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COMMENT

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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: Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors, 68 *Fed. Reg.* 12622 (March 17, 2003)

Dear Ms. Webb:

Registration requirements benefit the public by weeding out persons who have shown that they are unfit to deal with the public and by making it easier for a regulator to adopt and enforce appropriate requirements. However, unnecessary registration requirements – like unnecessary regulation – actually hurt the public. In the case of commodity pool operators, unnecessary registration requirements reduce investment opportunities and innovation and increase the costs to those people who do invest. The Commission's proposal strikes the appropriate balance between those instances where registration benefits participants and those where it harms them.

CFTC registration and regulation are crucial when unsophisticated customers are solicited to invest in the futures markets by persons who would not otherwise be subject to regulation for those activities, and the Commission's proposal continues to require CPO registration in these instances. The two major exemptions and the exclusion proposed by the Commission apply only where one of these key elements is missing. Stated positively, the Managed Futures Association proposal requires that the customers be sophisticated, the NFA proposal requires that the solicitation – and the trading strategy – be aimed at other markets, and the Rule 4.5 proposal requires that the activities be subject to regulation by another regulator.[1]

[1] Although these are all Commission proposals, we will use "MFA proposal" to describe the proposed exemption that arose out of an MFA proposal, "NFA proposal" to describe

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The Rule 4.5 Proposal

The Rule 4.5 proposal would reduce participant costs – thereby increasing participant returns – by eliminating the costs of duplicative regulation for vehicles that are not marketed as commodity pools, and we support it in its entirety. Rule 4.5 currently excludes certain persons from the definition of commodity pool operator in connection with regulated collective investment vehicles that do not devote more than 5% of their liquidation value to margin and premiums for speculative futures and option positions. The Commission adopted this exclusion because it recognized that these pooled investment vehicles are already subject to significant regulation that casts an umbrella over all of the vehicles' investment activities. The Rule 4.5 proposal carries the Commission's original analysis to its logical conclusion by removing all restrictions on futures market activity.

Current and proposed Rule 4.5 both provide that the exclusion is not available if the vehicles are marketed as commodity pools. Since Rule 4.5 is an exclusion rather than an exemption, the anti-fraud provisions of Section 4(o) of the CEA do not apply.[2] Investments in these vehicles can be – and often are – sold to unsophisticated customers. While the sale of these investment vehicles is subject to the anti-fraud provisions in other statutes, unsophisticated customers should also have the benefit of Section 4(o) if the investment is marketed as a commodity pool. Therefore, we agree that the exclusion should not be available if the vehicles are marketed as commodity pools.

The NFA Proposal

The NFA proposal is directed at operators of collective investment vehicles that are not marketed as commodity pools and that do only a *de minimis* amount of futures transactions. The collective investment vehicles covered by the proposed exemption are not sold to the public as commodity pools, and investors do not invest in them as a means of investing in the futures markets. Furthermore, these vehicles are not true commodity pools in either their intent or their trading strategy. In fact, many of these vehicles currently avoid the futures markets altogether because of the additional costs that registration would impose.

This proposal provides significant regulatory benefits to the public as a whole 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

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the proposed exemption that arose out of an NFA proposal, and "Rule 4.5 proposal" to describe the proposed amendments to Rule 4.5.

[2] Of course, Section 4(b) and other provisions of the Act continue to apply just as they would to any other market participant.

provides significant benefits to the participants of the exempt funds by allowing the funds to hedge their risks and diversify their investments using the futures markets and by eliminating regulatory costs that would otherwise be passed on to those participants – regulatory costs that the participants neither expect nor need since they do not view the vehicle as a commodity pool.

The NFA proposal also contains significant regulatory protections for the investing public. This proposal provides an exemption from registration rather than an exclusion from the definition of CPO, which means that fund operators are still subject to the anti-fraud provisions of Section 4(o) of the Act. NFA's proposal also ensures a minimum level of participant sophistication by requiring that participants be accredited investors.[3]

The distinction between hedge and speculative positions in current Rule 4.5 and the proposal submitted by NFA is based on a very simple premise – true hedging activities, as defined in Rule 1.3(z), are incidental to the transactions they hedge against. After all, a farmer does not plant a corn crop as an excuse to sell corn futures contracts. Furthermore, 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. On the other hand, we recognize that a test that does not distinguish between hedge and speculative trading is simpler to calculate and avoids any ambiguity about which risk management positions qualify as hedge positions.[4] Therefore, we do not object to the Commission's proposal to adopt a test that treats all futures positions alike.

While we do not object to the general test, we do have concerns about the proposed trading levels. The purpose of the *de minimis* requirement is to identify – and therefore deny the exemption to – those collective investment vehicles that use futures as a major part of their investment strategy. In order to achieve this objective, the *de minimis* level must be set low enough to eliminate true commodity pools but high enough to enable other collective investment vehicles to benefit from it. Finding a level that is neither over-inclusive nor under-inclusive is, of course, the hardest part of the process, and we recognize that it is impossible to craft a test so precise as to leave no room for error.

It is equally hard to determine what level of overall futures trading activity equates to unlimited hedging plus a small amount of funds (be it 1% or 5%) committed to speculative trading. It is clear, however, that collective investment vehicles can easily

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[3] *See* SEC Rule 501(a).

[4] Although Rule 1.3(z) is fairly clear, it defines "hedge" much more narrowly than the term is used in the securities industry. Since the operators of these collective investment vehicles tend to be more familiar with securities industry terminology, they may unintentionally include non-1.3(z) transactions on the hedge side of the equation.

commit more than that to bona fide hedging activities. Therefore, a *de minimis* test that includes hedge positions must use a higher percentage than a test that excludes them in order to reach the same result. The 2% and 50% levels proposed by the Commission are so low that the exemption would be unavailable to many collective investment vehicles that are not true commodity pools. Therefore, we recommend that the levels be raised to 5% and 100%.

The MFA Proposal

The MFA proposal provides an exemption from registration based solely upon the sophistication of the pool's participants. We agree that sophistication is the right yardstick to use in providing a registration exemption for persons who operate funds that primarily engage in futures transactions or hold themselves out as commodity pools. 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. It also makes some logical sense to require a higher level of sophistication in order to warrant a complete exemption from registration than is required for Rule 4.7 relief. Therefore, we support this proposal.

These three proposals – the Rule 4.5 proposal, the NFA proposal, and the MFA proposal – all benefit participants by eliminating the costs of unnecessary regulation. They also enhance customer protection and promote regulatory efficiency by allowing the Commission and NFA to focus their resources where they are needed most – on otherwise unregulated CPOs who solicit unsophisticated customers to invest in the futures markets.

Other Comments

NFA supports the amendments to Rule 4.13(a)(2) to increase the ceiling on capital contributions from $200,000 to $400,000, expand the participants excluded from the 15 person limit, and clarify that these participants' contributions do not count towards the $400,000 ceiling. As the Commission notes, this exemption has not been adjusted for inflation in the twenty plus years since it was adopted, and it is appropriate to do so now.

NFA also supports the proposed requirements for CPOs that avail themselves of an exemption under Rule 4.13. 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.

The Commission requested comments on an alternative proposal for relief based on a notice-registration scheme. Such a scheme is unnecessary and could have unintended effects. It is unnecessary because exempt CPOs continue to be subject to the CFTC's jurisdiction under the Act and other statutes, and they also continue to be subject to a private right of action for violating Sections 4(b) and 4(o) of the Act.

Furthermore, a notice-registration scheme could actually lead investors to believe that the CPO's activities are being monitored by the Commission because the entity is "registered." A notice-registration scheme is not appropriate under these circumstances.

NFA supports the proposed amendments to Rule 4.14 to expand the Rule 4.14(a)(8) exemption to include state-registered and exempt investment advisers (IAs), to provide relief for CTAs who provide trading advice to foreign pools, and to make it clear that the exemption from CTA registration is available even where the CTA advises a mix of the vehicles specified in the rule. We also agree with the Commission that this relief should not be available with respect to individual accounts. Such an exemption could create a recordkeeping and investigatory nightmare, and we note that there is no similar exemption from IA registration.

We agree that a legal entity should be counted as a single person for purposes of the small CTA exemption found in Section 4m(1) of the Act. This method reflects reality and is consistent with the approach taken by the SEC. Therefore, we strongly support this change.

The Commission also proposes changing the Disclosure Document delivery requirements to allow CPOs and CTAs to advertise commodity pools and managed account programs and to solicit prospective pool participants and clients without having to provide a Disclosure Document prior to the solicitation.[5] The current process is inefficient for both the prospective pool participant or client and the CPO or CTA because it requires prospects to receive extensive information before they even know if they are interested. The proposed changes will allow CPOs and CTAs to solicit prospective participants and clients in the manner that is most efficient for both parties. Obviously, the communication could not be misleading, and any performance information should be based on the Commission's proposed ROR calculation. Furthermore, 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.[6] Therefore, we support this change.

We do, however, have one minor comment on the language in the proposed amendment. The language states that any material distributed in advance of the Disclosure Document must be consistent with <u>or amended by</u> the Disclosure Document, which could be read to mean that the material does not have to be

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[5] Although CPOs can provide a notice of intended offering to more sophisticated prospects and profile documents to all prospects, both of these provisions have their drawbacks, and neither of them is available to CTAs.

[6] Solicitations for public pools would still have to comply with the Securities Exchange Act of 1934 and related SEC requirements.

consistent with the Disclosure Document at the time it is distributed as long as it corrected when the Disclosure Document is delivered. We do not believe this is the Commission's intent, and we recommend revising the language to state that the material must be consistent with the Disclosure Document at the time the material is distributed.[7]

The Commission proposes amending Rules 4.21 and 4.22 to codify the relief it has provided to master and feeder funds, and we support these amendments. The Commission also proposes to codify the procedures that CPOs may use to distribute periodic account statements electronically, and we disagree with that proposal.[8] As we commented in regard to the Commission's earlier proposals to amend Rules 1.33 and 1.46, codifying these procedures reduces – rather than enhances – flexibility.[9] While we agree with the content of the Commission's interpretive statement regarding those procedures and believe it should be treated as acceptable practices guidance, there may be other procedures that are equally effective.

The Commission's release also asks for comments on the criteria that should apply if it allows CPOs to distribute their annual reports electronically. As long as the reports include either an electronic image of the CPA's physical signature or some other form of electronic signature, the Commission should provide maximum flexibility and allow annual reports to be distributed electronically using the same criteria that apply to account statements. In fact, we believe that electronic distribution has distinct advantages and should be encouraged.[10]

The Commission has stated that account statements and annual reports distributed to participants can contain a facsimile signature as long as the manual signature is on the document that is filed with the Commission, and it proposes codifying this interpretation (but requiring the document with the manual signature to be filed with NFA rather than the Commission). We agree that filings should be made with

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[7] In this connection, we recommend that the Commission review its Interpretation Regarding Use of Electronic Media by Commodity Pool Operators and Commodity Trading Advisors for Delivery of Disclosure Documents and Other Materials, 62 *Fed. Reg.* 39104 (July 22, 1997). The Commission may want to consider revising certain provisions of that interpretation, such as the provisions that require CPOs and CTAs to use a special risk disclosure statement that must be viewed before accessing any performance information.

[8] Id.

[9] See September 18, 2001 letter from Thomas W. Sexton to Jean A. Webb regarding Rules Relating to Intermediaries of Commodity Interest Transactions.

[10] We also encourage the Commission to allow annual reports to be filed electronically as long as they contain an electronic signature and appropriate safeguards are in place.

NFA, but we do not see the need to have a manual signature in our files (or the Commission's) as long as it is maintained by the CPO and can be examined during an audit.

Finally, we agree that the list of permitted signatories should be expanded. We recommend that the rules specifically state that listed principals are duly authorized to bind the pool operator so that any listed principal is a permitted signatory.

* * *

The Commission's proposed registration exemptions benefit the public by eliminating unnecessary regulatory costs, expanding investment opportunities, and focusing regulatory resources on those collective investment vehicles that pose the greatest risk to the public. With the few modifications mentioned above, we support these proposals and urge the Commission to adopt them.

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,

Thomas W. Sexton
Vice President and General Counsel

(kpc/CommentLetters/CPO Exemptions)