

periodic Account Statements electronically; and (4) harmonize the various signature requirements of Part 4. Each of the proposals is discussed below.

II. Comments on the Prior Rulemaking Activities

A. Comments on the Prior Rule 4.5 Proposal

The Commission received five comment letters in response to the Prior Rule 4.5 Proposal.²⁸ All of the commenters supported the proposed amendment, with various commenters stating that it would provide increased trading flexibility under Rule 4.5 in general and accommodate security futures products in particular. Commenters did, however, request certain clarifications of the terms and application of the non-hedge tests employed in the Prior Rule 4.5 Proposal—e.g., suggesting that “aggregate notional value” be determined on a net basis and that, at all times, qualifying entities should be able to satisfy one test or the other. As is discussed below in this **Federal Register** release, the Commission has taken these requests for clarification into account in both the rules it is proposing and the no-action positions it is maintaining.

B. Comments on the ANPR

The Commission received twenty-three comment letters in response to the ANPR.²⁹ All of these commenters similarly encouraged Commission efforts to expand registration exemptions for CPOs and CTAs. While commenters generally supported both the NFA and MFA Proposals, several specifically urged adoption of the MFA Proposal, stating that it would bring more participants into the commodity interest markets. Additionally, one commenter suggested that the Commission adopt registration exemptions based on the temporary registration no-action relief issued in connection with the ANPR, and several

commenters suggested that the Commission adopt the NFA Proposal, the MFA Proposal and the temporary registration no-action relief. Commenters offered various recommendations as to CPO and CTA registration exemption rules the Commission should adopt in furtherance of the ANPR. In particular, commenters requested clarification of the application of exemptive relief in the fund-of-funds context. The Commission similarly has taken these comments into account in the proposals it is making below.

III. The Proposals

The relief the Commission is proposing today is consistent with the purpose and intent of the CFMA, and with the input the Commission has received in connection with its prior initiatives (i.e., the Prior Rule 4.5 Proposal, the ANPR, and the Roundtable). Accordingly, it is intended to allow greater flexibility and innovation, and to take into account market developments and the current investment environment, by modernizing the requirements for determining who should be excluded from the CPO definition, and who should remain within the CPO and CTA definitions but be exempt from registration. Thus, this relief is intended to encourage and facilitate participation in the commodity interest markets by additional collective investment vehicles and their advisers, with the added benefit to all market participants of increased liquidity.

A. Proposed Amendment to Rule 4.5: Deleting Trading Criteria for Exclusion From the CPO Definition

Currently, Rule 4.5(c)(2)(i) provides that the Notice of Eligibility must contain a representation that the eligible person will operate the qualifying entity such that the entity:

Will use commodity futures or commodity options contracts solely for bona fide hedging purposes within the meaning and intent of [Rule] 1.3(z)(1); *Provided, however*, That in addition, with respect to positions in commodity futures or commodity option contracts which do not come within the meaning and intent of [Rule] 1.3(z)(1), a qualifying entity may represent that the aggregate initial margin and premiums required to establish such positions will not exceed five percent of the liquidation value of the qualifying entity's portfolio, after taking into account unrealized profits and unrealized losses on any such contracts it has entered into; And, *Provided further*, That in the case of an option that is in-the-money at the time of purchase, the in-the-money amount as defined in [Rule] 190.01(x) may be excluded in computing such 5 percent.

This representation has come to be known as the “Five Percent Test.”

Because futures margins have generally been set at levels near or below 5 percent of contract value, the Five Percent Test has permitted the notional value of non-hedging commodity futures and option positions to approximate the liquidation value of an entity's portfolio. Recently, however, eligible persons and qualifying entities have expressed concern to Commission staff over the Five Percent Test, because margin levels for certain stock index futures have come to significantly exceed 5 percent of contract value, thereby limiting the use of such contracts in non-hedging strategies to a much greater extent than other types of contracts with lower margins. They also have expressed concern that a similar constraint could arise with respect to security futures contracts, because the required margin for security futures is 20 percent of contract value.³⁰ In response to these concerns, the Commission proposed to amend Rule 4.5 by adding as an alternative to the Five Percent Test a limitation based on the notional value of non-hedge positions, i.e., that:

the aggregate notional value of [non-hedge commodity interest] positions does not exceed the liquidation value of the qualifying entity's portfolio, after taking into account unrealized profits and unrealized losses on any such contracts it has entered into. For [this purpose], the term “notional value” shall be calculated for each such futures position by multiplying the size of the contract, in contract units, by the current market price per unit and for each such option position by multiplying the size of the contract, in contract units, by the strike price per unit.³¹

However, by this **Federal Register** release and in furtherance of the ANPR, the Commission is proposing to provide an additional exemption from CPO registration relief based *solely* on pool participant sophistication, without any requirement that the pool operator must be subject to another regulatory scheme and without any restriction whatsoever on the purpose or scope of the pool's commodity interest trading.³² Since the eligible persons and qualifying entities of Rule 4.5 are, as stated in the title of the rule, “otherwise regulated,” the Commission believes that, like the unregulated CPOs for whom it is proposing relief below, these persons

²⁸ Letters were submitted by: a registered futures association; an investment company trade association; a bar association; a contract market; and an investment adviser.

One commenter suggested that the Commission adopt specified additional categories of eligible persons and non-pools under Rule 4.5. This suggestion is, however, outside the scope of this proposed rulemaking. The Commission nonetheless intends to consider it in the future.

²⁹ Letters were submitted by: a registered futures association; two futures industry trade associations; four hedge funds and their managers; one exempt CPO; one national securities exchange; two contract markets; seven law firms; two attorneys; two bar associations; and one certified public accounting firm.

³⁰ See CFTC Rule 41.45(b)(1) and Securities and Exchange Commission (SEC) Rule 242.403(b)(1), 67 FR 53146, 53174 and 53179, respectively (Aug. 14, 2002).

³¹ 67 FR 65743, 65746.

³² The Commission is proposing this relief, which is based on the MFA Proposal, in new Rule 4.13(a)(4), discussed below.