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MANAGED FUNDS ASSOCIATION

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April 27, 1998

Jean A. Webb
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

COMMENT

Re: Regulation of Noncompetitive Transactions Executed on or Subject to the Rules of a Contract Market

Dear Ms. Webb:

The Managed Funds Association (the "MFA") respectfully submits this comment letter to the Commodity Futures Trading Commission (the "CFTC") in response to its request for comments on its release published January 26, 1998 in the Federal Register at 63 Fed. Reg. 3708 (the "Concept Release"). The Concept Release solicits comments on whether the regulatory structure governing certain transactions executed on or subject to the rules of a contract market should be modified in light of recent developments in the marketplace.

Background

MFA is a national trade association of more than 600 members. MFA's membership is made up of a diverse group of alternative investment professionals, including hedge fund and commodity trading managers, commodity pool operators and fund of funds managers. These fund managers are responsible for a significant portion of the nearly $250 billion invested in hedge funds and the vast majority of the over $35 billion invested in managed futures funds (collectively referred to as "Managed Funds"). MFA members also include brokers, exchanges, cash managers, foreign exchange dealers, banks and other professionals who provide support services such as accountants, lawyers, consultants, and academics. Accordingly, MFA and its members have a vital interest in this Concept Release.

MFA commends the CFTC for its current efforts to streamline and modernize the regulatory structures that apply to the markets under its jurisdiction. The current Concept Release is perhaps the most important item on the expansive list of initiatives undertaken by the CFTC in recent times because it reflects the Commission's willingness to rethink basic issues of market structure and competition as a result of major market innovations and developments in recent years.

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We believe it should be a goal of the Commission to foster innovation and competition in all markets subject, of course, to appropriate regulatory oversight.[1] We concur with the Commission in the view that expansion of the boundaries for trading activities on existing contract markets would enhance the usefulness and efficiency of those markets - and ultimately have very positive procompetitive effects. In fact, absent continued market innovation and the CFTC's promotion of appropriate linkages between markets -- whether cash, futures, or otherwise -- exchange-traded markets will not thrive.

MFA believes that Congress in adding Section 4(c) to the Commodity Exchange Act intended that the Commission exercise its authority to permit contract markets and others to develop market mechanisms that would answer the needs of the marketplace and its participants in a competitive environment. We hope that the dialogue undertaken by the Concept Release will facilitate increased, competitive uses of futures markets - through, for example, EFPs, EOPs, EFSs and block trading.

General Comments

Managed Funds are major end-users of futures markets with a unique and broad perspective on these markets as well as a keen interest in their regulation. Managed Funds are not only anxious to facilitate the growth, depth, and fluidity among various market alternatives and to streamline regulatory burdens where possible to increase market efficiencies but also understand the importance of appropriate regulatory oversight to market integrity. The broad perspective that Managed Funds bring to the issues raised by the CFTC's Concept Release derives from the fact that as a group (and, in some cases, even as individual funds):

We actively trade almost the entire spectrum of exchange-traded futures, including traditional agricultural commodities, metals, the energy complex, currencies, and other financial products.

We trade the cash markets underlying many futures contracts, most notably currencies and government securities but also physicals such as crude oil.

We trade in related derivatives, such as over-the-counter forwards, swaps, and options.

We trade these markets on an around-the-clock, global basis, dealing not just on U.S. futures exchanges but also on exchanges in Europe and Asia as well as off-exchange in the over-the-counter markets.

Our views on the issues raised by the Concept Release are also shaped by the knowledge that, while our primary goals are fiduciary in achieving greater returns and enhanced diversification for our investors,[2] Managed Funds also have provided important benefits to the

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[1] MFA supported a similar Commission effort in its development and adoption of its Part 36 Rules.

[2] A recent extensive study of Managed Funds' performance finds that "hedge funds outperform mutual funds" and on a risk adjusted basis "hedge funds consistently earn excess returns". The authors of this study attribute the

markets in which we trade. The market benefits derive from the fact that Managed Funds:

Are a major new source of speculative capital, providing more than $35 billion from managed futures funds and an additional $250 billion from hedge funds. [3]

Are a major provider of much needed liquidity to many futures markets, absorbing the risks that commercials and other hedgers wish to shed. In addition, during periods of market stress Managed Funds have frequently stepped forward and absorbed selling pressure providing liquidity and helping to stabilize markets.[4]

Have provided this liquidity without increasing market volatility. The latest and most comprehensive research on this subject finds that, "commodity pool trading did not have any significant relationship with futures price volatility across a broad spectrum of markets."[5]

Are an important link in global financial markets helping to integrate cash, futures, forwards and other related markets, and thereby, improving market efficiency.

To continue providing these benefits to both our investors and financial markets as a whole, Managed Funds must maintain ready access to all markets. We must be able to access these markets and do so at the lowest possible cost without unnecessary or burdensome regulation. To date, EFPs have provided Managed Funds one way of effectively moving between cash and futures positions, shifting positions into or out of the futures markets as investment strategies and trade execution requirements demand. For example, when a particular futures market loses liquidity on a transitory basis, Managed Funds can still enter the market by first going into the now relatively more liquid cash market and then executing an EFP at the appropriate time to ultimately enter the futures markets. Relative market liquidity may, of course, call for the reverse sequence of transactions. While a relatively small percent of overall futures volume, EFPs have nevertheless become an important market lubricant, facilitating the smooth movement of investor's funds into and across diverse markets. As a result, EFPs have assisted Managed Funds in providing greater liquidity to futures markets without disrupting these markets or adding to volatility.

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superior performance of hedge funds to the flexibility of their structure, especially the use of incentive fees to align the interests of portfolio managers and investors. This study also finds that hedge funds, as a new asset class, can be a valuable addition to existing portfolios. See Ackermann, McEnally, and Ravenscraft, "The Performance of Hedge Funds : Risk, Return, and Incentives," University of North Carolina, (September,1997).

[3] In "Hedge Funds and Financial Market Dynamics", International Monetary Fund, Occasional Paper 166 (May,1998), the IMF staff points out that certain information services, such as Hedge Fund Research and Van Hedge Fund Advisors, estimate a much larger universe of Managed Funds and assets under management (as many as 3000 funds and $368 billion in assets as of 1997).

[4] A recent study by the IMF found little or no evidence that Managed Funds have contributed to market instability. In fact, the authors point to evidence that Managed Funds function as "stabilizing speculators". See "Hedge Funds and Financial Market Dynamics", pp.8-10.

[5] See Irwin and Yoshimaru, "Managed Futures Trading and Futures Price Volatility", Final Research Report (May,1996), pg.21.

In today's global financial markets, the use of EFPs has evolved beyond the traditional role they played for commercials dealing in physical commodities and using futures to hedge their exposures. Any consideration of additional regulation of EFPs should take full account of and be appropriately sensitive to the expanded functions EFPs now play for other major participants in futures markets. EFPs, in other words, provide institutional investors, such as Managed Funds, many of the same benefits they have provided commercial users of futures markets – greater ease of entry into and exit from cash and futures markets. Because of the above considerations, the MFA opposes restrictions on EFPs that would make them less useful to our members. Additional regulation that unnecessarily raises the cost of using or reduces the effectiveness of EFPs will harm MFA's members and the investors they represent by reducing fund performance. Such unwarranted regulation will also harm the futures markets we trade (and that the CFTC regulates) by reducing market liquidity. In turn, other users of these futures markets will suffer from the loss of liquidity.

In this regard, the MFA is opposed to codifying the Division of Trading and Markets (T&M) "EFP Report". The CFTC should view EFPs and their regulation in the light of today's market realities – realities that flow from the needs of major investors in integrated and global financial markets as well as from the needs of commercial processors and refiners of physical commodities. Without responding to each of the questions posed by the CFTC, the MFA wishes to state its general view that the additional regulation of EFPs proposed in the Concept Release, especially regulation dealing with the cash side of the EFP transaction, is unnecessary. Simply put, no case has been made that a problem exists that warrants additional regulation.

The MFA does, however, strongly support the CFTC's proposal to extend the concepts underlying EFPs to allow exchanges to develop similar practices for options -- EOPs or exchanges-of-options-for-physicals -- and swaps -- EFSs or exchanges-of-futures-for-swaps. These new trading opportunities would provide greater fluidity and liquidity to the markets and allow Managed Funds to more effectively manage their investors' funds.

The MFA also supports the CFTC's proposal to allow futures exchanges greater flexibility in adopting rules to accommodate large-order execution. The addition of efficient large order execution ability to exchanges is essential to maintain liquidity by attracting large traders. Encouraging competition among alternative market mechanisms should be a major priority of the Commission. Increased innovation and competition in this area has the potential to greatly benefit investors in managed futures funds. In much of their trades outside futures exchanges, Managed Funds are able to take advantage of large-order execution facilities. This has allowed us to provide better execution and better returns to our investors. Moreover, to our knowledge, there is no evidence that these mechanisms have reduced liquidity or impaired market efficiency and price discovery in these other markets. Nor is there any reason, in our opinion, to believe that they would do so in futures markets.

Conclusion

In closing, the MFA believes that EFPs, along with EOPs and EFSs, and large-order execution facilities should not be stigmatized as "non-competitive" transactions. In modern financial markets, competition takes many forms and occurs on many different dimensions. A narrow view of "competition" that focuses only on whether or not all order flow is channeled into a centralized pit misses the more fundamental competition that takes place between alternative mechanisms for making markets and satisfying investor and trader demands for liquidity. The Commission should establish a regulatory framework whereby exchanges are able to offer market users a choice of alternatives to open auction execution; then let the marketplace subject to regulatory oversight determine the most efficient modes of execution. As the Commission is aware from the positive response it received when these issues were raised at the recent Financial Products Advisory Committee meeting, there is overwhelming support for the Commission's efforts to encourage and facilitate these important market developments.

Please do not hesitate to contact me at (202) 828-6040 if you have any questions.

Sincerely yours,

John G. Gaine
President