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MANAGED FUNDS ASSOCIATION

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The Association for investment professionals in futures, hedge funds and other alternative investments.

July 11, 2001

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

COMMENT

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

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OFFICE OF THE SECRETARIAT

RE: CFTC RIN 3038-AB77; SEC RIN 3235-AI13 File No.
S7-11-01 – Narrow Based Security Indexes

Dear Ms. Webb and Mr. Katz:

Managed Funds Association (MFA) submits this comment letter in connection with the joint rulemaking undertaken by the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) regarding, among other things, the definition of narrow based security index futures products. Our comments focus on CFTC proposed rule 41.13 and SEC proposed rule 3a55-3 and questions 6-11 in the preamble to the proposed rule. The MFA believes that both law and policy dictate that the Commissions should adopt a different test for evaluating whether foreign futures security index contracts which are traded on foreign boards of trade are "narrow based security futures indices" from the test for domestic futures security index contracts. In addition, MFA believes that the Commissions should make it absolutely clear that foreign futures security index contracts which are composed solely of foreign securities and which are traded on foreign boards of trade are futures contracts subject to the exclusive jurisdiction of the CFTC.

Managed Funds Association (MFA) is the global voice of the alternative investment industry. MFA, located in Washington, D.C., is a membership organization dedicated to serving the needs of the professionals who specialize in the global

alternative investment industry - hedge funds, funds of funds and private and public managed futures funds. MFA has over 600 members who represent all segments of the alternative investment industry - including commodity trading advisors and commodity pool operators. Our members represent a significant portion of the \$500 billion invested in hedge funds, funds of funds, futures funds and other alternative investment vehicles. MFA members, which include many of the largest international financial services conglomerates, are based in both the U.S. and Europe.

MFA members, through their hedge funds, funds of funds, commodity funds and managed accounts are responsible for a significant part of the volume and open interest on futures traded on U.S. and foreign exchanges. We anticipate that MFA members will similarly be responsible for a significant part of the volume and open interest in any security futures (when traded). Accordingly, MFA and its members have a real and important concern that appropriate criteria be employed that will carry out the Congressional intent in authorizing the creation of security futures markets. We have recently requested the Treasury Department, and mention here, that we strongly favor extending 60/40 tax treatment to liquidity providers as well as to persons trading on eligible foreign boards of trade. In addition, many MFA members are quite active in the approximately \$90 trillion over the counter derivatives market. The OTC derivatives market provides MFA members and others with an alternative to security futures.

MFA joins in the views expressed in the comment letter filed by the Futures Industry Association on narrow based security futures indexes. As noted above, MFA believes that a different test should be applied to foreign security futures indexes for purposes of determining whether they are "narrow based" or "broad based" from the test applied to products traded on domestic exchanges. We endorse, but will not repeat, the arguments made by several commenters, including the FIA, regarding why a different test for foreign security future indexes is appropriate and in the public interest. We believe FIA's proposed foreign security future test is reasonable and encourage the Commissions to adopt it.

We would like to focus the rest of our comments on 3 points related to foreign security futures indexes which are traded on a foreign board of trade.

First, we believe that the Commissions should specifically exclude from the domestic narrow based versus broad based debate the status of foreign security futures which are traded on foreign boards of trade that are composed **solely of foreign securities**. While we were, and remain, skeptical of the arguments that narrow based indices and futures on individual U.S. securities could be used to manipulate U.S. equity markets, there may be arguably some basis to these arguments. The same can not be said with respect to futures related to solely foreign securities which are traded on foreign boards of trade. There appears to be no U.S. policy interest in defining a futures contract traded on a foreign board of trade on an individual foreign security or on an index which is composed solely of foreign securities as being either a "security future" or a narrow based index which should be treated as a "security." There is no chance of a United States equity security being manipulated. While this result may seem readily apparent,



we believe clarity in this area will prevent jurisdictional disputes in the future. For this reason, MFA requests that the Commissions explicitly state in the final rule that a futures contract on a foreign security or an index which is composed solely of foreign securities and which is traded on a foreign board of trade is a future and will not be construed to be a "security future" or a narrow based index for purposes of U.S. law.

Second, MFA believes that the CFTC should move quickly to identify or confirm those foreign boards of trade which operate under a regulatory regime which is comparable to that in the United States. Knowing which foreign boards of trade operate under comparable regulatory treatment is extremely important information for U.S. investors. In addition, such action could lead to the elimination of the unfair "tax" on U.S. investors. Under Section 1256(g)(7) of the Internal Revenue Code foreign futures contracts can receive the same tax treatment as domestic futures contracts if the Treasury Department has determined that the foreign board of trade meets certain criteria. In effect, a U.S. investor is "taxed" for purchasing foreign futures contracts if the foreign board of trade has not been determined to meet the statutory test. While many foreign boards of trade clearly meet the statutory test only 2 "determinations" have been made in over the course of several years. We believe that most of the industrialized nations – at least the G-12 Countries – meet the statutory test. MFA believes this oversight by past Administrations should be corrected quickly. We encourage the CFTC to move as quickly as possible to identify for the U.S. Treasury and the IRS those foreign boards of trade which qualify. This action will end the unfair "tax" on U.S. citizens who choose to participate in the foreign futures markets on qualified foreign boards of trade.

Third, we believe that the Commissions should permit eligible contract participants (ECPs) to trade foreign security futures indexes – either narrow based or broad based – on foreign boards of trade if they so choose. As several commentators pointed out the prohibition on U.S. persons' trading single and narrow based index stock futures on foreign boards of trade has been effectively repealed for ECPs by their ability to use the OTC derivatives market. With the passage of the CFMA, the OTC derivatives market has legal certainty. An ECPs can now trade the exact same single stock future – or index - which is offered on a foreign board of trade in the OTC market. ECPs are now permitted to do indirectly through the OTC market what they are prohibited from doing directly – that is trading a foreign security futures contract on a foreign board of trade. The CFMA's effective repeal of the prohibition of U.S. investors' transactions on foreign boards of trade – at least with respect to ECPs – should be recognized.

Finally, we would also note that the investor protection arguments which have been used to support the prohibition do not apply to ECPs. We believe there are some continuing public policy justifications for prohibiting retail customers to trade these products on foreign boards of trade. Retail investors need investor protection.¹ However, ECPs are sophisticated investors who have the financial resources and advisors to research foreign financial products and foreign boards of trade. Congress recognized in

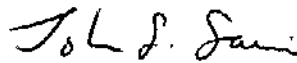
¹ It is not clear to MFA why the retail protections in Part 30 of the CFTC's regulations would not provide sufficient protection to retail investors. There has been successful abuse-free trading of foreign stock index based futures by U.S. persons for many years.



the CFMA that ECPs don't need the same type of protections that retail investors need and permitted these U.S. persons to participate in the virtually unregulated OTC derivatives market. Since it is clear that these U.S. persons do not need the SEC and CFTC's investor protection in the OTC derivatives market it is not clear why these same U.S. persons should be prohibited from buying and selling foreign security futures on foreign boards of trade. For these reasons, we believe the Commissions should, at a minimum, permit U.S. persons who qualify as ECPs to buy and sell foreign security futures on foreign boards of trade.

We appreciate the opportunity to comment on this joint rule making. If the staff of either Commission has any questions regarding this letter please feel free to contact me or Patrick J. McCarty, General Counsel, at (202) 367-1140 (phone) or (202) 367-2140 (fax).

Sincerely yours,



John G. Gaine
President

Cc: Commodity Futures Trading Commission
Honorable James E. Newsome, Acting Chairman
Honorable Barbara Pedersen Holm
Honorable David D. Spears
Honorable Thomas J. Erickson

Securities and Exchange Commission
Honorable Laura S. Unger, Acting Chairman
Honorable Isaac C. Hunt

