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COMMENT

June 14, 2000

Ms. Jean A. Webb
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Proposed Rule 4.27 – Public Reporting by Operators of Certain Large Commodity Pools

Dear Ms. Webb:

Sidley & Austin, which represents a number of Commodity Futures Trading Commission ("CFTC") registrants active in the hedge fund sector, respectfully submits this comment letter to the CFTC in response to the CFTC's request for comments concerning its Proposed Rule 4.27 (the "Proposed Rule") (65 F.R. 20395, April 17, 2000).

We are aware of a number of the comments being submitted to the CFTC in opposition to the Proposed Rule and hope not to burden the CFTC by repeating the objections raised in such letters. Accordingly, we will limit our comments to underscoring the proprietary and confidential nature, lack of value, potentially misleading character (both in respect of assessing the risk profile of individual hedge funds and as a means of comparing different hedge funds) and inappropriateness to "funds of funds" of the disclosures required by the Proposed Rule, as well as raising procedural questions as to whether the CFTC is the appropriate body to be considering the Proposed Rule.

As a preliminary matter, we emphasize that the President's Working Group on Financial Markets ("PWG") has made, and has only the authority to make, recommendations to the CFTC; these recommendations by no means have the authoritative mandate of, for example, the Congressional directive to the CFTC to promulgate the Part 35 Swap Exemption. Consequently, if the CFTC concludes, as a result of further analysis and industry comment, that these recommendations are not, in fact, in the best interests of the financial community or not appropriately promulgated by the CFTC, the CFTC is not only entitled but obligated to reject them.

Four Principal Objections

I. Proprietary Nature of Proposed Disclosure

The PWG specifically qualified its disclosure recommendations by stating that the PWG did not intend to require "disclosure of proprietary information on strategies or positions." However, the evaluation of market risk is one of the most proprietary aspects of many alternative investment strategies. The methodology by which a particular strategy evaluates risk is as proprietary as the methodology by which it evaluates trading positions.

In order to protect its intellectual property, a hedge fund could conceivably adopt some commonly-used method of assessing risk solely for purposes of producing disclosures complying with the Proposed Rule even though such method was not the one actually used by such hedge fund. Any potential benefit from doing so could, however, derive only from (i) creating the ability to compare different hedge funds based on a common standard for assessing risk, and/or (ii) giving counterparties additional data which could inform their credit analyses. As described below, neither of these potential benefits would be achieved (and compelling the hedge fund to undertake a separate risk analysis solely for reporting purposes would, of course, be very burdensome). Furthermore, it would be highly problematic from a liability perspective for hedge funds to publish risk analyses which were not, in fact, those used by the respective hedge funds and which they, presumably, believed to be inaccurate.

We would also point out that other regulatory and self-regulatory bodies (for example, Congress and the Financial Accounting Standards Board) are actively considering other forms of hedge fund disclosure. In fact, the market has already compelled many hedge funds to make far more extensive disclosure to their investors than ever before. Not only does the Proposed Rule with its emphasis on public disclosure (as opposed to disclosure to counterparties, see below) pose material risks to hedge fund managers' intellectual property, but it also may be a remedy which is no longer needed — at least, not to the extent that would justify its risks.

II. Valuelessness of Public (*i.e.*, Outdated) Risk Disclosures

We do not understand what the benefits of *public* disclosure of the information subject to the Proposed Rule might be. Virtually all of the public is both wholly uninvolved in the hedge fund sector and unable to appreciate either the highly technical nature or the inherent limitations of the Proposed Rule 4.27 information. More importantly, even in terms of dealing with the "expert public" (*i.e.*, the financial community), the mechanics of public disclosure assure that the information provided will be long out of date before it becomes available. In the field of risk control it goes without saying that out-of-date information is at least valueless if not actually misleading. Again, important liability issues are raised. What is the liability exposure of a hedge fund which dutifully publishes its Rule 4.27 disclosures, knowing that its current risk profile is materially different from that currently being published? LTCM's 4.27 disclosures for the second quarter of 1998 would presumably have indicated minimal risk and would have been circulating in August 1998, just as LTCM was collapsing. Public disclosure is necessarily out-of-date disclosure, and out-of date disclosure is worthless in assessing risk.

In terms both of identifying an audience likely to make use of 4.27 disclosures and limiting systemic risk, the obvious recipients of the disclosures suggested by 4.27 would be the brokers, lenders and counterparties (collectively, "counterparties") which transact with the hedge funds. However, counterparties are far more sophisticated in their assessment of risk than any uniform system of risk disclosure such as Rule 4.27 could ever hope to be, and counterparties' information is "real time," based on minute-by-minute monitoring of the positions held with them. Importantly, by properly monitoring and managing the positions held with it by a hedge fund, a counterparty should be able to control its exposure to such fund, *irrespective* of the fund's positions with other counterparties. Many funds and individual traders have any number of obligations of which a given counterparty has no knowledge. The margining and risk control systems of each dealer should be designed to protect that dealer based on the margin deposited with it. One dealer should have no need to know the positions held by a hedge fund at other dealers. If all counterparties properly monitor their own risk, there is no systemic risk. The reason that LTCM precipitated the market crisis of 1998 (the "Market Crisis") was that — for a variety of reasons unlikely to be repeated — counterparties did not follow their standard risk management procedures in dealing with LTCM's accounts. (Hence, the emphasis in the aftermath of LTCM on dealers and banks maintaining "sound practices.") It is perhaps true that if LTCM's dealers had had information concerning how over-extended LTCM was, they might have thought twice about not following their usual risk management policies, but they certainly did not need that information in order to follow such policies.

III. Potentially Misleading Character of the Proposed Disclosures

Standard measures of risk are often very poor assessments of a hedge fund's actual risk profile. Virtually all hedge funds inform their investors that they must be prepared to lose all or substantially all of their investment. In the context of such purely speculative investments, all assets are Value at Risk. Similarly, market "shock" scenarios are often irrelevant in assessing a hedge fund's actual risk, as (i) the diversified portfolio of most hedge funds makes it impossible to predict the effect of "market shocks" with any level of confidence, as such "shocks" would affect different positions very differently, and (ii) it is less changes in any given market indicators or price levels which cause major hedge fund losses than it is the actions of dealers and other market participants (for example, reducing credit lines or requiring significantly increased margin) — actions which cannot be modelled. The factor which precipitates "market crises" is not value at risk, but the "risk of ruin" — that occasional confluence of circumstances which results in sudden and dramatic losses. Not only is "risk of ruin" essentially impossible to assess, but also to the extent that the Proposed Rule were to suggest that its disclosures had in some manner addressed this risk, the Proposed Rule would provide a dangerously misleading sense of comfort.

Adding to the misleading character of the Rule 4.27 disclosures would be the inconsistencies between the disclosures submitted by different registrants. Hedge funds are sufficiently different from each other that it is entirely appropriate to permit, as the Proposed Rule would do, different funds to use different methods of calculating their Rule 4.27 information. However, this necessarily implies that it will not be possible to compare hedge funds on the basis of such information. A hedge fund which seems to "test out" under certain disclosures as an extremely low risk fund could, in fact, be much more exposed to major losses under certain market conditions than another fund which "tests out" as having a much higher risk. The publication of Rule 4.27 information by hedge funds will inevitably lead to attempts to compare funds on the basis of such information, and any such comparisons would be inherently misleading.

IV. Inappropriateness of Applying the Proposed Rule to "Funds of Funds"

The Proposed Rule, by its terms, applies to operators of "funds of funds" — hedge funds which do not invest or trade directly, but rather invest in other hedge funds. However, it would almost certainly be impossible for fund of funds to comply with the Proposed Rule. Funds of funds do not receive information regarding the trading positions of the underlying hedge funds in which they invest, much less the information necessary for a 4.27 disclosure. Even were the underlying funds in general to report sufficient 4.27 information so as to permit a fund of funds itself to produce 4.27 reports, there would remain the issue of funds of funds invested in one or more of the numerous hedge funds which are themselves too small to be required to produce reports under the Proposed Rule.

We expect that the *prima facie* inclusion of funds of funds within the scope of the Proposed Rule may simply be a technical drafting oversight which there is no need to belabor. We would simply point out that in addition to the impossibility of compliance, there is no regulatory justification for including funds of funds within the scope of the Proposed Rule. Funds of funds do not create any of the systemic risk that the Proposed Rule was intended to address for the obvious reason that funds of funds do not trade in the market. Funds of funds do not enter into counterparty relationships, do not finance trading positions and do not meet margin calls. Their position in respect of the integrity of the financial markets is entirely secondary to that of the hedge funds in which they invest (which may or may not themselves be subject to the Proposed Rule, depending on the CFTC's determination of each such fund's potential to create or contribute to systemic risks). Consequently, the policy reasons behind the Proposed Rule do not apply to funds of funds, and they clearly should be excluded from its scope.

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Procedural Issues

In addition to the substantive difficulties with the Proposed Rule, there are important procedural issues to be considered. As the immediate shock of the LTCM fiasco recedes, Congress (as well as the international financial community at large) are questioning the benefits of public disclosure in light of the potential impairment of hedge fund operations that would result from such disclosures. Hedge funds contribute significantly to the efficient reaction of the world's markets. "By participating in the market as risk seekers, Hedge Fund Managers play a unique and critical role in financial markets by providing needed liquidity and reducing systems risk. In this sense Hedge Funds often act as 'risk absorbers' in markets by serving as ready counterparts to those wishing to hedge risk, even when markets are volatile, and, in so doing, reduce pressure on market prices while increasing liquidity."[1] Any regulatory measure such as the Proposed Rule which is uniformly opposed by the hedge fund industry must be closely scrutinized to determine whether its potential benefits merit the systemic risks of curtailing the hedge funds' important "risk absorber" function. At this writing, essentially the same disclosure issues addressed in Rule 4.27 are before Congress in the form of the Baker Bill. If that Bill is passed, Rule 4.27 will be mooted. If it is not, perhaps it is because Congress recognizes that — or at least believes that more analysis is needed to determine whether — the potential costs of the proposed disclosures outweigh their potential benefits. We understand, of course, that there are many reasons that legislation may not pass other than its substantive merits. However, we submit that the CFTC should not interrupt a Congressional debate specifically directed at hedge fund risk disclosures by adopting the Proposed Rule while Congress is still considering the matter.

We also suggest that the CFTC is not the appropriate body to impose sweeping disclosure requirements on hedge funds. Most hedge funds, and certainly all hedge funds which were contributors to or victims of the Market Crisis of 1998, are only incidentally commodity pools. Hedge funds' use of futures is generally confined to risk management as well as bona fide and anticipatory hedging. In the case of true "commodity pools," not only was there no Market Crisis of 1998 (as such pools do not finance their positions, the "credit squeezing" had little, if any, effect on such funds), but also the CFTC already has in place a comprehensive system of "large trader" reporting to monitor the risk exposure taken by such pools. Furthermore, these pools, taken in the aggregate, are far too small a factor in the financial markets to cause any form of systemic market risk. The Market Crisis of 1998 was a securities and over-the-counter derivatives, not a futures, market crisis, and the CFTC is not the appropriate regulator of the former. There must be a presumption against the CFTC promulgating — especially in the face of widespread securities industry objections — the Proposed Rule whose principal effects will be on securities, not futures, traders. On the contrary, Congress in the Reauthorization process appears to be moving towards focusing the CFTC's

[1] Sound Practice for Hedge Fund Managers (February 2000) at page 6.

jurisdiction and resources on the "core" futures markets to the exclusion of the over-the-counter and other derivatives markets in which the hedge funds primarily trade and invest. See Commodity Futures Markets Modernization Act of 2000; HR 4541.

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Conclusion

We, of course, share — as does the entire financial community — the PWG's sentiment that "highly leveraged institutions" should not be permitted to pose systemic risks to the financial markets. A sense of outrage over the LTCM episode is both inevitable and justified, and if we felt that the Proposed Rule would constructively contribute to preventing another LTCM, we would support it wholeheartedly. We respectfully submit, however, that public disclosure is inherently incapable of addressing the systemic risks of "highly leveraged institutions," while such disclosure would pose serious risks to the viability of the hedge fund industry and the market efficiencies which it makes possible by putting at risk the intellectual property which is the most important asset of hedge fund managers.

Counterparty, as opposed to public, credit analysis has worked remarkably well over the decades — LTCM has attracted so much attention, in part because it was a "Six Sigma" event. The United States securities markets are the most efficient, as well as the most stable, in the world. The counterparties have been in the business of assessing risk for over a century, and have done very well at it. Market crises have from time to time occurred and, we assume, will continue to do so, but it would be a remarkable conclusion that, as a result of LTCM, the safety of the markets should now require mandated public disclosures such as have never before been made or even proposed. If the counterparties felt that such disclosures were even of minor value as a risk control tool, we can be sure that they would have insisted on them long ago.

In concluding, we wish to make clear that we are not proposing that no response be made to the LTCM episode, only that a response which focuses on public disclosure is mistaken. At the same time, we believe that it is important to recognize that there are significant ongoing initiatives aimed at preventing a repetition of LTCM. In general, these have focused on the importance of improving the internal risk controls applied by counterparties and hedge funds managers — see, *e.g.*, Banks' Interactions with Highly Leveraged Institutions (Basle Committee on Banking Supervision; January 1999) and Sound Practices for Hedge Fund Managers (Various Major Hedge Fund Sponsors; February 8, 2000). This — not the public disclosure approach underlying the Proposed Rule — is the direction in which we encourage the CFTC to turn its attention in its efforts to address the "Lessons of Long-Term Capital Management."

Sincerely yours,

David R. Sawyier

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Partner

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