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Testimony of John G. Gaine
President, Managed Funds Association
Open Meeting on Intermediaries
Commodity Futures Trading Commission
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Mr. Chairman, thank you for the opportunity to speak to you today regarding your ongoing study of the potential changes in the regulation of intermediaries pursuant to Section 125 of the Commodity Futures Modernization Act of 2000 (CFMA). I am John G. Gaine, president of Managed Funds Association (MFA).

MFA, located in Washington, DC, is a global membership association dedicated to serving the needs of the professionals worldwide who specialize in the alternative investment industry—hedge funds, funds of funds, and private and public managed futures fund. MFA has over 600 members who represent a significant portion of the $500 billion invested in alternative investment vehicles around the world. MFA members include many of the largest international financial services conglomerates and are based in both the U.S. and Europe.

Since its inception over a decade ago, MFA has been committed to working closely with the CFTC on the regulatory framework promulgated pursuant to the Commodity Exchange Act. We find this relationship to be even more important subsequent to the passage of the progressive CFMA. As part of this ongoing relationship, MFA has actively worked to aid the CFTC in fulfilling the obligations of Section 125 of the CFMA, particularly the CFTC's study on intermediaries. For the purposes of the study, to ensure a thorough cross-section of the industry with a specific focus on commodity trading advisors (CTAs) and commodity pool operators (CPOs), MFA facilitated many meetings between the CFTC and a number of MFA's Members.

MFA applauds the CFTC in its progress to date on this study. We are particularly pleased to see the light at the end of the tunnel of the long-debated notional funds issue. Despite myriad discordant opinions, MFA is confident that we are near resolution. We hope the Commission will adopt its proposed rules that will require a method of calculation using the amount committed to trading as the denominator in calculating CTA performance.

Furthermore, MFA strongly advocates a harmonization of regulation of Commodity Trading Advisors (CTAs) and Commodity Pool Operators (CPOs) by the different regulatory agencies, in particular the Securities and Exchange Commission (SEC) and the CFTC. As the managed funds industry grows exponentially, questions as to whether, and how, to regulate different investment vehicles will continue to proliferate.

While the Commission has made great strides thus far in conducting the study on intermediaries, MFA hopes the Commission does not view its work as completed. As the Commission makes its report to Congress (as legislatively mandated by Section 125), we are hopeful the Commission will consider some issues that MFA views as outstanding, particularly accounting procedures, disclosure document delivery prior to solicitation, MFA Proposed Rule 4.9 and NFA Proposed *de minimis* Rule.

Accounting Procedures.

In March 2001, before the accounting scandals that surrounded (and continue to surround) the collapse of Enron, the American Institute of Certified Public Accountants released its Statement of Position (SOP) 01-1, *Amendment to Scope of Statement of Position 95-2, Financial Reporting by Nonpublic Investment Partnerships, to Include Commodity Pools*. SOP 95-2, which requires the presentation of a condensed schedule of investments, originally exempted investment partnerships that are commodity pools

subject to regulation under the CEA. SOP 01-1 eliminated this exemption thereby requiring commodity pools to present a condensed schedule of investments in financial statements presented in accordance with generally accepted accounting principles (GAAP), commencing with the year ended December 31, 2001. Undoubtedly, heightened public and government scrutiny currently envelops any policy considerations of accounting practices. However, we contend that the Enron scandal does not warrant unwise and over-reactive policy changes. SOP 01-1 requires disclosure of positions that amount to disclosure of proprietary investment strategies of funds of funds, resulting in competitive harm to their business.

MFA hopes to work with the CFTC to develop equitable and fair reporting requirements in accordance with GAAP while protecting the proprietary interests of CPOs.

Disclosure Document Delivery.

Another issue important to MFA Members is the disclosure document delivery requirement prior to solicitation. MFA believes that the timing requirements for disclosure documents should be consistent with the requirements imposed on Futures Commission Merchants and Introducing Brokers. In particular, the Commission should delete the requirement that a CPO or CTA provide a disclosure document to a prospective pool participant or client prior to soliciting that person. A CPO would still be required to provide a disclosure document to a participant prior to accepting or receiving funds from the participant, and a CTA would still be required to provide a disclosure document to a client prior to entering into an agreement with the client to direct or guide the client's account.

Although the Commission recently amended its rules to allow CPOs to use a profile disclosure document for solicitation purposes, which was significant and commendable progress, eliminating the requirement that some type of disclosure document be provided before solicitation of a prospective participant or client will give CPOs and CTAs greater flexibility in determining interest prior to providing the disclosure documents. Please keep in mind that all solicitations would continue to be subject to NFA Compliance Rule 2-29; solicitations for public pools would be subject to the relevant securities laws and regulations; and advertisements would also be subject to CFTC Rule 4.41. Thus, the Commission could rest assured that a framework would continue to exist to ensure upstanding and monitored business practices on the part of registered CPOs and CTAs.

If the Commission does not wish to eliminate the current restrictions on advertising prior to delivery of a disclosure document, MFA urges the Commission, in the spirit of harmonization of the regulatory frameworks under the various agencies, to authorize CPOs and CTAs to use tombstone advertisements similar to those authorized by SEC Rule 134.

MFA Proposed Rule 4.9.

Another great concern of the industry, in particular hedge funds, is the requirement for registration as a CPO if the hedge fund trades futures and options contracts on a futures exchange. Currently, any such hedge fund is required to register as a CPO with the CFTC. The MFA advocates our Proposed Rule 4.9, a new exemption from CPO registration for CPOs of pools offered and sold only to sophisticated persons in private transactions exempt from registration under the Securities Act of 1933. We wish to distinguish unregistered from unregulated. While hedge funds are largely

unregistered, unless as a CPO, they are not completely free from regulation. Furthermore, the exemption we seek under Proposed Rule 4.9 would be carefully tailored to apply to only accredited and sophisticated investors as defined under the CEA and other legislation. Each direct investor that is an individual must be at least a qualified eligible person, and each investor that is an entity must be an accredited investor. Plus, the CPOs exempt from registration will continue to remain under the jurisdiction of the CFTC's authority, as clearly stated in the rule.

We believe such an exemption, while decreasing the number of registrants, actually will increase the number of CPOs subject to the CFTC's jurisdiction, thereby increasing the CFTC's role in the financial markets. Such a rule will not result in maverick hedge fund managers, but will bring sophisticated investors into a new market. Once again, I wish to stress the importance of the limitation of the exemption to sophisticated and accredited investors. By no means do we advocate opening such a door to investors unfamiliar with the terrain of the derivatives and futures industry.

NFA Proposed de minimis *Rule.*

In conjunction with MFA's Proposed Rule 4.9, MFA also supports NFA's postion that the Commission adopt an exemption from registration for CPOs who operate collective investment vehicles that do only a *de minimis* amount of futures transactions and for CTAs who provide their trading advice solely to these vehicles and to collective investment vehicles described in Rule 4.5. Our reasons for our position are the same as I outlined for our position of Proposed Rule 4.9.

These are some of the major issues facing the managed funds industry today, at least in terms of the intermediaries the CFTC has been studying. We hope the Commission realizes their importance to both MFA and the industry as a whole. We also

realize that new concerns will develop as new rules are promulgated, and we look forward to assisting the Commission in any way we are able.

Once again, I appreciate the opportunity to speak before you today, and MFA will continue to be ready and willing to do so in the future.