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COMMENT

January 10, 2003

Via Electronic Mail: secretary@cftc.gov

Jean A. Webb, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Advance Notice of Proposed Rulemaking on CPO and CTA Registration Exemptions

Dear Ms. Webb:

We are writing to recommend that the Commission adopt as a final rule, with certain modifications discussed herein, the relief provided in the Advanced Notice of Proposed Rulemaking and the No-Action Relief incorporated therein, issued November 6, 2002. Specifically, we recommend that the Commission adopt an exemption from commodity pool operator ("CPO") and/or commodity trading advisor ("CTA") registration for fund managers and trading advisors (collectively, "managers" herein) who:

- limit participants in their funds primarily to investors who are, at minimum, "accredited investors"; and
- utilize futures such that the aggregate notional value of such futures positions does not exceed 50% of the liquidation value of the fund.

We also recommend that the Commission expand the relief available to fund-of-funds managers and provide an exemption with respect to separate accounts managed by CTAs, each as further described below.

Introduction

Seward & Kissel represents numerous private investment partnerships and related offshore funds managed by U.S. investment managers. These funds invest primarily in equity securities and typically invest in commodity futures contracts (generally financial futures) primarily for hedging purposes. Under current CFTC regulations, the managers of such funds are generally required to register as CPOs and/or CTAs and are subject to all applicable CFTC regulations. Over the years, many fund managers have resorted to alternate, less efficient trading techniques to hedge their funds, in order to avoid the administrative burdens of the Series 3 examination and the disclosure and regulatory requirements imposed under CFTC Regulations. For example, some managers utilize thinly traded options on securities indices rather than more liquid and efficient stock index futures, which would require the manager to register as a CPO and/or CTA.

We believe that the standards in the No-Action Relief (i.e., the "accredited investor" eligibility requirements for investors and the limitations on a fund's ability to utilize futures such that the aggregate notional value does not exceed 50% of the liquidation value of the fund (the "50% limit")) are appropriate standards and should form the basis of a new exemption from CPO/CTA registration. While we support the intent behind the proposals of the Managed Funds Association and National Futures Association, we believe that each of those proposals contains requirements that may restrict managers who should be eligible for exempt treatment in a manner consistent with the No-Action Relief.

Accredited Investor Standard

The "accredited investor standard" adopted in the No-Action Relief conforms to the eligibility standards required under the federal securities regulations for private offerings conducted in accordance with Regulation D under the Securities Act of 1933, as amended, by most private investment funds. As this objective standard is generally recognized as deeming an investor knowledgeable and financially sophisticated, we believe that this is the appropriate investor qualification standard for participation in a fund that utilizes commodity futures to a limited extent, rather than the higher "qualified eligible person" ("QEP") standard of CFTC Rule 4.7[1].

In addition, we believe that the new exemption should contain a provision permitting a fund to admit a limited number of unaccredited investors, if such investors are otherwise qualified or sophisticated[2]. This would be useful to permit investments by qualified investors who do not technically meet the definition of an accredited investor, including:

- individuals who are "knowledgeable employees" under Section 2(a)(51) of the Investment Company Act of 1940, as amended[3];
- investments by trusts formed by accredited investors for the benefit of their family members, when the grantors and/or trustees of the trust are accredited, but the trust itself is not funded with an amount that would enable it to be an "accredited investor".

Use of Futures

The No-Action Relief is intended to apply to managers of funds that consist only of accredited investors and that are primarily *securities funds,* for which futures are a secondary trading strategy. Accordingly, we believe that the 50% limit is the appropriate limit for such managers[4].

We understand that under the No-Action Relief, the 50% limit on the use of futures is a maintenance test; however, we recommend that the new exemption provide that this test be measured at the time each futures position is established and/or incorporate a cure period if a manager exceeds the limit. For example, the exemption could require a fund manager to compute the aggregate notional value

1 Under CFTC Rule 4.7, an investor must be accredited and generally must maintain a portfolio of $2 million in securities to be deemed a QEP.

2 We note that Rule 506 of Regulation D under the Securities Act of 1933, as amended, contains a provision permitting an issuer to admit up to 35 unaccredited (but sophisticated) investors.

3 See Commission Rule 4.7(a)(2), which provides an exemption from the maintenance of a $2 million portfolio for knowledgeable employees.

4 In addition, we believe that the 50% limit would be easier for fund managers to track and compute on a regular basis than the 5% limit proposed by the National Futures Association ("NFA"). The NFA proposal would provide an exemption from registration to pool operators that commit 5% or less of the liquidation value of the pool to initial margins and premiums on commodity futures and options that do not constitute "bona fide hedging" under CFTC Rule 1.3(z)(1).

of the futures interests in its fund on a monthly or quarterly basis and, if the value exceeds the 50% limit, the manager would have a specific period of time in which to remedy the violation.

The Commission specifically requested comment on whether or not the use of futures should be limited only to hedging as a condition for exempt treatment. As the new exemption would be applicable to funds that are primarily securities funds, we believe that managers should retain the flexibility to use futures in any manner that enables them to achieve the investment objective of the fund, whether for hedging or non-hedging purposes.

Funds of Funds

Under the Commission's historical position, the manager of a fund-of-funds ("investor fund") who invests in commodity pools, must register as a CPO. In fact, the manager of an investor fund that invests in just one underlying commodity pool is required to register. Many such managers refuse to invest in any commodity pools so as to avoid registration, which may act to disadvantage their investors. Because these managers form their funds to invest primarily in equity oriented investment funds (and not "for the purpose of trading in any commodity"[5] interest, which is the definition of a CPO), they should not be required to register as CPOs. Since the operators of funds-of-funds are not directly transacting in commodity futures, no useful purpose seems to be served by requiring them to register.

The No-Action Relief for fund-of-funds managers provides that a manager of an investor fund can rely on the No-Action Relief only if (i) the managers of all the underlying funds that are commodity pools in which the investor fund invests have also claimed the No-Action Relief, and (ii) the portion of the investor fund that trades futures directly does not exceed the 50% limit. The requirement that underlying fund managers must have claimed the No-Action Relief provides little relief to fund-of-funds managers and imposes an undue burden on such managers. A fund-of-funds manager who invests the investor fund's assets in even one underlying commodity fund that began trading futures prior to November 6, 2002 would not qualify for the No-Action Relief because the underlying manager would have been registered as a CPO (assuming the underlying manager does not withdraw its registration with the CFTC in order to claim the Relief on its own behalf). In addition, a fund-of-funds manager who relies on the No-Action Relief is prohibited from investing in a commodity fund for which any underlying manager is registered as a CPO unless and until the manager of the investor fund also registers.

Consequently, we recommend that the final rule include, at a minimum, a specific exemption from registration for fund-of-funds managers:

- who invest in underlying funds or separate accounts, each of which uses futures in accordance with the 50% limit (whether or not the managers of such underlying funds are registered with the Commission); and

- whose direct use of futures in the investor fund complies with the 50% limit with respect to the portion of the investor fund that is not invested in underlying funds.

The manager of an investor fund should be able to rely on representations from each underlying manager as to its compliance with the 50% limit.

We also recommend that the manager of an investor fund be exempt from CPO registration if the aggregate notional value of the investor fund's pro rata portion of the commodity interests of the underlying funds does not exceed 50% of the liquidation value of the investor fund.

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[5] 7 U.S.C. §1(a)(5) (2000).

For example, an investor fund might invest 25% of its assets in each of the following four underlying funds:

Underlying Fund	Notional Value of Commodity Interests (expressed as a percentage of the liquidation value of the Underlying Fund)
Fund A	0%
Fund B	0%
Fund C	10%
Fund D	60%

In this example, the aggregate notional value of the commodity interests in the investor fund would be 17.5%, far below the 50% limit provided in the No-Action Relief to managers who invest directly in futures. We believe that a manager of an investor fund should be given the same flexibility as the manager of a fund that invests directly in commodities.

Exemption for Separate Account Managers

The No-Action Relief applies to a CTA only with respect to the advice such advisor provides to funds. If any of the proposed exemptions were to pass (whether as proposed or as amended), there would be a disparity between the relief available to commodity advisors to funds and the relief available to advisors to managed accounts. Accordingly, we recommend that the new rule also include an exemption from registration for a CTA who provides commodity advice to certain separately managed accounts and that such accounts be disregarded when counting towards the 15 client exemption from registration provided to CTAs under the Commodity Exchange Act.[6]

To qualify for the new exemption, we recommend that the advisor be required to provide advice to separate accounts, each of which:

- qualifies as an "accredited" investor (as modified in our recommendation above); and
- utilizes futures such that the aggregate notional value of such futures positions does not exceed 50% of the liquidation value of the account.

Conclusion

We commend the Commission for reconsidering an exemption from CPO/CTA registration with respect to fund managers who utilize futures in a manner incidental to the investment strategy of the funds. An exemption from registration similar to the No-Action Relief would permit these managers to use commodity futures and would provide greater flexibility to managers in providing investment services to their clients and would also expand the availability of futures (including single stock futures) to a greater number of qualified investors.

[6] See 7 U.S.C. §4m (2000), which provides an exemption from CTA registration to any commodity trading advisor who, in the preceding 12 months, has not furnished commodity trading advice to more than 15 persons and who does not hold himself out to the public as a trading advisor.

If you would like to discuss any of our recommendations, or if you have any questions, please feel free to call either Jack Rigney (212-574-1254) or Billie Cook (212-574-1225).

Very truly yours,

Jack Rigney

Jack Rigney

Billie Cook

Billie Cook

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