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EMPLOYEE PLAN TRADING IN COMMODITY FUTURES

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I. Introduction

Investment managers of employee benefit plans recently have developed considerable interest in the utilization of commodity futures contracts. A few very large plans have begun trading commodity futures and it appears that others are about to do so. Several substantial legal problems, however, confront both plans interested in using futures and those who would assist plans in such trading. Some of these problems are caused by the Employee Retirement Income Security Act (ERISA), others are caused by long-standing employee plan trust investment rules contained in or derived from the Internal Revenue Code (Code), and still others are caused by banking, futures and securities regulation.

Most of the plans that are trading or are considering trading in commodity futures are large plans with skilled investment advisers, either in-house or retained. These plans have the resources to develop in-house

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* See Cohen, Financial Futures Mart Gets Boost From Sears Pension, FUTURES INDUS. ASSOC. BULL. #5510 (1979); DuPont Begins Using Futures Markets After Overcoming ERISA Woes, SECURITIES WEEK, Oct. 22, 1979, at 6. [hereinafter cited as DuPont Futures]
* Internal Revenue Code of 1954 (as amended) [hereinafter cited as I.R.C. or the Code].
expertise or retain individuals with expertise in the futures markets. These plans have another advantage in that they can afford a significant commitment to commodity futures trading as an integral part of a comprehensive investment program.

Smaller plans might also realize benefits from trading in commodity futures, although because of cost considerations they may be too small to trade directly. Therefore, these plans may create a demand for pooled investment vehicles designed specifically to allow employee plans to utilize commodity futures. Through such vehicles smaller plans can reap at least some of the benefits of commodity futures trading.

This article discusses briefly why a plan might wish to trade commodity futures, and then considers the legal problems involved both for plans trading directly and for plans trading through pooled investment vehicles.

II. Commodity Futures Trading

A. In General

In general, commodity futures trading is governed by the Commodity Exchange Act and regulations of the Commodity Futures Trading Commission (CFTC). The twelve commodity futures exchanges currently operating in the United States offer futures trading in a wide range of commodities. The kinds of commodities for which contracts are traded on these exchanges can be divided into four categories: agricultural commodities, metals, currencies, and interest-bearing paper. In each case, the futures contract covers a standard amount and description of a commodity. For example, on the Chicago Board of Trade, where the first interest rate future was traded on October 20, 1975, Government National Mortgage Association bond futures are traded in units of $100,000 face amount. The actual terms and conditions of the contracts are found in the rules of the exchanges: the trader does not literally acquire a document, but merely a set of contractual rights. Another unique characteristic of futures trading is that futures contracts can only be bought and sold by open outcry on the floors of the exchanges in trading "pits." The Commodity Exchange Act does not permit an over-the-counter market for fu-

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* A complete description of the mechanics of commodity futures transactions and a comprehensive treatment of the benefits which employee plans can derive from trading in commodity futures is beyond the scope of this article. Instead, a basic description is given of commodity futures trading followed by a few examples of how commodity futures might typically be traded by employee plans. For an overview of commodity futures, see Chicago Mercantile Exchange, Trading in Tommorsows (1970); A. Little, Financial Futures Hedging Guide (1979) [hereinafter cited as Little]. For a discussion of institutional use of the futures market, see Loosigian, Institutional Use of Financial Futures (Oct. 24, 1979) (published as part of the Financial Futures Conference of 1979); Teberg, Options and Financial Futures, 12 Rev. Sec. Reg. 1 (1979); Little, The Two Edged Sword: Using Financial Futures for Risk Aversion or Risk Taking, PENSIONS AND INVESTMENTS, August 13, 1979, at 25.

trading in commodity futures contracts.

Each futures transaction is cleared daily and the clearing house affiliated with the particular exchange is interposed as the seller to each buyer and the buyer to each seller. The clearance process is intended to add an element of protection for buyers and sellers of futures contracts because at the end of the day each trader holds a contract with the clearing house, and does not have to depend on the creditworthiness of the trader with whom the trade was initially executed.

Participants in the futures market do not normally intend to make or take delivery of the commodities underlying the contracts. Instead, they usually intend to offset their outstanding positions prior to the delivery dates by taking opposite positions in identical contracts. Thus, a trader who in June purchases (“goes long”) a futures contract covering $1,000,000 face amount of Treasury Bills for delivery in September will typically settle his contract prior to the September delivery date by selling (“going short”) an identical contract. The short position offsets the long position, thereby liquidating the trader’s contract. Consequently, the trader avoids the necessity of making or taking delivery of Treasury Bills.

When a futures contract is purchased or sold, the customer must pay “initial margin” to the Futures Commission Merchant (FCM) who handles his trading account. The required minimum margin level for each futures contract traded on an exchange is set by that exchange. In general, these amounts vary according to the volatility of the particular commodity. After the initial margin has been paid, and the commodity futures position established, the trader is subject to the daily calculation of “variation margin” with respect to his contract. If the contract declines in value, the amount of the decline will be withdrawn from his account on a daily basis. The customer will not have to restore the margin account to its initial balance until withdrawals have reduced the margin account below a predetermined portion of the initial balance, referred to as the “maintenance margin” level. If the amount in the margin account drops

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8 Id. § 4.
9 The opportunity for gain, or the risk of loss, in trading commodity futures contracts comes from the increase or decrease in the value of the contract during the period between the date the contract was entered into and the liquidation date. If a contract for the September delivery of Treasury Bills is worth $960,000 in June when the trader goes long, the value of the contract may increase to $980,000 in August, in which case the trader can settle out with a gain of $20,000 by going short one identical contract at that time. By the same token, if the September contract is worth only $940,000 in August, the trader will realize a $20,000 loss if he goes short to settle out.
10 For most exchanges there are two types of initial margin. The clearing house sets initial margin requirements for its members. These requirements may differ from the initial margin requirements set by the exchange for customer accounts. Also, margin requirements may differ between hedge and speculative accounts.
11 “Maintenance margin” may be set at the initial margin level by an exchange. In such case, a margin call would be made after any decline in the value of a contract, unless previously realized profits were left in the margin account and were sufficient to cover the
below this level, the FCM will make a margin call and the customer will be required to restore the margin to its initial amount. If the value of a customer's contract increases, the profit is credited to that customer's account. Exchange rules permit traders to withdraw at their discretion amounts in the margin account in excess of the initial margin. However, FCMs often impose initial margin requirements on customers that are higher than exchange requirements. Accordingly, the FCM may call for additional margin over and above the amount required by exchange rules. The extra margin required by the FCM may vary from customer to customer depending upon the size and nature of the particular customer's account.

Margin trading in a commodity futures context does not mean the same thing as buying securities "on margin," which involves a loan by a broker to an investor for the immediate acquisition of a security. Initial margin in the commodity futures context is "earnest money." It is an attempt to protect the clearing house, the exchange members, and the market generally by requiring the initial commitment of money from each market participant. If the market moves adversely to a participant, the margin insures that there will be sufficient funds on hand so that, if variation margin is not paid promptly, there is time to liquidate the participant's position without the exchange member, clearing house, or FCM having to use its own funds to pay the deficit. This is why margin levels are generally reflective of market volatility.

B. Examples of Hedging

1. Short Hedge

One example of how an institutional investor, such as an employee benefit plan, might employ commodity futures in its overall investment strategy is the conventional short hedge. In a short hedge, an investor holding financial instruments seeks to protect current portfolio values against an anticipated rise in interest rates and decline in prices.

Assume that on January 1 Investor X holds a portfolio of $1,000,000 of Government National Mortgage Association pass-through securities amount of the margin call.

12 [To] equate commodities margins with securities margins is to misunderstand the role margin plays in the commodities industry. . . . In the securities market, margin represents a down-payment for securities purchased on credit. In the commodities industry, margin is not a down-payment. The purchaser or seller of a futures contract is not buying or selling the underlying commodity. Margin is merely the earnest money which is put up in order to trade contracts, as opposed to the commodity itself. Most contracts are liquidated before it actually comes time to buy or sell the underlying commodity.

The margin, or up-front money, is used simply to assure that a customer is able to pay for the losses that might occur during the trading on a particular day. Russo, The Markets Worked as They Should Have, N.Y. Times, April 27, 1980, § 3, at 18, col. 2; see text accompanying note 118 infra.
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(GNMAs) with an 8% coupon and that it plans to sell the GNMAs in June. The current price for 8% GNMAs is 98-00 (i.e., 98.00%, for a yield of 8.23%) and Investor X anticipates a rise in interest rates over the next several months. In order to avoid erosion of the value of this portion of its portfolio, Investor X sells 10 GNMA futures contracts on an exchange at a price of 97-00 (i.e., 97.00%, for a yield of 8.37%). Each contract covers $100,000 principal amount of 8% GNMAs.13

Assume that interest rates rise as Investor X anticipated and that on June 1 the price for 8% GNMAs is 93-00 (i.e., 93.00%, for a yield of 8.95%). Investor X sells the $1,000,000 of GNMAs at that price for a loss of $50,000 since January 1,14 and closes out its hedge by purchasing 10 GNMA futures contracts at a price of 92-00 (i.e., 92.00%, for a yield of 9.11%). This purchase offsets its January 1 sale and takes the trader out of the futures market. X’s profit is $50,00015 and it has protected its portfolio from a decrease in value created by the rise in interest rates foreseen in January.

If interest rates decline, however, the appreciation of Investor X’s GNMA portfolio would be offset by a loss in its futures position. By entering into a short hedge in January Investor X in effect decides to forego the possibility of portfolio appreciation due to a decline in interest rates in order to protect against an anticipated interest rate increase.

2. Long Hedge

A second example of how an employee benefit plan or other institutional investor might use commodity futures is the long hedge. In a long hedge, an investor in financial instruments seeks to protect a planned future investment against an anticipated decline in interest rates.

Assume that on January 1 Investor Y knows that on June 1 it will receive about $1,000,000 which it would then invest in intermediate term U.S. Treasury Notes or comparable instruments. The current price of 5-year 8% Treasury Notes is 96-00 (i.e., 96.00%, for a yield of 9.01%) and Investor Y anticipates a decline in interest rates over the next several months. In order to “lock in” the current yield for the planned June investment in Treasury Notes, Investor Y buys 10 Treasury Note futures contracts on January 1 at a price of 95-16 (i.e., 95.50%, for a yield of 9.14%). Each contract covers $100,000 principal amount of 4-6 year 8% Treasury Notes.

Assume that interest rates decline as Investor Y anticipated and that on June 1, when it receives $1,000,000 for investment, the price of 5-year

13 GNMA certificates including coupons higher and lower than the designated 8% rate may be delivered with the proper adjustments.
14 Investor X owned GNMAs worth $980,000 on January 1 and sold them on June 1 for $930,000.
15 Investor X purchased each contract at 92-00 and sold it at 97-00, for a profit of $5,000. For 10 contracts the aggregate profit is $50,000, excluding commission and margin costs.
8% Treasury Notes is 100-00 (i.e., 100%, for a yield of 8.00%). Investor Y purchases $1,000,000 of 5-year 8% Treasury Notes with the funds received and sells 10 Treasury Note futures contracts at a price of 99-16 (i.e., 99.50%, for a yield of 8.12%). This sale offsets the January 1 purchase and takes Investor Y out of the futures market with a realized profit of $40,000. Thus, Investor Y has a real cost of $960,000 for the Treasury Notes ($1,000,000 purchase price less $40,000 profit on the futures transaction) and its yield on the Notes is 9.01%, exactly the rate it was attempting to "lock in" in January.

If interest rates increase, however, Investor Y's reduced cost for $1,000,000 of Treasury Notes would be offset by a loss on the futures position. The effective yield would continue to be 9.01%. By entering into a long hedge in January Investor Y in effect decides to forego the advantage of any possible increase in interest rates by June in order to protect against an anticipated interest rate decline.

C. The Uses of Futures Contracts for Institutional Investors

Hedging, taking a position in the futures market which is thought to be the opposite of one's actual or anticipated position in a "cash commodity", is the most attractive use of the futures market for institutional investors such as employee plans. By effective hedging with commodity futures a plan can limit its risk in the "cash market." A hedge can lock in, or fix, an approximate yield on cash market investments at the relatively modest cost of posting and maintaining margin.

To an employee plan whose portfolio is heavily invested in debt securities, the fact that hedging will place an upper limit on gains is acceptable because the investor is by hypothesis primarily interested in the stability of the interim yield, and preservation of the value of the corpus of the portfolio. Hedging can also add liquidity and make the portfolio more flexible. If cash market losses are offset by futures market gains, the plan can more easily afford to realize cash market losses if, for example, it feels compelled to liquidate some of its debt holdings to meet benefit payments or to capitalize on investment opportunities.

For a plan whose portfolio emphasizes capital appreciation through investment in equities the fact that hedging reduces the potential for gains may be a significant drawback. However, while the manager of a

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16 Investor Y purchased each contract at 95-16 and later sold it at 99-16, for a profit of $4,000. For 10 contracts the aggregate profit is $40,000, excluding commission and margin costs.

17 "Cash commodity" means an actual commodity (e.g., a portfolio of Treasury Notes) rather than a commodity futures contract, forward contract, or option covering the commodity.

18 A "cash market" or "spot market" transaction is one where delivery of the cash commodity is made immediately or within a few days of the trade date. The term "cash market" is distinguishable from the terms "futures market" or "forward market," where delivery of the commodity may not be made for a substantial period.
portfolio which emphasizes equities might believe it inadvisable to hedge by taking equal and exactly opposite positions in the futures market, it eventually may be considered imprudent not to employ hedging to some degree, in order to limit the greater risk inherent in an equity oriented portfolio.

Another investment technique which resembles a hedge is a simple transaction to lock in a future price. A plan which anticipates the need to buy or sell a commodity traded on a futures exchange can lock in its price by buying or selling a futures contract. For example, Investor Y in the long hedge example given above could accept delivery of the Treasury Notes at the maturity of the futures contract, rather than closing out its futures position and purchasing the Notes in the cash market.

An investor may choose to speculate in futures. Speculation provides the opportunity for significant gains with a relatively small cash commitment. For legal reasons discussed below, and perhaps for sound investment reasons as well, speculation should be carefully controlled and in most cases limited to a small portion of a plan's portfolio. The complexity of effective speculation in the futures market and legal restrictions on investments by fiduciaries, such as the requirement that plan assets be invested prudently, may cause speculative activity to be limited to those plans which are very large and have the ability to develop or retain advisers with expertise in futures trading.

A common theme among those discussing institutional investment in the futures markets is that it may soon be considered imprudent not to hedge a portfolio at least partially with futures. See, e.g., Little, supra note 6, at 8; Gurwin, supra note 1, at 100.

A partial hedge of an equity portfolio might consist of perfect hedges (or as near to perfect hedges as possible) against the investments on the debt side of the portfolio or "imperfect" hedges against the equity investments themselves. As an example of the latter, the plan might hedge consumer industry stocks (which are sensitive to inflationary interest rate trends) with long positions in precious metals, which would presumably be inversely affected by such trends. Unfortunately, the risk involved in, and the expertise needed for, hedging increases drastically when the hedge is not a perfect hedge. Thus, a futures market hedge against an equity asset would be extremely complex and should not be entered into without expert assistance.

"Speculation" means the purchase or sale of commodity futures for any reason other than hedging. Hedging, as illustrated by the examples in the text, see text accompanying notes 13-16 supra, generally may be said to involve either the sale of commodity futures to protect against a price decline in a commodity or the purchase of commodity futures to protect against a price increase in a commodity. Hedgers are generally institutions (e.g., an employee benefit plan) who have on hand or will need to acquire substantial amounts of a "commodity" and wish to avoid price risk. Under the Commodity Exchange Act, a "commodity" includes anything upon which there is a futures contract. 7 U.S.C. § 2 (1976 & Supp. II 1979). Speculators assume risk, and seek substantial rewards, by purchasing or selling commodity futures.

Some plans can invest in commodity futures without concern as to whether the investments are considered prudent under Title I of ERISA because Department of Labor regulations exempt them from the requirements of Title I. See 29 C.F.R. §§ 2510.3-0(b). Such plans include certain Individual Retirement Accounts, and certain "Keogh" plans cov-
Some types of plans may be better suited than others for speculation in futures. An individual account plan, such as a profit sharing plan, can give participants the opportunity to direct that the amounts in their accounts be invested in one or more funds, each fund having a different investment objective. If the sponsor of such a plan creates a futures fund, the manager of that fund could speculate in futures instead of using the futures market for risk management. Although such a plan design might not be advisable in many cases, it could be desirable for plans wishing to provide tax deferred high yield investments to employees in addition to a means to share in the profits of the company.

III. Legal Considerations

A. Prudence

A major stumbling block to employee plan investment in commodity futures has been the prudence requirement of ERISA. This requirement, which applies to the investment conduct of plan fiduciaries, is set forth in section 404(a)(1)(B) of ERISA. The section states that a fiduciary must discharge his duties with respect to a plan with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.

Although a federal prudence requirement applicable specifically to the investment of employee plan funds was not codified until the passage of ERISA, various forms of a prudent man rule have existed in the United States since at least 1830 as a part of state law relating to fiduciary con-
Thus, a prudence requirement generally was applicable to fiduciaries of employee benefit plans prior to ERISA. Furthermore, as discussed below, the Internal Revenue Service (IRS) long has taken the position that adherence to a prudent man standard is a requirement for tax qualification of employee plans.

Historically, courts applied the prudence requirement to each individual investment made by a fiduciary. The fact that a plan trust's portfolio performed reasonably well overall might not have protected a fiduciary from liability for losses on one or more individual imprudent investments. The concept of balancing a trust portfolio's investments with certain high risk and/or negatively covariant investments, practices presently associ-
ated with the portfolio theory of investment, was not available to plan fiduciaries.\textsuperscript{34}

1. Labor Department Regulation

Fortunately, the new Department of Labor regulation interpreting the prudent man rule of ERISA embraces the concept of testing individual transactions in light of the overall investment strategy and investment conduct of the plan’s fiduciaries. In this and several other respects, the regulation is an intentional departure from traditional common law concepts.\textsuperscript{35} The prudence regulation states that the requirements of section 404(a)(1)(B) of ERISA are satisfied if the fiduciary, with respect to each investment, has given “appropriate consideration” to the facts and circumstances of the investment including the role of the investment in the “plan’s investment portfolio,” and has acted accordingly.\textsuperscript{36} The regulation defines appropriate consideration as including

\begin{quote}
\textit{a determination by the fiduciary that the particular investment or investment course of action is reasonably designed, as part of the plan portfolio with respect to which the fiduciary has investment duties, to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action. . . .}\textsuperscript{37}
\end{quote}

If the ratio of risk to gain on a particular investment is reasonable in relation to the overall ratio of risk to gain for the portfolio, the individual

\textsuperscript{34} See A. AMLING, INVESTMENTS: AN INTRODUCTION TO ANALYSIS AND MANAGEMENT (4th ed. 1975). For an example of portfolio theory applied by one pension plan, see Derven, \textit{International Paper: Letting the Chips Fall}, 15 \textit{Pension World} 16 (1979).


\textsuperscript{36} The legislative history of [ERISA] indicates that the common law of trusts, which forms the basis for and is federalized and codified in part 4 of Title I of [ERISA], should, nevertheless, not be mechanically applied to employee benefit plans. The ‘prudence’ rule in [ERISA] sets forth a standard built upon, but that should and does depart from, traditional trust law in certain respects.

Supplementary Information, \textit{supra} note 31, at 37,221, 37,222 (footnote omitted).

\textsuperscript{37} 29 C.F.R. § 2550.404a-1(b)(1) (1979).

\textsuperscript{38} 29 C.F.R. § 2550.404a-1(b)(2)(i) (1979).
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investment can be treated as prudent although it might be considered a high risk investment if viewed independently.

The definition of appropriate consideration also includes consideration of the diversification, liquidity, and investment return needs of the plan. Thus, a plan fiduciary can and should take factors other than gain into account in judging the value of an investment. For example, many portfolios contain investments which supply needed liquidity to a plan even though those investments reduce the overall gain of the portfolio.

A hedging strategy has an objective similar to diversification. The principal aim of diversification, at least in an ERISA context, is to insulate the overall portfolio from the risk of loss attaching to a particular investment by making a variety of investments such that, with respect to each, the risk of loss is thought to arise from largely independent factors, that is investments which are not covariant. Hedging an investment goes beyond merely purchasing an investment with independent risk factors. It seeks an investment with a negative covariance to an existing (or planned) investment, so that those market forces which would produce a loss on the prospective investment would generally produce a gain on the existing investment, and vice versa. Thus, although using futures as part of a hedging strategy offsets the opportunity for gain on another portion of the portfolio, it provides an efficient way of achieving the minimization of covariance that is the primary aim of diversifying a portfolio.

2. The Need for Proper Authority and Trading Guidelines

The prudence regulation does not take a position on whether a particular investment or investment strategy, such as the use of commodity futures, is or is not prudent. Furthermore, although the regulation is intended to provide a "safe harbor," its deliberate generality will not

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28 Id. The Department of Labor believes a fiduciary should take into consideration "the composition of the portfolio with regard to diversification." Id. While diversification is an element of appropriate consideration for purposes of the definition of prudent conduct, it is also a separate requirement under § 404(a)(1)(C) of ERISA.

29 The recognition of valid criteria other than opportunity for gain is as important as the regulation's focus on overall portfolio investment. A prudence standard based only on the concept of gains, even if applied in the context of the entire portfolio, might be violated by hedging transactions.

30 The Labor Department states that "the word 'diversification' is to be given its customary meaning as a mechanism for reducing the risk of large losses. . . ." Supplementary Information, supra note 31, at 37,223. In a non-ERISA context, diversification can relate to gains as well as losses. That is, a diversified portfolio may have the aim of taking advantage of potential windfalls as well as avoiding large losses from over-commitments.

41 It should also be noted that the Department does not view compliance with the provisions of the regulation as necessarily constituting the exclusive method for satisfying the requirements of the 'prudence' rule. Rather, the regulation is in the nature of a 'safe harbor' provision; it is the opinion of the Department that fiduciaries who comply with the provisions of the regulation will have satisfied the requirements of the 'prudence' rule, but no opinion is expressed in the regulation as to the status of activities undertaken or performed that do not so comply.
allow a fiduciary to avoid the possibility of liability through mechanical compliance with a set of objective standards. Thus, before authorizing or implementing any non-traditional investment conduct, such as the use of commodity futures, a fiduciary with any degree of investment discretion should carefully consider not only the substance of the Labor Department's position on prudent investments, but also more traditional concepts of prudent fiduciary conduct, such as proper authorization and the establishment of documented investment guidelines.

The plan or trust instrument should authorize futures trading. The authorization should be broad enough to cover all contemplated investments but sufficiently specific to preclude those that are not contemplated. At the same time authorization is given, the fiduciary charged with overall plan investment responsibility should document the reasons for and the goals of futures trading. Guidelines should be developed specifying the limits on the amount of plan assets committed to futures trading, taking into account the likelihood of margin calls. There should be provision for a periodic review of trading and its effect on the overall portfolio. If the plan is to use futures to hedge cash market investments, the guidelines must provide for coordination between the futures trading

Supplementary Information, supra note 31, at 37,222.

42 The common law of trusts would require authorization of futures trading:

*Unless it is otherwise provided by the terms of the trust, the following are not proper trust investments: (1) purchase of securities for purposes of speculation, for example, purchase of shares of stock on margin or purchase of bonds selling at a great discount because of uncertainty whether they will be paid on maturity; (2) purchase of securities in new and untried enterprises; (3) employment of trust property in the carrying on of trade or business; (4) purchase of land or other things for resale.*

**RESTATEMENT (SECOND) OF TRUSTS** § 227, Comment f (1959) [hereinafter cited as TRUST RESTATEMENT] (emphasis added).

The role of common law in interpreting the fiduciary rules of ERISA is still open to consideration. The common law rule is inherent in the trust requirement of ERISA § 403. "In developing a law of remedies [under ERISA], the Congress intended the federal courts to draw on principles of traditional trust law. . . ." Eaves v. Penn, 587 F.2d 453, 462 (10th Cir. 1978) (citing 120 CONG. REC. 15,737 (1975) (remarks of Sen. Williams) reprinted in [1974] U.S. CODE CONG. & AD. NEWS 5177, 5186). See also **CONFERENCE REPORT, supra** note 25, at 306. Recently, the Court of Appeals for the Fifth Circuit acknowledged the potential importance of common law. Iron Wkr. Local 272 v. Bowen, No. 78-1789, slip op. at 8817 (5th Cir. Aug. 25, 1980). For tax-qualified plans, there is a general rule that all investments must be permitted by the trust agreement. Treas. Reg. § 1.401-1(b)(5)(i) (1976). For national banks acting as trustees, there is a similar requirement set forth in regulations of the Comptroller of the Currency. See note 130 infra.

43 The authorization in invest in commodity futures should not be written so broadly as to approve all speculative or innovative investment. In Revenue Ruling 73-532, 1973-2 C.B. 128, the IRS held that a trust forming part of a plan which states that "the trustee shall have complete power to invest trust funds without regard to whether investments may be new, speculative, hazardous, adventurous, or productive of income . . ." would not constitute a qualified trust for purposes of the Code. The reason for disqualification was that the language would allow the trustee to ignore the exclusive benefit requirement of § 401(a)(2) of the Code. See text accompanying notes 47-52 infra.
and the hedged investments. 44

Taking these steps before engaging in futures trading not only insures that those with potential liability under ERISA perform a thorough analysis in keeping with the prudence regulation and traditional concepts of prudent conduct, but also provides evidence that this analysis has taken place. The importance of both the analysis and evidence of the analysis cannot be over-emphasized. The risk of loss, varying to some degree with the variety of futures contract to be traded, can be quite substantial.

While stop-loss limits should enable a trader to realize and stop its loss on any given day,44 it is possible in rare cases for the market to “go the limit” every day for many days even though no trading takes place. If no one is willing to take an opposite position within the price limit set for the particular day, a trader may be unable to stop its losses because the contract cannot be closed out.44

3. IRS Investment Requisites

The prudent conduct requirement of section 404 of ERISA applies to almost all employee benefit plans covered by Title I of that Act. However, tax-qualified plans47 may also be subject to investment requisites, including a prudence requirement, derived by the IRS from the tax-qualification requirements of section 401 of the Code.

Section 401(a) of the Code states that a trust will be a qualified trust

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44 The need in some situations for coordination among fiduciaries managing separate portions of a plan’s portfolio may have been overlooked by the Department of Labor, which states in the preamble to the prudence regulation that:

Paragraph (b)(1) of the regulations adopted also provides that such a fiduciary need give appropriate consideration to the role the proposed investment or reinvestment course of action plays in that portion only, of the plan’s investment portfolio, with respect to which the fiduciary has investment duties.

Supplementary Information, supra note 31, at 37,223. Hedging through futures by definition involves coordination with at least a portion of a plan’s cash position investments, some of which may be under the control of another fiduciary.

44 Exchanges set limits on how far up or down the price of a commodity can move on a particular day. If the price reaches the limit, further trading is suspended except at prices equal to or within the limits. Thus, on a day when silver for delivery 3 months in the future opens at $17 an ounce the limits on trading may be set at $18 per ounce and $16 an ounce, and no trading could then take place at prices exceeding $18 or less than $16.

44 Even if a contract cannot be closed out, there are complex trading techniques which may permit the investor in this circumstance to liquidate his futures position. These techniques rely on the use of spreads, which involve taking long and short “positions” in different months in the same commodity, and on the fact that, with certain exceptions, there are no price limits applicable to futures trading in the “spot” (or nearest) month.

44 A trust forming part of an employee benefit plan which satisfies the requirements of § 401 of the Code is exempt from taxation under I.R.C. § 501. Employer contributions to such a trust are deductible and are not currently taxable to employees. Similar tax benefits are afforded to non-trusted annuity plans which meet the requirements of § 403 of the Code. With the exception of certain unfunded plans providing deferred compensation, usually for highly paid executives, virtually all employee retirement plans seek to maintain tax-qualified status under I.R.C. § 401.
under that section if it is “part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries. . . .” Although section 1.401-1(b)(5)(i) of the Income Tax Regulations provides that contributions to a trust forming part of a qualified plan may be used to purchase any investment permitted by the trust agreement and allowed by local law, the IRS has said that the primary purpose of benefiting employees must be maintained with respect to investments of the trust funds. The IRS has further said that an investment is consistent with the exclusive benefit requirement if it meets certain “applicable investment requisites”:

(1) The cost must not exceed fair market value at the time of purchase, (2) a fair return commensurate with the prevailing rate must be provided, (3) sufficient liquidity must be maintained to permit distributions in accordance with the terms of the plan, and (4) the safeguards and diversity that a prudent investor would adhere to must be present.

The IRS investment requisites are applied on an investment-by-investment basis, and contain their own prudence rule in the fourth requirement. The extent to which these requisites still have vitality is unclear, but if they do, plans would encounter difficulties in justifying any transaction in the futures market, including a hedge.
As recently as 1979 the IRS relied on the exclusive benefit rule, as applied to a particular investment, to disqualify a plan. In Private Letter Ruling 7944001, the IRS noted that an investment found to be improper under the investment requisites of the exclusive benefit rule, including prudence, would disqualify a plan not only in the year in which the transaction was entered into, but in every year until the transaction was corrected. Private Letter Ruling 7944001 involved an unsecured loan between a plan and the employer shortly before the employer became insolvent, and therefore presents a less sympathetic case than mere trading in a somewhat novel market such as commodity futures. Nevertheless, it is significant that since the passage of ERISA, the IRS has relied in at least one case on its own requirements of prudent investment for tax qualification purposes.  

The broad question of tax qualification is wholly within IRS jurisdiction. Whether or when the IRS will change its views as to the investment requisites applicable to fiduciaries of qualified plans is not at all clear. Unless a change is made, however, plans cannot ignore the IRS when resolving questions of prudence.

4. Conclusion

An employee benefit plan wishing to trade commodity futures can do so in compliance with the prudence requirement of ERISA. With proper authorization, written guidelines, and careful attention to individual investment decisions a fiduciary can justify hedging, and to a lesser degree speculation, in futures. The IRS investment standards, including prudence, present a continuing problem since they are not as flexible as the Department of Labor’s formulation. In view of the apparently unequivocal legislative history to ERISA, it is likely that the IRS ultimately will be forced to defer to the Department of Labor’s standards in its regulation of qualified plans.

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agers have met the requisite standard of care and prudence: Trading in securities on margin, trading in commodity futures, investments in working interests in oil and gas wells, the purchase of “puts” and “calls,” and “straddles,” the purchase of warrants, and selling short. Treas. Reg. § 53.4944-1(a)(2)(i) (1976) (emphasis added).

This regulation was recently cited by the IRS in ruling that the purchase of certain life insurance policies by an organization exempt from federal income tax under § 501(c)(3) of the Code was imprudent and therefore jeopardized the exempt function of the organization. See Rev. Rul. 80-133, 1980-19 I.R.B. 13.

[1979] Private Letter Rulings (P-H) ¶ 2455. Although the IRS pointed out that the loan at issue in Private Letter Ruling 7944001 constituted a “prohibited transaction” under the Code and ERISA, it did not feel it necessary to make any reference to the prudence rule of ERISA. Id.

See note 51 supra.
B. ERISA Trust Considerations

Under section 403 of ERISA, assets of most employee benefit plans must be held in trust by one or more trustees. Therefore, a plan must structure its futures trading so as to keep all assets under the exclusive control of plan trustees.

A proposed Department of Labor regulation defines the term "plan assets" generally as "all property, tangible or intangible . . . in which the plan has any beneficial ownership interest . . . ." The precise meaning of "beneficial ownership interest" is not clear and neither the proposed regulation nor the Supplementary Information thereto provide further guidance.

1. Futures Contracts

Although it is not clear how broadly the Department of Labor views the term "beneficial ownership interest," the term easily encompasses direct ownership, such as a plan acquires over a commodity futures contract. Therefore, commodity futures contracts purchased by a plan must be considered as constituting plan assets and must be held in trust.

This raises a question whether the indicia of ownership of the contract can be transferred to the trustee of a plan trading a commodity future. In the normal case there is no certificate or other indicia of ownership transferred in connection with the purchase of a commodity futures contract. It may be sufficient for the trustee to be timely notified of the execution of contracts on the plan's behalf. Clearly a good faith attempt at com-

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84 [A]ll assets of an employee plan shall be held in trust by one or more trustees. Such trustee or trustees shall be either named in the trust instrument or in the plan instrument or appointed by a person who is a named fiduciary, and upon acceptance of being named or appointed, the trustee or trustees shall have exclusive authority and discretion to manage and control the assets of the plan. . . . ERISA § 403(a) (emphasis added). Employee plans funded through the purchase of insurance contracts are not required to have a trustee. ERISA §403(b)(2). However, if plan assets are held in a separate account of an insurance company, many of the considerations applicable to trusts may apply to the handling of the separate account as well. See ERISA § 401(b)(2)(B).


87 The customer directs the FCM to purchase or sell the desired contract and, after execution, the FCM sends the customer a confirmation of the trade. A commodity futures trade does not result in any document executed by the parties. Similarly, the liquidation of a contract will be unaccompanied by any documentation other than the confirmation slip and subsequent monthly statement of account. Therefore, there is nothing for a plan trustee to have custody over except the confirmation, which gives the name and quantity of the commodity, the delivery month and the price. The trustee might store the data evidencing the transactions engaged in, but it is impossible to hold any document carrying a power of disposition over the underlying property.

88 A footnote to the Supplementary Information to Regulation § 2550.403a-1 states that:
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pliance with the custody requirement is advisable, and in addition to monitoring confirmations of trades, the trustee might maintain a ledger account of all transactions entered into through the FCM.

2. Margin Accounts

The requirement of section 403 that plan assets be held in trust and be subject to the exclusive control of the plan trustee also raises difficult questions with respect to initial margin. If margin is a deposit or down payment it can be argued forcefully that the margin is not an asset of the plan. However, although the trader does not have complete control over the disposition of the margin in the hands of the FCM, the margin is regarded for purposes of commodities law as owned by the trader. Rules promulgated by the Commodity Futures Trading Commission require that the margin be held in a segregated account and be treated as owned by the customer. When a contract is closed out, the margin is returned to the customer. Thus the plan has a substantial ownership interest which probably constitutes a "beneficial ownership interest" within the meaning of the proposed plan asset regulation.

One plan apparently has attempted to resolve this problem by depositing the margin in an escrow account with a third party bank acting as trustee. The FCM has access to the escrow account held by the bank and is able to draw on the account to meet variation margin calls while

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[T]he Department has received inquiries as to whether it is permissible for securities in which a plan has invested to be registered in the name of a broker-dealer or the broker-dealer's nominee, sometimes referred to as "street name" registration. The Department would generally view such a practice under the proposed regulation as violating the requirement of section 403(a) of the Act that plan assets must be held in trust, except under those circumstances where the broker-dealer holds the securities as trustee for the plan pursuant to an executed trust agreement. Supplementary Information, supra note 31, at 50,366 n.14. If commodity futures trading were analogized to securities trading, the above-quoted language and the literal language of ERISA § 403 might lead to the conclusion that the trustee must have title to or even custody of actual contracts. If the footnote means that all securities or at least the title thereto must be held in the custody of a trustee, there is a serious problem because there is no certificate or other document which can be viewed as manifesting the contract. However, the footnote can also be read as being limited in application to the holding of a plan's securities in the street name of its broker. If this reading is correct, it is possible to argue that providing the trustee with trade confirmations is sufficient, especially since there is no apparent practical alternative means of satisfying the statute's requirements.

A customer may retain substantial control over the assets in the margin account. Within limits, the customer can decide what kinds of assets to place in the margin account and can substitute new assets for those initially placed in the account.

Section 4(d)(2) of the Commodity Exchange Act states that margin must be "separately accounted for and shall not be commingled with the funds of [the FCM]..." and will otherwise be treated "as belonging to the customers..." 7 U.S.C. § 6(d)(2) (1976 & Supp. II 1979). CFTC regulations set forth detailed requirements with respect to customer's money, securities and property. 17 C.F.R. §§ 1.20-1.30 (1979).

See DuPont Futures, supra note 2.

An employee plan trading commodity futures that did not allow the FCM access to
the money is at the same time arguably held in the plan trust because the plan trustee also has access to the margin. However, to the extent that the broker has access to the escrow account, it is difficult to conclude that the plan trustee has the "exclusive authority and discretion" over those assets required by section 403 of ERISA.63

At present there does not appear to be a straightforward solution to the apparent conflict between section 403 of ERISA and the requirement that initial margin be in the possession of the FCM. Therefore, as a practical matter, plans which are to trade futures should make a good faith attempt to alter the standard arrangements concerning margin accounts in order to satisfy both rules. In the longer term, however, because both rules serve valid public policy ends, it is to be hoped that a more direct solution could be found, perhaps in the Department of Labor's plan asset regulation.64 It would be unfortunate if plans were ultimately precluded from access to the futures markets because of such a technicality.

3. Investment Responsibility

Under section 403 of ERISA only certain fiduciaries of the plan can exercise managerial discretion over the disposition of the assets.65 If a named fiduciary of a plan, such as an employer's in-house investment

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63 If the third-party approach, see text accompanying notes 61 & 62, is used, it is crucial that the margin be maintained for the exclusive benefit of the plan except for margin calls. Thus, the margin must not be invested for the benefit of the FCM or otherwise dealt with in a way that might benefit the FCM. Otherwise, ERISA prohibited transaction and tax qualification problems arise. See text accompanying note 82 infra.

64 The Labor Department's proposed regulation defining plan assets, Prop. Reg. § 2550.401b-1(a), 44 Fed. Reg. 50,363 (1979), reproposed in part, 45 Fed. Reg. 38,084 (1979), has been opposed strongly by numerous commentators. The definition of plan assets contained in the proposal is extremely broad, and many have argued that the proposal would create arbitrary and burdensome results. The final regulation may not be published for some time, as the result of the controversy surrounding the original proposal and the reproposal.

On September 18, 1980, Merrill Lynch, Pierce, Fenner & Smith filed a request with the Department of Labor seeking relief from the effects of the trust requirement of § 403 as it would apply to a futures margin account. On October 17, the Futures Industry Association filed a letter with the Department joining in Merrill Lynch's request.

65 [U]pon acceptance of being named or appointed, the trustee or trustees shall have exclusive authority and discretion to manage and control the assets of the plan, except to the extent that—

(1) the plan expressly provides that the trustee or trustees are subject to the direction of a named fiduciary who is not a trustee, in which case the trustees shall be subject to proper directions of such fiduciary which are made in accordance with the terms of the plan and which are not contrary to this title, or

(2) authority to manage, acquire, or dispose of assets of the plan is delegated to one or more investment managers pursuant to section 402(c)(3).

ERISA § 403(a) (emphasis added).
management committee or the plan's trustee, retains control over all futures investments, the asset management requirement of section 403 is satisfied. Section 403 is also satisfied if the plan's assets are invested at the direction of an investment manager. An investment manager is defined by ERISA as

any fiduciary (other than a trustee or named fiduciary, as defined in section 402(a)(2)) -

(A) who has the power to manage, acquire, or dispose of any asset of a plan;
(B) who is (i) registered as an investment adviser under the Investment Advisers Act of 1940 . . . and
(C) has acknowledged in writing that he is a fiduciary with respect to the plan.«6

Such a plan may well decide that it does not have the in-house expertise to trade in commodity futures, and that the plan trustee either lacks such expertise or is unwilling to make trading decisions with respect to commodity futures. In these cases, a plan will have to obtain the expert advice of an FCM or a "commodity trading advisor" (CTA) in order to participate in the commodities markets.«7 If the functions of the CTA rise to the level of exercising discretion over the management or disposition of the assets of the plan, the CTA will either have to qualify as an investment manager, be named as a fiduciary in the plan instrument, or be appointed as a trustee.

In theory it is possible for a CTA to render advice which is often followed by someone who actually has ultimate responsibility for investment decisions, without the CTA having to be a named fiduciary, trustee, or investment manager. For this to be the case, the CTA cannot have any real power, formally or effectively, to decide whether to execute the recommended trades.«8 It would be difficult, however, for a plan to derive

«6 ERISA § 3(38).
«7 With certain exceptions, anyone who is engaged for compensation or profit in the business of advising others directly or indirectly as to the value of commodities or the advisability of trading futures contracts is a "commodity trading advisor" (CTA). 7 U.S.C. § 2 (1976 & Supp. II 1979). An FCM can render investment advice or exercise discretion in connection with its handling of a discretionary account without being deemed to be a commodity trading advisor. 17 C.F.R. § 1.3(bb) (1979). Thus, an FCM would not have to register as a CTA when managing discretionary accounts. However, such an FCM would be subject to all of the ERISA problems applicable to CTAs in that circumstance. Thus, the discussion in the text of the problems of CTAs should be considered to apply as well to FCMs to the extent they are rendering advice to customers or taking on discretionary control of the investment of an employee plan customer's account.
«8 Apparently a person can render "investment advice" to a plan without having that activity rise to the level of authority or discretion requiring appointment as a named fiduciary, trustee, or investment manager. Section 402(c) of ERISA states that:

Any employee benefit plan may provide . . . (2) that a named fiduciary, or fiduciary designated by a named fiduciary pursuant to a plan procedure described in section 405(c)(1), may employ one or more persons to render advice with regard to
any benefit from the advice of a CTA without giving the CTA effective power to implement the advice. Commodity futures trading is typically conducted rapidly in an active market where, to be effective, trades must be executed quickly. A plan’s management committee cannot convene to consider each recommendation to buy or sell. A trustee receiving constant advice could not take the time to analyze that advice and exercise independent judgment before following it.

In order to become an investment manager, a CTA must register as an investment adviser under the Investment Advisers Act of 1940. The Investment Advisers Act defines an investment adviser as

any person who, for compensation, engages in the business of advising others, either directly or through publications or writing, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities . . . .

While commodity futures contracts are not securities, a CTA might become registered as an investment adviser if, in addition to rendering advice with regard to futures, it offers advice on securities trading. However,

any responsibility such fiduciary has under the plan . . .

Id.

A person rendering investment advice is a fiduciary under Department of Labor regulations, if

[S]uch person renders advice to the plan as to the value of securities or other property, or makes recommendations as to the advisability of investing in, purchasing, or selling securities or other property; and (ii) Such person either directly or indirectly . . . [h]as discretionary authority or control, whether or not pursuant to agreement, arrangement or understanding, with respect to purchasing or selling securities or other property for the plan; or . . . [r]enders any advice . . . on a regular basis to the plan pursuant to a mutual agreement, arrangement or understanding, written or otherwise, between such person and the plan or a fiduciary with respect to the plan, that such services will serve as a primary basis for investment decisions with respect to plan assets, and that such person will render individualized investment advice to the plan based on the particular needs of the plan regarding such matters as, among other things, investment policies or strategy, overall portfolio composition or diversification of plan investments.

29 C.F.R. § 2510.3-21(c) (1980).


70 Id. § 80b-2(a)(11) (emphasis added).

71 Sinva, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 253 F. Supp. 359, 367 (S.D.N.Y. 1966); see also N. Wolfson, R. Phillips & T. Russo, Regulation of Brokers, Dealers and Securities Markets §§ 1-39 (1977) [hereinafter cited as Wolfson, Phillips & Russo]. Whether or not a futures contract on a security is, by itself, a separate security, so that a CTA trading such futures could be treated as rendering advice with regard to securities for purposes of the 1940 Act, is an academic question. Futures transactions executed on an exchange are subject to the exclusive jurisdiction of the CFTC. See Russo & Lyon, The Exclusive Jurisdiction of the Commodity Futures Trading Commission, 6 Hofstra L. Rev. 57 (1977). The definition of the term “security” creates other ERISA problems for plans and members of the futures industry. See text accompanying notes 143-153 infra.
even if a CTA is registered as an investment adviser, there would remain a question as to whether the CTA would be regarded as an investment manager under ERISA when the CTA is acting as a CTA rather than as a securities investment adviser. It might well be argued that futures trading is not within the intended scope of the exception for assets managed by investment managers. However, any advice regarding hedging would, by definition, go beyond mere advice regarding trading on a commodity exchange. Such advice would encompass the relevant portions of the rest of the plan’s portfolio and, in that connection, would be connected so integrally with advice on the disposition of the plan’s securities that registration as an investment advisor should be viewed as appropriate for purposes of section 3(38) of ERISA.

If a CTA cannot or does not want to be an investment manager, it can exercise authority or discretion over the plan’s assets only if appointed as a named fiduciary or a trustee. It does not appear that Congress intended that outside advisers be given discretion over plan assets through grants of pro forma status as a named fiduciary or trustee. The issue should be clarified by amending section 3(38) or by regulatory relief from the burden of having to make a CTA a trustee or named fiduciary.

C. ERISA Prohibited Transactions

Sections 406 and 502 of ERISA and section 4975 of the Code impose severe penalties on “disqualified persons” who engage in “prohibited transactions” with employee plans. The term “disqualified person” in-

78 In order to be a trustee, an FCM or CTA doing business in corporate form would probably have to have the legal power to function as a trustee under local law. Generally, a corporation will have the power to act as a trustee of any trust the operation of which is incidental to the conduct of the corporation’s business. See G. Bogert, THE LAW OF TRUSTS AND TRUSTEES § 131 (2d ed. 1965); A. Scott, THE LAW OF TRUSTS § 96 (3d ed. 1967). However, there are some states where a CTA or FCM would not have the power to be a trustee regardless of the purpose of the trust. Id. The question whether an FCM or CTA has such power apparently has not been faced in any state.

ERISA might preempt any state law limiting the power of a corporation to act as a trustee of an employee benefit plan trust. However, a tax-qualified trust must be valid under local law. I.R.S. Pub. 776, Part 2 § f (2-72). Thus, the power to act as trustee under state laws will continue to be an important consideration when trading with assets of tax-qualified plans.

78 ERISA § 405 specifically provides for retaining outside fiduciaries as advisers but distinguishes between such advisory functions and actual authority over disposition of plan assets, which must stay with the trustee or the named fiduciary. ERISA § 405(c)(1)(B). The legislative history appears to contemplate that, when trustee responsibility is given to named fiduciaries, the named fiduciaries will not be outsiders such as investment specialists, but insiders such as an investment committee made up of employees of the sponsor. See CONFERENCE REPORT, supra note 25, at 298.

74 The persons who are restricted in their dealings with plans are referred to as “parties in interest” under §§ 406 and 502 of ERISA and “disqualified persons” under § 4975 of the Code. Since both terms are essentially the same, for these purposes we will hereinafter use only the term disqualified persons.

78 There are three kinds of sanctions for engaging in prohibited transactions. If the
cludes anyone who provides services to an employee benefit plan and anyone who is a fiduciary of a plan. By performing commodity futures trading functions on behalf of a plan investing in futures, an FCM inevitably will become a disqualified person with regard to that plan on the basis of the services provided. Furthermore, if the FCM goes beyond mere administrative functions and begins to recommend purchases, the FCM will run the risk of being treated as a fiduciary as well. Thus, both the FCM and the employee plan should analyze whether or not their relationship, and the transactions they engage in, create a possibility that the plan and the FCM will violate the prohibited transaction rules.

Prohibited transactions can be divided into two categories: a broad range of transactions which all disqualified persons are prohibited from engaging in, and a smaller group of transactions involving conflicts of interests which apply only to fiduciaries.

1. General Prohibited Transactions

The broad set of prohibitions against transactions between any disqualified person and a plan applies to transactions which involve the exchange of money or other property, with the exception of reasonable compensation for services, between disqualified persons and a plan. Other prohibited transactions include the provision of more than one service between a disqualified person and a plan, and the extension of credit between a disqualified person and a plan.

The prohibition against multiple services may create an obstacle to certain FCM activities. Typically, an FCM will perform multiple functions; the FCM may execute trades on behalf of the plan and may also provide reporting and research functions for the plan. Depending upon the circumstances, the several functions might be definable as a single service for purposes of avoiding the prohibition against multiple services. Even if the FCM is considered to be providing multiple services, those services might be permitted under ERISA section 408(b)(2) and Code section 4975(d)(2) and regulations thereunder which exempt arrange-

prohibited transaction results in loss to the employee benefit plan, a fiduciary involved in the transaction is liable for damages under ERISA § 409. Those who are involved in a prohibited transaction are all subject to equitable relief and can be forced to rescind the transaction.

Disqualified persons are liable for an excise tax levied, in the case of qualified plans, under § 4975 of the Code. The excise tax is 5% of the “amount involved” in the prohibited transaction, unless the transaction is not “corrected within ninety days after the IRS asserts a tax deficiency,” in which case an excise tax of 100% is levied. The Department of Labor has authority to assess similar civil penalties under § 502(i) of ERISA with respect to non-qualified plans. However, the plan itself is never liable for damages, excise taxes or penalty fees under the prohibited transaction provisions of the Code and ERISA.

* If an FCM gives advice on trading in addition to the other services provided by the FCM, and if the FCM knows that its advice will be followed, it is quite likely that the FCM will be treated as a fiduciary. See ERISA § 3(21); 29 C.F.R. § 2510.3(21) (1979).

** ERISA § 406(a); I.R.C. § 4975(c)(1)(A)-(D).
ments for additional services that are necessary to the operation of the plan. The term “necessary to the operation of the plan” is interpreted broadly in the regulations and should cover the services involved in executing a program of commodity futures trades. Because the relationship between the plan and FCM can vary, that relationship should always be compared with the requirements of the regulation in order to make sure that the exemption applies. The relationship should be reviewed periodically to make certain that it has not evolved beyond the boundaries of the exemption.

The prohibition against the transfer of assets and the prohibition against the extension of credit create more difficult problems. Compensation paid to the FCM for services will not be prohibited per se unless the amount is unreasonable. However, the margin may be treated as a plan asset, as described above in the discussion of ERISA trust requirements. In that case, unless the margin is invested for the benefit of the trader, the placing of a margin account with the FCM could be treated as a transfer of money, a transfer of the use of money, or a extension of credit to the FCM.

In the usual case, the question of who receives the benefit of investment of the margin will be subject to negotiation between the FCM and the trader. However, if the margin is a plan asset, and if the benefit of interim investment of the margin inures to the FCM or another party in interest, a prohibited transaction may occur under ERISA section 406 and Code section 4975. Tax qualification problems may also arise under the requirement of section 401 of the Code that all assets be held for the exclusive benefit of employees or their beneficiaries. Thus, the income on the investment of the margin should always inure to the benefit of the plan. This problem may be solved if the margin is determined not to be a plan asset by the Department of Labor, or if some other form of admin-

78 Treas. Reg. § 54.4975-6(a) (1977); see also ERISA § 408(b)(2); 29 C.F.R. § 2550.408(b)(2) (1979) (non-tax qualified plans).
80 ERISA § 408(b)(2); I.R.C. § 4975(d)(2).
81 See text accompanying notes 54-64 supra.
82 I.R.C. §§ 4975(c)(1)(B) & (D); ERISA §§ 406(a)(1)(B) & (D). “Margin” buying of commodity futures should not be considered an extension of credit to the plan as it would be in a securities context. See note 71 supra.
83 If the margin is a plan asset and the benefit of the interim investment of the margin inures to a party in interest, these events could be considered as either an extension of credit under ERISA § 406(a)(1)(B) and I.R.C. § 4975(c)(1)(B), or a transfer of assets for the use of a disqualified person under ERISA § 406(a)(1)(D) and I.R.C. § 4975(c)(1)(D). Use of the “float” on the margin for the benefit of the FCM could also result in a violation of the exclusive benefit rule of I.R.C. § 401(a)(2). See text accompanying note 61 supra.
84 The Department of Labor’s proposed regulation defining plan assets would apparently treat margin as a plan asset, because plan assets include any asset in which a plan has any “beneficial ownership interest.” Prop. Reg. § 2550.401b-1(a), 44 Fed. Reg. 50363 (1979); see text accompanying notes 55 & 56 supra. The Department may be induced to create an exception to this rule, as it has for assets underlying certain government-guaranteed securi-
istrative relief is provided.

2. Prohibited Transactions of Fiduciaries

If an FCM or CTA becomes a de facto fiduciary of a plan by rendering advice which the plan follows automatically, or by otherwise assuming a role involving the exercise of discretionary powers over some of the plan’s assets, the FCM will also be subject to the second set of prohibitions set forth in section 406(b) of ERISA and section 4975(c)(1) of the Code. These sections prohibit a fiduciary from dealing with plan assets for his own interest, acting on behalf of a party with competing interests in a transaction, or receiving compensation arising out of the transaction from anyone other than the plan. Such self-dealing rules normally will not interfere with the conduct of an FCM or CTA acting in good faith because such persons will not put themselves in a position where their interests conflict with their clients'.

However, an inadvertent violation may occur. An FCM may represent both the buyer and seller of a particular contract in a single trade. If one of the parties is a plan with respect to which the FCM is a fiduciary, the FCM may be violating the prohibition against representing a party with interests adverse to the plan. If the FCM receives a commission from

ties notwithstanding that such underlying assets may be regarded as beneficially owned by purchasers of the securities. See Prop. Reg. § 2550.401b-1(b), 44 Fed. Reg. 50, 363 (1979). Merrill Lynch, Pierce, Fenner & Smith Inc. and the Futures Industry Association have requested relief from the effects of the plan asset regulations. See note 64 supra.

Absent a change in the regulation, the futures industry may be forced to seek a class exemption from the prohibited transaction rules as those rules might apply to the maintenance of the margin account. No one has as yet requested such relief. The Department of Labor currently takes more than a year to process such requests.

85 ERISA § 406(b); I.R.C. § 4975(c)(1)(D)-(F).

88 If an FCM has two floor brokers working in the same trading pit it would be quite likely that the FCM would be representing both sides of many contracts entered into in that trading pit. It is also possible that the floor broker of an FCM will be executing a “cross trade” involving an employee benefit plan and some other customer of the same FCM. If the floor broker receives buy and sell orders to be executed at the market price from two different customers he must first attempt to execute those trades separately by open outcry in the trading pit. However, if he cannot find another trader willing to take an opposite position against either of his orders he may be permitted on some exchanges to execute the contract between his two customers. Commodity Exchange Act § 4(b)(D), 7 U.S.C. § 6b(D) (1976). Such trades can take place only in accordance with procedures set down in rules of the CFTC, 17 C.F.R. § 1.39 (1979), and of the exchanges. These procedures are designed to insure that a cross trade takes place only when it is in the best interest of both customers and when execution pursuant to open outcry has failed.

It is possible that compliance with those procedures would enable the FCM to argue that he had not dealt with plan assets in his own interest, or in the interest of an adverse party, within the meaning of ERISA § 406(b). Moreover, an FCM who fails to execute a cross trade may be violating his duty to both customers to achieve the best execution possible. This tension between ERISA § 406(b) and the cross trade provisions of the Commodity Exchange Act may be the proper subject of a request for an advisory opinion of the Department of Labor. See ERISA Proc. 76-1, 41 Fed. Reg. 30,281 (1976).
the party which takes the position opposite to the plan in the transaction, the payment may violate the rule against receiving compensation from a party with competing interests. If the FCM receives a commission from both parties, it may raise a question of whether the FCM was managing the plan's assets in such a way as to benefit the FCM. The prevention of such inadvertent conflicts can be administratively burdensome. However, the prohibited transaction rules apply regardless of intent, and the penalties for violating the rules are quite severe. For this reason, the relationship between the FCM and the plan should be continually monitored to determine whether the FCM is exercising fiduciary discretion over the plan's account. If such discretion is present, inadvertent self-dealing can then be avoided either by trading through another FCM or, where possible, refraining from simultaneous trades involving other clients.

3. Conclusion

The general prohibited transaction rules should not create insurmountable obstacles for plans using commodity futures. However, if an FCM becomes a fiduciary to a plan, potential conflicts of interest could create serious prohibited transaction problems. Therefore, it is advisable to separate trading functions from investment advisory functions as much as possible, at least until some form of administrative relief is provided.

If certain conditions are met, securities brokers are exempted from the prohibited transaction rules by Prohibited Transaction Class Exemption 79-1. Those rules apply to "the effecting or executing of any securities transactions on behalf of an employee benefit plan . . . and . . . the performance . . . of clearance, settlement, custodial or other functions incidental to such transactions". Exemption 79-1 applies to "a person who is a fiduciary with respect to . . . [a] plan and who is acting in such transactions as agent for the plan. . . ." FCMs could and should receive substantially identical relief since their role in effecting futures trades corresponds to the role of brokers and dealers in buying and selling securities. Unfortunately, no such exemption for FCMs has been requested, and in view of the time the Department of Labor normally needs to respond to a request for a class exemption, no relief can be expected in the immediate future.

D. Unrelated Business Income Tax


Section 511 of the Code imposes a tax on the "unrelated business taxable income" (UBTI) of organizations otherwise exempt from taxation.

87 See note 75 supra.
under section 501(a) of the Code. Most employee benefit plans are among the organizations subject to section 511. Section 512 defines unrelated business taxable income as "the gross income derived . . . from any unrelated trade or business regularly carried on by [the tax-exempt organization]", less appropriate deductions. The tax is imposed to prevent such organizations from using their tax exempt status to compete unfairly with tax-paying entities in trades or businesses outside the normal ambit of trust investment. The term "trade or business" is broadly defined and therefore might cover the trading of commodity futures, although the Supreme Court has held that the term does not cover the buying and selling of securities by individuals or trustees generally.

As a general rule, if the trade or business generating the income is

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80 I.R.C. § 511. The UBTI of a qualified employee plan trust would be taxed at the rates applicable to taxable trusts under § 1(e) of the Code. These rates reach a maximum of 70% on taxable income in excess of $106,000.

81 I.R.C. § 512(a)(1).

82 The reason for UBTI was that exempt organizations, especially those founded upon religious beliefs, were becoming more and more active in the secular business world and were competing with taxable entities. Under the 1939 Code, exempt organizations were not required to file information returns, so there was no way to know the full extent of their business activities. The tax exempt entities were buying businesses and paying for them out of untaxed earnings: thus allowing them to outbid taxable entities.

Davis, The UBTI Problems for Qualified Retirement Trusts Investing in Limited Partnerships, 5 J. PENSION, PLAN. & COMPLIANCE 395, 396 (1979) [hereinafter cited as Davis]; see also J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 34.14(a) (1980).

83 [I]n general, any activity of a section 511 organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute "trade or business" within the meaning of section 162 - and which, in addition, is not substantially related to the performance of exempt functions - presents sufficient likelihood of unfair competition to be within the policy of the tax. Accordingly, for purposes of section 513 the term "trade or business" has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services.

Treas. Reg. § 1.513-1(b) (1975) (emphasis added). There is no definition of the term "trade or business" in § 162 of the Code or the regulations thereunder. However, the IRS has stated that a pursuit will be recognized as a trade or business for purposes of § 162 whenever a profit motive is present (even if no income is realized) and "some type of economic activity" is involved. I.R.S. PUB. 334, TAX GUIDE FOR SMALL BUSINESS 3 (1979). However, management of one's own portfolio of stocks and bonds will not constitute a trade or business. Higgins v. Commissioner, 312 U.S. 213, 218 (1940).

UBTI will not be realized unless the activity generating the income is "regularly carried on by" the exempt organization. I.R.C. § 511(a). However, the question of whether the trade or business is regularly carried on by the exempt organization is answered by comparison to the regularity with which such activities are carried on by tax-paying entities. Infrequency of an activity will not in itself lead to avoidance of UBTI if the business activity is characterizedly carried on infrequently, as with the purchase and long term leasing of equipment. Cooper Tire & Rubber Co. Empl. Ret. Fund v. Commissioner, 306 F.2d 20, 21 (6th Cir. 1962); Rev. Rul. 60-206, 1960-1 C.B. 201.


86 City Bank Farmers Trust Co. v. Helvering, 313 U.S. 121, 126 (1941).
substantially related to the exempt organization's purpose, the income is not treated as UBTI. However, even if it can be said that an employee benefit plan trust has as its purpose the holding and accumulation of funds for later payment to participants, that does not mean that a trade or business serves that purpose merely by generating income. Any trade or business regularly carried on by such a trust is deemed an unrelated trade or business.

Two important exceptions in section 512(b) modify the general definition of UBTI. Subsection (b)(1) excludes “all dividends, interest, payments with respect to securities loans, and annuities, and all deductions directly connected with such income.” Subsection (b)(5) excludes all gains or losses from the sale, exchange, or other disposition of property other than stock in trade, or inventory or property held primarily for sale to customers in the ordinary course of the trade or business.

2. Application to Commodity Futures

Trading in commodity futures should not create UBTI. Analogy to the treatment of investment in securities by trustees under section 162 should prevent gains from futures trading from being treated as income from a trade or business. Furthermore, futures trading should fall within the section 512(b)(5) exception for gain from the sale of property. In Revenue Ruling 66-47 the IRS held that profits from unexercised call options on stock held by an exempt organization were UBTI. Apparently the IRS overstepped the intended parameters of the term "trade or business" because the holding of this ruling was legislatively overturned.

However, the IRS has not taken a public position on the issue of whether or under what circumstances trading in commodity futures could constitute a trade or business for purposes of Code section 512. The
IRS might take the position that trading futures gives rise to UBTI if a plan is making a significant profit by substantial and active trading on a speculative basis. A plan contemplating such an investment strategy might first consider seeking a private letter ruling from the IRS, particularly if the strategy is to be implemented through a separate commodities fund. Alternatively, consideration might be given to utilization of an intermediary investment vehicle that trades futures contracts.

Even if it is clear that a plan would incur a tax on UBTI as a result of trading commodity futures, this would not automatically mean that the plan should not engage in such trading. The plan would have to determine whether the constructive purposes to be served by such trading outweigh the imposition of such a tax. If the plan is trading in futures for the purpose of hedging an investment, the plan may not expect gains from that trading; in fact, the plan may realize losses on its futures trading.

E. Unrelated Debt-Financed Income

While income, if any, from trading futures should not constitute UBTI under section 513(b) of the Code, some of such income might be taxed as "unrelated debt-financed income" (UDFI). Section 514 of the Code defines UDFI as a percentage of the income of a tax-exempt organization arising out of the use or disposition of "debt-financed property." Debt-

out of trading in organized securities markets generally.

The risk that a plan's investment strategy might be mistakenly characterized as speculation is another reason for documenting a plan's purpose when trading in commodity futures, and for setting forth the plan's objectives and methods. For example, with respect to a participant-directed individual account plan containing a commodity futures fund, it may be advisable to restrict the portion of the participant's account balance which can be placed in the futures fund so that the fund can serve no more than a subordinate role in the overall funding program.

It is possible that the IRS would consider UBTI to be generated by an individual account plan which offers participants an aggressively invested segregated futures fund, since it may be difficult to argue that the operations of the separate commodity futures fund are merely part of an overall integrated investment scheme. This could be viewed as a separately conducted scheme to speculate in commodity futures on a tax-deferred basis.

Currently, investment in a common trust fund should avoid application of the unrelated business tax, regardless of the nature of the trust's underlying income, because the income received by the plan should be considered to be passive income exempted from the UBTI by Code § 512(b)(1). Rev. Rul. 67-301, 1967-2 C.B. 146. See also PLR 7840093, [1978] PRIVATE LETTER RULINGS (P-H) ¶ 2863; PLR 7848051, [1978] PRIVATE LETTER RULINGS (P-H) ¶ 2751. However, consideration must be given to Proposed Treasury Regulation § 1.584-2(c)(3), 45 Fed. Reg. 52,848 (1980), which apparently would have the effect of overturning these rulings.

For an example of the balancing of relative benefit versus relative detriment in the UBTI area, see Davis, supra note 91, at 398-400.

I.R.C. § 514(a). The primary reason for the creation of a tax on UDFI was a belief that some exempt organizations were being used as part of an overall device which abused the tax exempt status of the organizations:

During the past several years a device has been developing which exploits


financed property is "any property which is held to produce income and with respect to which there is an acquisition indebtedness . . . at any time during the taxable year." Acquisition indebtedness means any indebtedness incurred in acquiring or improving property, including indebtedness incurred before, during or after the acquisition or improvement. The percentage of income from debt-financed property which is treated as UDFI corresponds to the percentage that the acquisition indebtedness bears to the adjusted basis of that property. Thus, if an employee benefit plan incurs debt in connection with the acquisition of property, a proportional amount of the income or gain therefrom will be taxed as UDFI.

Gains realized from the buying and selling of securities on margin are treated as UDFI. The IRS first indicated that income from the debt-financed acquisition of securities was UDFI in 1971, and in Elliot Knitwear Profit Sharing Plan v. Commissioner that position recently was upheld. In Elliot Knitwear, a profit-sharing plan purchased securities "on margin," paying only a portion of the purchase price. The plan argued that incurring such debt was inherent to its tax-exempt function, which would have allowed the plan to avoid UDFI treatment under Code section 514(c)(4). The plan also contended that the acquired property was "substantially related" to the performance of its exempt function, which would have allowed the plan to avoid UDFI treatment under Code section 514(b)(1)(A). The Third Circuit affirmed a finding against the plan on both issues.

With respect to the first contention, the plan argued that its exempt purpose was to accumulate income for its employees, and that therefore its exempt purpose included the investment of funds. The Third Circuit held that the fact that the plan was authorized to purchase securities on margin and was granted exempt status by the IRS does not lead to the conclusion that such purchases were inherent to its exempt purpose. The court felt such a conclusion would undermine the statute. The court

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weaknesses in the rules governing exempt organizations. The net effect is the use of the tax exemption to reduce taxes for owners of a business by converting ordinary income to capital gain and eventually to the acquisition of the business by a tax exempt organization entirely out of the earnings of that business. This device was challenged by the Government in the courts but existing law was construed by the Supreme Court to support it. . . .


107 I.R.C. § 514(b).


111 The rest of the purchase price was, in effect, borrowed from the broker. This is what is typically referred to as margin buying in the securities context. Margin buying in a futures context is different. See note 118 supra.

112 Id. at 350.
believed the exempt purpose of a profit-sharing plan is to provide for employee participation in employer profits.\textsuperscript{113} While the court characterized investment of the employer's contributions "for the additional accumulation of income and gains" as a desirable function, the court pointed out that the plan could accomplish this without borrowing. Thus, it was not essential to the existence of such a plan.\textsuperscript{114}

In presenting its second contention, the plan argued that the purpose of a qualified profit-sharing plan includes the accumulation of income and gains through investment in securities.\textsuperscript{115} The Third Circuit held that although it is reasonable to expect that the buying and selling of income-producing property will be a method utilized to increase and accumulate income and gain, this is solely a means of accomplishing the purpose of deferred compensation, not the purpose of the plan itself.\textsuperscript{116} The court said that even if one assumes, for argument, that investment of contributions for accumulation of income is a function of a profit-sharing plan, the acquisition of securities on margin is not necessary for such accumu-

\textsuperscript{113} The Elliott Knitwear court apparently adopted the narrow view that the tax-exempt purpose of a profit sharing plan is limited to the provision of deferred compensation through a participation in employer profits contributed to the plan. With regard to pension plans, the IRS believes the tax-exempt purpose or function to be the receipt of contributions and the use of contributions and increments thereon to provide pension benefits to the employee participants at retirement. Rev. Rul. 74-197, 1974-1 C.B. 143.

\textsuperscript{114} 614 F.2d at 350. The Third Circuit ruled \textit{inter alia}, that defining "inherent" as synonymous with "essential" was not clear error as the plan contended. The court further said that while investment of the fund was probably inherent to its tax-exempt function, debt-financed investment was not. "[The plan] will still function as intended. Certainly a fiduciary would not be surcharged for refraining from engaging in debt-financed market speculation." \textit{Id}. Because the narrow issue before the Third Circuit was whether debt-financed income was inherent or essential to the tax-exempt function, the court's statement that investing for "additional accumulation of income and gains" is not essential and may be dictum.

The Third Circuit's definition of a plan's tax-exempt purpose differs from the view held by Daniel I. Halperin, Deputy Assistant Secretary of the Treasury for Tax Legislation: Generally speaking, exempt organizations are able to earn portfolio income tax free as a by-product of an exemption granted for some other reason. It is not a necessary feature of the exemptions accorded most organizations listed in section 501(c) that the benefit of the exemption extend to portfolio income. On the other hand, exemption is accorded to trusts forming part of qualified retirement plans because the resulting subsidy in the form of tax deferral is the very \textit{raison d'etre} for the exemption of these trusts. We are less troubled by allowing them to maximize the benefits of their exemption through certain kinds of leverage investments.


\textsuperscript{115} 614 F.2d at 349.

\textsuperscript{116} Id. at 350. The Third Circuit stressed that I.R.C. \S 514(b)(1)(A) explicitly states that the statute does not exclude property that is substantially related by virtue of the "need of the organization for income or funds." 611 F.2d at 350.
The concept of margin in the context of the purchasing of securities is different from the concept of margin in the context of commodity futures trading. The commodity futures margin is not a down payment, but is more in the nature of "earnest money"—money put up by the trader to assure his commitment to meet his obligations. Since the contract is an agreement for future performance (i.e., the buyer has no right to delivery until he pays and has no obligation to pay until delivery date), there is no indebtedness. This is distinguishable from buying equity securities on margin. In that case, full consideration is given immediately, in part with funds borrowed from the broker or others, and the securities are delivered at the same time.

However, the IRS inclination to interpret the definition of UBTI expansively has carried over into issues relating to UDFI as well. In a recent Private Letter Ruling, the IRS held, in connection with an employee plan utilizing individual insurance policies, that certain property...
purchased with funds derived from insurance policy loans was debt-financed property that would result in UDFI. In its ruling, the IRS acknowledged the “seemingly well established principle” that life-insurance policy loans do not constitute indebtedness but chose to follow a lesser line of contrary authority.\textsuperscript{121} The IRS stated that:

In enacting Code Section 514, Congress attempted to prevent a tax-exempt organization from using borrowed funds to ultimately receive additional property at no expense to itself, rather than merely trying to find a means of investing its own funds at an adequate rate of return.\textsuperscript{122}

Because trading commodity futures does not involve the use of “borrowed funds,” it is extremely difficult to justify the application of Code section 514 to gains from such trading.\textsuperscript{123} However, Private Letter Ruling 7918095 creates the concern that the IRS might treat some varieties of leveraging as involving indebtedness for purposes of Code section 514 even if there is significant authority in law and logic for the proposition that such leveraging does not involve debt. Moreover, it can be argued that allowing an employee plan to engage in leveraging, that is, to enjoy the market gains and be liable for market losses on the basis of the full market price, without having to expend, initially, the full market price, is not good public policy.\textsuperscript{124} From one point of view, trading commodity futures involves just such leveraging.\textsuperscript{125} It is possible that future legislative or interpretive developments may extend the concept of Code section 514 to investment techniques such as trading futures which do involve lever-

\textsuperscript{121} Id. After having noted the “seemingly well established principle” that life-insurance policy loans do not constitute indebtedness, the Service found that there was “a line of authority” to the opposite effect with regard to interest deductions under § 163 of the Code. This other authority, which is confined to a narrow and unrelated issue, does not appear to be a compelling reason for rejecting the general rule.

\textsuperscript{122} PLR, 7918095 [1979] PRIVATE LETTER RULINGS (P-H) ¶ 3366.

\textsuperscript{123} Obviously, if debt can be found, the logic of Elliot Knitwear, 614 F.2d 347 (3d Cir. 1980) would lead to the characterization of any gains as UDFI. But see \textsuperscript{162} infra.

\textsuperscript{124} Assistant Treasury Secretary Daniel Halperin, in discussing proposed tax legislation that would permit plans to make leveraged real estate investments, stated: [I]t seems to us that legislation of this sort cannot properly be considered without an assessment of the general wisdom of encouraging pension assets to be invested on a leveraged basis in real estate equities. The use of leverage in a real estate investment, while enhancing an investor's ability to benefit from rises in prices for real estate generally, may also entail greater vulnerability to economic fluctuations, a matter of serious concern where the security of assets held to meet pension liabilities is involved.

\textsuperscript{162} Hearings on S. 650 Before the Subcomm. on Taxation and Debt Management Generally of the Senate Comm. on Finance, 96th Cong., 2d Sess. 3 (1980) (testimony of Daniel I. Halperin, Deputy Assistant Secretary of the Treasury for Tax Legislation).

Banking institutions acting as trustees are subject to the fiduciary responsibility provisions of ERISA like any other trustee, so the prudence and trust requirements as well as many of the prohibited transactions problems discussed above will apply to these institutions. However, because ERISA does not preempt other federal laws, or state banking or insurance laws, if a banking institution is a trustee of plan assets which might be invested in commodity futures both federal and state banking laws will have to be considered.

1. Nationally Chartered Banks

The Comptroller of the Currency has the power to authorize and regulate trust activities of national banks. Under regulations of the Comptroller, a national bank acting as a trustee can invest trust funds in any investment allowed by the trust instrument. If the trust instrument does not specify the bank's investment powers, the bank may invest in whatever investments corporate fiduciaries may invest in under local law.

The Comptroller has stated recently that it will look to ERISA rather than local law to determine the appropriateness of "speculative" investments on behalf of trusts containing employee benefit plan funds. Trust
Banking Circular 15, restated on July 13, 1979 and modifying the Comptroller's earlier positions on speculative investments, states that:

Employee benefit accounts which are subject to ERISA are now governed by the rule of prudence established pursuant to that statute. Under the prudence rule the relative riskiness of a specific investment or investment course of action does not render such investment or investment course of action either per se prudent or imprudent. The prudence of each investment decision should be judged with regard to the role that the proposed investment or investment course of action plays within the overall portfolio. The fiduciary must act in a manner consistent with appropriate consideration of the facts and circumstances that the fiduciary knows or should know are relevant, and document that it has done so.131

Although Trust Banking Circular 15 does not deal directly with futures trading, the Comptroller has traditionally treated futures trading as a speculative investment. Thus, it is reasonable to expect that the Comptroller will defer to ERISA with regard to such trading.152

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132 The Comptroller originally took the position that banks acting as trustees were not allowed to engage in "speculative investments", which included commodity futures investments. See Comptroller's Handbook for National Trust Examiners, Opinion 9.4070. In this opinion, the Comptroller took the position that all "speculative" investments were forbidden. This included all investments in commodities and commodity futures. Since that time the Comptroller has taken an increasingly liberal approach with regard to individual and commingled trust accounts. In Opinion 9.4205 the Comptroller stated:

If state law expressly and explicitly authorizes fiduciaries to sell covered options, a national bank located in that state may do so. This would be true even if the governing instrument in question did not contain express authority. In such a case a broad discretionary investment power would be satisfactory.

Id.

In September of 1978, the Comptroller issued a letter to an individual bank allowing that bank to purchase Treasury Bill futures on behalf of a common trust fund as a hedging technique. Deputy Comptroller for Specialized Examinations, Opinion No. 62, [1978-1979 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 85,137. The common trust fund involved in Opinion No. 62 apparently did not contain any employee plan assets, though there is nothing which would indicate that a different result would have been reached if it had contained such assets. That opinion distinguished between futures contracts in financial instruments and futures contracts in more traditional commodities. The Comptroller held that while investments in the latter were still considered improper, investments in certain financial instrument futures could be justified if they served to hedge certain cash market investments in instruments which had traditionally been considered legitimate investments. Id. at 77,138.

Opinion No. 62 drew in part upon the Comptroller's evolving approach to investment in futures by banks acting for their own account, as set forth in Banking Circular 79. Comptroller of the Currency, Banking Circular 79 (Nov. 2, 1976) [current] FED. BANKING L. REP. (CCH) ¶ 96,977 [hereinafter cited as Banking Circular 79]. In Banking Circular 79, the Comptroller took the position that banks could invest for their own account to a very limited extent in financial instrument futures, but that they had to conform to a restrictive set of guidelines, and had to obtain prior approval for such investments from the Comptroller.
While adopting ERISA as the operative law, the Comptroller retains jurisdiction to decide whether a national bank is investing employee benefit plan funds properly. Bank examiners will approve or disapprove of those activities based on the examiner's judgment of whether the activity meets ERISA standards.\textsuperscript{133}

One guide for banks wishing to set up a futures trading program acceptable to bank examiners is Trust Banking Circular 2 which provides a procedure for trading options.\textsuperscript{134} The procedure insures that there is 1) specific authority to trade in options, 2) approval of specific investment schemes, 3) proper record keeping and accounting, and 4) a system of adequate internal safeguards for the operation of the options trading program. Although Trust Banking Circular 2 applies to options rather than futures, it provides a sound, workable example of how a bank trustee, or any trustee, should conduct any kind of money market trading on behalf of an employee benefit plan.

The Comptroller is authorized to give bankers prior approval for programs of futures investing, and it may be advisable to seek such approval. Recently the Comptroller gave specific approval to Harris Trust & Savings to trade in futures for hedging purposes on behalf of employee plan trusts.\textsuperscript{135} While the Harris Bank, as a state-chartered bank, did not need to seek Comptroller approval, it stated that it had done so "as a matter of policy." This is the first instance of explicit Comptroller approval of futures trading on behalf of trusts. The Comptroller may soon issue a revised banking circular dealing with bank trust investment in futures generally.\textsuperscript{136}

2. Federally Chartered Savings Banks and Savings & Loan Institutions

The Depository Institutions Deregulation and Monetary Control Act


\textsuperscript{133} See Comptroller of the Currency, Trust Banking Circular 14 (June 26, 1979).


\textsuperscript{136} While Banking Circular 79, \textit{supra} note 131, does not apply to banks investing as trustees, the news release that accompanied the November 1979 revision stated that the Comptroller "may issue a similar policy statement for bank trust departments . . . at a later time." Comptroller of the Currency, Press Release No. 15 (Nov. 2, 1976) Thus, bank trustees might anticipate that the Comptroller will soon take a position similar to Banking Circular 79 with regard to trust investment in futures. It should also be noted that revised Banking Circular 79 was part of a joint release by the Comptroller, the Federal Home Loan Bank Board and the Federal Deposit Insurance Corporation. Thus, state chartered Member banks and federally insured Non-member banks may receive the same guidance with regard to trust investment in futures that national banks may receive.
of 1980 gives the Federal Home Loan Bank Board (FHLBB) the authority to grant trustee powers to certain federally chartered savings banks and savings & loan institutions. The FHLBB has not yet granted any such power, and analysis of questions relating to the exercise of such powers must obviously await FHLBB action.

3. State Chartered Institutions

ERISA does not preempt state banking laws. State-chartered banks, thrift institutions (including savings banks) and trust companies acting as trustees will have to take into consideration local law requirements regarding proper investments by trustees. Even if state law allows trading in commodity futures by such institutions when they are acting as trustees, Federal Reserve Board, FSLIC and FDIC rules and regulations may have to be reviewed in order to insure that the institutions are acting properly in trading futures. If a state-chartered bank is commingling the assets of trusts in a common trust fund, the bank must comply with rules and regulations of the Comptroller in order for the common trust fund to qualify for tax-exempt status under section 584 of the Code. The Federal Home Loan Bank Board and the Federal Reserve Board may join the Comptroller in ruling

137 Depository Institutions Deregulation and Monetary Control Act of 1980, P.L. 96-221, 94 Stat. 142 (codified at 12 U.S.C. §§ 3501-3524 (Supp. I 1980)). This Act gives the Federal Home Loan Bank Board the power to grant special permission to savings banks and savings and loan institutions to act as trustee, executor, administrator, guardian, or in any other fiduciary capacity in which State banks, trust companies, or other corporations which come into competition with savings banks and savings and loan institutions are permitted to act under the laws of the State in which the association is located. Id. § 403; 12 U.S.C. § 1464(n)(1) (Supp. I 1980).
138 See note 126 supra.
139 As with the Comptroller's regulations regarding national banks, state laws generally allow bank trustees to invest trust assets in accordance with specific instructions in the trust instrument. See Trust Restatement, supra note 42, § 186. In the absence of specific instructions in the trust instrument, state laws either require adherence to a legal list of investments, see, e.g., Ala. Code tit. 19, § 3-120, or a prudent man standard, see, e.g., N.Y. Banking Law § 100-6; N.Y. Est., Powers & Trusts Law § 11-2(a)(1), or a combination of the two, see, e.g., N.J. Rev. Stat. §§ 3A:15-1 to 15-.5, 15-35 to 15-41.
140 State law may not allow an institution to act as a trustee in the first place. All states allow state-chartered commercial banks and trust companies to act as trustees, but authority for savings banks and thrift institutions varies from state to state.
142 I.R.C. § 584(a)(2). If the bank is commingling only the assets of employee plan trusts, and is willing to operate the commingled trust in accordance with the requirements of I.R.C. § 401 relating to qualified employee plans, the commingled trust can enjoy tax-exempt status as a group trust. Rev. Rul. 56-267, 1956-1 C.B. 208. If this is done, the bank can avoid compliance with certain rules and regulations of the Comptroller.
on investment of trust assets in futures.\textsuperscript{143}

E. Pooled Investment Vehicles

Many plans, especially smaller plans, will want to trade commodity futures indirectly through the purchase of interests in pooled investment vehicles (PIVs) which will in turn trade wholly or in part in commodity futures.\textsuperscript{144} A plan which indirectly trades in futures does not need to develop the degree of expertise in these markets needed by direct investors.

The kinds of PIVs presently trading in futures take several forms, although they are primarily limited partnerships. While there are a great number of commodity futures pools in existence, the structuring of pools specifically to accommodate investment by employee benefit plans is only beginning. A plan's choice of a particular PIV or variety of PIVs will depend on several factors, including the ERISA problems raised or solved by that vehicle.

1. Prudence Requirement

Indirect trading may involve different considerations when determining whether the plan meets the prudence requirement. The plan can limit its commitment through indirect trading. Additionally, the plan may be able to rely on the expertise of the pool manager and thus may avoid liability for individual trading decisions.\textsuperscript{145} Hedging is the most easily justifiable use of futures, however, and when a plan trades indirectly it not only has less control over the positions taken by the pool but probably cannot correlate specific positions in the futures market to specific plan assets. The plan cannot identify specific hedges. Therefore, plans which trade futures indirectly may have to justify their investment in a pool as

\textsuperscript{143} See note 135 supra.

\textsuperscript{144} The Commodity Exchange Act provides a measure of protection for investors in commodity future PIVs through the regulation of “commodity pool operators.” Section 2(a)(1) of the Commodity Exchange Act provides as follows:

For the purposes of this Act, the term “commodity pool operator” shall mean any 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.

\textsuperscript{145} See note 39 supra.
prudent speculation in futures. Although any investment which is new or which involves an amount of risk might in isolation be considered imprudent, indirect trading in futures might be justifiable on the basis of its role in relation to the rest of the portfolio in general. However, a plan might not be able to justify as large a commitment of assets as it could if it were trading directly and could identify specific hedges. If a plan cannot identify specific hedges, poor performance by the pool manager will be less tolerable since it cannot be linked to identifiable gains in another portion of the plan's portfolio. Thus, a plan should pay considerable attention to the investment quality of the PIV.

A plan can judge the investment quality of a PIV in part by past performance. However, a plan must also review the experience and integrity of those who will be managing the PIV. The plan must also study all available disclosure documents especially with regard to the trading program to be followed by those managing the PIV's assets, and it must be able later to determine whether that program is being followed. A plan must continue to review periodically the PIV's performance, personnel, and investment program.

2. Trust Considerations

When a plan invests in any PIV, the assets of the PIV may or may not be treated as plan assets. If the plan's interest in a PIV does not result in the underlying assets' being treated as plan assets, ERISA section 403 merely requires that the trustee of the plan retain custody and control of that which represents ownership of or participation in the PIV. If the underlying assets are treated as plan assets, the plan must make a determination as to whether those assets are properly held in trust and whether the person with authority and discretion to manage those assets was appointed in compliance with ERISA section 403.

The purchase of an interest in a PIV that under local law conveys a beneficial ownership in the underlying assets, such as an interest in a trust or a partnership, will probably cause the property held by the PIV to be treated as plan assets under ERISA.146 If an employee plan is to avoid the problems associated with this treatment of the underlying assets, the plan must either purchase an interest in a 1940 Act investment company or a security evidencing an interest in a PIV. This security must be freely transferable, widely held, and properly registered.147 Unfortu-

146 See text accompanying note 55 supra.

147 There are four exceptions to the general rule of the proposed plan asset regulation that a plan asset is any asset in which the plan has a beneficial ownership interest. Only two of the exceptions might apply in the case of a PIV trading in futures. The first exception is provided for investments in registered investment companies. If a plan is investing in a registered investment company which invests part of its assets in commodity futures the plan can consider its investment as an effective shield whereby only the interest in the investment company itself is treatable as a plan asset.

Under § 2550.401b-1(e), if an employee plan purchases an equity security issued by a
nately, most commodity pools do not meet either criterion.

If the underlying assets are treated as plan assets, the PIV must be a trust, or the assets of the PIV must be held in trust.\footnote{148} In either event, the person who manages the underlying assets must be either named in the plan document or in the plan trust instrument or must be appointed by a person who is a named fiduciary of the plan.\footnote{149} For reasons discussed above, an FCM or CTA may have difficulty in assuming formal discretion over commodity futures trading by a PIV in which employee plans invest.\footnote{150}

The requirement that all plan assets be held in trust, including presumably property which is held by a PIV but which fails to meet the subsection (e) criteria for exception from the definition of plan assets in the proposed plan asset regulations, presents special problems. Attention should be focused on the distinction between “holding” and “custody.” A trustee “holds” real property in trust, for example, if it owns the real property, but it need only have custody of that which evidences such ownership interest (i.e., the indicia of ownership). Neither ERISA section 403, the proposed plan asset regulations,\footnote{151} nor the proposed regulations under section 403\footnote{152} specifically address whether custody by the plan’s

pool, the question of whether the underlying assets are plan assets will be answered without regard to whether the plan has a beneficial ownership interest in the underlying assets. Instead, the underlying assets will always be treated as plan assets unless the pool and the security issued by the pool satisfy a strict set of conditions. In the case of a PIV that is created for purposes other than investment in real estate, the security itself must be:

(i) Freely transferable;
(ii) Widely held; and
(iii) Either (A) registered under section 12(b) or 12(g) of the Securities Exchange Act as part of an offering of such securities to the public pursuant to an effective registration statement. . .

Id. There are a few PIVs currently in existence, the shares of which may fit within the above language. It is extremely doubtful, however, that a PIV investing in commodity futures could be designed or operated so as to fit within the exception to the rule of subsection (e) for “operating companies”. If a commodity futures pool could be designed to fit within the exception for operating companies, it might well have serious UBTI consequences for plans investing in the pool. See text accompanying notes 89-105 supra.

\footnote{148} Even if the PIV is or can be a trust, it may be that such trust must be a qualified group trust or common trust fund in order to avoid disqualification of the investing plan for tax purposes. Rev. Rul. 56-267, 1956-1 C.B. 206. If the IRS were to adopt the Department of Labor’s interpretation of plan assets, then it is possible that where the underlying assets of the pool are plan assets those assets must be placed in a trust which complies with the requirements of \$ 401 of the Code, as in the case of a group trust, or \$ 584 of the Code relating to bank common trust funds. Hopefully the IRS would not adopt a rule similar to that promulgated by the Department; employee plans would only be able to trade commodity futures directly or through mutual funds, insurance companies, banks or entities whose securities comply with the widely held securities exception under Proposed Regulation \$ 2250.401b-1(e), 44 Fed. Reg. 50 (1979).

\footnote{149} ERISA \$ 403. See text accompanying notes 65-73 supra.

\footnote{150} See text accompanying notes 85-87 supra.

\footnote{151} See text accompanying note 31 supra.

\footnote{152} See notes 55 & 56 supra.
trustee of the indicia of an ownership interest in a PIV is sufficient to satisfy section 403 in those cases where a) the property managed by the PIV manager is determined to be plan assets, and b) the PIV manager has therefore been formally recognized by the plan as a fiduciary with investment discretion. The Department of Labor has said that the focus of the PIV rules in the proposed plan asset regulation is to determine whether, in substance, the manager of the PIV has been delegated investment discretion. This is certainly a valid regulatory purpose, but it need not lead to the literal conclusion that custody of all property managed by a PIV manager for a plan has to be in the custody of the plan’s trustee.

3. Prohibited Transactions

If the underlying assets of a PIV, such as a commodity pool, are treated as plan assets, a host of potential prohibited transactions will arise whether or not the trust requirement has been satisfied. The operator of the PIV will be managing the underlying assets. If those assets are plan assets, the services provided by the PIV operator will result in treatment of the PIV operator as a disqualified person, and probably as a fiduciary.

Once the PIV operator, or the PIV itself, has become a disqualified person, further transactions between the PIV or the PIV operator and the plan are prohibited. These further transactions include any future sales between the PIV and the plan, the provision of unrelated services in the future between the PIV and the plan, or any transactions which may be collateral to but are separate from the actual sale of the interest in the PIV to the plan.¹⁴

IV. Overview

The fact that investment managers of employee benefit plan funds are only now beginning to explore the utilization of commodity futures is understandable. These managers traditionally have had very conservative opinions as to prudent investment conduct. It was not until after World War II that such fiduciaries committed significant percentages of their portfolios to equity investments. The passage of ERISA in 1974 introduced new uncertainties because it established new specific federal requirements of prudence and diversification as well as a new framework for allocation and delegation of fiduciary responsibility. Before ERISA the pension community also lacked the authority for a more expansive interpretation of prudence. Paradoxically, this authority is now provided by the Department of Labor’s prudence regulation.

However, the timing of the recent interest by plans in futures trading

¹⁴ See note 75 supra.
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has much to do with the markets themselves. The relevance of futures trading to employee plan funds was not readily apparent until the development of financial instrument or interest-rate futures in the mid-to-late 1970s. The commodity futures exchanges and the regulation of the exchanges (as well as those who trade on them) are still in a developing stage. Moreover, psychological factors cannot be totally discounted: the open outcry method of trading, the dramatic amount of leverage employed in trading, the use of the terms “speculation” or “speculator,” and the large percentage of traders who are speculators, are all factors contributing to a wariness which institutional investors often must overcome before deciding to enter the commodity futures markets. Successful commodity futures trading requires considerable sophistication.

Against this background, it should not be surprising that when employee plan fund managers decide to trade commodity futures, they discover that there are unresolved legal questions and some outright legal obstacles. The relevant provisions of ERISA and the Code were not drafted with any thought in mind that plans might wish to trade commodity futures. The legal characterization of futures as other than securities has developed without any thought given to the effects of such characterization on employee plan investments. The IRS and the Department of Labor, in their regulation of employee plans, have not had sufficient occasion to consider commodity futures trading by plans. The result is that the rules which have been developed to regulate employee plans have accidentally created in some cases legal questions and impediments to the trading of futures by plans. In other cases, because of the novelty of futures trading by plans, appropriate interpretations and exceptions have not yet been developed with regard to those rules which concededly should apply to plans trading futures.

The accidentally created legal problems can be resolved through effort and education. If an interested person were to take the initiative, Prohibited Transaction Exemption 79-1 might well be extended by the Department of Labor to cover FCMs, as well as securities brokers. Because margin trading in commodity futures so clearly does not involve the use of debt, the IRS should rule, if requested to do so, that a plan does not realize UDFI from trading futures under the present provisions of Code section 514. Resolution of the more difficult problems, such as CTAs acting as investment managers and margin being held in trust, will require not only education but also deliberation by regulators, and perhaps by Congress.

Whether and under what conditions employee plans can gain access to the futures markets is a question which must turn on whether employee plans should have access to the futures markets. Whether plans should have access to the futures markets must be decided on the basis of public policy. Tax benefits have been granted by statute to many varieties of

185 See † following note 162 infra.
employee plans because it is perceived that they serve an important social end. For the same reason, an elaborate regulatory scheme governing the structure and operation of employee plans has been constructed.

The opinions of the IRS,166 the Third Circuit,167 the Supreme Court,168 and a Deputy Assistant Secretary of the Treasury,169 discussed above, illustrate why employee plans might merit tax benefits and regulatory oversight. While the opinions differ regarding what might be the essential qualities of pension and profit-sharing plans, it is clear that all of these authorities recognize that plans do not exist merely to defer employee compensation. They exist primarily to provide a sharing of profits, a pension, an equity interest in the business concern, or perhaps some form of health, accident or other welfare benefit. Realizing income from the investment of funds set aside to achieve these ends is important and very helpful, and may even be an essential part of funded employee plans. However, it is the eventual benefits which the employees are to receive that are the justification for the special treatment of such plans. The investment of funds is but one means of insuring that the promised benefits will in fact be realized.

Thus unfettered access to the futures market cannot be justified merely because such access affords the opportunity for profit. Access and the ease of access must be determined on the basis of how commodity futures can help funded employee benefit plans provide their respective benefits. There is little doubt that commodity futures trading, in at least some circumstances, is perfectly consistent with the goal of insuring the provision of plan benefits.

At least some hedge transactions, such as those described in the two examples in Section II of this article,160 are logically consistent with even the most conservative views as to the role of investment management in providing employee benefits through a funded plan. In the case of a defined benefit pension plan, for example, an actuary determines the adequacy of the fund to meet promised benefits and then informs the employer approximately how much money must be contributed to the fund to insure that it remains adequate. The amount of the contribution is premised on certain assumptions, including the future investment performance of the trustee or investment manager. By hedging with commodity futures, the plan trustee or investment manager can more easily attain the funding targets that have been set by the actuary and the employer as the trustee invests and reinvests the employer contributions. The net costs to the fund for use of this very helpful tool are the brokerage commissions and the loss of opportunity to profit from unanticipated changes in the market.

166 See note 113 supra.
167 See text accompanying notes 109-117 supra.
168 See text accompanying notes 93 & 94 supra.
169 See text accompanying note 123 supra.
160 See text accompanying notes 13-16 supra.
Because in some circumstances trading commodity futures clearly can help employee benefit plans provide the benefits they have promised, those who regulate such plans ought not to preclude plans from having any access to the futures markets, and they should eliminate any artificial legal impediments to such access. The question is not whether trading commodity futures is appropriate for employee plans, but rather under what circumstances it is appropriate. Thus, for example, the Department of Labor and the IRS should not resolve problems stemming from the ERISA rules governing investment procedures on the basis of whether employee plans generally should or should not engage in futures trading. Such problems must be resolved by addressing on an individual basis each of the policy justifications for such rules. For example, the question of whether margin constitutes a plan asset should be resolved in a fashion which clearly allows plans to trade futures through margin accounts, but which satisfies the statutory policy that plan assets be managed by and held by appropriate fiduciaries.

The much more difficult and perhaps overriding question is when, if ever, it is appropriate to distinguish among the various commodity trading philosophies or strategems which might be employed on behalf of a plan. If such distinctions are appropriate, they can be made in the form of one or more regulations or rules. Alternatively, the formulation of the distinctions may be left to the ongoing process of determining what is and is not prudent investment conduct.

The first part of this overriding question, whether distinctions among trading strategems are appropriate, appears to be, but is not, a simple matter. Speculation in agricultural futures seems to have much less to do with the purposes of employee plans than does hedging Treasury Bills with Treasury Bill futures contracts. However, it can be said that it is impossible to construct a perfect hedge transaction.\textsuperscript{1} Moreover, what constitutes hedging to one observer may be viewed as a variety of speculation by another observer. Even if it were possible in all cases to distinguish hedging from speculation, speculation may be appropriate for some varieties of plans but not for others. A judgment on a particular trading strategy cannot be divorced from the circumstances of the particular plan which is utilizing that strategy. Therefore, to distinguish among the various ways of using commodity futures may in the abstract be appropriate, but as a practical matter it may be very difficult to make such distinctions in a meaningful way.

If it is decided that meaningful distinctions among trading strategems can be made, and that they should be incorporated into one or more regu-

\textsuperscript{1} At any given time, the price of a futures contract may be more or less than the prevailing cash price for the commodity. Over any significant period of time, however, this difference fluctuates for a variety of reasons. Thus it is impossible during the several months involved in any hedge transaction to be certain that the profit or loss on the futures position will exactly offset the loss or profit on the cash position. To this extent it may be argued that no hedge can be known in advance to be “perfect” although it may turn out to be so.
lations or rules, the temptation to create an inflexible de facto legal list of permissible uses should be avoided. Furthermore, for the reasons discussed above, the drafters of such regulations or rules would face difficult questions as to the number and kinds of distinctions that can or should be made.

Allowing the determination of which uses of commodity futures are appropriate to be made solely by reference to the prudence rules is appealing, both because of the difficulties discussed above and because a determination of appropriateness is so similar to a determination of prudence. In this regard, it should be recalled that the Department of Labor prudence regulation is intended as a "safe harbor." The Department of Labor has not precluded the justification of investments or investment techniques on a basis other than that described in the regulation. However, a decision to allow the courts to determine the prudence of particular futures trading programs on a case-by-case basis will leave plans with years of uncertainty as to whether a particular strategy may or may not be legally permissible.

Whether it is the courts, the Congress, or the regulators who are ultimately to determine the extent to which employee plans will be able to utilize the futures markets, the guiding principle must be the best interest of employee plan beneficiaries. It is the view of the authors that the starting point in such an inquiry is the question whether trustees or investment managers should concentrate on maximizing the return on capital or should concentrate on the preservation of capital, realizing of course, that in an inflationary economy the latter can at times depend upon the former. Deputy Assistant Secretary of the Treasury Halperin, as evidenced by the development of his thinking on plan investments between February and September 1980, has tried to utilize such an analytical approach. Unless such an approach is widely adopted, the law governing employee plans and commodity futures will continue to be inconsistent. Plans will be able to utilize commodity futures only with the aid of expert legal advice which enables them to chart a difficult course between two highly particularized bodies of law. Until the legal problems we have described are resolved in a more straightforward fashion, the practical effect will be limited use of the futures markets on the part of employee plans, which is the same as substituting inertia for the reasoned application of social policy.†

† On November 3, 1980, after this article had been sent to the publisher, the IRS released to the public Private Letter Ruling 8044023 concerning the question whether UBTI or UDFI would be realized by employee plans investing in a limited partnership registered as a 1940 Act Investment Company which in turn traded in futures as a general hedge against the fund's portfolio of long-term bonds. The IRS noted that the employee plans, as limited partners, would realize UBTI or UDFI if any income of the partnership was treatable as such. However, the IRS held that the fund's futures trading would not result in UBTI or UDFI.

162 See text accompanying notes 114 & 124 supra.
The IRS reasoned that income from futures trading was income from the sale of property within the meaning of § 512(b)(5) and was therefore not treatable as UBTI. See text accompanying note 98 supra. With regard to UDFI, the IRS stated that the fund, in trading futures, was not purchasing the underlying commodities, since the fund intended to avoid delivery by closing out all positions prior to the delivery month. According to the IRS, the fund would merely be entering into a series of "executory arrangements" which would not involve any acquisition indebtedness.

Private Letter Rulings may not be cited as precedent. I.R.C. § 6110(J)(3). Also, the IRS might not reach the same conclusion it reached in Private Letter Ruling 8044023 under a different set of facts, such as speculation, trading for delivery, direct trading, or trading through non-1940 Act pooled investment vehicles. Nonetheless, the reasoning behind the ruling, that futures trading qualifies for the § 512(b)(5) exception to UBTI treatment and does not involve acquisition indebtedness so long as delivery is avoided, indicates an evolving IRS position in harmony with the arguments set forth above. See text accompanying note 119 supra.
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