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Rosenman

ROSENMAN & COLIN LLP
575 MADISON AVENUE
NEW YORK NY 10022-2585

TELEPHONE: (212) 940-8800
FACSIMILE: (212) 940-8776
WEB SITE: http://www.rosenman.com

805 15TH STREET NW
WASHINGTON DC 20005-2212

ONE GATEWAY CENTER
NEWARK NJ 07102-5397

101 SOUTH TRYON STREET
CHARLOTTE NC 28280-0008

FRED MICHAEL SANTO
(212) 940-8720

E-MAIL ADDRESS
Fmsanto@rosenman.com

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OFFICE OF THE SECRETARIAT

June 15, 2000

COMMENT

Jean A. Webb, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1115 21st Street, NW
Washington, DC 20581

Re: Proposed Rule 4.27

Dear Ms. Webb:

We would like to take this opportunity to respond to the CFTC's request for comments on proposed Rule 4.27 (the "Proposed Rule"). We believe that the Proposed Rule (1) would distort the marketplace with its "one-size-fits-all" regime, (2) would unfairly create additional legal risk and regulatory burdens, (3) would be incompatible with fund-of-funds arrangements, (4) is reactionary in nature, and (5) is premature.

1. According to the President's Working Group on Financial Markets' Report "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management" (the "PWG Report") – relied upon almost exclusively in the Supplementary Information accompanying the Proposed Rule as the basis for the Rule – "CPO reports . . . suggest that the significant majority of reporting hedge funds have balance-sheet leverage ratios (total assets to capital) of less than 2-to-1."[1] Long-Term Capital Management ("LTCM") had a balance-sheet leverage ratio of 25-to-1.[2] The "one-size-fits-all" regime proposed by the CFTC would require *all* CPOs over a certain size to take on an additional regulatory and legal burden despite the fact that most of the entities to be regulated are not leveraged to anywhere near the LTCM levels. The PWG Report itself concluded no

1 "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management," President's Working Group on Financial Markets, April 28, 1999, p. 5.

2 Id, 12.

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more than that: "According to September 1998 CPO filings, at least ten hedge funds with capital exceeding $100 million leveraged their capital more than ten times."[3]

The marketplace is a more efficient regulator of leverage because it can account for leverage and credit risk on a counterparty-by-counterparty basis burdening hedge funds as much or as little as circumstances merit. This is more efficient than an across-the-board regulation that has no relevance to the majority of the regulated entities since the majority do not leverage themselves at or near the LTCM levels.

2. The Proposed Rule would unfairly create additional legal risk and regulatory burdens. This would result from four factors: 1) the lack of specificity concerning computation of "value-at-risk ("VAR")," 2) the across-the-board impact on other CPOs, 3) the fact that all CPOs of funds above a certain size would have to comply, and (4) the broad and vague requirements of the five narrative descriptive sections of proposed Section 4.27(c)(2). First, the absence of specificity concerning the calculation of "VAR" would leave open to question how a CPO required to comply with the rule would be able to attest to the completeness and accuracy of the calculation of VAR. Second, notwithstanding the fact that CPOs of only "large" funds would be subject to the rule, it would raise questions regarding the materiality of the omitted information by so-called "small" funds. Third, the Proposed Rule does not distinguish between and among funds which use futures significantly, and those which use futures for hedging only, or to a de minimus extent because they are primarily securities based. Why should a fund which is predominantly securities based be uniquely subject to these regulations and attendant liabilities when the hedge fund community at large is not? Fourth, the proposed five factor reporting obligation is so broad and vague as to leave open to the imagination how much detail to include. Moreover, it clearly would call for disclosure of sensitive and proprietary information which could put a CPO into the "Hobson's Choice" dilemma of giving its competitors too much information or violating the Rule.

3. The Proposed Rule would not be compatible with fund-of-funds arrangements because it would place a reporting obligation on a fund-of-funds meeting the threshold size requirements of the Proposed Rule, but would not directly place such an obligation on an investee fund which a fund-of-funds would invest into if the investee fund is below the proposed rule's size threshold. This is problematic because a fund-of-funds would need investee funds' VAR calculations to calculate its aggregate VAR in accordance with the Proposed Rule. The result of this incompatibility is that, despite being nominally outside the purview of the Proposed Rule, investee funds would be forced to supply VAR information to investing fund-of-funds. Since VAR is non-specific, there is a risk of multiple VAR methodologies being used, and therefore—no way for a fund-of-funds to comply with the Proposed Rule. Alternatively, if VAR calculations are not prepared by the investee funds in accordance with the time strictures of the Proposed Rule, and/or are

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3 Id.

not prepared with the same methodology used by the other investee funds and the fund-of-funds itself, the fund-of-funds may be forced to terminate a relationship with one or more investee funds to be compliant with the Proposed Rule.

4. It is a truism that "hard cases make bad law." The LTCM debacle was an exceptionally hard case. Further, as noted by Commissioner Erickson, "It is not clear that reporting on a quarterly basis would have been sufficient to address the events precipitating the private rescue of LTCM."[4] In fact, as the PWG Report states: "Both LTCM and other market participants suffered losses in individual markets that greatly exceeded what conventional risk models, estimated during more stable periods, suggested were probable."[5] VAR relies on historic parameters and does not determine the extraordinary, the so-called "risk of ruin." The global events of August 1998 precipitating LTCM's decline are described by the PWG Report as extraordinary.[6] LTCM itself, per the PWG Report, "stood out" from other hedge funds in many respects.[7] The impetus for the Proposed Rule is an extraordinary event that, in similar future extraordinary cases, would not be remedied by the Proposed Rule.

5. The Proposed Rule is premature. First, it is premature because of the CFTC's current review of its overall regulatory framework, which, when concluded, could result in the rule being reversed or revoked. Second, the Congress is considering its own legislation on a much broader scale, which in certain respects would even be less broad than the CFTC proposal. Since the CFTC's involvement in the hedge fund arena is only one piece of a much larger puzzle, it would, in our view, be more appropriate for all the relevant governmental agencies to take simultaneous action pursuant to a statutorily approved approach, rather than the CFTC being an island unto itself on this point.

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Thank you for this opportunity to comment.

Sincerely,

Fred M. Santo, a Partner

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4 65 F.R. 20395, 20403.

5 President's Working Group on Financial Markets, p. 12.

6 Id.

7 Id, 14.