations, but invited requests for interpretive determinations on the scope of the language "persons, and any principal or employee thereof" in Rule 4.5.[77] In this case, sufficient practical justification existed for the CFTC to expand the applicability of the phrase "principal or employee." The failure to resolve this relatively straightforward issue conflicts with the CFTC's articulated intent that the rule alleviate case-by-case determinations with respect to eligibility requirements.[78] The CFTC's willingness to consider interpretive requests should be commended. Its failure to resolve this issue within the rule, however, is questionable.

An analysis of the structure of Rule 4.5 provides a clear outline of the entities to which the exclusion applies. Rule 4.5(a) excludes from the definition of the term "commodity pool operator" the following persons, and any principal or employee thereof, concerning the operation of stipulated *qualifying entities:*[79]

> (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, trust company or any other such financial depository institution subject to regulation by any state or the United States; and

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76. *See supra* note 65 (noting that legislative history accompanying Committee Report focused on reauthorization hearing rather than explaining statutory changes).

77. 50 Fed. Reg. 15868, 15871 (1985).

78. *Id.* at 15877.

79. 17 C.F.R. §4.5(a) (1985). The "qualifying entities" set forth in paragraph (b) which parallel the persons excluded from the definition of commodity pool operator include:

(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, a separate account established and maintained or offered by an insurance company pursuant to the laws of any State or territory of the United States, under which income gains and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account, without regard to other income, gains, or losses of the insurance company;

(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 it is acting as a fiduciary and for which it is vested with investment authority; and

(4) With respect to any person specified in paragraph (a)(4) of this section, and subject to the proviso thereof, a pension plan that is subject to Title I of the Employee Retirement Income Security Act of 1974; *provided, however,* That such entity will be operated in the manner specified in paragraph (c)(2) of this section.

(4) A trustee or named fiduciary of a pension plan that is subject to Title I of the Employee Retirement Income Security Act of 1974.[80]

1. Registered Investment Companies

Registered investment companies are clearly "otherwise regulated" pursuant to stringent regulatory constraints imposed by the Investment Company Act of 1940[81] as well as the Securities Act of 1933[82] and the Securities Exchange Act of 1934.[83] Unlike the other four categories of excluded entities, a registered investment company is delineated as both the "otherwise regulated person" under paragraph (a)(1) and its "qualifying entity" under paragraph (b)(1).[84] A legitimate issue arose under this category questioning

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80. The fourth definitional exclusion for trustees or named fiduciaries of ERISA pension plans also states by way of proviso:

> That exclusion from the definition of the term "commodity pool operator" is hereby granted to, and nothing herein shall be deemed to require compliance with the provisions of this section for exclusion from the definition of the term "commodity pool operator" with respect to, a trustee or named fiduciary of any of the following pension plans:
>
> (i) A noncontributory plan, whether defined benefit or defined contribution, covered under Title I of the Employee Retirement Income Security Act of 1974;
>
> (ii) A contributory defined benefit plan covered under Title IV of the Employee Retirement Income Security Act of 1974; *Provided, however,* That with respect to any such plan to which an employee may voluntarily contribute, no portion of an employee's contribution is committed as margin or premiums for futures or options contracts; and
>
> (iii) A plan defined as a governmental plan in Section 3(32) of Title I of the Employee Retirement Income Security Act of 1974.

17 C.F.R. §4.5(a) (1985) (emphasis original).

81. 15 U.S.C. §80 (1982). The Investment Company Act (ICA) was created in response to many well publicized abuses perpetrated by management on shareholders. *See* Note, *The Investment Company Act of 1940,* 41 COLUM. L. REV. 269, 272 (1941). Investment companies must file a detailed registration statement including a statement of fundamental investment policies. *See* ICA §§7-8. They must obtain shareholder approval of changes in investment policies and must send periodic reports to shareholders detailing assets and values. *See* ICA §§13, 24, 30. The ICA contains broad prohibitions against potentially abusive activities such as self dealing of affiliates, creation of senior securities and employment of individuals with criminal backgrounds. *See* ICA §§9, 17, 18. Similarly, §37 of the ICA establishes larceny, embezzlement or conversion of investment company securities as federal crimes. Under §36 of the ICA, an investment company cannot exchange shares at less than net asset value without SEC approval. Section 30 of the ICA and the rules thereunder impose substantial detailed recordkeeping requirements. Section 36 of the ICA creates fiduciary duties for investment company directors. This brief summary only touches on many of the ICA's constraints, which are discussed in depth in numerous articles. *See* Comment, *The Application of Section 17 of the Investment Company Act of 1940 to Portfolio Affiliates,* 120 U. PA. L. REV. 983 (1972); *The Mutual Fund Industry: A Legal Survey,* 44 NOTRE DAME LAW. 732 (1969); *Mutual Funds as Investors of Large Pools of Money,* 115 U. PA. L. REV. 663 (1967); Kerr and Applebaum, *Inadvertent Investment Companies—Ten Years After,* 25 BUS. LAW. 887 (1970); *see generally* POZEN, FINANCIAL INSTITUTIONS: INVESTMENT MANAGEMENT, 192 (1977).

82. 15 U.S.C. §77a (1982).

83. *Id.* § 78a.

84. Although §4.20(a) of the CFTC regulations requires a CPO and its pool to be separate

whether a registered investment company's depositor, sponsor, underwriter or investment adviser fell outside the definition of the term "commodity pool operator" under the interpretive exclusion for a "principal or employee."[85] The CFTC does not believe that the activities in which these categories of individuals typically engage resemble the activities in which a CPO typically engages.[86] The release, therefore, indicates that investment company depositors, sponsors, underwriters or investment advisers are outside the CPO definition and, thus, that relief from regulation as a CPO is not necessary in order to exclude them from the CPO definition.

While reaching the correct regulatory result, the CFTC could have improved its action by incorporating an exclusion for these categories within the scope of the investment company exclusion. Alternatively, the CFTC could have expanded the phrase "principal or employee" to include persons who functionally, but not literally, come within that phrase.[87] It is not difficult to imagine that investment company sponsors, depositors, underwriters or investment advisers could be construed to trigger the definition of commodity pool operator when performing their roles for investment companies. Indeed, the CFTC itself has taken this position.[88]

The release clarified that each portfolio of a registered "series" investment company that intends to trade commodity interests may be treated as a separate entity for the purpose of fulfilling the rule's operating criteria if there is separate ownership and identities of each portfolio series.[89] In this way, a series investment company would not have to aggregate all of its portfolios to determine whether the Rule 4.5 criteria had been met. Although not discussed in the release, the same result should apply to a registered unit investment trust with discrete underlying funds or series dedicated to unique portfolios.[90] A good example of this exists in variable annuity or variable

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legal entities, the CFTC explained the unitary organizational aspect of Rule 4.5(a)(1) and (a)(2), noting that §4.20(a) recognizes that in the case of a corporation the CPO and its pool may be one and the same. Accordingly, that rule provides exemption from its requirements in the case of certain corporations—that is, those who demonstrate to the Commission that they will be operated in a manner consistent with the purposes of the rule. 50 Fed. Reg. 15868, 15871 n.30 (1985).

85. *See* Comment Letter of Goldman, Sachs & Co. at 6; Comment Letter of Prudential Insurance Company of America at 4, n.4; Comment Letter of Securities and Exchange Commission at 5; Comment Letter of American Council of Life Insurance at 24.

86. 50 Fed. Reg. 15868, 15871 (1985).

87. *See supra* note 73 and accompanying text (discussing functional expansion of phrase "principal or employee").

88. *See supra* note 46 & 47 and accompanying text (defining commodity pool operator).

89. 50 Fed. Reg. 15868, 15782 (1985). A "series" investment company is an open-end management investment company, or mutual fund, whose shares are divided into series or classes, each representing a distinct portfolio of investments with different objectives. *See* Woodward, Chiechi and Peherson, *Series Investment Companies,* 15 REV. SEC. REG. 815 (1982).

90. Section 4(2) of the Investment Company Act of 1940 classifies a unit investment trust as "an investment company which (A) is organized under a trust indenture, contract of custodianship or agency or similar instrument, (B) does not have a board of directors, and (C) only issues redeemable securities, each of which represents an undivided interest in a unit of specified securities . . ." 15 U.S.C. §80a-4(2) (1982).

life insurance separate accounts having multiple underlying funds with separate investment objectives, net asset valuation and dividend policies.

2. State Regulated Insurance Companies

The second major definitional exclusion of Rule 4.5 extends to state regulated insurance companies with respect to the operation of insurance company separate accounts, as defined under the Investment Company Act of 1940,[91] to fund variable annuities or variable life insurance contracts whose value fluctuates with the investment experience of the separate account. Insurance companies and their registered separate accounts are perhaps the most heavily "otherwise regulated" entities eligible under Rule 4.5, being subject to both the Investment Company Act of 1940[92] and extensive state insurance regulatory structures.[93] The CFTC revised paragraph (b)(2)

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91. Section 2(a)(37) of the Investment Company Act of 1940 defines a separate account to mean "an account established and maintained by an insurance company pursuant to the laws of any State or territory of the United States, or of Canada or any province thereof, under which income, gains and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains, or lossess of the insurance company." 15 U.S.C. §80a-2(37) (1982).

92. *See supra* note 81 (discussing regulation under the Investment Company Act).

93. In most states, an independent state agency, the insurance department, is responsible for administering state insurance laws. The insurance commissioner has the authority to issue a license to do business with domestic and foreign insurance companies. Consistent with this authority, the commissioner may revoke, suspend or refuse to renew an insurance company's certificate of authority, for cause. In exercising control over the actions of insurers, commissioners may impose penalties for violations of law.

All insurers doing business in a state are required to file annual reports with the insurance department. The annual reports provide information regarding operations and financial condition, including detailed schedules and items stipulated in an "annual statement blank" developed by the National Association of Insurance Commissioners (NAIC), which is used in all states. The annual statement is examined by the states as a tool in auditing each insurer's financial condition.

In addition to reviewing insurers' annual statements, commissioners are required to examine periodically the affairs of each insurer doing business in the state. The insurance department conducts evaluations of insurers' policy reserve liabilities and scrutinizes policy forms and other related documents such as riders, applications, and supplemental contracts.

The authority to promulgate regulations implementing the insurance code represents another significant quasi-legislative power of the insurance department. Commissioners also possess quasi-judicial powers to conduct hearings, compel testimony or evidence, and to issue orders.

The insurance laws of all states contain provisions governing insurers, agents, and brokers which prohibit unfair or deceptive trade practices, false advertising, intimidation, coercion, unfair discrimination or rebating. *See* NAIC Model Unfair Trade Practices Act, NARS/NAIC Model Regulation Service (1985) at 900-1. Agents' qualification and licensing provisions establish rigorous standards measuring prospective licensees' character and competence. State insurance statutes and regulations stipulate various minimum standard policy provisions which define the rights and duties of policy owners, insureds and beneficiaries to protect the interests of the insuring public.

As a prerequisite to incorporation, state insurance codes prescribe the amounts of minimum capital and surplus for domestic stock insurers and the minimum surplus for domestic mutual of the rule to accommodate a significant concern voiced by the life insurance industry that proposed Rule 4.5(b)(2) went far beyond the intended scope of the Committee's Report by, in effect, deeming the acquisition of commodity interests in an insurance company's general assets as the operation of a commodity pool.[94] This unanticipated coverage by Rule 4.5 would have occurred because proposed paragraph (b)(2) covered the "assets of any trust, custodial account or other separate unit of investment for which [the insurance company] is acting as a fiduciary,"[95] and would not have limited the scope of the putative "commodity pool" to separate accounts funding variable contracts.[96]

The life insurance industry explained that the funds accumulated in support of insurance contract obligations are invested in assets that are the property of the insurance company. Unlike some entities within the scope of Rule 4.5, contract owners of traditional, fixed life insurance products do not own any interest in the general assets of a life insurance company. As a result of this distinction, the life insurance industry argued that insurance company general assets do not constitute a "pool" in which policy holders participate.

The CFTC rectified the deficiencies noted by the insurance industry, limiting the scope of paragraph (b)(2) so that only insurance company separate accounts, and not general assets, might be deemed "pools" necessitating relief under the Rule.[97] In sum, the CFTC's revision of paragraph (b)(2) more precisely refines its intended scope and eliminates any suggestion that life insurance company general assets, if they include financial futures, may be commodity pools.

3. Financial Depository Institutions

The third category for which Rule 4.5 provides relief includes state or federally regulated banks, trust companies and similar financial depository institutions. The Rule applies to the assets of any trust, custodial account or

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insurers. State insurance provisions specify in detail authorized asset categories as well as qualitative and quantitative restrictions. These regulatory provisions also prescribe rules for asset valuation which are used to measure an insurer's financial soundness and stability. *See generally* D. GREG AND V. LUCAS, LIFE AND HEALTH INSURANCE HANDBOOK (1977) (discussion of regulation of insurance companies).

94. *See* Comment Letter of the American Council of Life Insurance at 24.

95. 49 Fed. Reg. at 4788.

96. *See supra* note 91 (defining term "separate account").

97. The life insurance industry also noted that although separate accounts funding variable life insurance are registered as investment companies with the SEC, these pools are uniquely distinguishable from investment companies and commodity pools because insurance companies guaranteed a minimum death benefit in scheduled premium variable life insurance then in existence. *See* Comment Letter of American Council of Life Insurance at 16. *But see* Comment Letter of Prudential Insurance Company of America at 4 (finding "it hard to see why the person or entity managing [variable life separate account] assets would not fall within the definition of the term commodity pool.").

other separate unit of investment for which the financial institution acts as fiduciary vested with investment authority. The drafters refined the scope of this exclusion more carefully to focus upon depository institutions acting in an investment management capacity on behalf of customers. In contrast, proposed paragraph (b)(3) had pertained more broadly to all fiduciary functions. The banking industry noted, however, that banks and trust companies frequently act in a fiduciary capacity without having any investment authority, and thus would be unable to make the required representations on operational criteria.[98] Accordingly, the banking industry recommended that paragraph (b)(3) should be limited to the fiduciary accounts in which the bank or trust company has investment authority.

The CFTC's modification of paragraph (b)(3) reflects a reasonable accommodation of these practical considerations. Another alternative that also could have been implemented in this respect would provide selective exemption from the operational representations that these entities could not undertake, rather than blanket exemption. For example, when acting in a nondiscretionary fiduciary capacity, these entities presumably could represent without difficulty that they were not marketing or promoting a commodity pool. Similarly, these entities could disclose the purpose of and limitations on commodity interest trading, even in nondiscretionary trust activities.

Interestingly, other functionally similar institutions remain putative "pools" for purposes of Rule 4.5. For example, some registered unit investment trusts sell interests in a fixed group of securities deposited with a trustee. These trusts resemble nondiscretionary fiduciary accounts because the trustees do not change the composition of the trust's portfolio. Perhaps the CFTC should consider extending similar interpretive relief to these functionally similar "qualifying entities."

The CFTC also expanded paragraph (a)(3) to cover other financial depository institutions that are governed in a manner equivalent to state and federally regulated banks or trust companies. Commentators noted that bank affiliates are regulated as extensively as their parents[99] and that savings and loan institutions operate under regulatory frameworks similar to banks and trust companies.[100] In response to other commentators,[101] the release indicates that this expansion also extends to United States branches and agencies of

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98. *See* Comment Letter of Comptroller at 2; *accord,* Comment Letter of American Bankers Association at 10. *Contra,* Comment Letter of Commodity Pool Institute at 7 (submitting that banking industry should make disclosures required of others in order to prevent disparate regulatory burdens on pools competing with bank collective asset offerings).

99. *See* Comment Letter of American Bankers Association.

100. *See* Comment Letter of United States League of Savings Institutions. Historically, jurisdictional disputes have existed in the regulation of discretionary collective asset management by banks. *See SEC, Bank Regulatory Agencies Meet to Resolve Conflicts on Disclosure,* 298 SEC. REG. L. REP. (BNA) (Apr. 16, 1975) at A-1; Murnane, *SEC, FTC, and the Federal Bank Regulators: Emerging Problems of Administrative Jurisdictional Overlap,* 61 GEO. L. J. 37 (1972).

101. *See* Comment Letter of Institute of Foreign Bankers, Inc.

foreign banks subject to state or federal regulation "equivalent to" banks or trust companies.[102] Significantly, in expanding paragraph (a)(3) to include bank affiliates, the CFTC carefully clarified that Rule 4.5 is not available to banking affiliates acting as futures commissions merchants because their primary regulator is viewed to be the CFTC.[103]

4. Pension Plans

Proposed Rule 4.5 also would have excluded trustees or named fiduciaries of defined benefit pension plans subject to ERISA and insured by the Pension Benefit Guaranty Corporation from the definition of commodity pool operator.[104] This category proved to be the most extensively revised in the proposal. Certain commentators broadly suggested that all pension plans subject to ERISA should not be considered "pools" and thus should not be subject to any Rule 4.5 operating criteria.[105] The CFTC reasoned that the terms "commodity pool operator" or "pool," and the Committee's Report could justify relief to only certain ERISA plans.[106] Thus, Rule 4.5 defines the term "pool" not to include ERISA regulated non-contributory pension plans (whether defined benefit or defined contribution) or contributory defined benefit plans. The proposed rule warranted this revision because the employer bears the funding responsibility for losses under these plan categories. Furthermore, non-contributory plans differ from commodity pools because no funds are solicited from participants.[107]

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102. As a matter of regulatory parity, it is unclear why the CFTC was compelled to extend paragraph (a)(4) to other "equivalently" regulated entities like agencies of foreign banks, but required other pension plans not specified in paragraph (a)(4) to seek case-by-case relief depending on the extent of the entity's regulation. This category could also have been included in a parallel exclusive section pertaining to other pension plans subject to "equivalent" state or federal regulation.

103. 50 Fed. Reg. 15868, 15873 n.35 (1985).

104. 49 Fed. Reg. at 4788.

105. *See* Comment Letter of Salomon Brothers, Inc.

106. 50 Fed. Reg. 15868, 15873 (1985).

107. The CFTC elaborated on the Rule 4.5(a)(4) exclusion from the "pool" definition in a "not a pool" letter granted to a master retirement trust composed of non-contributory pension plans. CFTC Interpretive Letter No. 85-13, [Current Binder] COMMODITY FUT. L. REP. (CCH) ¶ 22,734 (August 2, 1985). The CFTC emphasized that even though a Rule 4.5(a)(4) exclusion may be applicable to an individual pension plan, it does not necessarily follow that this exclusion will be available to a different entity, such as a master trust, which commingles such a pension plan's assets with the assets of other persons for trading in commodity interests. *Id.* at 31,074. The CFTC expressed its concern that a person who is not subject to a Rule 4.5 exclusion but who solicits or accepts investors' funds for the purpose of trading and commodity interests not evade regulatory requirements applicable to CPOs merely by including an otherwise excluded entity in its commingled trading vehicle. *Id.* at 31,075. In this instance, the CFTC concluded that the subject master retirement trust would not constitute a "pool" under Rule 4.10(d) because all of the pension plans in the trust were subject to the Rule 4.5(a)(4) exclusion from the "pool" definition, and because all the gains and losses from any commodity interest trading were allocated solely to those excluded plans. *Accord* CFTC Interpretive Letter No. 85-15 [Current Binder] COMMODITY FUT. L. REP. (CCH) ¶ 22,736 (Aug. 15, 1985) (exclusion from

ERISA regulated contributory defined benefit plans are also excluded from the "pool" definition, provided that no portion of an employee's contribution is committed as margin or premiums for futures or options contracts.[108] Mechanically, this aspect of the rule may be difficult to satisfy because plans would have to institute segregation procedures bifurcating plan assets acquired with employee contributions and assets acquired through employer contributions. This obligation may impose tedious redundancies that could overshadow the expense or burden of complying with the requirements of Rule 4.5. The extent to which contributory defined benefit plans exploit this definitional exception will provide the most accurate measure of the perceived burdens of Rule 4.5.

Paragraph (a)(4) also excludes governmental pension plans from the definition of the term "pool" because regulating trustees and named fiduciaries of these plans would raise "questions of state and local sovereignty [in which] the federal government should not interfere."[109] Given the CFTC's exclusive and plenary jurisdiction over commodity pools,[110] the rule's deference to state sovereignty is unfounded. Indeed, the CFTC has vigorously warned state securities administrators that the CFTC maintains exclusive jurisdiction in the regulation of commodity pools.[111] In view of this jurisdictional dispute, it may have been preferable to exclude trustees or named fiduciaries of governmental pension plans from the definition of CPO through Rule 4.5, rather than exempting governmental plans from the definition of "pool."

In sum, paragraph (a)(4) excludes these three types of pension plans from the definition of the term "pool" for purposes of Rule 4.5. The CFTC decided to include other ERISA regulated plans within the exclusion provided in Rule 4.5(b)(4), enabling trustees and named fiduciaries of these plans to claim exclusion from the CPO definition under Rule 4.5. The CFTC invited other pension plans not identified in paragraph (b)(4) to seek individual interpretive relief that would focus, among other things, on the extent of their regulatory schemes.[112]

The release emphasizes that not all pension plans outside the scope of

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"pool" definition for individual pensions plans in Rule 4.5(a)(i)(4)(i) and (ii) can be applied to single employer multiple pension plan master trust).

108. *See* 17 C.F.R. §4.5(a)(4)(i) - 4.5(a)(4)(ii) (1985).

109. 50 Fed. Reg. 15868, 15873 (1985).

110. *See supra* note 16 (explaining CFTC's exclusive jurisdiction).

111. Proposed Guidelines for Registration of Commodity Pool Programs proposed by the North American Securities Administrators Association (NASAA), 15 SEC. REG. L. REP. (BNA) 1181 (1983). The extent of this jurisdictional controversy was evidenced by the American Bar Association Committee on Commodities Regulation which strongly opposed this NASAA proposal, noting that the legislative intent for a single, federal body of commodity regulation has been affirmed and reaffirmed numerous times in unambiguous fashion by Congress and the courts.

112. *See* 50 Fed. Reg. 15868, 15874 (1985). *But see supra* note 102 (describing inconsistency in this approach).

Title I of ERISA, and thus ineligible as a qualifying entity under paragraph (b)(4), necessarily would be commodity pools.[113] In this connection, the CFTC noted that Individual Retirement Accounts (IRAs) and H.R. 10 Plans[114] covering only business owners and their spouses, by their very nature are not within the meaning and intent of the term "pool." This interpretive guidance should relieve managers of individual H.R. 10 plans and IRAs. By way of parallel analogy, certain entities excluded from the definition of investment company under the Investment Company Act of 1940[115] should also be entitled to similar interpretive relief. For example, some insurance companies operate single client separate accounts funding variable annuity contracts which are excluded from the definition of investment company.[116]

The CFTC did not adopt recommendations of several commentators that paragraph (a)(4) should be available to all ERISA fiduciaries rather than only "named" fiduciaries.[117] Commentators noted that nothing in the Committee's Report required addition of the word "named" to this category, and pointed out that neither section 404 of ERISA, which sets forth fiduciary duties, or section 406 of ERISA, which pertains to prohibited transactions, uses the term "named" fiduciary. Rather, these provisions simply refer to the term fiduciary without limitation. Commentators expressed concern that several persons, who technically are not "named" fiduciaries, may be acting in a fiduciary capacity with respect to a pension plan. For example, the named fiduciary could delegate to an investment manager the responsibility for managing and investing a designated portion of the plan's assets.

The CFTC determined that this recommendation was too broad because all ERISA fiduciaries are not "otherwise regulated" to the same extent as trustees and "named" fiduciaries of ERISA plans.[118] Although the release invites individuals who are not named fiduciaries to seek individual interpretive relief, the CFTC's failure to enlarge this category appears to be inconsistent with the CFTC's philosophy of permitting depository institutions "equivalently regulated" as banks and trust companies to qualify for the exclusion under paragraph (a)(3).

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113. 50 Fed. Reg. 15868, 15874 (1985).

114. Tax qualified retirement plans covering self-employed persons are generally referred to as "Keogh" or "H.R. 10" plans, in memory of their legislative origin. *See* Pension Plan Guide (CCH) at ¶ 32,000 for a detailed discussion of these plans.

115. Section 3(c) of the Investment Company Act provides definitional exclusions. 15 U.S.C. §80a-3(c) (1982).

116. These entities would satisfy Section 3(c)(1) of the Investment Company Act which excludes companies with fewer than 100 shareholders. 15 U.S.C. §80a-3(c)(1) (1982). Single client separate accounts would rely on this exclusion if they were unable to rely on the exclusion provided in Section 3(c)(11) for separate accounts funding certain corporate qualified pension plans. *Id.* §80a-3(c)(11).

117. *See* Comment Letter of Prudential Insurance Company of America at 7; Comment Letter of the American Council of Life Insurance at 25; Comment Letter of Merrill Lynch Futures, Inc.

118. 50 Fed. Reg. 15868, 15874 (1985).

IV. Notices Required for Exclusion

Financial institutions must file a notice of eligibility to claim the exclusion from the CPO definition of Rule 4.5(c). The CFTC ignored the suggestion of some commentators that filing requirements should be eliminated as burdensome.[119] The final rule, however, reflects suggestions that notices should not be supported by any specific documentation.[120] Responsively, the CFTC amended the rule to require other documentation only on an "as needed" basis.[121]

The notices of eligibility, which are effective upon filing, must be filed with the CFTC prior to the putative pool's operation. Rule 4.5(d) incorporates a practical modification, enlarging authorized signatories to the notice beyond just CEOs and CPOs to include "duly authorized representatives" that can bind the filing entity contractually.[122] Rule 4.5(d) also requires that eligibility notices be filed simultaneously with the National Futures Association so that it can execute its responsibilities as a self-regulatory organization and identify entities claiming exclusion under the rule.

The CFTC rejected recommendations of the banking industry that a "blanket" notice should pertain to banks acting as fiduciaries for trusts because these accounts are frequently opened and closed necessitating constant amendment of the eligibility notice.[123] Citing the need to identify entities claiming relief, the CFTC will allow each financial institution to file only one notice, but with each ultimate account trading commodity interests identified. This compromise eliminates duplicative filing burdens and parallels the treatment afforded individual series funds acquiring financial futures.[124] Analogously, an investment company presumably could file a single notice listing those individual series investing in financial futures instruments.

Paragraph (c) of Rule 4.5 omits a proposal that would have required management investment companies to list financial reporting and disclosure exemptions they had obtained from the SEC, in deference to the SEC's comment that the Investment Company Act only permits exemptions consistent with the public interest and the protection of investors.[125] This rule modification is indicative of the CFTC's reasonableness in recognizing the interplay of the excluded entity's primary scheme of regulation.

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119. *See* Comment Letter of Drexel, Burnham, Lambert; Comment Letter of Shearson/American Express.

120. *See* Comment Letter of National Association of Futures Trading Advisors; Comment Letter of Investment Company Institute.

121. 17 C.F.R. §4.5(c)(2)(v) (1985).

122. *See* Comment Letter of American Council of Life Insurance at 25.

123. *See* Comment Letter of Comptroller at 2; Comment Letter of American Bankers Association.

124. *See supra* notes 89 & 90 and accompanying text.

125. Section 6(c) of the Investment Company Act grants the SEC general exemptive authority under these conditions. 15 U.S.C. §80a-4(c) (1982); *see* Comment Letter of SEC at 2.

A. Representations Concerning Operating Standards

Perhaps the most significant regulatory aspect in the eligibility notice involves specific undertakings concerning the operation of excluded entities. According to the release, the rule attempts to track closely the guidance contained in the Committee's report concerning operating conditions.[126]

1. The Bona Fide Hedging Representation

The first operating standard proposed in Rule 4.5(c) was that the excluded entity "will use commodity futures or options contracts solely for bona fide hedging purposes." This representation was to be controlled by the definition of the term "bona fide hedging transactions and positions" set forth in the CFTC's rules at section 1.3(z)(1).[127] To this end, the CFTC explained that excluded financial institutions must correlate fluctuations in the value of futures or options positions relative to the value of actual or anticipated cash positions.[128] In other words, futures or options positions must be acquired with the intent set forth by section 1.3(z)(1).[129]

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126. While attention to the Committee's report is commendable, it should be noted that strict application to this report fails to recognize that it principally involved a reauthorization. Substantive legislation was not adopted concerning CPOs. *See supra* note 62. Thus, the report should be interpreted with some degree of flexibility. Moreover, the report's citation to operating standards was drawn from conditions established in CFTC interpretive letters. It becomes somewhat circular then, to place inordinate authoritative emphasis on the literal wording of the report's operating standards.

127. 17 C.F.R. §1.3(z)(1) (1985) 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.

128. 49 Fed. Reg. at 4781.

129. The requisite intent in this representation was clearly identified in several interpretive letters. See, for example, the Government Securities Series of the Hutton Investment Series, Inc. (April 4, 1984), in which the CFTC found that the investment company's contemplated

Significantly, the proposal release stated that certain "anticipatory" or "long hedge" strategies were not, in fact, bona fide hedging transactions.[130] An anticipatory hedge is a futures or options transaction in which the hedger does not own, but expects to acquire, the underlying commodity at the time of the transaction. Nevertheless, the CFTC acknowledged that there may be situations in which it may be economically inappropriate to complete an anticipatory hedge.[131] The CFTC, therefore, developed an "intent test" to ascertain whether an uncompleted anticipatory hedge is outside the scope of the term bona fide hedging transaction. Thus, under the Rule 4.5 proposal, a substantial majority—that is, 75 percent—of all anticipatory hedge transactions entered into each year must have been completed.[132]

The CFTC's anticipatory hedging proposal drew extensive and varied public comment. The SEC found the 75 percent test to be reasonable.[133] Other commentators, however, suggested that the intent test created a regulatory bias in favor of short, as opposed to long, positions that would introduce an extraneous influence into the commodity markets.[134] Commentators noted that the 75 percent test placed too much emphasis on mathematical certainty and not enough on commercial reality.[135] One solution offered to answer these concerns would have required that a "substantial majority" of anticipatory hedge transactions be completed during a prescribed sequence of months.[136] Under this alternative, it was suggested that an entity could document the completion of a substantial majority of its transactions and explain circumstances surrounding uncompleted transactions. It was also recommended that intent should be judged at the date of the formation of the anticipatory hedge rather than at the date of the completion or cancellation of the contract.[137]

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purchase of put options on interest rate futures contracts "to hedge a long position in the underlying futures contract" did not appear to be bona fide hedging activity. Similarly, in Colonial Tax Exempt High Yield Trust (Nov. 1, 1984), the CFTC held that a strategy selling tax-exempt bond future contracts and buying United States Government bond future contracts to protect against shifts in value due to over-or-under valuation of the tax-exempt bond market in relation to the taxable bond market, was not bona fide hedging.

130. 49 Fed. Reg. at 4781.

131. The release demonstrated this circumstance by way of the following example:

> [I]f 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.

49 Fed. Reg. at 4782 n.15 (emphasis in original).

132. *Id.* at 4782.

133. Comment Letter of SEC at 5.

134. *See* Comment Letter of Prudential Insurance Company of America at 10; Comment Letter of National Association of Futures Trading Advisors at 9.

135. *See* Comment Letter of Travelers Insurance Company at 9.

136. *See* Comment Letter of American Council of Life Insurance at 21. The CFTC previously had approved this approach in Prudential-Bache Growth Option Funds, Inc. (Sept. 13, 1983).

137. *See* Comment Letter of Investment Company Institute at 5; *accord,* Comment Letter of Wells Fargo Bank, N.A. at 2.

Revisions to Rule 4.5(c) reflect several of these recommendations and clarify others. According to the release, the requisite "intent" under this representation should be judged as of the date on which the transaction was entered into, rather than later when the transaction is or is not completed.[138] Further, the 75 percent test will be used as a general standard for later review.[139] Thus, in spite of vigorous opposition to the incorporation of a specific percentage in the proposed "intent test," the CFTC retained the 75 percent barometer of requisite hedging intent, although the release identifies it as a "general" rather than an absolute standard.[140] The release explains that in the absence of this mechanical standard, Rule 4.5 would not alleviate the need for case-by-case determinations concerning the eligibility and operating criteria requirements.

An investment banker challenged the applicability of the CFTC's bona fide hedging definition to Rule 4.5 entities, particularly in the context of long-hedge transactions.[141] More specifically, this commentator suggested that because the definition of hedging was developed at a time when the

138. 50 Fed. Reg. 15868, 15876-77 (1985).

139. *Id.*

140. After the adoption of Rule 4.5, the CFTC issued a no-action letter concerning the bona fide hedging representation in Rule 4.5(c)(2)(i) to a bank acting as trustee to more than $85 billion in assets of pension, profit-sharing and other employee benefit trusts maintained in a collective or commingled investment trust. The subject bank's trust was managed to replicate the performance of the Standard and Poor's 500 Index using stock index futures and money market instruments, and was established as a vehicle for temporary investment of funds earmarked for long-term equity investment. Because the bank acted as a discretionary trustee over trust account assets *only* while in the trust, this feature impaired the bank's ability to represent that commodity futures contracts were acquired solely for bona fide hedging purposes because the bank was a discretionary trustee over assets temporarily in the trust, and consequently was unable to correctly substantiate that the qualifying entities (employee benefit plans) used to trust solely for hedging purposes. CFTC Interpretive Letter No. 85-9 [Current Binder] COMMODITY FUT. L. REP. (CCH). ¶ 22,729 (July 16, 1985). This no-action letter was premised upon the bank's promise (i) to receive and record from the appropriate manager of assets committed to the bank's trust and representation that the futures contracts purchased through the trust will be used solely for "bona fide heading;" (ii) to obtain from the pension plan's investment manager identification of the specific hedging strategy employed, and request notice if the strategy is no longer being followed; and, (iii) to limit participation in the trust to plans acquiring units only when it is impractical for the plan to purchase common stocks immediately. *Id.* at 31,067. The letter also notes that the bank would be able to indirectly substantiate that the use of the trust constitutes bona fide hedging in obtaining "completion" representations from the participating plans. As a result of these representations and the specified reasons for which the trust may be used, the CFTC was persuaded that a substantial majority of the plan participant's trust transactions would be completed.

141. *See* Comment Letter of Wertheim & Co., Inc. at 4. An extensive paper prepared by staff in the CFTC's Division of Economic Analysis exhaustively analyzes the origin and evolution of the definition of "bona-fide hedging transaction," and its suitability for financial futures. *See* Imel, Hobson, and Tosini, *The CFTC's Hedging Definition—Development and Contemporary Issues* (October 1985). This paper notes that financial futures markets were non-existent in 1978 when the current definition of "bona-fide hedging transaction" was promulgated; in contrast, financial futures accounted for approximately 50% of total volume in U.S. futures markets in 1984. *Id.* at 1. The authors'analysisnotesthatseveraldifferencesexistbetweenthecircumstancesunderwhichanticipatory

commodity markets were used to facilitate the movement of physical goods from the producer to the consumer, the definition had limited applicability to portfolio managers charged with maximizing returns. Significantly, this argument distinguished the intent evidencing an anticipatory hedge involving financial futures from the intent associated with physical commodity futures. This commentator explained that in physical markets hedging intent is easily demonstrated by acquiring the physical commodity underlying the futures contract. In contrast, since the objective of an anticipatory hedge with financial futures is to track market prices, an entity legitimately can be viewed to be "completing its hedge" if in fact the market price moves such that no further need for the position exists. Because of this distinction, the proponents of this view asserted that the requirement to complete 75 percent of anticipatory hedges was ill-suited to the financial futures market.[142]

In substitution of the CFTC's 75 percent "intent test," these commentators suggested that requisite hedging intent can be gauged more accurately on anticipatory or long hedges by dedicating to readily identifiable liquid assets, those funds which the entity would have used, for example, to buy stocks were it not for the futures. In this way, the intent test is satisfied because assets equivalent to the hedged investment are kept liquid and not invested· otherwise, avoiding a doubling up of risk or speculative intent. Proponents of this view argue that anticipatory hedges should be considered complete since leverage is eliminated by isolating liquid assets to purchase the underlying valuation of the hedged instruments.

While not necessarily agreeing with these sophisticated comments, the CFTC nonetheless adopted the following alternative representation that may be used with respect to long positions in a commodity futures or commodity option contract:

> [T]he underlying commodity value[143] of such contract at all times will not exceed the sum of:

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hedge transactions are exempted from CFTC speculative limits for domestic agricultural futures, and the circumstances which prevail in the case of financial futures. *Id.* at 45. According to the paper, financial institutions eligible for Rule 4.5 share a common attribute with commodity pools that trading futures market users do not: the pooling of funds for trading or investment purposes. In this regard, the authors' note that the critical issue in CPO exclusions involves the scope and meaning of hedging in financial futures markets. *Id.* at 29. In contrast to agricultural commodities whose speculative limits are tied to specific risks arising from the ownership of fixed assets, anticipatory hedging and financial futures, by the very nature of these markets, cannot be tied to tangible items, such as fixed production facilities. As a result, risks being hedged or appropriate maximum speculative limits are not always evident. *Id.* at 46. In view of these considerations, the authors conclude that it is inappropriate to provide enumerated exemptions for anticipatory hedging in exchange rules governing position limits for financial futures. Instead, the áuthors recommend that the self-regulatory organizations administering hedging exemptions should examine the specific circumstances in each instance to assess conformance with the definition of bona-fide hedging transaction. *Id. See* SEC. REG. L. REP. (BNA) (Nov. 15, 1985) at 2020 (summarizing report of Imel, Hobson and Tosini).

142. *See* Comment Letter of Wertheim & Co., Inc. at 6.

143. The "underlying commodity value" for futures contracts equals the size of the contract

(A) Cash set aside in an identifiable manner, or short-term United States debt obligations or other United States dollar denominated high quality[144] short-term money market instruments so set aside, plus any funds deposited as margin on such contract;

(B) Cash proceeds from existing investment due in 30 days; and

(C) Accrued profits on such contract held at the futures commission merchant.

The CFTC strongly emphasized that this alternative representation should not be interpreted to encourage or to authorize the trading of commodity interests as a replacement for trading in the corresponding cash markets.[145] Thus, a Rule 4.5 entity's use of financial futures nonetheless must be incidental to its activities in the underlying cash market.[146] The CFTC further emphasized that the alternate representation serves only "as a substitute for compliance" with the bona fide hedging representation.[147] The release indicated that the adoption of the alternate representation does not disturb or

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times the daily settlement price of the contract. 50 Fed. Reg. 15868, 15876 (1985). For an option on a futures contract, this term is the underlying commodity value of the number of futures of contracts underlying the option. *Id.*

144. The term "high quality" is employed by Standard and Poors Corporation to designate investment grade securities. The other major rating services, Moodys and Fitch Investors Services, evaluate the same instruments under nominal indicia having slightly different standards. In the interest of uniformity, therefore, the CFTC should have substituted the term "investment grade" in this instance. *See generally* Dykstra, *Disclosure of Securities Ratings in SEC Filings*, 1978 DET. C. L. REV. 545, 547 n.10, 548 n.11 (1978).

145. 50 Fed. Reg. 15868, 15877 (1985).

146. The CFTC recently denied a bank's request for no-action relief because in operating a fund, the bank would not be trading commodity interests as contemplated by the alternative representation since the trading of commodity interests was essential, and not incidental to the operation of the fund. CFTC Interpretive Letter No. 85-10 [Current Binder] COMMODITY FUT. L. REP. (CCH) ¶ 22,730 (July 22, 1985). The subject bank argued that the operation of its fund under the alternative representation was incidental to the funds activities in the underlying cash securities market. The letter indicates that the subject bank's fund attempted to out perform the S&P 500 index by investing in either of two portfolios as follows:

> The first portfolio consists of a combination of S&P 500 stock index futures, treasury bills and short-term fixed income securities. The second portfolio consists of approximately 150 stocks chosen to be most representative of the S&P 500 index as a whole. From time to time the 150 stocks in the portfolio may be enlarged or reduced in number if there are either investment or operational advantages in doing so. Investments are switched from the futures portfolio to the stock portfolio, or vice versa, according to mispricing in the futures market. When futures are overvalued, investment is switched from the stocks to the futures. This swapping will take place whenever the inefficiency in the price exceeds the costs of the swap. *Id.* at 33,069.

The CFTC disagreed with the bank's position in denying the no-action request, and concluded (i) that the trading of commodity interests by the fund was essential—not incidental—to the strategy of the fund and, (ii) that, absent the use of commodity interests, the fund's investment strategy could not be pursued.

147. 50 Fed. Reg. 15868, 15877 (1985).

expand the definition of bona fide hedging transaction set out in Rule 1.3(z)(1).[148]

The incorporation of this radically different measure of hedging intent demonstrates significant administrative flexibility responsive to legitimate suggestions. By carefully circumscribing the purpose of this alternative, the CFTC has forestalled erosion or expansion of the definition of bona fide hedging transactions set forth in Rule 1.3(z)(1). Perhaps the CFTC can be criticized mildly for not renoticing this aspect of the proposal, once it resolved to incorporate an alternative, so that other different standards for bona fide hedge intent could have been elicited.[149]

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148. *Id.* Fully considered, the CFTC's qualification suggests that practices complying with the alternative representation are not hedging transactions, at least for CFTC purposes. This reading may stimulate investment companies to reevaluate previously authorized investment restrictions or portfolio practices. For example, VALIC Timed Opportunity Fund, Inc., obtained an order granting exemption from Sections 18(f)(1) and (17)(f) of the Investment Company Act of 1940 to permit investment in stock index futures contracts and interest rate futures contracts for hedging purposes. Investment Company Act Rel. No. 13,943 (May 16, 1984), 30 SEC Docket 10 (May 30, 1984) at 682. In connection with a representation in its exemption application that it will not invest in financial futures or options on stock index futures contracts for speculative purposes, this company made the following undertaking which resembles the alternate means to satisfy the bona fide hedging representation in Rule 4.5(c)(1)(i)(A), especially when considered in view of the meaning of the term "underlying commodity value," *supra* note 143:

> The Fund will maintain at all times in a segregated account with its custodian cash or cash equivalents which at least equal the sum of the aggregate settlement prices of all futures purchase contracts owned by the Fund, minus the amount of margin deposits with respect thereto, and which are not earmarked to support any other obligations of the Fund. Investment Company Act Rel. No. 13891 (Apr. 17, 1984), 30 SEC Docket 6 (May 1, 1984) at 381.

Similar undertakings have been given by investment companies seeking to use futures contracts and options thereon as a hedge, and in response, the SEC has granted exemptive and no-action requests under essentially comparable circumstances. See Prudential-Bache Option Growth Fund, Inc., File No. 812-5419, Investment Company Act Release Nos. 13,194 (April 26, 1983) and 13,272 (May 25, 1983); SteinRoe Bond Fund, Inc. (no-action letter, available Jan. 17, 1984); IDS Bond Fund, Inc. (no-action letter, available April 11, 1983); Montgomery Street Income Securities, Inc. (no-action letter, available April 11, 1983).

The prospectus for VALIC Timed Opportunity Fund, Inc. states that "The Fund will not enter into any financial futures contract or option thereon other than as a 'bona-fide hedging transaction' within the meaning of the regulations of the Commodity Futures Trading Commission." Other investment companies have incorporated analogous prospectus disclosure in describing the financial futures activities authorized in SEC exemptive orders and no-action letters. The Rule 4.5 release expands and clarifies the CFTC's position on hedging transactions beyond that existing when various investment companies obtained regulatory relief from the SEC concerning financial futures trading. As a result, these entites may begin to carefully evaluate the scope of hedging activities and investment restrictions developed and authorized before the adoption of Rule 4.5.

Rule 4.5(c) contains a proviso indicating that the operating representations shall not be deemed a substitute for compliance with the financial institution's primary scheme of regulation. In this way, the CFTC clarified that Rule 4.5 was not attempting to supercede other applicable disclosure, compliance or regulatory requirements.

149. In an analogous context, a Federal District Court recently granted a motion for summary judgment in favor of plaintiffs challenging aspects of a final rule that had not been

In response to a request for clarification, the CFTC indicated that whether the writing of commodity option contracts for yield purposes was entitled to relief under Rule 4.5 was to be determined on a case-by-case basis in light of particular facts.[150] While acknowledging that the writing of commodity option contracts did not satisfy the meaning and intent of "bona fide hedging transaction," one commentator suggested that these transactions should fall within the Rule 4.5 exclusion under limitations that would make them "covered" in substance if not in form, and provide a relatively risk-free function.[151] The release noted that the CFTC had addressed similar issues in previous "not a pool" interpretations and "no-action" positions.[152]

2. Representation Concerning Assets Devoted to Margin

The second operating standard required in paragraph (c) requires Rule 4.5 entities to represent that they will not enter into commodity futures and commodity options contracts "for which the aggregate initial margin and premiums exceed five percent of the fair market value of the entity's assets, *after taking into account unrealized profits and unrealized losses on any such contracts it has entered into.*"[153] The release provides helpful interpretive latitude by recognizing that there may be extraordinary circumstances in which a Rule 4.5 entity inadvertently exceeds the five percent limitation. For example, the exchange on which a particular commodity interest is traded may increase initial margin requirements and deem these new requirements prospectively and retroactively applicable. According to the release, the CFTC does not intend to interpret Rule 4.5 to require a forced liquidation of positions satisfying previous margin limitations in order to bring the Rule

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adequately exposed for public comment in the rulemakign notice. *See* United Church Board For World Missionaries v. SEC (D.D.C. 1985) (percentage of shareholder vote necessary to resubmit proposals in proxy materials increased in final rule without prior notice that this element was subject to change); SEC. REG. L. REP. (BNA) at 1653 (1985). Unlike this case, however, the CFTC's previously unnoticed substitute for compliance with the bona fide hedging representation expanded, rather than contracted, the rule's availability. Nonetheless, where agencies dispense with public participation procedures for "good cause" as permitted in the Administrative Procedure Act, 5 U.S.C. § 553(b)(3) and § 553(d)(3) (1982), the Administrative Conference of the United States Recommendation 83-2 (June 10, 1983) advises agencies to always provide an opportunity for post-promulgation comment in that situation. *See generally A Guide to Federal Agency Rulemaking,* Administrative Conference of the United States (1983) at 24, 43, 44, and 121 concerning variations between proposed and final rules.

150. 50 Fed. Reg. 15868, 15878 (1985).

151. *See* Comment Letter of BA Investment Corporation at 3.

152. *See, e.g.,* Colonial Tax-Exempt High Yield Trust (available Nov. 1, 1984) in which the CFTC found that writing put options on futures contracts the trust had sold, to offset these futures contracts positions, would not result in a bona fide hedging position. In CFTC Interpretive Letter No. 83-10, [1982-1984 Transfer Binder] COMMODITY FUT. L. REP. (CCH) ¶ 21,910 (Nov. 21, 1983), however, the CFTC determined that simulataneously purchasing put options or writing call options on stock index futures contracts would come within the terms of proposed Rule 4.5.

153. 50 Fed. Reg. 15868, 15883 (1985) (emphasis added).

4.5 entity within the five percent limitation.[154] This interpretive accommodation reasonably responds to practical operating conditions that may evolve and which are beyond the control of the Rule 4.5 entity. Entities relying upon this interpretive position, however, presumably must refrain from obtaining additional futures positions until the fair market value of their assets increased sufficiently to permit additional positions consistent with the five percent margin limitation. Another example of extraordinary circumstances within this interpretive leeway appears to include a situation in which the value of a Rule 4.5 entity's assets decrease after the acquisition of commodity interest contracts and initial satisfaction of the five percent benchmark.[155]

In the final version of Rule 4.5, the CFTC adopted two provisions concerning the computation of the five percent limitation that address impediments to qualification. The CFTC expanded the second operating standard to clarify that the five percent benchmark may not exceed the fair market value of a qualifying entity's assets after taking into account unrealized profits and unrealized losses on any such contracts the entity has entered into.[156] This refinement, which comports with generally accepted accounting principles, will insure that the five percent calculations fairly reflect the fair market value of all of the Rule 4.5 entity's assets. The release further notes that in computing the five percent limitation, a Rule 4.5 entity only has to include the amount of initial margin required by the exchange on which a commodity interest is traded, rather than an equal or greater amount required by the futures commission merchant or a lesser amount of margin required by the exchange clearinghouse.[157] In calculating the five percent limitation, commentators noted that the proposed rule failed to consider that the premium paid for the purchase of an "in-the-money"[158] option may exceed

154. *Id.*

155. Consistent with this view, two commentators recommended that the phrase "at the time the commitment was entered into" should have been added at the end of the 5% representation to avoid confusion. *See* Comment Letter of Chicago Mercantile Exchange at 7; *accord* Comment Letter of Colonial Advisory Services, Inc. In not addressing specifically or refuting these comments, the adoption release cannot legitimately be viewed to contradict this circumstance as "extraordinary" or "inadvertant."

156. 50 Fed. Reg. 15868, 15883 (1985). *See* Comment Letter of Goldman, Sachs and Co. at 5.

157. 50 Fed. Reg. 15868, 15883 (1985). In addition, the release states that where a Rule 4.5 entity grants a put or call option, it need not include the "in-the-money" amount of the position at the time it was established for purposes of the 5% computation. *Id.* 17 C.F.R. §190.01(x) (1984) defines "in-the-money" to mean:

> (1) With respect to a call option, the amount by which the value of the physical commodity or the contract for sale of a commodity for future delivery which is the subject of the option exceeds the strike price of the option; and
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> (2) With respect to a put option, the amount by which the value of the physical commodity or the contract for sale of a commodity for future delivery which is the subject of the option is exceeded by the strike price of the option.

158. *See supra* note 157 (defining term "in-the-money").

the initial margin on the underlying futures contract, although the market risk may not be greater than the initial margin.[159] As a result, these commentators suggested that the proposal would result in decisions premised on non-economic criteria by requiring the entire amount of option premiums to be included in computing the five percent limitation without regard to the intrinsic value of the option. The CFTC accommodated these concerns by incorporating a condition in paragraph (c)(2)(ii) that "in the case of an option that is in-the-money at the time of purchase, the in-the-money amount as defined in [CFTC rules] may be excluded in computing" the five percent test.[160] These various refinements to paragraph (c)(2)(ii) should enhance the rule's clarity and applicability.

3. The Marketing Representation

The third operating standard requires Rule 4.5 entities to represent that they will not be, nor have been, marketing participations to the public in a commodity pool or vehicle for trading in the commodity futures or commodity options market.[161] The release provides a number of clarifying interpretations responsive to commentators' concerns.

The proposal release indicated that an entity would be "marketing participations" in a manner inconsistent with the third representation if it was actively promoted as a hybrid—such as 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.[162] The CFTC reiterated this interpretation in the adoption release.[163] In its comment letter, however, the SEC observed that this position suggests that a qualifying entity seeking growth in its assets through commodity interest trading would not be eligible for a Rule 4.5 exemption. The SEC further noted that in some situations commodity interests are traded for the purpose of protecting assets from a decline in value *and* for the purpose of achieving growth that could not be realized by the use of other protective means. The SEC, therefore, recommended that Rule 4.5 be available under these circumstances.[164]

The SEC's recommendation articulated a valid concern that may confront a variety of financial institutions under this representation. The rule and its accompanying release failed to address the SEC's comment. This omission creates an unnecessary interpretive cloud over the third operating standard. As a result, the status of purely incidental commodity interest

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159. *See* Comment Letter of Goldman, Sachs and Co. at 4; *see also* Comment Letter of American Bankers Association at 9.

160. 50 Fed. Reg. 15868, 15883 (1985).

161. *Id.*

162. 49 Fed. Reg. at 4782.

163. 50 Fed. Reg. 15868, 15879 (1985).

164. Comment Letter of SEC at 3.

trading that both protects assets from a decline in value and bolsters growth is unclear.

In response to recommendations of several commentators, the release indicates that the marketing representation will be interpreted to permit a financial institution to describe accurately in its sales literature the limited use of its commodity interest trading and how it believes that commodity trading will be beneficial.[165] The CFTC also agreed with another commentator that any promotional material required by and consistent with the policies of a qualifying entity's "other" federal or state regulator would not be construed as prohibited marketing practices.[166] In this way, the CFTC eliminated potential inconsistencies between its regulations and those of the institution's primary regulator. For example, under the federal securities laws, investment companies must inform shareholders of investment objectives, investment restrictions, and risks. Investment companies acquiring financial futures in their portfolios would find it difficult to satisfy these prospectus disclosure obligations in a few short sentences because financial futures represent relatively complex instruments, and because the investing public is unfamiliar with these instruments. The interpretive grace provided in the adoption release should permit entities in analogous situations to fulfill obligations to their primary regulators without violating the marketing representation.

4. Disclosure Representation

The fourth operating standard in paragraph (c)(2) requires Rule 4.5 entities to represent that they "[w]ill 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."[167] Several insurance commentators noted that compliance with this representation would be inappropriate for ERISA plans, because disclosure to each plan participant concerning aspects of an asset in a plan's funding vehicle would be confusing to the participant and an unnecessary expense to the plan.[168] Similarly, banking commentators noted that the undertaking was not feasible with respect to bank commingled trust funds which may affect hundreds of thousands of prospective beneficiaries, some of whom are unidentified.[169] In accommodation of these concerns, the release indicated that financial institutions may satisfy the disclosure representation by including the specified information in any document routinely furnished to partic-

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165. *See* Comment Letter of Prudential Insurance Company of America at 14; *accord* American Bar Association Subcommittee on the Regulation of Securities and Commodities at 5.

166. *See* Comment Letter of American Council of Life Insurance at 22.

167. 50 Fed. Reg. 15868, 15883 (1985).

168. *See* Comment Letter of American Council of Life Insurance at 23; *accord* Comment Letter of Prudential Insurance Company of America at 14.

169. *See* Comment Letter of American Bankers Association at 5.

ipants pursuant to the Rule 4.5 entity's other federal or state regulator.[170] For entities not required to provide routine written communications, this undertaking may be fulfilled through disclosure in any instrument that is required by the institution's primary regulator to establish investment policies or objectives and made available, but not specifically furnished, to the entity's participants. For example, banks need only provide the disclosure representation to trustees of each account in a bank commingled trust fund that intends to trade commodity interests on behalf of beneficiaries.[171] Analogously, funding vehicles to ERISA pension plans may submit the required disclosure to pension plan trustees or fiduciaries in lieu of individual notices to each plan participant. In this instance, the CFTC struck a practical compromise that functionally serves the same regulatory end.

5. Representation Concerning Special Calls for Information

Paragraph (c)(2)(v) requires Rule 4.5 entities to represent that they will submit to special calls for information from the CFTC to require demonstration of compliance with the provisions of paragraph (c).[172] This condition enables the CFTC, upon complaint, to establish whether a Rule 4.5 entity is in continued compliance with the exemption criteria. Additionally, this undertaking may assist the CFTC in further refinement of hedging or other operating standards, and make data on commodity interest activity by financial institutions accessible.[173]

Commentators generally sought clarification on the nature and the manner of presentation of the information subject to special calls. Specifically, financial institutions opposed special calls for information that would require retroactive creation of data or subject entities to surprise inspections.[174] One primary regulator found this provision unnecessary, since the institution's "other" federal or state regulator could ascertain compliance with the requirements for exemption.[175]

According to the release, the CFTC intends that the information it would require pursuant to special calls would be information that the entity's other federal or state regulator would already require the entity to keep.[176] As an

170. 50 Fed. Reg. 15868, 15883 (1985).

171. *Id.* at 15879 n.69. In contrast, the release identifies a registered investment company as a Rule 4.5 entity that must make disclosures directly to shareholders. This statement is not entirely correct concerning funds that may rely on the simplified prospectus, Form N-1A under the Investment Company Act of 1940. FED. SEC. L. REP. (CCH) ¶ 51,201 (1985). This form authorizes and encourages succinct prospectuses of about twelve pages. Expanded disclosure, such as detailed specifics of investment objectives, may be set forth in a Statement of Additional Information available to investors on request. Under the CFTC's application of the disclosure undertaking, therefore, some investment companies should be able to comply in the Statement of Additional Information. *Id.* at ¶ 51,204.

172. 50 Fed. Reg. 15868, 15883 (1985).

173. 49 Fed. Reg. at 4782.

174. *See* Comment Letter of American Council of Life Insurance at 49.

175. *See* Comment Letter of Comptroller at 2.

176. 50 Fed. Reg. 15868, 15880 (1985).

example, the release cites data concerning the execution dates, execution prices and current values of an entity's cash market and commodity interest positions. Since any special calls would be strictly limited to documenting compliance with the information and representations on operating criteria that the notice of eligibility must contain, the CFTC does not view special calls as an inconvenience, a disruption, or a burden.[177]

B. *General Refinement*

Several commentators expressed concern that the CFTC should not use the Committee's report as a basis for interfering with the ability of Rule 4.5 entities to use the commodities markets in managing their investment portfolios.[178] These observers suggested that any limitation on the use of financial futures for hedging purposes should derive from an institution's primary federal or state regulator.

In response, a qualification concluding paragraph (c) carefully states that satisfaction of the operational representations "shall not be deemed a substitute for compliance with any criteria applicable to commodity futures or commodity options trading established by any regulator to which such person or qualifying entity is subject."[179]

As a practical administrative measure, the CFTC should consider promulgating a model form for the required exclusion notices. Uniform filings would facilitate CFTC review and cataloging. In addition, a model form would eliminate minor drafting burdens and incomplete responses.

V. Conclusion

In all likelihood, the current, dramatic trend in financial institutions using financial futures and options to hedge market and interest rate risks of portfolio instruments will continue. The CFTC wisely determined to provide relief to these heavily regulated institutions from unnecessary, and perhaps ill-suited, CFTC regulations. The thoroughness of the rulemaking process and the specific detail of the rule generally should eliminate the need for many routine requests for interpretive relief. Recognizing that this area is experiencing rapid evolution, the CFTC prudently provided the opportunity for entities within the spirit of the rule, but outside its literal scope, to obtain ad hoc interpretive relief. In this way, Rule 4.5 operates as a "safe harbor" for those financial institutions capable of fulfilling its standards. As such, however, the rule permits entities unable to comply with the explicit requirements of the proposal, nonetheless, to avail themselves of other means of regulatory relief. The CFTC's modification of the rule from a registration

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177. *Id.*

178. *See* Comment Letter of Futures Industry Association at 3; *accord* Comment Letter of Goldman, Sachs and Co. at 6.

179. 50 Fed. Reg. 15868, 15883 (1985).

exemption to a broader definitional exclusion reflects solomonic interpretation of the Senate Committee's report.

In several respects, the CFTC should refine the rule through administrative interpretation to eliminate practical disparities between similar entities. The exclusion for "principals and employees" of Rule 4.5 entities should be expanded to persons who functionally, but not literally, come within the phrase. The CFTC should extend the exclusion for "named" fiduciaries of ERISA pension plans to all fiduciaries in the same manner that depository institutions "equivalently regulated" as banks and trust companies were excluded.

A number of interpretive refinements to the required representations would enhance the rule's utility and fairness. For example, the CFTC should be willing to consider additional alternative representations to bona fide hedge intent concerning anticipatory hedges. Under the marketing representation, purely incidental commodity interest trading that both protects assets from deterioration and bolsters growth should not be precluded. A model form for exclusion notices would assist CFTC oversight and Rule 4.5 entities alike.

These suggestions notwithstanding, Rule 4.5 represents extensive, careful CFTC consideration, and flexibly incorporates many commentators' suggestions. As a result, the final version of Rule 4.5 provides significant improvement in the administrative process for financial institutions outside the scope of the term commodity pool operator. The process of revision and refinement of Rule 4.5 represents a valuable, worthwhile rulemaking.