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## Revisiting The Inadvertent Investment Company

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# Revisiting The Inadvertent Investment Company

Brian Vito

## Abstract

While the topic of financial regulation has recently experienced a resurgence in interest, one area that historically has received little attention and continues to exist in relative obscurity is the application of the Investment Company Act of 1940 (the “Company Act”) to commodity pools, as opposed to mutual funds, hedge funds and private equity funds. The purpose of this article is to distinguish the boundary between an investment company, as that term is defined in the Company Act, and a commodity pool, as the term is used to refer to an investment pool not within the auspices of the Company Act, not because of an exemption from the definition of investment company, but because it either is fully outside the definition of investment company or satisfies one of the exceptions (as opposed to exemptions) from the definition. An investment pool that trades primarily or exclusively in securities, including many private equity funds, most hedge funds and all mutual funds, is an investment company for purposes of the Company Act and, thus, must comply with the provisions thereof (in the case of a mutual fund) or operate within the scope of an exemption (in the case of a private equity fund or a hedge fund). Commodity pools, which are investment pools that trade primarily or exclusively in commodity contracts (e.g., futures contracts and options on futures contracts), that engage in no trading of securities, except for cash management purposes, are outside the reach of the Company Act and are regulated exclusively by the Commodity Futures Trading Commission, as opposed to being subject to the authority of the Securities and Exchange Commission, except with respect to the public registration of the offering of interests in such pools under the Securities Act of 1933 (if such interests are publicly offered). A commodity pool that trades in securities in addition to commodities contracts may, however, fall within the realm of the Company Act and thus either be subject to the Company Act’s regulations (which, for a variety of reasons, is impossible for a commodity pool) or comply with one of the exemptions from regulation thereunder (which primarily include Section 3(c)(1) and Section 3(c)(7)). These exemptions, however, require the commodity pool to observe certain restrictions, including those on the pool’s marketing activities (such as limiting the number of investors in the pool or limiting the pool’s investors to wealthy individuals and entities), which can make them unattractive to commodity pool operators. Recent financial events have resulted in the proposal of various regulatory reforms, ranging from minor adjustments to the current structure to sweeping overhauls of the financial regulatory regime. However, before considering such proposals for reform, it is important to understand the current financial industry regulations as they now exist. Unfortunately, an important element of the current regulatory structure, namely, the applicability of the Company Act to commodity pools, has garnered little attention and there is little guidance in legislation, regulation or the legal discourse on this. This article focuses specifically on the point

at which a commodity pool engages in the trading of securities such that it is an investment company under the Company Act. In response to this gap in the legal discourse, this article attempts to address this topic, which is particularly important in light of recent market events and proposals for regulatory change, by providing a complete and systematic explication of (i) the definition of an investment company under the Company Act; (ii) the definition of a security under the Company Act (which is necessary to determine whether an investment pool is an investment company under the definition of investment company); and (iii) the applicability of these definitions to the activities of commodity pools.

## REVISITING THE INADVERTENT INVESTMENT COMPANY

*Brian Vito*\*

### ABSTRACT

While the topic of financial regulation has recently experienced a resurgence in interest, one area that historically has received little attention and continues to exist in relative obscurity is the application of the Investment Company Act of 1940 (the “Company Act”) to commodity pools, as opposed to mutual funds, hedge funds and private equity funds. The purpose of this article is to distinguish the boundary between an investment company, as that term is defined in the Company Act, and a commodity pool, as the term is used to refer to an investment pool not within the auspices of the Company Act, not because of an exemption from the definition of investment company, but because it either is fully outside the definition of investment company or satisfies one of the exceptions (as opposed to exemptions) from the definition. An investment pool that trades primarily or exclusively in securities, including many private equity funds, most hedge funds and all mutual funds, is an investment company for purposes of the Company Act and, thus, must comply with the provisions thereof (in the case of a mutual fund) or operate within the scope of an exemption (in the case of a private equity fund or a hedge fund). Commodity pools, which are investment pools that trade primarily or exclusively in commodity contracts (*e.g.*, futures contracts and options on futures contracts), that engage in no trading of securities, except for cash management purposes, are outside the reach of the Company Act and are regulated exclusively by the Commodity Futures Trading Commission, as opposed to being subject to the authority of the Securities and Exchange Commission, except with respect to the public registration of the offering of interests in such pools under the Securities Act of 1933 (if such

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interests are publicly offered). A commodity pool that trades in securities in addition to commodities contracts may, however, fall within the realm of the Company Act and thus either be subject to the Company Act's regulations (which, for a variety of reasons, is impossible for a commodity pool) or comply with one of the exemptions from regulation thereunder (which primarily include Section 3(c)(1) and Section 3(c)(7)). These exemptions, however, require the commodity pool to observe certain restrictions, including those on the pool's marketing activities (such as limiting the number of investors in the pool or limiting the pool's investors to wealthy individuals and entities), which can make them unattractive to commodity pool operators.

Recent financial events have resulted in the proposal of various regulatory reforms, ranging from minor adjustments to the current structure to sweeping overhauls of the financial regulatory regime. However, before considering such proposals for reform, it is important to understand the current financial industry regulations as they now exist. Unfortunately, an important element of the current regulatory structure, namely, the applicability of the Company Act to commodity pools, has garnered little attention and there is little guidance in legislation, regulation or the legal discourse on this. This article focuses specifically on the point at which a commodity pool engages in the trading of securities such that it is an investment company under the Company Act. In response to this gap in the legal discourse, this article attempts to address this topic, which is particularly important in light of recent market events and proposals for regulatory change, by providing a complete and systematic explication of (i) the definition of an investment company under the Company Act; (ii) the definition of a security under the Company Act (which is necessary to determine whether an investment pool is an investment company under the definition of investment company); and (iii) the applicability of these definitions to the activities of commodity pools.

## I. INTRODUCTION

In light of recent financial market events, Congress and regulators including the Securities and Exchange Commission (the "SEC"), Commodity Futures Trading Commission (the "CFTC"), Department of the Treasury and the Federal Reserve have discussed and proposed significant revisions to the regulation of the use of financial derivatives and those that trade these instruments, including investment pools such

as commodity pools. One element of the existing regulatory framework is the Investment Company Act of 1940<sup>1</sup> (the “Company Act”), which proscribes certain activities by investment pools that fall within its scope—including mutual funds—in an effort to limit risk-taking by investment pools offered to the general public. However, a significant gap exists in the securities and commodities-related legal discourse with respect to what constitutes an “investment company” under the Company Act or, in other words, when an investment pool either (i) must comply with the provisions of the Company Act or (ii) utilize an exemption from the definition of “investment company” in order not to comply with the full provisions of the Company Act.

Little analysis exists of the location and application of this dividing line, which is often, in practice, difficult to find; in response, this article attempts to explicate the existing literature, which in many cases consists only of no-action letters issued by the SEC, and apply the extant rules to commodity pools. The question is particularly difficult with respect to commodity pools because, unlike a mutual fund or hedge fund that trades primarily or exclusively in securities (and thus is clearly within the scope of the Company Act, whether regulated as an investment company or operating under an exemption from such regulation), commodity pools that trade no securities are not investment companies. However, somewhere between a pure commodity pool that trades no securities and an investment pool that trades significantly in securities, lies a commodity pool that trades in some securities. This article addresses the question of when such a commodity pool crosses into the realm of the Company Act in an attempt to address the lack of significant existing analysis. Specifically with the renewed interest in regulating investment pools and the financial instruments they trade, this question deserves a full analysis that it has not previously received.

An “inadvertent investment company”<sup>2</sup> is an entity that, while not a mutual fund or similar traditional investment pool, finds itself within the auspices of the Company Act because it either intentionally or unintentionally (i) engages primarily in the business of investing or trading in securities or (ii) engages in the business of investing or trading in securities and owns investment securities having a value exceeding

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1. Investment Company Act of 1940, 15 U.S.C. § 80a-1 to -64.

2. SEC v. Nat’l Presto Indus., Inc., 486 F.3d 305, 312 (7th Cir. 2007).

40% of the value of its total assets.<sup>3</sup> While there are certain statutory exceptions to these two definitions of an investment company—any issuer, for example, that is primarily engaged “in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities” is excluded from the definition of investment company<sup>4</sup>—the boundaries of the Company Act are unclear, particularly with regard to its application to the investment activities of nontraditional investment pools, including commodity pools. Additionally, the definition of “security” for purposes of the Company Act is similarly unclear, and will also be analyzed in this article, as such analysis is essential to any complete discussion of the applicability of the Company Act to an investment pool’s trading activities.

While not a commodity pool, the situation in which the Tonopah Mining Company of Nevada (“Tonopah Mining”) found itself in 1941 prefigures a question confronted by many commodity pool operators—whether the SEC could consider their commodity pools to be investment companies, inadvertent or otherwise, and thus subject to the rules and regulations of the Company Act. Tonopah Mining began its existence in 1901 as a mining business, but by 1941 its assets consisted “in large part of mining securities”<sup>5</sup> and so it filed an application under Section 3(b)(2) of the Company Act with the SEC on December 4, 1941 “for an order or orders adjudging it to be excepted from the provisions of the said Act.”<sup>6</sup> The SEC granted Tonopah Mining a temporary exception from the provisions of the Company Act,<sup>7</sup> which was then extended four times<sup>8</sup> before the SEC held a hearing on the application.<sup>9</sup> The SEC extended the temporary exception twice more<sup>10</sup> before reconvening the hearing<sup>11</sup>

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3. Investment Company Act § 3(a)(1).

4. *Id.* § 3(b).

5. *In re* Tonopah Mining Co., 26 S.E.C. 426, SEC File No. 812-241, 1947 WL 26116, at \*2 (July 21, 1947).

6. Release No. 337, Release No. IC - 337, 1942 WL 34584, SEC File No. 812-241 (April 6, 1942).

7. *Id.*

8. *See id.*; Release No. 444, Release No. IC - 444, 1943 WL 30301, SEC File No. 812-241 (February 2, 1943); Release No. 474, Release No. IC - 474, 1943 WL 30324, SEC File No. 812-241 (March 31, 1943); Release No. 502, Release No. IC - 502, 1943 WL 30347, SEC File No. 812-241 (June 2, 1943).

9. Release No. 514, Release No. IC - 514, 1943 WL 30358, SEC File No. 812-241 (June 24, 1943).

10. *See* Release No. 529, Release No. IC - 529, 1943 WL 30373, SEC File No. 812-241 (July 29, 1943); Release No. 559, Release No. IC - 559, 1943 WL 30403, SEC

and finally issuing a declaratory order, nearly six years after Tonopah Mining had initially filed its application under Section 3(b)(2) for exception from the Company Act.<sup>12</sup> This delay perhaps was a result of, and the order itself exemplifies, the difficulty in determining the application of the Company Act at its boundaries to nontraditional issuers of securities, such as commodity pools.

A commodity pool generally is considered to be an entity managed “for the purpose of trading in any commodity for future delivery,”<sup>13</sup> including options contracts on commodity futures contracts. In other words, a commodity pool is a variation on the investment pool theme, a theme that also includes mutual funds, hedge funds and private equity funds, that specializes in the trading, or trades exclusively, in commodities contracts. Unlike these other forms of investment pools, which are entities organized primarily or exclusively for the trading of securities, and clearly within the scope of the Company Act, commodity pools often do not trade in securities and even less frequently trade in securities as a component of their primary trading strategies (as opposed to using securities for cash management). Those commodity pools that do not trade in securities clearly fall outside the Company Act’s definition of investment company and, therefore outside the scope of the Company Act’s regulatory reach. Some commodity pools, however, either do trade, desire to trade, or may potentially trade in securities (either for cash management purposes or as a component of their trading strategies), potentially subjecting themselves to the regulatory regime of the Company Act. However, at what point a commodity pool’s securities trading-related activity is sufficient to qualify it as an investment company under the Company Act is unclear. The Tonopah Mining order confronts this question and sets out a series of factors to be considered when answering this question. These factors are addressed in Part II of this paper. In addition to the ambiguity surrounding what constitutes a permissible amount of trading in securities for a commodity pool, what financial instruments are considered by the SEC to be securities for purposes of the Company Act remains unclear. It is clear, however, that

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File No. 812-241 (October 1, 1943).

11. Release No. 996, Release No. IC - 996, 1946 WL 24746, SEC File No. 812-241 (December 26, 1946).

12. *In re* Tonopah Mining Co., 26 S.E.C. 426, SEC File No. 812-241, 1947 WL 25615 (July 22, 1947).

13. Commodity Exchange Act, 7 U.S.C. § 1a(5).



there are differences, perhaps significant, between the scope of financial instruments considered to be securities for purposes of the Company Act as opposed to the Securities Act and Exchange Act.

Part II of this paper, as noted, addresses the first of these two fundamental questions (or, in other words, the Tonopah Mining issue)—namely, what level of trading in securities may an entity conduct before it falls within the reach of the Company Act's definition of investment company. The focus of this section is on the application of the Company Act and its definition of investment company to the activities of a commodity pool as that commodity pool's portfolio moves beyond the trading of only commodity futures contracts and options on commodity futures contracts and whether the additional activities place such commodity pool within the definition of investment company under the Company Act. Part III discusses the second of these two fundamental questions by considering what financial instruments are securities for the purpose of determining the level of permissible securities trading-related activity as discussed in Part II. While the status of a financial instrument as a security in many situations under federal securities laws is clear (or at least more clear than such financial instrument's status under the Company Act), there are more than a few ambiguous cases; particularly so in the context of the Company Act because, in part and as will be discussed, Congress has not kept the Company Act's definition of security in line with the definitions contained in the Securities Act and Exchange Act. Specifically, in addition to the uncertainty that surrounds certain financial instruments as to whether they are securities for the purposes of the federal securities laws in general, certain financial instruments that are, for the purposes of the federal securities laws other than the Company Act, established as securities or non-securities by law or regulation, do not have similar confirmations of status under the Company Act.

Part IV suggests potential revisions to the current Company Act regulatory structure that would address the two fundamental issues covered in Parts II and III, in part by (i) defining more specifically the scope of being primarily engaged in the business of trading in securities and (ii) establishing the status of certain financial instruments as securities or non-securities for purposes of the Company Act.

## II. THE APPLICATION OF THE COMPANY ACT TO COMMODITY POOLS

### A. DEFINITION OF INVESTMENT COMPANY

The most visible example of an investment company that is regulated and must be registered as such is the publicly offered mutual fund, which is nothing other than “a pool of assets consisting of securities belonging to the shareholders of the fund.”<sup>14</sup> Falling squarely within the definitions of investment company because they are primarily engaged in the trading of securities and do not qualify for any of the available exceptions or exemptions from such categorization, mutual funds (which are a primary form of “registered investment company” or “RIC”) must register with the SEC under the Company Act as investment companies. They must also abide by the many restrictions on management and investment activities faced by registered investment companies, including substantive corporate governance standards, the requirement of an independent board and regulations on their investment activities and capital structure,<sup>15</sup> and must register the issuance of their securities (the participation interests an investor in such mutual fund purchases) under the Securities Act. In addition to the registration requirements faced by mutual funds under the Company Act and regarding the issuance of their securities under the Securities Act, the investment adviser of a mutual fund must register with the SEC as a registered investment adviser (a “registered investment adviser” or “RIA”) under the Investment Advisers Act of 1940 (the “Advisers Act”).

The Company Act provides three definitions of investment company, two of which may be applicable to an investment pool, a commodity pool or any other issuer of securities.<sup>16</sup> Under Section 3(a)(1)(A) of the Company Act, “any issuer which is or holds itself out

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14. JOHN C. COFFEE, JR. ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 39 (10th ed. 2007); *see Zell v. InterCapital Income Sec., Inc.*, 675 F.2d 1031, 1046 (9th Cir. 1982).

15. COFFEE ET AL., *supra* note 14, at 60.

16. Investment Company Act § 3(a)(1)(A), (C). Investment Company Act § 3(a)(1)(B), which includes “any issuer which is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificates outstanding”, is not applicable to the typical inadvertent investment company situation or commodity pools in general.

as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities”<sup>17</sup> qualifies as an investment company. An entity that falls within the definition of investment company under Section 3(a)(1)(A) will be labeled a “Type A” investment company, meaning one that is “primarily engaged” in the trading of securities. Under Section 3(a)(1)(C) of the Company Act, “any issuer which is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer’s total assets (exclusive of government securities and cash items) on an unconsolidated basis”<sup>18</sup> is also an investment company, and will be labeled a “Type C” investment company, as an entity that (i) engages in the trading of securities and (ii) has a significant investment in investment securities. Unlike a Type A investment company, a Type C investment company need not be primarily engaged in the trading in securities. However, by being primarily engaged in a business other than that of trading in securities, it can avoid falling within the scope of the Type C definition of investment company.

Section 3(b) of the Company Act provides an exception to the broad language of the definition of the Type C investment company by stating that, notwithstanding Section 3(a)(1)(C), “any issuer primarily engaged, directly or through a wholly-owned subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities” is not an investment company.<sup>19</sup> Thus, to expand on the definition of a Type C investment company already given, a Type C investment company is any entity that (i) engages in the trading of securities, (ii) has a significant investment in securities and (iii) is not primarily engaged in a business other than that of trading in securities.

These definitions of both Type A and Type C investment companies, and the exception provided by Section 3(b)(1) immediately raise questions regarding their substance that require an analysis of whether an entity, including a commodity pool, is an investment company of either type. First, both definitions of investment company use the term “security,” which is a defined term under the Company Act.

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17. *Id.* § 3(a)(1)(A).

18. *Id.* § 3(a)(1)(C).

19. *Id.* § 3(b)(1).

The definition of “security,” contained in Section 2(a)(36) is similar to the definition of security given by other federal securities laws, but there are some differences that will be discussed later. Second, the definition of the Type C investment company uses the term “investment securities,” as defined by Section 3(a)(2) of the Company Act. The nature of these two definitions will be the subject of Part III of this paper.

The rest of this Part II addresses the remaining two questions raised by the definitions of both Type A and Type C investment companies and the exception from these definitions of investment company provided by Section 3(b)(1). First, the definition of the Type A investment company and the exception provided in Section 3(b)(1) from the definition of the Type C investment company use the phrase “being ‘primarily engaged’ in the business of trading in securities” or similar language. Second, the definition of the Type C investment company requires an analysis of the meaning of being engaged in the business of trading in securities, rather than being primarily engaged in the business of trading in securities—or, stated differently, where the demarcation between being engaged in the business of trading in securities and being primarily engaged in such business—and being primarily engaged in another business—lies.

The reason for considerable concern as to whether a commodity pool falls within either definition of an investment company, an exception to the definition of an investment company, or an exemption from application of the Company Act stems from the significant consequences faced by an inadvertent investment company. If an inadvertent investment company does not (i) register as an investment company and (ii) comply with the regulations on an investment company’s investment activity, it operates illegally, thereby creating rescission rights for investors, making all of its contracts voidable, and potentially subjecting its operator to criminal penalties.<sup>20</sup> However, it is not feasible for a commodity pool to register as an investment company and comply with the Company Act’s substantive regulation of investment activity. For example, as discussed in the next section, a commodity pool could not comply with the prohibition on investing in senior securities, such as futures contracts, because, for obvious reasons, a commodity pool that cannot trade in futures contracts is not a

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20. *Id.* § 7.

commodity pool.<sup>21</sup> Thus, it is imperative that a commodity pool either maintain its operations outside the reach of the definitions of an investment company, comply with a valid exception from those definitions, or fall under an exemption from the application of the Company Act.

## B. COMMODITY POOLS

A commodity pool is “the commodities industry’s equivalent to the securities industry’s mutual fund.”<sup>22</sup> Generally, it is a limited liability company or a limited partnership that offers limited liability company membership interests or limited partnership interests, respectively, to investors and pools the assets of the investors to invest in commodities futures contracts and options on commodities futures contracts. The entity—the commodity pool itself—is operated by a commodity pool operator<sup>23</sup> (a “CPO”) and managed by a commodity trading advisor<sup>24</sup> (a “CTA”). Often, these two functions are performed by the same entity. The Commodity Exchange Act<sup>25</sup> and the regulations promulgated by the

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21. *Id.* § 18; Dreyfus Strategic Investing & Dreyfus Strategic Income (pub. avail. June 22, 1987) (staff no-action letter response), available at <http://www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm>.

22. James G. Smith, *A Securities Law Primer for Commodity Pool Operators*, 1996 COLUM. BUS. L. REV. 281, 282.

23. *See generally* 7 U.S.C. § 1a(5) (“[A]ny person engaged in a business that 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 or derivatives transaction execution facility, except that the term does not include such persons not within the intent of the definition of the term as the Commission may specify by rule, regulation, or order.”).

24. *See generally* Commodity Exchange Act, 7 U.S.C. § 1a(6)(A) (“[A]ny person who (i) for compensation or profit, engages in the business of advising others, either directly or through publications, writings, or electronic media, as to the value of or the advisability of trading in (I) any contract of sale of a commodity for future delivery made or to be made on or subject to the rules of a contract market or derivatives transaction execution facility; (II) any commodity option authorized under section 6c of this title; or (III) any leverage transaction authorized under section 23 of this title; or (ii) for compensation or profit, and as part of a regular business, issues or promulgates analyses or reports concerning any of the activities referred to in clause (i).”).

25. *Id.* §§ 1-27.

CFTC thereunder regulate the activity of CPOs and CTAs, but do not regulate the activity of a commodity pool itself. Uniquely, while the securities regulatory regime may subject the advisor of an investment pool to the Advisers Act, the commodities legislative and regulatory regime does not seek to regulate the activity of commodity pools themselves. This also distinctly contrasts the securities regulatory regime that seeks to regulate directly the activity of an investment pool through the provisions of the Company Act

Investors in a commodity pool generally provide their capital for investment purposes by purchasing interests in the commodity pool. These interests are securities under the federal securities laws,<sup>26</sup> which subject their public offering to the registration requirements of the Securities Act.<sup>27</sup> Many commodity pools offer their interests privately in reliance on the exemption from registration provided by Section 4(2) of the Securities Act<sup>28</sup> and the nonexclusive safe harbor of Regulation D promulgated thereunder.<sup>29</sup> Commodity pools may, however, offer their interests publicly<sup>30</sup> by registering the issuance under the Securities Act or, while retaining a private offering, for purposes of privately offering interests to more than 499 investors<sup>31</sup> or to obtain certain benefits under the Employee Retirement Income Security Act (otherwise known as “ERISA”),<sup>32</sup> register the interests themselves (as opposed to the registration of the offering under the Securities Act) pursuant to Section

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26. See Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2010); *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

27. Securities Act § 5(a).

28. *Id.* § 4(2).

29. SEC General Rules and Regulations, Regulation D, 17 C.F.R. §§ 230.501-230.508 (2010).

30. See, e.g., Superfund Gold, L.P., Registration Statement (Form S-1) (June 12, 2008), *available at* <http://www.sec.gov/Archives/edgar/data/1433147/000095013708008437/c27204sv1.htm>.

31. Securities Exchange Act of 1934 § 12(g)(1)(B), 15 U.S.C. § 78l (2010).

32. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (1998) (If a pool is unable to comply with the so-called “25% test” (where less than 25% of any class of the pool’s equity interests are owned by “benefit plan investors”) in order to avoid the application of ERISA to the pool and/or the pool’s manager, a pool may register its securities under the Exchange Act § 12(g), which eliminates the need for the manager to consider the percentage of the pool owned by “benefit plan investors.”).

12(g) of the Exchange Act.<sup>33</sup>

Commodity pools differ from hedge funds and private equity funds in that they generally do not need to rely on exemptions from the Company Act because traditional commodity pools do not trade in securities (or do so only on a limited basis for the purpose of cash management rather than as a component of their trading strategies), thus leaving them outside the scope of the definition of either a Type A or Type C investment company. Hedge funds and private equity funds, which generally trade in securities as a primary focus of their investment strategies, often rely on the exemption provided in Section 3(c)(1)<sup>34</sup> of the Company Act, which exempts investment pools that privately offer their securities and have no more than one hundred investors. They may also rely on the exemption provided by Section 3(c)(7)<sup>35</sup> of the Company Act, which exempts commodity pools that privately offer their securities and have only qualified purchasers as investors.

Nevertheless, registered investment companies, including mutual funds, and those investment pools that do fall within the scope of the Company Act but are unable to rely on either Section 3(c)(1) or Section 3(c)(7) of the Company Act (or any of the other available exemptions), must follow the activity regulations prescribed by the Company Act and the regulations promulgated thereunder. As with hedge funds and private equity funds, the restrictions placed on the investment activities of registered investment companies would be onerous to the point of destroying the ability of a commodity pool to function as such. In other words, a commodity pool that registered as an investment company would not be a commodity pool.<sup>36</sup>

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33. Securities Exchange Act § 12(g).

34. Investment Company Act. 15 U.S.C. § 3(c)(1) (“Notwithstanding [the definitions of investment company], none of the following persons is an investment company within the meaning of this title: any issuer whose outstanding securities are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities.”).

35. *Id.* § 3(c)(7)(A) (“Notwithstanding [the definitions of investment company], none of the following persons is an investment company within the meaning of this title: any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities.”).

36. The SEC has, however, recently accepted the registration statements of two commodity pools as registered investment companies, which not only seems contrary to the Company Act, but circumvents the CFTC’s regulatory regime with respect to these

The onerous nature of the activity restrictions stems from the prohibition on non-exempt investment companies from issuing senior securities. The SEC generally views the activity of investing in futures contracts, including commodities futures contracts, as the issuance of senior securities.<sup>37</sup> This stance significantly limits (but does not entirely restrict) the ability of registered investment companies to trade futures contracts and thus would render a commodity pool unable to function as a commodity pool.

Certain commodity pools, however, (i) trade in securities for cash management purposes, (ii) trade in a *de minimis* amount of securities for hedging or diversification purposes or (iii) trade securities as a core element of their trading strategies. While such commodity pools may rely on the exemptions from the Company Act's restrictions provided by Section 3(c)(1) and Section 3(c)(7), many commodity pools instead would prefer to be excluded from the regulation of the Company Act by not falling under the definitions of Type A and Type C investment companies or, if they fall within the definition of Type C investment company, by relying on the exclusion provided by Section 3(b)(1) of the Company Act.

Commodity pools that run any risk of being investment companies prefer to be excluded from the definition of investment company or to rely on the exception provided by Section 3(b)(1) of the Company Act, as opposed to relying on the exemptions of Section 3(c)(1) and Section 3(c)(7) for a variety of reasons. Perhaps the most significant of these reasons is the offering restrictions enforced by the Section 3(c)(1) and 3(c)(7) exemptions.

While most commodity pools are privately offered, those that do not rely on either Section 3(c)(1) or Section 3(c)(7) of the Company Act

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pools, which will be regulated as investment companies rather than commodity pools because registered investment companies are outside the CFTC's regulatory jurisdiction. *See, e.g.*, AQR Funds, Registration Statement (Form N-1A) (Dec. 17, 2008), *available at* <http://www.sec.gov/Archives/edgar/data/1444822/000119312508255181/dn1aa.htm>; The Frontier Fund, Registration Statement (Form S-1) (Feb. 1, 2010), *available at* <http://sec.gov/Archives/edgar/data/1261379/000119312510018523/ds1.htm>.

37. Investment Company Act § 18; Letter from Gerald T. Lins, Attorney, on behalf of Dreyfus Strategic Investing and Dreyfus Strategic Income to Mary Podesta, Chief Counsel, Division of Investment Management, Securities and Exchange Commission (Mar. 20, 1987), *available at* <http://www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm>.



may be publicly offered, provided they comply with the provisions of the Securities Act and the Securities Exchange Act<sup>38</sup> (unlike hedge funds or private equity funds, which may never publicly offer their interests because of their reliance on the Section 3(c)(1) or Section 3(c)(7) exemptions).<sup>39</sup> Such publicly offered commodity pools may solicit potential investors that do not meet any SEC or CFTC-imposed investor qualification standards (there may be some investor standards even for publicly offered commodity pools at the state level). Moreover, their method of solicitation may include advertising in ways that are prohibited by the private offering exemptions from the Securities Act. Privately offered commodity pools rely on the same Regulation D<sup>40</sup> nonexclusive safe harbor under Section 4(2) of the Securities Act<sup>41</sup> to offer their interests privately as do other investment pools. Rule 506 of Regulation D<sup>42</sup> exempts private offerings with up to 35 non-accredited investors and an unlimited amount of accredited investors<sup>43</sup> from the registration requirements of the Securities Act.<sup>44</sup> The Exchange Act, however, limits the sale of unregistered securities to no more than 499 investors, but privately offered commodity pools, unlike hedge funds and private equity funds,<sup>45</sup> may register their interests under the

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38. A commodity pool that is outside the scope of the Investment Company Act, and thus does not need to rely on either the section 3(c)(1) or section 3(c)(7) exemption from the provisions of the Company Act, is subject to no securities law requirement that it be privately offered; such commodity pool may, however, have to be privately offered to ensure compliance on the part of its commodity trading advisor and/or commodity pool operator with certain commodities laws or regulations if such party is relying on certain exemptions from CFTC regulations. *See e.g.*, 17 C.F.R. § 4.7 (2010); 17 C.F.R. § 4.13(a)(4) (2010).

39. Hedge funds and private equity funds, because they fall within the definition of investment company, may not publicly offer their interests (i.e., register the offering of their interests under the Securities Act) without having to register as investment companies, in which case they cease to be hedge funds or private equity funds and become mutual funds, with all the attendant restrictions faced by registered investment companies.

40. SEC General Rules and Regulations, Regulation D, 17 C.F.R. §§ 230.501-230.508 (2010).

41. Securities Act of 1933 § 4(2).

42. SEC General Rules and Regulations, Regulation D, 17 C.F.R. § 230.506 (2010).

*Id.* § 230.501(e)(1)(iv) (2010).

44. *Id.* § 230.506(a) (2010).

45. Hedge funds and private equity funds may register their securities under the Exchange Act, but generally do not do so because of the attendant reporting

Exchange Act and thus privately offer their interests to more than 499 investors.<sup>46</sup>

In summary, commodity pools that are excluded from the definition of investment company may register the issuance of their securities under the Securities Act and thus publicly offer their securities, something investment pools relying on the exemptions provided by Sections 3(c)(1) and 3(c)(7) of the Company Act may not do. Second, in addition to being prohibited from publicly offering their securities without registering as an investment company, investment pools that must rely on Sections 3(c)(1) and 3(c)(7) of the Company Act face restrictions on the number or nature of investors, respectively, that may purchase interests.<sup>47</sup> If an investment pool relies on the exemption provided by Section 3(c)(1) from the definition of investment company, rather than relying on being excluded from the definition of investment company or the exemption provided by Section 3(b)(1), it may have no more than 100 investors, a limit not faced by investment pools not relying on the Section 3(c)(1) exemption.<sup>48</sup> If an investment pool must rely on the exemption provided by Section 3(c)(7) of the Company Act, because it is not excluded from the definition of investment company

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requirements imposed by such registration on the entities (*e.g.*, the requirement that such entities with securities registered under the Exchange Act file Forms 8-K, 10-Q and 10-K) and the reporting requirements imposed on their investors, meaning holders of securities registered under the Exchange Act (*e.g.*, Forms 3, 4 and 5). These requirements are generally of less concern to commodity pools and their investors.

46. 15 U.S.C.A. § 78l(g)(1) (West 2004).

47. Company Act § 3(c)(1) limits its exemption to “[a]ny issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities . . . .” Investment Company Act of 1940, 15 U.S.C. § 80-3(c)(1). The Company Act § 3(c)(7) exemption is limited to “[a]ny issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities.” A qualified purchaser generally is a natural person who owns not less than \$5,000,000 in investments or any other person who in the aggregate owns and invests, on a discretionary basis, not less than \$25,000,000 in investments. Investment Company Act § 2(a)(51).

48. Investment Company Act § 3(c)(1). When not relying on a particular exemption limiting an offering, an issuer may have up to 499 investors before it must register the securities under 15 U.S.C. 78l(g) (and thereafter may have an unlimited number of investors).

and cannot rely on the exclusion or exemption provided by Section 3(b)(1) or Section 3(c)(1), respectively, then it must limit its investors to only qualified purchasers,<sup>49</sup> which is a more limiting requirement than the Regulation D requirement that private offering be generally limited to accredited investors.<sup>50</sup>

While privately offered commodity pools generally rely on the exemption from registration under the Securities Act provided by Regulation D, which limits investors to no more than 35 non-accredited investors and an unlimited number of accredited investors,<sup>51</sup> investment pools relying on the Section 3(c)(7) exemption from the Company Act's requirements are limited to accepting only qualified purchasers as investors.<sup>52</sup> The definition of accredited investor includes any entity with total assets in excess of \$5,000,000, any natural person with net or joint net worth with that natural person's spouse in excess of \$1,000,000, and any natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person's spouse in excess of \$300,000 in each of those years.<sup>53</sup> The definition of qualified purchaser, however, includes all accredited investors, but many (if not most or all) accredited investors are not qualified purchasers.<sup>54</sup> In order to be a qualified purchaser, an investor must be an entity that owns at least \$25,000,000 in investments or a natural person who, individually or with that person's spouse, owns at least \$5,000,000 in investments.<sup>55</sup> Thus, the test for whether an investor is a qualified purchaser not only considers invested assets, rather than net assets, as with the test for accredited investors, but also requires significantly larger amounts invested than the net asset requirements of the accredited investor standard.

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49. Investment Company Act § 3(c)(7).

50. Unlike a qualified purchaser, an accredited investor for purposes of Regulation D is generally a natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds \$1,000,000, or who had an individual income in excess of \$200,000 in each of the two most recent years, or joint income with that person's spouse in excess of \$300,000 in each of those years, and has a reasonable expectation of reaching the same income level in the current year, or any other person with total assets in excess of \$5,000,000. SEC General Rules and Regulations, Regulation D, 17 C.F.R. § 230.501(a) (2010).

51. *Id.* § 230.506(b)(2), 230.501(e)(1)iv).

52. Investment Company Act § 3(c)(7)(A).

53. § 230.501(a).

54. § 230.501(a); Investment Company Act § 2(a)(51).

55. Investment Company Act § 2(a)(51).

Due to the material differences between the accredited investor and qualified purchaser standards, commodity pool operators generally would prefer not to have to rely on the Section 3(c)(7) exemption for two reasons. First, the exemption's qualified purchaser requirement restricts the commodity pool to a smaller portion of the total available investors. Second, the qualified purchaser requirement complicates both solicitation of investors and compliance.

If a commodity pool relies on the Section 3(c)(1) exemption, it would not have to limit itself to only qualified purchasers. However, because the offering would have to be private to comply with Section 3(c)(1), the commodity pool still would have to limit itself to allowing only accredited investors if it utilizes the Regulation D private offering safe harbor. Nevertheless, it is limited to no more than 100 investors.<sup>56</sup>

Commodity pools, if they do not engage in the trading of securities, do not fall within the scope of the Company Act's Type A or Type C definitions of investment company.<sup>57</sup> Even those commodity pools that trade securities generally are not "primarily engaged" in the trading of securities, so they need not overly concern themselves with being considered Type A investment companies. However, the definition of "primarily engaged" is ambiguous, and will be explored in the next section of this paper. On the other hand, commodity pools that trade securities, even relatively small amounts of securities, must concern themselves with being considered Type C investment companies because a Type C investment company need only engage in the trading of securities and have a significant investment in investment securities.<sup>58</sup> A commodity pool that otherwise would qualify as a Type C investment company may rely on the exception provided by Section 3(b)(1) of the Company Act, which excepts from the definition of investment company an entity that, regardless of its level of trading in securities, is primarily engaged in a business other than that of trading in securities. Because of the Section 3(b)(1) exception, an entity's status as a Type C investment company also may involve a determination of whether that entity is "primarily engaged" in trading in securities. The next section of this paper focuses on whether an entity, particularly a commodity pool, is "primarily engaged" in trading in securities or a business other than

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56. *Id.* § 3(c)(1).

57. *Id.* § 3(a)(1)(A), (C).

58. *Id.* § 3(a)(1)(C).

trading in securities.

While a commodity pool that finds itself within the scope of the definition of Type A investment company may rely on the same exemptions from the Company Act's rules and regulations that hedge funds and private equity funds rely upon, namely Sections 3(c)(1) and 3(c)(7) of the Company Act, for the reasons already discussed, commodity pools would prefer to remain outside the scope of the definition of investment company so that they need not comply with the marketing restrictions imposed by those exemptions. Similarly, a commodity pool that falls under the definition of a Type C investment company because it is engaged in trading in securities and has a substantial investment in securities, but that does not primarily engage in a business other than trading in securities (the Section 3(b)(1) exception), may also rely on the Section 3(c)(1) and 3(c)(7) exemptions. However, for the same reasons already noted, such an entity would prefer not to have to do so. Thus, the question remains as to how a commodity pool operator determines that its commodity pool is not primarily engaged in trading in securities.

### C. APPLICATION

#### *1. Engaged and Primarily Engaged*

As discussed, a commodity pool that trades only financial instruments other than securities need not be concerned with the regulations of the Company Act because it is excluded from the definitions of investment company contained therein. However, which financial instruments qualify as securities for purposes of a commodity pool's determination as to whether it trades securities—and thus may fall within the scope of the Company Act's definition of investment company—is a complicated question. Significant variation exists within the financial instrument universe and which financial instruments qualify as securities for Company Act purposes does not necessarily align with status determinations made under the other federal securities laws. Which financial instruments are securities for Company Act purposes is the focus of Part III of this paper. The remainder of Part II discusses the available guidance as to whether a commodity pool primarily engages in trading in securities, a question of primary importance to commodity pools that trade securities.

Commodity pools, whether they trade securities as a part of their

investment strategies or not, often hold certain securities for cash management purposes. Due to the leverage available to traders of commodity futures contracts and options on commodity futures contracts, only a portion of a commodity pool's assets need be utilized in the trading and margining of their portfolio.<sup>59</sup> For cash management purposes, commodity pools often hold U.S. government securities and cash items, which are excluded from the 40% test contained in the definition of a Type C investment company.<sup>60</sup> The exact nature of U.S. government securities and cash items will be discussed in Part III, but it is important to note here that those commodity pools that (i) trade securities only for cash management purposes and (ii) restrict such trading of securities to U.S. government securities and cash items will not find themselves within the definition of a Type C investment company. For that matter, such a commodity pool also would not find itself within the definition of a Type A investment company because a commodity pool trading in only U.S. government securities and cash items for cash management purposes is unlikely to be considered primarily engaged in the trading of securities.<sup>61</sup>

A commodity pool that (i) only trades in securities for cash management purposes but (ii) uses securities other than U.S. government securities runs a significant risk of falling within the definition of a Type C investment company, notwithstanding the Section 3(b)(1) exception. While such a commodity pool may not primarily engage in the trading of securities, and therefore is not a Type A investment company, 40% of such a commodity pool's assets may be held as investment securities. Its total assets may fall within the 40% threshold because of the leverage inherent in the trading of commodity

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59. The purchaser of a futures contract need not pay the value of the futures contract, but only must post a good-faith margin deposit, which provides the purchaser significant leverage (i.e., the ability to purchase a large position for only a fraction of its full value). *See, e.g.*, JOHN C. HULL, *OPTIONS, FUTURES, AND OTHER DERIVATIVES* § 2.4 (7th ed. 2009).

60. Investment Company Act § 3(a)(1)(C). “‘Government security’ means any security issued or guaranteed as to principal or interest by the United States, or by a person controlled or supervised by and acting as an instrumentality of the Government of the United States by the Congress of the United States; or any certificate of deposit for any of the foregoing . . . .” *Id.* § 2(a)(16).

61. Investment Company Act § 3(a)(1)(C) requires that greater than 40% of the value of an entity's total assets be securities, however government securities and cash items are excluded from the calculation.

futures contracts and options on commodity futures contracts and the exclusion of U.S. government securities and cash items from the denominator when making the calculation of the percent of a commodity pool's total assets held as investment securities. The 40% figure is calculated by dividing the value of the commodity pool's investment securities (securities other than U.S. government securities, securities issued by employees' securities companies and securities of majority-owned subsidiaries of the commodity pool that are not registered investment companies or investment companies relying upon Section 3(c)(1) or 3(c)(7) of the Company Act)<sup>62</sup> by the value of the commodity pool's total assets *minus* the value of the commodity pool's U.S. government securities and cash items.<sup>63</sup> While the specific values used in this calculation can vary, and the methods of calculation are the subject of the next section of this paper, a commodity pool significantly increases its risk of having to rely on the Section 3(b)(1) exemption by trading securities other than U.S. government securities for cash management purposes.

The remainder of this section will address the fundamental question of what securities trading activities a commodity pool may engage in without being "primarily engaged" in the trading of securities for purposes of the definition of a Type A investment company, or before it is no longer "primarily engaged" in a business other than that of trading in securities for purposes of the exception provided by Section 3(b)(1) of the Company Act. Because a commodity pool that primarily engages in a business other than trading in securities likely cannot also primarily engage in trading in securities, these are essentially the same question, specifically—to what extent a commodity pool may trade in securities without being "primarily engaged" in the trading of securities.

The opinion of the SEC in the matter of *Tonopah Mining* was the first interpretive guidance as to the "primarily engaged" element of the definitions of investment company under the Company Act.<sup>64</sup> In

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62. "As used in § 3(a)(1)(C) of the Company Act, 'investment securities' includes all securities except (A) Government securities, (B) securities issued by employees' securities companies, and (C) securities issued by majority-owned subsidiaries of the owner which are not (i) investment companies, and (ii) are not relying on the exception from the definition of investment company in paragraph (1) or (7) of [Section 3(c) of the Company Act]." Investment Company Act § 3(a)(2).

63. *Id.* § 3(a)(1)(A), (C).

64. *In re Tonopah Mining Co.*, 26 S.E.C. 426, SEC File No. 812-241, 1947 WL 26116 (July 21, 1947).

response to Tonopah Mining's application for an order under Section 3(b)(2)<sup>65</sup> of the Company Act "declaring it not to be an investment company within the meaning of the [Company] Act on the ground that it is primarily engaged" in a business other than the trading of securities, the SEC denied the order because the company failed to "establish that it is primarily engaged in a business other than that of investing, reinvesting, owning, holding or trading in securities."<sup>66</sup> The level of Tonopah Mining's trading in securities was not in dispute—over 40% of the company's assets, exclusive of U.S. government securities and cash items, were, at the time, held as investment securities.<sup>67</sup> Its business was originally one of metal mining, thus placing Tonopah Mining squarely within the scope of the definition of a Type C investment company and making it a primary example of the "inadvertent investment company." Rather than relying without further guidance on the Section 3(b)(1) exception for Type C investment companies that are primarily engaged in a business other than that of trading in securities, Tonopah Mining applied to the SEC under Section 3(b)(2) for an order specifically excepting it from the definition of a Type C investment company as being primarily engaged in a business other than that of trading in securities.<sup>68</sup> Such an order also would have excluded Tonopah Mining from the scope of the definition of a Type A investment company because an entity that primarily engages in a business other than that of trading in securities cannot also, at the same time, primarily engage in the trading of securities.<sup>69</sup>

Tonopah Mining was "undoubtedly primarily engaged in the mining business directly and through majority-owned subsidiaries" in the early years of its existence. It "regarded its portfolio of investments as a so-called exploration fund for the purpose of exploring and

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65. "Notwithstanding [Section 3(a)(1)(C)], none of the following persons is an investment company within the meaning of this title: . . . (2) Any issuer which the Commission, upon application by such issuer, finds and by order declares to be primarily engaged in a business other than that of investing, reinvesting, owning, holding, or trading in securities either directly or (A) through majority-owned subsidiaries or (B) through controlled companies conducting similar types of businesses." Investment Company Act § 3(b)(2).

66. *In re Tonopah*, at \*1.

67. *Id.*

68. *In re Tonopah*, 26 at \*1; Investment Company Act of 1940, § 3(b)(2), 15 U.S.C. § 80a-3(b)(2).

69. Investment Company Act § 3(a)(1)(A).



developing mining properties”<sup>70</sup> rather than as an investment fund for investment purposes. By the time Tonopah Mining applied for the order under Section 3(b)(2) of the Company Act, however, the company and its subsidiaries had only one active mining property as part of their overall portfolio of investments.<sup>71</sup> In analyzing the activities of Tonopah Mining and determining whether it was primarily engaged in a business other than trading in securities, the SEC took into consideration the company’s (i) historical development; (ii) representations as to its business; (iii) the activities of its officers and directors; (iv) the nature of its assets; and (v) the sources of its income.<sup>72</sup> These five factors are known collectively as the “Tonopah Factors” and may be expressed more generally as “the company’s history, the way the company represents itself to the investing public today, the activities of its officers and directors, the nature of its assets, and the sources of its income.”<sup>73</sup> In its order, the SEC gave the most weight to the fourth and fifth factors, without necessarily stating that the nature of an entity’s assets and the sources of its income would be dispositive of the line of business (the trading in securities or otherwise) in which it engages.<sup>74</sup>

The SEC has, in the sixty years or so since the *Tonopah Mining* order, continued to look to the Tonopah Factors in no-action letters when asked to provide interpretive guidance as to whether an entity’s activities result in such entity being primarily engaged in the business of trading in securities.<sup>75</sup> The courts, too, have used the Tonopah Factors when faced with this question.<sup>76</sup> In the time since the *Tonopah Mining* order, the SEC has issued some guidance in the form of no-action letters

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70. *In re Tonopah*, 1947 WL, at \*2.

71. *Id.*

72. *Id.* at \*\* 2-6.

73. *SEC v. Nat’l Presto Indus., Inc.*, 486 F.3d 305, 313 (7th Cir. 2007).

74. *Managed Futures Ass’n, SEC No-Action Letter*, Fed. Sec. L. Rep. (CCH) ¶ 77,231, 1996 WL 422672 (July 15, 1996).

75. *See, e.g.*, *Peavey Commodity Futures Fund I, II and III, SEC No-Action Letter*, Fed. Sec. L. Rep. (CCH) ¶ 77, 511, 1983 WL 28438 (June 2, 1983); *Alpha-Delta Fund, SEC No-Action Letter*, Fed. Sec. L. Rep. (CCH) ¶ 80,606, 1976 WL 9134 (May 4, 1976); *Managed Futures Ass’n, SEC No-Action Letter*, Fed. Sec. L. Rep. (CCH) ¶ 77,231, 1996 WL 422672 (July 15, 1996); *Ft. Tryon Futures Fund Ltd. P’ship, SEC No-Action Letter*, Fed. Sec. L. Rep. (CCH) ¶ 79,610, 1990 WL 286989 (Aug. 16, 1990); *E. F. Hutton & Co., Inc., SEC No-Action Letter*, 1983 WL 28486 (July 22, 1983).

76. *See, e.g.*, *Nat’l Presto*, 486 F.3d 305; *SEC v. Fifth Avenue Coach Lines, Inc.*, 435 F.2d 510 (2d Cir. 1970).

regarding the application of the Tonopah Factors to commodity pools specifically, but has not necessarily provided concrete examples of the application of the Tonopah Factors to commodity pools. When reviewing the application of the Tonopah Factors to commodity pools, the SEC has stated that it “would consider of first importance the area of business in which the entity anticipates realization of the greatest gains and exposure to the largest risks of loss,” noting that the composition of a commodity pool’s assets and the sources of its income are “usually regarded as the most telling” as to whether it is primarily engaged in a business other than that of trading in securities.<sup>77</sup> This application of the Tonopah Factors, which considers both a commodity pool’s stated intentions and its actual results, will be referred to as the “Peavey Test” because of its use in the *Peavey Commodity Futures Funds* no-action letters. It reflects the fact that “with respect to a commodity pool, a snapshot picture of its balance sheet contrasting the value of its future contracts (unrealized gain on such contracts) with the value of its other assets” may not necessarily “reveal the primary nature of the business”<sup>78</sup> because a commodity pool’s “reserves and margin deposits, which often are in the form of United States government notes, may not reveal the primary nature of the business.”<sup>79</sup>

In addition to the Peavey Test as an application of the Tonopah Factors, in a subsequent SEC no-action letter interpreting the Tonopah factors, the SEC stated that it has “recognized that a commodity pool’s balance sheet may not necessarily be a useful indicator of the pool’s primary business.”<sup>80</sup> As such, “the most important factor to be considered is the portion of the pool’s business with respect to which it anticipates realization of the greatest gains and exposure to the largest risk of loss.”<sup>81</sup> The SEC, providing slightly more detail, noted that “a commodity pool’s primary business should be deemed to be investing or trading in commodity interests if (1) the pool looks primarily to commodity interests as its principal intended source of gains, (2) the pool anticipates that commodity interests present the primary risk of loss, and (3) the pool’s historical development, public representations of

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77. Peavey, SEC No-Action Letter.

78. *Id.*

79. *Id.*; Currency Fund, SEC No-Action Letter, WSB File No. 092986005, 1986 WL 68339 (May 29, 1986).

80. Managed Futures Ass’n, SEC No-Action Letter.

81. *Id.*

policy (in its prospectus or offering circular and in marketing materials), and the activities of those charged with management of the pool demonstrate that the pool's primary business is investing or trading in commodity interests, rather than securities."<sup>82</sup> Thus, the fact that a commodity pool has more than 40% of its assets held as securities would not necessarily indicate that it primarily engages in the business of investing in securities.<sup>83</sup>

The disconnect between a commodity pool's primary business activity and its balance sheet and assets stems from, as already discussed, the leverage inherent in commodity futures contracts and options on such contracts. Because of such leverage, much of a commodity pool's assets are held as cash or in cash-like securities not for core investment strategy purposes, but for cash management purposes. Despite having stated that it "did not, nor did [it] intend to, imply that the investment of margin deposits in Treasury bills in order to earn income to offset brokerage and other costs will invariably result in investment company status, even if more than 50% of a company's capital is devoted to such use, *provided* it can be demonstrated factually that the primary engagement of such company is in commodities activities,"<sup>84</sup> and that "a company's real intentions may be revealed by its operations and, therefore, its gains *and* losses in futures trading, in comparison to its gains *and* losses on its government securities and other securities would be relevant to a determination of the company's primary business,"<sup>85</sup> the SEC has issued little guidance as to the specific or concrete application of this analysis to entities in general or commodity pools in particular.

So far, the interpretive guidance from the SEC regarding whether a commodity pool is primarily engaged in the business of trading in securities discussed has applied to commodity pools that trade some amount of securities, but has not analyzed any specific amount of securities trading activity. The SEC has issued three additional no-action letters<sup>86</sup> discussing the application of the investment company definitions to commodity pools that provide some additional detail on the meaning of "primarily engaged" for the purpose of the Company

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82. *Id.*

83. Peavey, SEC No-Action Letter.

84. Alpha-Delta, SEC No-Action Letter (emphasis added).

85. Peavey, SEC No-Action Letter.

86. Ft. Tryon Futures Fund, SEC No-Action Letter; Managed Futures Ass'n, SEC No-Action Letter; E. F. Hutton, SEC No-Action Letter.

Act.

In a no-action letter issued to the Ft. Tryon Futures Fund Limited Partnership (“Ft. Tryon”) in 1990, the SEC stated that it would not recommend enforcement action against Ft. Tryon for investing up to 25% of its assets in another commodity pool without registering itself as an investment company and subjecting itself to the Company Act regulations.<sup>87</sup> This no-action letter illuminates a concrete percentage of trading in securities that a commodity pool may engage in without being primarily engaged in the business of trading in securities because limited partnership interests are securities for purposes of federal securities laws, including the Company Act.<sup>88</sup> In reaching its decision, the SEC expressed its reliance on certain representations given by Ft. Tryon in its request for no-action relief, stating that it would not recommend enforcement action under the Company Act against Ft. Tryon.<sup>89</sup> The representations given by Ft. Tryon in its request letter include that: (i) most of its assets would be used for commodities trading and thus exposed to the risks of commodities trading; (ii) the gains and losses from commodities trading were expected to exceed the gain or loss from the investment in the other commodity pools; (iii) the activities of the officers and employees of the commodity pool operator and/or commodity trading advisor were largely related to the commodity trading activities of Ft. Tryon; and (iv) Ft. Tryon’s sources of income were gains realized on the trading of its assets, including those assets used to margin its commodity trading accounts, interests on its assets and any increase in the value of the interests in the other commodity pools.<sup>90</sup> These representations were given by Ft. Tryon in its request for no-action relief in response to the analysis the SEC used in its Peavey Commodity Futures Funds no-action letters, which was based primarily

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87. Ft. Tryon Futures Fund, SEC No-Action Letter.

88. The test of whether an interest is a security “is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others” or, in other words, there must be (i) an investment of money (ii) in a common enterprise with (iii) an expectation of profits to be derived (iv) solely from the efforts of others. *SEC v. W. J. Howey Co.*, 328 U.S. 293, 301 (1946). Each of these four elements has significant jurisprudence behind it, but the details are beyond the scope of this article. For an introduction, see, e.g., THERESA A. GABALON & LARRY D. SONDERQUIST, *SECURITIES LAW, CONCEPTS AND INSIGHTS SERIES* (3rd ed. 2007).

89. Ft. Tryon Futures Fund, SEC No-Action Letter.

90. *Id.*

on the SEC's analysis in its Tonopah Mining order.<sup>91</sup>

Unfortunately, a later SEC no-action letter issued to the Managed Futures Association (the "MFA Letter")<sup>92</sup> has since called into question any clarity provided by the Ft. Tryon letter. While limited partnership interests<sup>93</sup> for federal securities laws<sup>94</sup> are generally regarded clearly as securities, even when the limited partnership interests are issued by an investment pool,<sup>95</sup> in the MFA Letter, the SEC stated that it would not recommend enforcement action under the Company Act against a commodity pool that does not register as an investment company, despite investing more than 40% of its assets in the interests of other commodity pools.<sup>96</sup> The SEC was willing to provide this relief in reliance on the exception provided in Section 3(b)(1) of the Company Act. It based this relief on its determination that such a commodity pool would be primarily engaged not in the business of trading in securities, but in the business of trading in commodity interests, by "look[ing] through' the second-tier pools in which [the commodity pool] has invested and treat[ing] the business activities of each second-tier pool as having been engaged in directly by the commodity pool itself."<sup>97</sup>

While the Ft. Tryon letter stands for the proposition that a commodity pool may invest up to 25% of its assets in securities without being primarily engaged in the business of trading in securities, the MFA Letter stands for the proposition that a commodity pool that invests its assets in other commodity pools may treat its interests in those other commodity pools as commodity interests, rather than securities, by looking through the investee commodity pools to their activities trading in commodity interests. Therefore, the MFA Letter essentially challenges the interpretation that Ft. Tryon was investing in securities and, therefore, permitted commodity pools a 25% allocation to securities without being primarily engaged in the business of trading in securities. The MFA Letter forces consideration of the possibility that the SEC, in the Ft. Tryon letter, may not have viewed the commodity pool interests in which Ft. Tryon invested as securities. Rather, it may

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91. Ft. Tryon Fund, SEC Request Letter (July 2, 1990).

92. Managed Futures Ass'n, SEC No-Action Letter.

93. As well as membership interests in limited liability companies, but not, however, general partnership interests. *Howey*, 328 U.S. at 293.

94. Namely, in addition to the Company Act, the Securities Act and Exchange Act.

95. *Howey*, 328 U.S. at 293.

96. Managed Futures Ass'n, SEC No-Action Letter.

97. *Id.*

have looked through to the activity of the investee commodity pools because the SEC did not explicitly state in the Ft. Tryon letter that it viewed the commodity pool interests as securities. The Ft. Tryon letter may no longer stand (if it ever did) for the position that a commodity pool may invest up to 25% of its assets in securities without being primarily engaged in the business of investing in securities. Rather, it may stand for the proposition that a commodity pool may invest up to 25% of its assets in the interests of another commodity pool without being primarily engaged in the business of investing in securities. If that is the case, then the Ft. Tryon letter provides no independent guidance other than that given by the MFA Letter.

So while the Ft. Tryon letter may provide some comfort (or prior to the MFA Letter may have provided some comfort) that a commodity pool that invests up to 25% of its assets in securities is not primarily engaged in the business of trading in securities, in light of the MFA Letter, a commodity pool operator in analyzing the activity of its commodity pool for purposes of the Company Act's definition of investment company should be cautious of relying too heavily on the Ft. Tryon letter's guidance. Some years prior to the issuance of the Ft. Tryon letter, the SEC responded to a no-action request by E.F. Hutton and Company Inc. ("E.F. Hutton") that proposed to invest up to 33% of a commodity pool's assets in securities.<sup>98</sup> The SEC's response to this inquiry, however, declined to take a no-action position, instead referring E.F. Hutton to the Peavey Commodity Futures Fund no-action letters and the Tonopah Factors. Thus a commodity pool may invest up to 33% of its assets in securities and satisfy the Peavey Test that it is not primarily engaged in the business of trading in securities, but the E.F. Hutton letter itself provides little interpretive guidance.<sup>99</sup>

The available guidance on the acceptable level of securities trading in which a commodity pool may engage in without primarily engaging

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98. E. F. Hutton & Co., Inc., SEC No-Action Letter, 1983 WL 28486 (July 22, 1983).

99. In referring E.F. Hutton to the Peavey Commodity Futures Fund no-action letters, the SEC stated that a commodity pool's "investment in equity securities should be added to whatever other investments in securities other than futures contracts on securities and options on such futures the pool has made or contemplates making, and the income and gains or losses on such investments should be added to the income and gains or losses on the pool's investments in securities other than futures contracts on securities and options on such futures." *Id.*

in the business of trading in securities leaves much to be desired; merely stating that the analysis involves consideration of the composition of a commodity pool's assets and the sources of its income, focusing on "the area of business in which the entity anticipates realization of the greatest gains and exposure to the largest risk of loss,"<sup>100</sup> and less importantly, the activities of its employees, its representations as to its business and its historical development.<sup>101</sup> Thus, the Tonopah Factors together with the Peavey Test suggest that the inquiry as to whether a commodity pool is primarily engaged in the business of trading in securities is one that requires a fact-intensive analysis of a variety of elements specific to an individual commodity pool. Yet, available guidance does not provide specific details as to how a commodity pool operator should apply the Tonopah Factors or the Peavey Test. Specifically, there are two primary elements of the application of the Tonopah Factors and the Peavey Test: (i) the method for determining the composition of a commodity pool's assets and the sources of its income (and the actual determination according to such method); and (ii) the amount of a commodity pool's assets that may be allocated to securities before such commodity pool loses its ability to rely on the Section 3(b)(1) exemption that it is not primarily engaged in the business of trading in securities.<sup>102</sup> The Ft. Tryon and E.F. Hutton letters may clarify item (ii) of the inquiry,<sup>103</sup> but neither provides much comfort. Item (i) is the subject of the next section of this paper.

A commodity pool that trades in securities must consider the inadvertent investment company fate of Tonopah Mining. Any commodity pool that trades in securities—more specifically, engages or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities<sup>104</sup>—and has 40% or more of its assets held as investment securities (other than U.S. government securities and cash items), may fall within the definition of a Type C investment company. While such a commodity pool may rely on the exemptions provided by Section 3(c)(1) and 3(c)(7) of the Company Act, relying on

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100. Peavey Commodity Futures Fund I, II and III, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 77, 511, 1983 WL 28438 (June 2, 1983).

101. *In re* Tonopah, 26 S.E.C. 426, SEC File No. 812-241, 1947 WL 26116 (July 21, 1947); Peavey, SEC No-Action Letter.

102. *In re* Tonopah, 26 S.E.C. 426; Peavey, SEC No-Action Letter.

103. Ft. Tryon Futures Fund, SEC No-Action Letter; E. F. Hutton, SEC No-Action Letter.

104. Investment Company Act of 1940, § 3(a)(1)(C), 15 U.S.C. § 80a-3(a)(1)(C).

the exception provided by Section 3(b)(1) is preferable for a variety of reasons. Under the Section 3(b)(1) exception, such commodity pool must primarily engage in a business other than that of trading in securities.

Determining whether a commodity pool that trades in securities primarily engages in a business other than trading in securities requires the uncertain application of the Tonopah Factors and the Peavey Test. Unfortunately, ambiguity surrounds both the method for calculating a commodity pool's securities-related activity and the amount of securities-related activity permissible before a commodity pool loses its ability to rely on the Section 3(b)(1) exception. Making the analysis even more complex, the 40% test for purposes of Section 3(a)(1)(C) of the Company Act is distinct from the test for whether the amount of a commodity pool's assets held as securities precludes reliance on the Section 3(b)(1) exception; it is possible for a commodity pool to fail the 40% test (*i.e.*, have more than 40% of its total assets, exclusive of U.S. government securities and cash items, held as investment securities) but by the Tonopah Factors and the Peavey Test, not be primarily engaged in the business of trading in securities. Also, the specific percentages given in the Ft. Tryon and E.F. Hutton letters have more applicability to the determination of whether a commodity pool falls within the definition of a Type A investment company because a commodity pool that fails the 40% test is unlikely to meet the percentages given by these two letters. It remains unclear, however, what, if any, current guidance these two letters provide as to what level of activity constitutes primary engagement in the business of trading in securities.

While the SEC has stated that it considers the composition of a commodity pool's assets and the sources of its income of primary importance, that is not to say such considerations are dispositive.<sup>105</sup> The SEC may consider all of the Tonopah Factors when determining whether a commodity pool primarily engages in the business of trading in securities.<sup>106</sup> The SEC may consider whether, for example, the employees of a commodity pool's commodity pool operator spend a disproportionate amount of time analyzing or trading in securities, negotiating securities trading arrangements or over the counter securities products or designing systems related to the trading of securities, even if

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105. Peavey, SEC No-Action Letter.

106. *Id.*



the trading of securities represents a small amount of the commodity pool's activities. Also, the SEC may consider whether a commodity pool operator represents a commodity pool to potential investors as a securities-related investment by looking at marketing materials and annual reports. Finally, the SEC may consider whether a commodity pool has historically acted as a commodity pool or as another form of investment pool (or, as with Tonopah Mining, an entirely different type of entity).

Ultimately, perhaps the best guidance available to a commodity pool operator when trying to interpret the applicability of the Company Act to a commodity pool is that the term "primarily engaged" must be used in a reasonable manner. When considering the Tonopah Factors and the Peavey Test, any result that strains the reading of "primarily engaged" to the point of making the term "primarily" lose any semblance of meaning (and thus cease to differentiate "engaged" from "primarily engaged") is likely incorrect. Section 3(a)(1)(C) of the Company Act uses the term "engaged" while Sections 3(a)(1)(A) and 3(b)(1) use the term "primarily engaged"; it would be nonsensical for these terms to be synonymous, thus requiring some added level of activity to differentiate "primarily engaged" from "engaged."

"Primarily" generally means "mostly," or at least more than a *de minimis* amount. As such, if 10%, or up to 20%, of a commodity pool's assets are allocated to trading in securities, it is unlikely that this activity would qualify as a primary engagement in the business of trading in securities. However, the SEC has not, through any interpretive guidance other than that contained in the Ft. Tryon and E.F. Hutton letters, stated that this amount of trading in securities or any other amount of trading in securities is clearly not within the scope of the term "primarily engaged."

## 2. *Calculating Assets and Sources of Income*

The SEC has stated that it considers the composition of a commodity pool's assets and the sources of its income, focusing on "the area of business in which the entity anticipates realization of the greatest gains and exposure to the largest risk of loss" to be of primary importance.<sup>107</sup> However, it has not discussed how to calculate either the composition of a commodity pool's assets or the primary sources of its

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107. *Id.*

income. With regard to the determination of the composition of a commodity pool's assets, interests in commodity futures contracts and options on commodity futures contracts tend to present more difficult valuation questions than securities. Derivatives are financial instruments that derive their value from other underlying financial instruments<sup>108</sup> and include futures contracts and options on futures contracts.<sup>109</sup> They not only have more complicated valuation procedures,<sup>110</sup> but because of the embedded leverage involved in these instruments they have three different measures of value—the amount margined for the positions, the notional principal amount (or notional value) of the positions and the fair market value of the positions. Margin requirements are a small portion of the notional value and generally range from approximately 5% to 15% of the notional value of these contracts, allowing a commodity pool to command significant positions in commodity futures contracts and options on commodity futures contracts on commodities markets<sup>111</sup> without significant capital outlays. As a result, the balance sheet of commodity pools, when looked at from a capital allocation perspective, are often highly skewed toward securities ownership because the capital not used for margining commodities positions (which may make up a large portion of the commodity pool's total assets) is frequently held in cash-like securities for cash management purposes.

When calculating the composition of a commodity pool's assets, the balance sheet snapshot approach would overemphasize the commodity pool's allocation to securities, but using the notional principal amounts of commodities contracts would likely overstate the

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108. COFFEE ET AL., *supra* note 14, at 334.

109. Futures contracts, which are standardized, exchange-traded forward contracts, derive their values from the values of the underlying assets, and options on futures contracts derive their values from the values of the underlying futures contracts, among other considerations. *See, e.g.*, Hull, *supra* note 61, ch. 1.

110. Options valuation involves a variety of components, and a number of differing valuation methods have emerged in addition to the original Black-Scholes model. *See, e.g.*, FRANCESCA TAYLOR, *MASTERING DERIVATIVES MARKETS* (3d ed. 2007); *see also* HULL, *supra* note 61, ch. 1.

111. For example, the designated contract markets ("DCMs") Chicago Mercantile Exchange ("CME"), Chicago Board of Trade ("CBOT"), New York Mercantile Exchange ("NYMEX"), Commodity Exchange ("COMEX") and ICE Futures US (formerly New York Board of Trade, or "NYBOT").

value of those interests.<sup>112</sup> The SEC has provided no guidance on the method for calculating the composition of a commodity pool's assets—in other words, whether such calculation should be determined using values on a gross or net basis—nor has it provided guidance for the methods to be used for calculating the value of individual assets.<sup>113</sup> The other of the two most important Tonopah Factors is the sources of a commodity pool's income that present the greatest possibility for gain and exposure to the largest risk of loss. Ambiguity exists here too, as with the valuation of a commodity pool's assets. There are various ways in which to calculate a commodity pool's risk of loss, each of which could lead to a differing result as to which investments present a commodity pool with the greatest risk of loss.<sup>114</sup> Similarly, there are various ways to calculate the potential for gain—and a commodity pool's expectation may not match reality.

The Tonopah Factors and the Peavey Test, while providing general guidance for commodity pool operators, lack concrete guidance as to their application to specific commodity pools. In addition, it is possible for a commodity pool, under the Tonopah Factors and the Peavey Test, to look, *ex ante*, like it primarily engages in a business other than that of trading in securities, yet *ex post*, derives significant profits from the trading of securities, even if such a scenario may be unlikely or highly unlikely given the commodity pool's trading strategy and asset allocation (*e.g.*, by suffering large losses on its commodities positions while experiencing large gains on its cash management securities positions). In addition to the uncertainty regarding what constitutes being primarily engaged in the business of trading in securities, uncertainty exists as to which financial instruments are considered to be securities for the purpose of the Company Act. Part III of this paper addresses this inquiry.

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112. The Bank for International Settlements estimates the outstanding notional value of over-the-counter derivatives contracts at \$604 trillion as of June 2009, compared to a gross market value of \$25 trillion as of the same date. Bank of International Settlements, Monetary and Economic Dept., (Nov. 2009), *OTC Derivatives Market Activity in the First Half of 2009*, available at [http://www.bis.org/publ/otc\\_hy0911.pdf?noframes=1](http://www.bis.org/publ/otc_hy0911.pdf?noframes=1).

113. Options on futures contracts, for example, may be valued in a variety of different ways, with the most common being the Black-Scholes method; nonetheless, there are alternative valuation models. *See, e.g.*, TAYLOR, *supra* note 113, at 52.

114. For example, Value at Risk ("VaR") is a common method of estimating the risk of loss, but there are other possible measures, including Expected Shortfall; *see, e.g.*, HULL, *supra* note 61, ch. 20.

### III. DEFINING “SECURITY” FOR COMPANY ACT PURPOSES

#### A. “SECURITY” IN GENERAL

Both the Securities Act<sup>115</sup> and the Exchange Act<sup>116</sup> define “security.” Although the definitions are functionally identical in many ways, there are a few differences. The most significant difference is the Exchange Act’s exclusion from its definition of security of “currency or any note, draft, bill of exchange, or banker’s acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.”<sup>117</sup> Both definitions begin with a list of specific

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<sup>115</sup> Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2010) (“The term ‘security’ means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a ‘security’, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.”).

<sup>116</sup> Commodity Exchange Act § 3(a)(10). (“The term ‘security’ means any note, stock, treasury stock, security future, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a ‘security’; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker’s acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.”).

<sup>117</sup> *Id.* The following is a full comparison showing the differences from the Securities Act definition to the Exchange Act definition (underlined text is added in the Exchange Act; struck-through text is deleted in the Exchange Act): “The term ‘security’

financial instruments and broader terms such as “investment contract” and conclude with a general inclusion of any instrument “commonly known as a ‘security,’”<sup>118</sup> with the intention “to include within the definition the many types of instruments that in our commercial world fall within the ordinary concept of a security.”<sup>119</sup> The primary test for what financial instruments qualify as “investment contracts” was given by the Supreme Court in the 1946 *Howey* decision,<sup>120</sup> which stated that an “investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.”<sup>121</sup>

Analyzing a financial instrument under (i) the specific list of items given in the federal securities laws’ definitions of securities and, if not enumerated therein, (ii) the *Howey* case’s analysis of whether such financial instrument falls within the scope of “investment contract” is the general scheme for determining whether a financial instrument is a security for purposes of the federal securities laws. The definition contained in the Company Act is significantly similar. However, there are important differences in the ultimate result of the application of the various definitions.<sup>122</sup>

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means any note, stock, treasury stock, security future, bond, debenture, ~~evidence of indebtedness~~, certificate of interest or participation in any profit-sharing agreement; or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, ~~fractional undivided interest in oil, gas, or other mineral rights~~, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any ~~interest or~~ instrument commonly known as a ‘security’; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, ~~guarantee of,~~ or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker’s acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.”

118. Securities Act § 2(a)(1); *Id.* § 3(a)(10).

119. H.R. REP. NO. 85, at 11 (1933).

120. SEC v. W.J. Howey Co., 328 U.S. 293, 293 (1946).

121. *Id.*

122. Investment Company Act of 1940, § 2(a)(36), 15 U.S.C. § 80a-2(a)(36). The

## B. "COMMODITY" IN GENERAL

The Commodity Exchange Act defines the term "commodity" and includes "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in."<sup>123</sup> Many financial instruments may be easily classified as either a security or commodity for purposes of these definitions. Many of those classified as securities (*e.g.*, exchange-traded stocks) are rarely traded by commodity pools (which generally trade cash-like securities). However, in determining whether certain financial instruments, often traded by commodity pools, are securities for purposes of the Company Act, the meaning of the term "security future" plays an important role and is included within the scope of each definition of security in the Company Act, Securities Act and Exchange Act and is defined in the Exchange Act.<sup>124</sup>

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following is a full comparison showing the differences from the Securities Act definition to the Company Act definition (underlined text is added in the Company Act): Security "means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security; (including a certificate of deposit-) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a 'security', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing." *Id.*

123. Commodity Exchange Act § 1a(4). "The term 'commodity' means wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, *Solanum tuberosum* (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles, except onions as provided in [Public Law 85-839 (U.S.C. 13-1)], and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in." *Id.*

124. *Id.* § 3(a)(55)(A). "The terms 'security future', 'narrow-based security index', and 'security futures product' have the same meanings as provided in section 3(a)(55) of the Securities Exchange Act of 1934." Securities Act § 2(a)(16). "The term 'security future' means a contract of sale for future delivery of a single security or of a narrow-based security index, including any interest therein or based on the value thereof, except an exempted security under subsection (a)(12) as in effect on [January 11, 1983 (other

A security future is generally a contract of sale for future delivery of a single security or of a narrow-based security index, except an exempted security.<sup>125</sup> Congress established this definition in the Commodity Futures Modernization Act of 2000<sup>126</sup> (the “CFMA”), which legalized futures contracts on single securities and narrow-based stock indices.<sup>127</sup> These financial instruments had, since the so-called Shad-Johnson Accord<sup>128</sup> that was a negotiated jurisdictional compromise between the SEC and the CFTC, been illegal;<sup>129</sup> with the passage of the CFMA, Congress granted joint regulatory jurisdiction to the SEC and the CFTC over security futures.<sup>130</sup> Futures contracts on broad-based securities indices, which are not security futures and thus not securities for federal securities laws purposes, were left solely within the regulatory jurisdiction of the CFTC.<sup>131</sup> Congress added security futures to the definitions of “security” contained in the Securities Act, Exchange Act and Company Act (although the Securities Act and Company Act simply refer to the definition contained in the Exchange Act.)<sup>132</sup>

By redefining certain futures contracts that otherwise would have fallen within the definition of commodity as security futures (and thus securities and within the SEC’s jurisdiction), Congress left the regulation of those contracts (including futures contracts and options on futures contracts on commodities) that fall under the definition of “commodity” and trade on exchanges regulated by the CFTC within the CFTC’s regulatory authority. These financial instruments, which include futures on broad-based stock indices, are not securities for federal securities laws purposes, including the Company Act. As with exchange-traded stocks (clearly securities) and futures on broad-based

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than any municipal security as defined in subsection (a)(29) as in effect on January 11, 1983)]. The term ‘security future’ does not include any agreement, contract, or transaction excluded from the Commodity Exchange Act under section 2(c), 2(d), 2(f), or 2(g) of Title 7 (as in effect on December 21, 2000) or title IV of the Commodity Futures Modernization Act of 2000.” *Id.*

125. *Id.* § 3(a)(55).

126. Pub. L. No. 106-554, 114 Stat. 2763 (2000).

127. COFFEE ET AL., *supra* note 14, at 21-22, 47-50.

128. *Id.*

129. *Id.*

130. *Id.*

131. *Id.*

132. Investment Company Act of 1940, § 2(a)(52), 15 U.S.C. § 80a-2(a)(52). “The terms ‘security future’ and ‘narrow-based security index’ have the same meanings as provided in section 39(a)(55) of the Securities Exchange Act of 1934.” *Id.*

stock indices or commodities (clearly non-securities), many financial instruments are either clearly securities or clearly non-securities for all federal securities laws purposes. However, as will be discussed in the remainder of Part III, there are some differences regarding which financial instruments are considered securities for Company Act purposes and those which are considered securities under the Securities Act and Exchange Act.

### C. “SECURITY” IN THE COMPANY ACT

The definition of “security” contained in the Company Act is substantively similar to that of the Exchange Act and materially identical to that of the Securities Act.<sup>133</sup> The first of the two primary differences between the Company Act’s definition of “security” and that of the Exchange Act is the concept of exempted securities,<sup>134</sup> which under the Exchange Act includes government securities.<sup>135</sup> The Company Act does not qualify its definition of “security” with any financial instruments that are exempt from such definition. As a result, debt instruments, regardless of their issuer, are securities for purposes of the Company Act, whereas under the Exchange Act, debt instruments issued by certain government issuers are considered exempted securities.<sup>136</sup> Debt

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133. *Id.* § 2(a)(36). “‘Security’ means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a ‘security’, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.” *Id.*

134. Exchange Act § 3(a)(12).

135. *Id.* § 3(a)(12)(A)(i).

136. The definition of “exempt securities” exempts “such other securities (which may include, among others, unregistered securities, the market in which is predominantly intrastate) as the Commission may, by such rules and regulations as it deems consistent with the public interest and the protection of investors, either unconditionally or upon specified terms and conditions or for stated periods, exempt from the operation of any one or more provisions of this title which by their terms do



instruments issued by the government of the United States,<sup>137</sup> as well as many other nations,<sup>138</sup> qualify as exempt securities under the Exchange Act, but are securities for purposes of the Company Act. However, the Company Act, which includes “security futures” in its definition of security,<sup>139</sup> takes its definition of security futures from the Exchange Act.<sup>140</sup> This leads to the anomalous, and perhaps unintentional, result that, for Company Act purposes, futures on these debt instruments are not security futures—and thus not securities (unlike the debt instruments themselves).<sup>141</sup> Under the definition of security future in the Exchange Act, which includes futures on single securities, a future on a single debt instrument is a future on a single security (a debt instrument being a security),<sup>142</sup> thus making the future a security future. The Exchange Act, however, exempts these government-issued debt instruments from its definition of security (unlike the Company Act, under which such government-issued debt instruments are securities), so futures on these certain government-issued debt instruments are not futures on a single security, and thus not security futures or securities for Company Act purposes.<sup>143</sup>

The second of the two primary differences between the definitions of “security” contained in the Securities Act and Exchange Act and the Company Act relates to the regulation of swap contracts.<sup>144</sup> In addition to exempting certain securities from the definition of “security” for

not apply to an ‘exempted security’ or to ‘exempted securities.’” *Id.* § 3(a)(12)(A)(vii).

137. Under the Exchange Act, the definition of “exempt securities” exempts “government securities” and the term “government securities” is defined to include “securities which are direct obligations of, or obligations guaranteed as to principal or interest by, the United States.” *Id.* § 3(a)(42)(A).

138. Debt securities issued by the United Kingdom, Canada, Japan, Australia, France, New Zealand, Austria, Denmark, Finland, the Netherlands, Switzerland, Germany, Ireland, Italy, Spain, Mexico, Brazil, Argentina, Venezuela, Belgium, and Sweden are exempt. *See e.g., supra* note 135.

139. Investment Company Act § 2(a)(36).

140. *Id.* § 2(a)(52); Exchange Act § 3(a)(55).

141. The debt instruments themselves would be securities. *Id.* § 2(a)(36); SEC v. W.J. Howey Co., 328 U.S. 293, 297 (1946).

142. Investment Company Act § 2(a)(36).

143. Exchange Act § 3(a)(55); Investment Company Act § 2(a)(52),(36).

144. A swap “is a contract between two parties (usually called the counterparties) under which they agree to exchange a series of cash flows over time.” COFFEE ET AL., *supra* note 14, at 334. A swap may, in some situations, be, in economic function, analyzed as a combination of two forward contracts. *See, e.g., HULL, supra* note 61, ch. 7.

purposes of the Exchange Act (and, by the Company Act's incorporation of the Exchange Act's definition of security future, from qualifying as security futures and thus securities under the Company Act), the Exchange Act also exempts swap contracts from its definition of "security."<sup>145</sup> While the Securities Act does not contain a definition of "exempt securities," it too exempts swap contracts from its definition of security.<sup>146</sup> The CFMA added those exemptions<sup>147</sup> and took "security-based swap agreements" and "non-security based swap agreements" out of the definitions of "security" for purposes of the Securities Act and Exchange Act. The definitions of "security-based swap agreements" and "non-security based swap agreements" together "cover the waterfront and exempt all swap agreements"<sup>148</sup> from being considered "securities" under the Securities Act and Exchange Act. Security-based swap agreements are swap agreements "of which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein,"<sup>149</sup> but unlike security futures, are

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145. Exchange Act § 3A.

146. Securities Act § 2A.

147. Commodity Futures Modernization Act §§ 301-04.

148. COFFEE ET AL., *supra* note 14, at 335.

149. Non-security based swap agreements are "any swap agreement . . . that is not a security-based swap agreement." Gramm-Leach-Bliley Act § 206C (codified as amended at 15 U.S.C. 78c (1934)). A "swap agreement" is "any agreement, contract, or transaction . . . that (1) is a put, call, cap, floor, collar, or similar option of any kind for the purchase or sale of, or based on the value of one or more interest or other rates, currencies, commodities, indices, quantitative measures, or other financial or economic interest or property of any kind; (2) provides for any purchase, sale, payment or delivery (other than a dividend on an equity security) that is dependent on the occurrence, non-occurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence; (3) provides on an executory basis for the exchange, on a fixed or contingent basis, of one or more payments based on the value or level of one or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind, or any interest therein or based on the value thereof, and that transfers, as between the parties to the transaction, in whole or in part, the financial risk associated with a future change in any such value or level without also conveying a current or future direct or indirect ownership interest in an asset (including any enterprise or investment pool) or liability that incorporates the financial risk so transferred, including any such agreement, contract, or transaction commonly known as an interest rate swap, including a rate floor, rate cap, rate collar, cross-currency rate swap, basis swap, currency swap, equity index swap, equity swap, debt index swap, debt swap, credit spread, credit default swap,

not themselves securities under the Securities Act or the Exchange Act.<sup>150</sup> “Security-based swap agreement” status under the Company Act, however, remains unclear because Congress did not similarly amend the Company Act by the CFMA to exempt swap contracts from the definition of “security” contained in the Company Act. The SEC has not provided any guidance as to whether it considers swap contracts to be securities under the Company Act’s definition. However, the fact that Congress added the exclusion of swap contracts from the definitions of securities under the Securities Act and Exchange Act at the same time as it amended the definitions of securities under the Securities Act, Exchange Act *and* Company Act to include security futures,<sup>151</sup> suggests that Congress intended swap contracts to remain (or at least potentially remain, subject to SEC rulemaking) within the definition of “security” for Company Act purposes. A plausible means of analyzing swap contracts for the purpose of the Company Act’s definition of “security” (as opposed to considering all swap contracts to be securities for Company Act purposes) is contained in the next section of this paper.

While the definition of both Type A and Type C investment company use the term “security,” the definition of Type C investment company also uses the terms “government security” and “investment security.”<sup>152</sup> The term “government security” is defined, primarily, as “any security issued or guaranteed as to principal or interest by the United States”<sup>153</sup> and “investment security” is defined as “all securities except (A) Government securities, (B) securities issued by employees’

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credit swap, weather swap, or commodity swap; (4) provides for the purchase or sale, on a fixed or contingent basis, of any commodity, currency, instrument, interest, right, service, good, article, or property of any kind; or (5) is any combination or permutation of, or option on, any agreement, contract, or transaction described in any of paragraphs (1) through (4).” *Id.* § 206A.

150. Exchange Act § 3A. “The definition of ‘security’ in section 2(a)(1) of this title does not include any non-security-based swap agreement [or] any security-based swap agreement.” Securities Act § 2A. “The definition of ‘security’ in section 3(a)(10) of this title does not include any non-security-based swap agreement [or] any security-based swap agreement.” *Id.*

151. The addition of the swap exemptions and the addition of the definitions of security future (and the addition of the term security future to the definitions of security) were all done by Congress simultaneously by way of the CFMA.

*See* Commodity Futures Modernization Act (codified as amended at H.R. 5660 (2000)).

152. Investment Company Act of 1940, § 3(a)(1)(C), 15 U.S.C. 80a-3(a)(1)(C).

153. *Id.* § 2(a)(16).

securities companies, and (C) securities issued by majority-owned subsidiaries of the owner which (i) are not investment companies, and (ii) are not relying on the exemption from the definition of investment company” provided in [Sections 3(c)(1) or 3(c)(7)].<sup>154</sup> The definitions of these two terms both incorporate the definition of security and are necessary for the determination of an investment pool’s status as an investment company; however, they generally present less ambiguity and difficulty than the general definition of security for purposes of the Company Act because the field of potential securities issued by the U.S. government is limited to those financial instruments that generally fall clearly within the scope of securities. When calculating the 40% test, “investment securities” will include those items determined to be “securities” (where the difficulty lies—that is, one must first answer the question whether a financial instrument is a security before one can reach the question whether it is an investment security) except for certain clearly-delineated financial instruments.

#### D. TRADING OF AMBIGUOUS INSTRUMENTS BY COMMODITY POOLS

##### 1. Swap Contracts

Congress, by not exempting swap contracts from the Company Act’s definition of security when it exempted swap contracts from the Securities Act and Exchange Act definitions of security, left significant ambiguity as to whether swap contracts qualify as securities for Company Act purposes. Treating swap contracts as securities for Company Act purposes would result in an odd difference in treatment from their treatment under other federal securities laws. However, it is difficult to imagine Congress not aware of this result when it amended the Securities Act, Exchange Act *and* Company Act by the CFMA. As such, despite the difference in treatment, it seems likely Congress did not want all swap contracts exempted from the definition of security for Company Act purposes (unlike for Securities Act and Exchange Act purposes). This, however, does not necessarily imply that Congress intended for all swap contracts to qualify as securities under the Company Act.

Congress may have intended for swap contracts, under the

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154. *Id.* § 3(a)(2).

Company Act, to be analyzed under the “security future” rubric, meaning treated as if they were futures on underlying instruments rather than swap contracts on underlying instruments. However, if a future on an underlying financial instrument were a security future (and thus a security under the Company Act), a swap contract on such underlying financial instrument would be treated as a security under the Company Act. Thus, while a swap contract on a (i) commodity, (ii) futures contract on a commodity, (iii) futures contract on a commodity-based index or (iv) futures contract on a broad-based securities index (*i.e.*, a non-security) would be a non-security for Company Act purposes, a swap on a (i) single security or (ii) narrow-based securities index would be a security for Company Act purposes. Although this approach tracks the approach Congress took with regard to security futures and may be a valid means of determining whether a swap is a security for Company Act purposes, significant ambiguity remains with respect to the treatment of swap contracts under the Company Act without guidance from either Congress or the SEC.

## 2. Currency Forward Contracts

Congress explicitly excluded currency from the definition of security in the Exchange Act,<sup>155</sup> but did not do so in the definition of security in either the Securities Act<sup>156</sup> or the Company Act.<sup>157</sup> This differing treatment at least leads to some ambiguity as to whether currency is to be considered a security for the purposes of either the Securities Act or the Company Act. Also, while futures on currency are not security futures, including for the Company Act because the Company Act takes its definition of a security future from the Exchange Act, the status of over the counter forward contracts on currencies is at best ambiguous because the SEC has declined to take a position with respect to this type of financial instrument.<sup>158</sup> In the Currency Fund no-action letter, the SEC staff advised that it would not be willing to recommend not taking enforcement action against an investment pool for not registering under the Company Act.<sup>159</sup> The investment pool in

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155. Exchange Act § 3(a)(10).

156. Securities Act of 1933, § 2(a)(1), 15 U.S.C. § 77b(a)(1).

157. Company Act § 2(a)(36).

158. Currency Fund, SEC No-Action Letter, WSB File No. 092986005, 1986 WL 68339 (May 29, 1986).

159. *Id.*

question proposed to invest half of its assets in a subsidiary that would then invest substantially all of its assets in over the counter currency forwards. However, the SEC would not agree that currency forwards were not securities under the Company Act and provided no analysis in declining to issue the no-action relief.<sup>160</sup> Thus, as it is with swap contracts, whether currency forward contracts are securities under the Company Act remains unclear. The commodity pool industry generally treats currency forward contracts as non-securities and futures contracts on currencies are not securities; this may be a reasonable position, but there is no assurance that the SEC will not eventually take a contrary position.

#### IV. REVISING THE CURRENT REGULATORY STRUCTURE

##### A. DEFINING “PRIMARYLY ENGAGED”

Congress or the SEC could provide significant clarity for those entities, including commodity pools, that run a risk of qualifying as an inadvertent investment companies by specifically defining a threshold for “primary engagement” that would clearly delineate the difference between being engaged in the business of trading in securities and being primarily engaged in the business of trading in securities. In addition, Congress or the SEC could further clarify the issue by setting out with specificity the method by which an investment pool’s activity should be quantified and, ultimately, determined as being primarily engaged in the business of trading in securities or not. The Tonopah Factors and Peavey Test notwithstanding, significant ambiguity exists as to where the line between being engaged in the business of trading in securities and being primarily engaged in the business of trading in securities lies. Unfortunately, the Ft. Tryon and E.F. Hutton letters provide little additional guidance on the matter and fail to define for commodity pool operators a specific amount of trading in securities that their commodity

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160. The entire text of the SEC’s response is as follows: “The determinative issue raised by your letter of February 27, 1986, is whether a ‘forward currency contract’ or ‘foreign currency contract’ is a security for purposes of the Investment Company Act of 1940 (‘Act’). On the basis of the facts and representations contained in your letter, we are unable to concur with your view that they are not. Therefore, we are unable to assure you that we would not recommend any enforcement action to the Commission if the Currency Fund proceeds without registering under the Act.” *Id.*

pools may engage in without falling within the definition of Type A investment company. Similarly, none of the Tonopah Factors, Peavey Test or the Ft. Tryon or E.F. Hutton letters shed significant light on when a commodity pool can rely on the Section 3(b)(1) exception—that is, the exception for entities that are primarily engaged in a business other than that of trading in securities—or provide a framework that commodity pool operators may readily apply.

This paper proposes a non-exclusive safe harbor approach to the clarification of being “primarily engaged” in the business of trading in securities for purposes of the Company Act. Much as Regulation D provides a non-exclusive safe harbor for private offerings under Section 4(2) of the Securities Act, the SEC could adopt regulations detailing a method by which commodity pools could ensure their being primarily engaged in a business other than that of trading in securities, and by doing so, would not fall under the Type A definition or Type C definition of investment company. The non-exclusivity of the proposed safe harbor would guarantee that a commodity pool that is unable to comply with the provisions therein could rely on a Tonopah Factors or Peavey Test analysis to conclude that it is not primarily engaged in the business of trading in securities, just as an issuer that is unable to, or accidentally does not, comply with, the rules of Regulation D may rely on the general exemption of “transactions by an issuer not involving any public offering” contained in the Securities Act itself.<sup>161</sup> The SEC has, in fact, already taken a similar approach with respect to the Type C definition of investment company.<sup>162</sup> Company Act Rule 3a-1 (“Certain *Prima Facie* Investment Companies”) exempts certain entities, notwithstanding the definition of investment company contained in Section 3(a)(1)(C) of the Company Act, from the Type C definition of investment company—specifically, those entities that hold no more than 45% of their assets (exclusive of U.S. government securities and cash items) as securities and derive no more than 45% of their net income from securities.<sup>163</sup> Thus, a commodity pool that engages in securities

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161. Securities Act § 4(2).

162. Company Act Rule 3a-1, 17 C.F.R. § 270.3a-1.

163. *Id.*: “Notwithstanding section 3(a)(1)(C) of the Act, an issuer will be deemed not to be an investment company under the Act; Provided, That: (a) No more than 45 percent of the value (as defined in section 2(a)(41) of the Act) of such issuer’s total assets (exclusive of Government securities and cash items) consists of, and no more than 45 percent of such issuer’s net income after taxes (for the last four fiscal quarters combined) is derived from, securities other than: (1) Government securities; (2)

trading, but holds less than or equal to 45% of its assets as securities and derives less than or equal to 45% of its net income from these securities, despite holding more than 40% of its assets as securities, will not be considered a Type C investment company.<sup>164</sup> This Rule 3a-1, however, does not address what it means to be primarily engaged in the trading of securities for the purpose of the Type A definition of investment company and states that a qualification for an entity's reliance on its exemption is that the entity not otherwise be an investment company (*i.e.*, be "primarily engaged" in the business of trading in securities).<sup>165</sup> Additionally, because of the difficulties in determining the percentage of a commodity pool's assets held as securities and whether it derives less than or equal to 45% of its net income from securities, Rule 3a-1 is not a particularly helpful safe harbor for commodity pools.

Because at the time of the Ft. Tryon letter the SEC presumably seemed comfortable with a commodity pool allocating 25% of its assets to trading in securities, perhaps this should be a starting point for the discussion of a non-exclusive safe-harbor interpretation of "primary engagement" by the SEC. From this starting point, because the SEC declined to take a position in the E.F. Hutton letter, it seems the SEC would, at least in some situations, be comfortable with a finding that a commodity pool investing up to one-third of its assets in securities does not primarily engage in the business of trading in securities. From a general perspective too, a commodity pool that has 33% of its assets invested in securities hardly seems to be "primarily engaged" in the business of trading in securities; once the allocation reaches more than 50%, however, it certainly seems reasonable to interpret that commodity

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Securities issued by employees' securities companies; (3) Securities issued by majority-owned subsidiaries of the issuer (other than subsidiaries relying on the exclusion from the definition of investment company in section 3(b)(3) or section 3(c)(1) of the Act) which are not investment companies; and (4) Securities issued by companies: (i) Which are controlled primarily by such issuer; (ii) Through which such issuer engages in a business other than that of investing, reinvesting, owning, holding or trading in securities; and (iii) Which are not investment companies; (b) The issuer is not an investment company as defined in section 3(a)(1)(A) or 3(a)(1)(B) of the Act and is not a special situation investment company; and (c) The percentages described in paragraph (a) of this section are determined on an unconsolidated basis, except that the issuer shall consolidate its financial statements with the financial statements of any wholly-owned subsidiaries."

164. *Id.*

165. *Id.* § 270.3a-1(b).



pool as being primarily engaged (simply based on the general use of the term “primarily”) in the trading of securities and thus falling within the definition of Type A investment company (and falling within the definition of Type C investment company without being able to rely on the Section 3(b)(1) exemption from the Type C investment company definition because it would likely fail the 40% test contained in the definition of Type C investment company, and not be able to argue reasonably that it is not primarily engaged in the business of trading in securities). Indeed, The SEC received a request for a no-action position with regard to a commodity pool that proposed to invest up to 50% of its assets in other commodity pools (before the MFA letter, so at the time it would seem the SEC would have viewed this investment as being in securities), which was withdrawn without the SEC issuing a response, probably because the SEC indicated it would not be able to recommend that no enforcement action would be taken.<sup>166</sup>

Notably, if a commodity pool with a portfolio allocation of 40% to securities were unable to be primarily engaged in the business of trading in securities—or, in other words, if such an allocation conclusively resulted in the commodity pool being primarily engaged in the business of trading in securities—the Section 3(b)(1) exception from the definition of Type C investment company would be rendered useless. Similarly, if it were impossible for a commodity pool that holds no more than 45% of its assets as securities and derives no more than 45% of its net income from trading in securities, the exemption provided in Company Act Rule 3a-1 would lose its function as an exemption because it does not apply to entities that are primarily engaged in the business of trading in securities.<sup>167</sup> Presumably Congress, when it enacted the Company Act, expected Section 3(b)(1) to have a function, meaning to be able to except an entity that has a 40% allocation (exclusive of government securities) of its portfolio to investment securities from being subject to the Company Act’s definitions of investment company. Therefore there must be a situation where a commodity pool that falls within the definition of Type C investment company because of its 40% allocation (exclusive of government securities) to investment securities can be primarily engaged in a business other than that of trading in securities. From this line of reasoning, which applies similarly to the percentages provided by the

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166. In Re Futures Portfolio Fund, L.P., SEC Request Letter (Mar. 13, 1990).

167. 17 C.F.R. § 270.3a-1(b).

SEC in Company Act Rule 3a-1, it would seem a commodity pool that trades securities as 40% or more of its portfolio (at least up to 45%) must have an opportunity not to be a Type C investment company, which should be reflected in any safe harbor regulations. Therefore this paper proposes that the non-exclusive safe harbor allow a commodity pool (or any other entity) an allocation to securities trading of up to—but not including—50%, but allowing an allocation of up to 60% for up to a period of two months out of any given year to allow for unplanned or unusual variation. This proposed safe harbor would supersede the current exemption provided by Company Act Rule 3a-1, which would unify the definitions for being primarily engaged in the business of trading in securities between the Type A and Type C definitions of investment company and would remove the current 45% limit on income attributable to securities by entities wishing to avail themselves of Rule 3a-1. The difficulty in calculating potential income makes this proposed safe harbor desirable; if the recent market events have taught us anything, it is that market events are unpredictable.

Under this proposed safe harbor, the calculation of risk allocation, one of the difficulties of the Tonopah Factors and Peavey Test, becomes unnecessary. However, the question of how to calculate a commodity pool's allocation to securities trading for the 50% (and 60%) limit remains of significant importance (under the proposed safe harbor, the only element of the test for primary engagement being asset allocation). Commodity pools, as already discussed, will have a significant allocation of their assets to highly leveraged financial instruments—including financial instruments that are not available in an unleveraged form, such as futures contracts on commodities, and options on futures contracts on commodities. Such an allocation makes calculating an overall or total asset allocation difficult because only a portion of available assets are used to margin the leveraged positions that have a much larger notional value. For leveraged financial instruments, rather than using the initial or ongoing margin requirements (which would be reflected on the balance sheet) or the full notional value (which, especially for swap contracts, may significantly over-value the transaction), this paper suggests the use of the close-out value of the transactions, as calculated pursuant to the terms of the contract governing the financial instrument. For example, the close-out value of an exchange-traded security is the latest bid price on that security on the exchange where it is traded; similarly, the close-out value of an

exchange-traded futures contract is the latest bid price on that futures contract on the exchange where it is traded (which is the notional value of the contract). However, for over the counter transactions, including swap contracts, the notional value is not necessarily the same as the close-out price, but the close-out price more accurately reflects the actual value of the contract to the parties. This method attempts accurately to reflect, with respect to commodity pools, the significant risk/return and asset allocation to the trading of non-securities. These characteristics, which stem from any inherent leverage, are significantly more likely to guide the returns (or losses) of commodity pools than the pools allocations to securities, which are likely to be less leveraged or unleveraged.

Ultimately, with respect to whether a commodity pool is an investment company under the definitions of investment company in the Company Act, the inquiry involves two analytic steps: (i) is the commodity pool primarily engaged in the business of trading in securities or (ii) does the commodity pool hold a significant portion of its assets as securities while not being primarily engaged in a business other than that of trading in securities (*i.e.*, while being primarily engaged in the business of trading in securities). The Tonopah Factors and the Peavey Test provide some guidance as to what constitutes being primarily engaged in the business of trading in securities, but they are both fact-intensive and situation-specific inquiries, and the SEC has not provided much guidance in the way of how to apply the Tonopah Factors or the Peavey Test. To address this uncertainty, the SEC could adopt a non-exclusive safe harbor stating that a commodity pool that invests less than 50%, while still allowing for some periodic variation of its assets in securities using the close-out values of all its positions, would be primarily engaged in a business other than that of trading in securities. Such a safe harbor would assure such commodity pools that they would not be inadvertent investment companies under either the Type A investment company or Type C investment company definition.

## B. DEFINING “SECURITY”

### *1. Futures on Exempted Government Debt Instruments*

While not necessarily an ambiguity in the definition of security itself for purposes of the Company Act, because of the Company Act’s use of the Exchange Act’s definition of security future, which in turn

incorporates the exemptions from the definition of security under the Exchange Act, including the exemption for U.S. government securities and debt instruments issued by certain other governments, under the Company Act these financial instruments themselves are securities (unlike under the Exchange Act). Futures on these financial instruments, however, are not security futures, and thus not securities for purposes of the Company Act. It is unclear whether this was Congress' intended result when it added security futures to the definition of security in the Security Act. The SEC has not taken a position on whether it would view futures on debt instruments issued by these exempted governments as security futures (and therefore securities) under the Company Act, but it seems unlikely that it could do so without contradicting the plain definitions of the terms; nonetheless, the SEC may wish to consider taking a position for the sake of clarity.

## *2. Swap Contracts*

Congress could address the current ambiguity regarding whether swap contracts should qualify as securities under the Company Act's definition of security by adding an equivalent of Section 2A of the Securities Act or Section 3A of the Exchange Act to the Company Act. By doing so, Congress would exempt swap contracts from the definition of "security" for purposes of the Company Act in the same way it exempted swap contracts from the definition of security for purposes of the Securities Act and Exchange Act. This would be the ideal result from the perspective of commodity pools. Similarly, from the perspective of the unification of standards and definitions under the federal securities laws, swap contracts should be treated similarly under each of the major federal securities laws. That the federal securities laws should be consistent with their views on which financial instruments are securities lends support to the position that, even without a specific exemption from the definition of security under the Company Act, swap contracts should not be considered securities for purposes of the Company Act. However, without guidance from the SEC, this may be a somewhat aggressive approach, and commodity pools may be better served in the absence of guidance from the SEC by taking the more conservative position that swap contracts should be analyzed as security futures are analyzed—that is, by looking to the financial instrument underlying the future (or, in this case, swap) contract.

The most conservative position, which is the opposite of the Securities Act and Exchange Act position that no swap contracts are securities, would be to consider all swap contracts securities under the Company Act; such a position, however, seems to contradict significantly with the approach taken by Congress with respect to swap contracts under the Securities Act and Exchange Act, as well as the approach taken with respect to futures contracts (*i.e.*, not all futures contracts are treated as securities for purposes of the Company Act but only those based on underlying securities). The SEC could, absent specific action by Congress, address at least some of the ambiguity by expressing its intention to analyze swap contracts under the Company Act in the same way it analyses security futures.

### 3. *Currency Forward Contracts*

Many commodity pools trade not just currency futures contracts (traded on exchanges) but also currency forward contracts. The SEC, when presented with an opportunity to provide an opinion that currency forward contracts would not be treated as securities under the Company Act, declined to take such a position.<sup>168</sup> The request for no-action relief, which the SEC declined to provide, argued that currency forward contracts, not being specifically mentioned by the definition of security contained in the Company Act, should not be securities (*i.e.*, investment contracts) under the *Howey* test.<sup>169</sup> Currency forward contracts are not treated as securities for purposes of either the Securities Act or the Exchange Act. Moreover, under the Company Act as well as the Securities Act and Exchange Act, currency futures contracts are not security futures, so the underlying financial instrument—a currency—is not treated for purposes of the definition of security future as a security; as such, currency forward contracts, which function in much the same manner as currency futures contracts, traded over the counter rather than on an exchange, should, for constancy, not be treated as securities for purposes of the Company Act. Finally, current practice by the commodity pool industry treats currency forward contracts as non-securities, and, without a significant reason to alter this practice, the SEC should adopt it, providing certainty that it will not view currency forward contracts as securities under the Company Act.

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168. Currency Fund, SEC No-Action Letter.

169. *Id.*

## V. CONCLUSION

When applied to commodity pools as opposed to traditional investment pools, the Company Act presents a variety of ambiguities that ought to be addressed by Congress, the SEC or both. These difficulties stand apart from any debate over the level of regulation appropriately placed on the activities of commodity pools because they are not about the extent to which the activities of commodity pools should be regulated, but whether the existing rules and regulations of the Company Act apply. Whether one seeks additional regulation of commodity pools (which, remember, are regulated under the CFTC jurisdiction aside from any residual regulation under the Company Act) or not, the ambiguities may be corrected without a widespread policy analysis of commodity pool regulation. Of course, depending on one's position, one's answer to how to resolve the difficulties may be different, but the need for resolution should be apparent regardless of one's desired level of regulatory strictness.

There are two primary difficulties. The first is the definition of primary engagement for the purposes of the Company Act's definitions of investment company and the exemptions thereunder. In other words, whether an entity is engaged primarily in the business of trading in securities and thus, absent an exemption, an investment company or not, is a question not easily answered in some cases, particularly with regard to commodity pools because from an asset allocation perspective they may have a large allocation to securities (due to leverage and cash management). The second primary difficulty is the definition of security for purposes of the Company Act. Whether a financial instrument is a security under the Company Act, even if its status is clear under the Securities Act and the Exchange Act, may not be clear under the Company Act.

Ultimately, Congress and the SEC should address the fundamental question of the application of the Company Act to non-traditional investment pools (such as commodity pools) by establishing a safe harbor for activity outside of being primarily engaged in the business of trading in securities. Additionally, Congress and the SEC should address the second fundamental question by establishing which financial instruments constitute securities for Company Act purposes. The simplest solution here would be to harmonize the definitions across the federal securities laws by stating that, for purposes of the Company Act,

“security” will be determined in the same way as it is for the Securities Act and the Exchange Act, which is essentially this paper’s proposal.