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January 23, 2003

Via E-Mail (Secretary@cftc.gov)

Ms. Jean A. Webb
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Commodity Pool Operators and Commodity Trading Advisors;
Exemption from Requirement to Register for CPOs of Certain Pools
and CTAs Advising Such Pools, 67 *Fed. Reg.* 68785 (November 13,
2002)

Dear Ms. Webb:

On November 13, 2002, the Commodity Futures Trading Commission published an advanced notice of proposed rule-making regarding registration exemptions for commodity pool operators (CPOs) and commodity trading advisors (CTAs). The notice asked for comments on National Futures Association (NFA) and Managed Funds Association (MFA) petitions for rulemaking and included temporary no-action relief for certain hedge funds. NFA appreciates this opportunity to comment on the notice.

NFA commends the Commission for its efforts to make the regulatory process more efficient and to eliminate unnecessary burdens on money managers. With a few exceptions, the Commission's current rules require fund operators to register as CPOs if the fund trades even one futures contract. This corresponds with the language in the Commodity Exchange Act (CEA) and may have been appropriate in the Commission's early days when neither the Commission nor the industry had much experience with funds participating in the futures markets. However, our experience over the last 30 years has shown that all commodity pools are not created equal. For some types of hedge funds, CPO

registration imposes regulatory burdens without providing a corresponding benefit to pool participants, the futures markets, or the general public.¹

As the release notes, NFA filed a petition for rulemaking with the Commission in 1999 asking the Commission to amend CFTC Regulation 4.13 to exempt operators of collective investment vehicles from CPO registration if they operate only vehicles that do a *de minimis* amount of futures transactions and that do not market themselves to the public as commodity pools.² NFA believes that its proposal provides significant regulatory benefits to the regulators and the public because it allows both the Commission and NFA to focus their resources on those entities that are marketed to the public as vehicles for futures trading. It also provides significant benefits to fund operators by minimizing their regulatory burdens.

Of course, regulatory efficiency should never come at the expense of customer protection, which has always been NFA's number one priority. Therefore, NFA's proposal ensures that these fund operators remain subject to the anti-fraud and anti-manipulation provisions of the Act and that the Commission has access to relevant information. It also provides that the exemption is available only if the fund's participants are accredited investors, and it requires the operator to notify prospective participants that it is not registered with the Commission. Given the nature of these funds, however, we do not believe that any additional requirements are necessary in order to protect the fund's participants.³

NFA urges the Commission to grant NFA's petition for rulemaking. We are not, however, wedded to the exact language in our proposal.⁴ In fact, we recommend that the Commission add an alternative *de minimis* test similar to the

¹ Both NFA's proposal and the Commission's no-action position include relief for CTAs who provide trading advice to collective investment vehicles that engage in a *de minimis* amount of futures trading. For simplicity, we will address all of our comments to CPO registration. However, our comments apply equally to CTAs who limit their activities to providing advice to these vehicles.

² This was a reworking and resubmission of a petition filed in 1998.

³ For example, we do not see a need to require the exempt CPO to provide participants with annual statements. Since these funds are not true commodity pools, the fund operator is in the best position to determine what type of information is helpful to participants and how often it should be provided.

⁴ We particularly support revising the filing requirements so that the notice of eligibility is filed only with NFA, making the rule consistent with the Commission's recent action delegating similar responsibilities to NFA.

test used in the Commission's no-action relief. This approach would be similar to that taken by the Commission in proposing amendments to Regulation 4.5.⁵

For funds that primarily engage in futures transactions or hold themselves out as commodity pools, NFA believes that exemption from CPO registration may be appropriate where participation is limited to highly sophisticated investors. Such an exemption would be consistent with recent changes to the CEA to create a new category of market participant called an "eligible contract participant" (ECP) and to exempt or exclude certain transactions involving ECPs from the CEA. It would also be consistent with the Investment Company Act of 1940 (ICA), which removes funds with only qualified purchasers from the definition of investment company and, therefore, from the ICA's registration requirements. Of course, an exemption based solely on the nature of the participants assumes that the participants both understand the investment and have the resources to protect themselves from unethical practices. Therefore, finding the right level of sophistication is particularly important when used to provide a complete exemption from registration rather than relief from some regulatory requirements.

The Commission asked whether there should be any limit on non-hedge activity by persons qualifying for a registration exemption. Obviously, a *de minimis* test (whether based on notional value or margins and premiums) is simpler to calculate if it treats both hedge and non-hedge positions alike, especially where there may be some ambiguity about which risk management positions qualify as hedge positions. On the other hand, a fund that engages in a noticeable amount of speculative futures activity raises more concerns than a fund that primarily uses futures to hedge its other investments. Therefore, while we can support either computation, a *de minimis* test that excludes hedge positions from the calculation should use a lower percentage than a test that includes those positions.⁶

The Commission also asked for comments on whether exempt CPOs should be subject to special calls and to limited recordkeeping and notice requirements, as included in the NFA and MFA proposals. We believe that special calls, limited recordkeeping requirements, and notice to NFA (as the Commission's delegate) are a more efficient means of determining whether the entity qualifies for the exemption than making the Commission rely on its investigative authority. Although these requirements differ somewhat between the NFA and the MFA proposals, those differences are immaterial, and we can

⁵ Although NFA does not have a specific recommendation regarding the appropriate level for the notional value test, we believe that it should be at least as high as the no-action level (i.e., notional value of hedge and non-hedge positions does not exceed 50% of the fund's liquidation value).

⁶ Obviously, an exemption based solely on the sophistication of the pool's participants would allow the pool to engage in unlimited speculative trading.

support either version. Under both proposals we also believe that customers should be told that the collective investment vehicle is not regulated by the CFTC. In the case of a *de minimis* exemption, customers should also be advised of the trading limitations.

Finally, NFA notes that both NFA's proposal and the Commission's no-action position are designed to exempt persons who operate vehicles that principally invest in instruments not regulated under the CEA. If these requirements are applied only at the end of the day, however, they will exempt operators of commodity pools that invest in futures using day trading strategies. Therefore, the Commission should consider whether to apply the *de minimis* requirements on a continuous, intra-day basis.

In conclusion, NFA asks the Commission to adopt an exemption for operators of hedge funds that do a *de minimis* amount of futures trading. We also recommend that the *de minimis* exemption contain alternate tests – one based on required margin and options premiums and one based on the notional value of futures positions and commodity options. The Commission should also consider a separate exemption for operators of commodity pools that are limited to highly sophisticated investors.

If you have any questions concerning this letter, please contact me (312-781-1413, tsexton@nfa.futures.org) or Kathryn Camp (312-781-1393, kcamp@nfa.futures.org).

Respectfully submitted,

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(kpc/CommentLetters/DeMinimis)