MEMO# 15304

October 28, 2002

CFTC PROPOSES AMENDMENT TO RULE 4.5 AND ISSUES RELATED NO-ACTION POSITION

[15304] October 28, 2002 TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 42-02 COMPLIANCE ADVISORY COMMITTEE No. 95-02 SEC RULES COMMITTEE No. 87-02 RE: CFTC PROPOSES AMENDMENT TO RULE 4.5 AND ISSUES RELATED NO-ACTION POSITION The Commodity Futures Trading Commission has proposed an amendment to Rule 4.5, the CFTC rule that provides a conditional exclusion from the definition of "commodity pool operator" ("CPO") to certain regulated entities, including registered investment companies.1 In conjunction with proposing the amendment, the CFTC is providing no-action relief that allows eligible persons, effective immediately, to rely on the new standard it has proposed under the rule, pending final action on the proposal. The proposed amendment and the no-action position are briefly summarized below. Comments on the proposal must be filed with the CFTC by December 12th. If there are issues you would like the Institute to consider addressing in its comment letter, please contact Tami Salmon at (202) 326-5825 or Frances Stadler at (202) 326-5822 by November 11th. Proposed Amendment Rule 4.5 permits investment companies and other specified entities to trade commodity futures and options thereon without having to register with the CFTC as CPOs if they file a notice making certain representations related to their commodity trading activities. The rule currently permits the unlimited use of commodity futures or options contracts by qualifying entities "solely for bona fide hedging purposes" (as defined in CFTC Rule 1.3(z)) and, in addition, allows non-hedge trading of commodity futures and options so long as the aggregate initial margins and premiums required to establish non-hedge positions do not exceed five percent of the liquidation value of the entity's portfolio (the "five percent test"). According to the Proposing Release, concerns recently have been expressed to the CFTC staff about the five percent test because the margin levels for certain stock index futures significantly exceed five percent, and the required margin for security futures products, which 1 Commodity Futures Trading Commission, Exclusion for Certain Otherwise Regulated Persons From the Definition of the Term "Commodity Pool Operator," 67 Fed. Reg. 65743 (October 28, 2002) ("Proposing Release"). A copy of the Proposing Release is attached. 2 are scheduled to begin trading in the near future, will be 20 percent of contract value. Consequently, the five percent test would limit the use of such contracts for non-hedge purposes to a much greater extent than other types of futures contracts with lower margins. To address these concerns, the CFTC is proposing to add a new, alternative test to Rule 4.5 that would allow a qualifying entity to represent that the aggregate notional value of non-hedge commodity interest positions does not exceed the liquidation value of the entity's portfolio.2 For purposes of this test, notional value would be calculated for futures by multiplying, for each futures position, the size of the contract, in contract units, by the

current market price per unit and, for options, by multiplying for each such position the size of the contract, in contract units, by the strike price per unit. The Proposing Release includes two examples to illustrate the different effects of the existing and proposed non-hedging tests with respect to different types of futures contracts. No-Action Position The Proposing Release notes that the proposed amendment would facilitate the use of the commodity interest markets by persons and entities that are "otherwise regulated" and that it may benefit other market participants through increased liquidity. On this basis, the CFTC has determined that, pending action on the proposal, it will not commence any enforcement action for failure to register as a CPO where a qualifying entity is operated in accordance with Rule 4.5 as proposed to be amended. According to the Proposing Release, eligible persons who have claimed relief under Rule 4.5 or who claim such relief in the future do not need to take any additional action beyond making the representations currently required by the rule, including the representation concerning the five percent test. The no-action position will remain in effect until final action is taken on the proposal, at which time compliance with the terms of any amendment to the rule or with the existing five percent test will be required. The Proposing Release states that in the event the CFTC adopts an alternative non-hedge test that differs from its proposal, it will provide sufficient time for affected persons to comply with that test. Frances M. Stadler Deputy Senior Counsel Attachment (in .pdf format) 2 The Proposing Release notes that the proposal would not affect the ability of persons relying on Rule 4.5 to use commodity futures and options for bona fide hedging purposes on an unlimited basis.
