98-28

(11)

RECEIVED
C.F.T.C.

1998 OCT 20 P 5:01

MANAGED FUNDS ASSOCIATION

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

SECRETARIAT

COMMENT

COMMODITY FUTURES TRADING COMMISSION RECEIVED FOR PUBLIC RECORD

Oct 21 1 11 PM '98

October 19, 1998

Ms. Jean A. Webb
Office of the Secretariat
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, DC 20581

Re: Speculative Position Limit Rules

Dear Ms. Webb:

Managed Funds Association (the "MFA") appreciates the opportunity to provide comments in response to the Release (the "Release") issued by the Commodity Futures Trading Commission (the "Commission") and published in the Federal Register at 63 Fed. Reg. 38525 (July 17, 1998) seeking public comment on the Commission's proposed revisions to its rules on federal speculative position limits.

MFA is a national trade association representing the managed funds industry. MFA's more than 700 members provide diverse perspectives of alternative investment professionals, including hedge fund managers, commodity trading advisors, investment advisers, commodity pool operators and fund of funds managers. These professionals in the aggregate manage a significant portion of the nearly $250 billion invested in hedge funds and a vast majority of the over $35 billion invested in managed futures funds. MFA members also include professionals providing essential services to the managed funds industry such as brokers, exchanges, cash managers, foreign exchange dealers, banks, accountants, lawyers, consultants and academics.

Members of MFA are active participants in the futures markets and accordingly are advocates of both market integrity and a marketplace free of unreasonable or unnecessary constraints. Each is essential to the success of our members' businesses. Speculative position limits are merely one tool for preserving market integrity and are not an adequate substitute for effective market

1200 19th Street, N.W. Suite 300 Washington, DC 20036-2422 Tel: 202.828.6040 Fax: 202.828.6041 Web site: www.mfainfo.org

surveillance. Many academics and the Commission's own studies over the years have indicated that speculative position limits are not an efficient regulatory tool and their damage to market liquidity may be significant.[1] The Commission's authority to set such limits under Section 4 (a) (1) of the Commodity Exchange Act (the "CEA") is confined to those controls which the Commission finds "necessary" (as opposed to a broader standard such as "reasonably necessary" or "in the public interest") to forestall excessive speculation and "unreasonable" fluctuations in the price of commodity futures contracts. As such, the Commission must take into account countervailing statutory considerations including whether speculative position limits are the most efficient and least anticompetitive regulatory tool available. Accordingly, it is clear the Commission has the authority to adopt exemptions to the use of speculative position limits and that Congress intended the Commission to approach application of speculative position limits prudently, taking into account the impact on market liquidity and the need to eliminate unwarranted obstacles to legitimate commercial and trading activities in these markets. See H.R. Rep. No. 624, 99 Cong., 2d Sess. 43-44 (1986). For these reasons, MFA is extremely supportive of the Commission's stated intention to codify the prior exemptive relief which the Commission has granted to exchanges from the requirement that specific speculative position limits be imposed on certain contracts and also its prior exemptive relief relating to the substitution of position accountability rules for position limits for high volume and liquid markets. MFA consistently has favored exemption of exchanges from the requirement that speculative position limits be specified for all contracts and that they be permitted to substitute position accountability rules instead of speculative position limits for all contract markets for which exchanges believe such rules are necessary.

As reflected in MFA's comment letters and the letters of its members (some of which were first submitted more than a decade ago) in responding to the Commission's request for comments regarding changes to its aggregation policies and increases in speculative position limits, MFA and its membership have long been in favor of the elimination of speculative position limits and the Commission's approval of less restrictive, less anticompetitive and more effective means of

---

1 The empirical evidence which exists and academic studies conclude that current limits add no benefit to the liquidity and efficiency of the markets and in fact impair the price discovery mechanism by discouraging liquidity. The Commission's Advisory Committee on the Economic Role of Contract Markets as early as 1976 concluded that speculative position limits may actually reduce competition, lead to congestion in the delivery month and have no utility for markets with a broad supply or which may be easily arbitraged in foreign markets. See Advisory Committee Report, p. 28 (July 17, 1976). This conclusion was more recently confirmed by the Commission's Working Group on Speculative Position Limits of the Regulatory Coordination Advisory Committee. See Report of the Working Group, p.4 (May 20, 1991). Those non-U.S. jurisdictions which do not impose limits and the increased limits in U.S. markets have not resulted in price aberrations or manipulative activity as reflected in the Commission's Division of Economic Analysis studies on the first two phases of the increase in speculative position limits. The studies found no significant shifts either in the composition of the participants in the markets (i.e., speculative vs. hedge) or volatility of the markets attributable to these increases.

monitoring and discouraging market disruptions and manipulation. MFA commends the Commission for its continuing review of the application of its speculative position limit and aggregation rules in light of current market conditions and appreciates the responsiveness of the current Commission to move forward on increased position limits which have been pending for a number of years. MFA also urges the Commission to consider eliminating federally specified speculative position limits and to provide exchanges some flexibility in fashioning the appropriate regulatory response. In this regard, MFA notes the Commission would continue to maintain the authority not only to review, but also to enforce, exchange rules, which should provide the Commission with adequate tools to ensure effective exchange rules are appropriately enforced.

While MFA favors codification of the exemptive relief the Commission has granted to date from exchange establishment of speculative position limits, MFA urges the Commission to codify all its prior exemptive relief in this regard rather than merely certain levels of its prior exemptive relief. While MFA agrees that there may not be any contracts whose cash market currently reflects the virtually inexhaustible deliverable supply and high liquidity of those markets previously exempted by the Commission, it is likely additional contracts may be created in the future, either relating to the same cash markets or in other cash markets that develop the same liquidity, that would be eligible for such exemptive relief. If such contracts qualify under the Commission's standards applied in its previous grant of such exemptive relief, the exemptive relief should be available. As the Commission has not indicated its intent to narrow its prior grants of exemptive relief, but merely to codify such exemptions, all four categories of prior exemptive relief should be codified in the Commission's rules and should be available to new as well as existing contracts. If the Commission intends to narrow its prior grants of exemptive relief, it should indicate that intention to permit public comment on such limitations.

MFA also is unaware of any previous requirement that a contract be initially listed for twelve months prior to an exchange being permitted to apply for one of these types of exemptive relief. While Commission staff may have observed that historically contracts have not tended to achieve the liquidity parameters required under the exemptive relief prior to the initial twelve months of trading, the measure for such exemptive relief should be liquidity and the ability to be arbitraged and an exchange should be able to apply for such exemptive relief as soon as such a contract is eligible, if it so chooses. In this regard, MFA notes this framework is especially appropriate at the federal oversight level because exchanges, which bear primary responsibility to ensure market integrity, have the option not to seek exemptive relief and to impose more restrictive standards. The fact that in some cases exchanges have not chosen to apply for exemptive relief or have imposed more restrictive standards is evidence merely of the validity of the structure in which the Commission merely provides oversight rather than as justification for elimination of previously designed exemptive frameworks. Accordingly, MFA recommends the Commission codify all four levels of its previously exempted categories and that if the Commission believes the twelve-month period is helpful as an indicator of previous experience, that such time period be included as a permissive factor rather than a mandatory standard. MFA believes the omission was inadvertent, but if it was the Commission's intention to narrow its prior exemptive relief, MFA would object to the elimination of the last three position accountability categories' application to new futures and option contracts and the Commission's requirement that an exchange wait twelve months after a contract market's initial listing before being able to apply for substitution of position accountability rules. MFA would likewise object to any other aspect of the proposed codification that is more restrictive than the Commission's historical practice.

MFA is unaware of any difficulties created by the Commission's historical approach in providing exemptive relief to contracts qualifying for the other position accountability categories and the Commission does not state a reason for making this exemptive relief more difficult or unavailable. We believe it is possible that new contracts may be listed for mature contracts and may gain significant liquidity within a short period or existing or new cash markets may develop rapidly and therefore would warrant application of position accountability rules prior to twelve months' trading. In light of the exchanges' regulatory obligations to ensure market integrity and their closer relation to both the trading and the market involved, we believe exchanges are uniquely equipped to make these evaluations as is clear from the fact that certain of the exemptive relief has not been sought for eligible contracts.

MFA also favors the Commission's expansion of the definition of eligible entities in Section 150.1(d) to a broader range of entities and their affiliates. Consistent with what MFA believes to be the intent of the Commission under this proposed rule amendment, MFA would recommend that the Commission language refer to trusts, financial intermediaries, corporate divisions and other similarly organized entities or associations provided they can otherwise demonstrate the independence necessary to qualify for the exemptive relief in Rule 150. The language of proposed Section 150.1(d) should be expanded to refer to separately structured or organized affiliates or divisions of an eligible entity. Financial institutions often engage in trading in multiple, independent control centers. Given the evolving nature of the institutional presence in these markets and the benefits to the markets resulting from such participation, the Commission should maintain the flexibility demonstrated in its Rule 150.3 exemptive relief so as not to foreclose independent control centers from attempting to demonstrate to the Commission the independence of their account controllers. In light of the stringent requirements establishing independence of decision making contained in Rule 150 and the Commission's favorable experience with the operation of the rule, MFA believes that as long as an entity or division is able to establish a separate management structure, including "chinese walls," sufficient to satisfy the existing requirements of the exemption, the objectives of the rule are satisfied and should not provide an opportunity for trading in concert.

Lastly, MFA does not endorse the Commission's elimination of the limited partner and shareholder exemption from the definition of financial interests requiring aggregation reflected in proposed Rule 150.4 (c) because the rule does not reflect current practice (see Rule 18.01(a)) and MFA knows of no abuse requiring aggregation of such limited partners and shareholders who typically do not participate in management decisions, including trading decisions on behalf of the entity. At a minimum, the proposed rule is too broad. Many of MFA's members would be affected by such a broad rule change and MFA believes the rule is not necessary in light of the Commission's codification of its rule requiring aggregation of those trading in concert pursuant to an implied or express agreement. Such a rulemaking is inconsistent with the Commission's historical stance, dating back to the initial enunciation of its Aggregation Policy in 1979 and more recently in its adoption of Rule 150.3 which recognized appropriate exemptive relief for positions commonly owned but independently controlled. MFA believes that proposed Rule 150.1 (currently Rule 1.61(g)) provides a sufficient basis for aggregation of the positions of the pool with those of their beneficial ownership interests where such owners either control or materially impact the pool's trading decisions.

Adoption of such a rule would significantly detriment a substantial portion of MFA's membership who frequently utilize single investor or few investor pools or even fund of fund allocations in which there are fewer than 10 beneficial owners or the pool's beneficial owner owns in excess of 10% or even 25% (at times even 100%) of the pool's capital. These pools offer substantive benefits to their investors as compared to a separate managed account including limited liability, administrative convenience for investment results, monitoring and reconciliation of trading positions, tax reports and in some cases, certain tax advantages. Typically, these pools are specifically organized to preclude such participation by passive investors. Under the organizational documents for such entities as well as under the laws applicable to pools (such as partnership and tax laws), limited partners are generally precluded from managing the partnership. Such owners may not have control in fact, but also as a legal matter would eliminate the benefit which they originally sought in investing in a pool organized in the manner in which it is organized if they failed to maintain such independence from the management of the pool. Accordingly, MFA believes that the rule as proposed should not be adopted and that existing aggregation policies, as would be codified by the Commission in these proposed rules should suffice to respond to such abuses. If the Commission has identified specific abuses related to pools whose pool operators are exempt under Rule 4.13 and whose limited partners control trading decisions or trading decisions are not controlled by independently registered commodity trading advisors subject to the Commission's rules, MFA would recommend the proposed exclusion relate only to such of those pools that are not operated by a registered commodity pool operator, or for whom trading decisions are not made by a registered commodity trading advisor, or for whom trading decisions can not be established to have been made by an independent account controller.

MFA believes the above referenced proposed rule requiring aggregation of partnership positions for limited partners, or corporate positions for shareholders would be impossible to implement. In the normal course, such beneficial owners neither have access to, or knowledge of, a pool's actual trading positions and therefore as a practical matter, would have no way in which to monitor or prevent violation of the rule. To require such pools to report positions to beneficial owners in a timely manner so as to prevent an inadvertent violation is likely to seriously detriment all the beneficial owners of the pool as the pool's positions may be seriously compromised by knowledge of the positions which the pool trades. Further, if an entity were required to disclose its positions to individual investors, many account controllers would refuse to trade for such entities as in their view, knowledge of actual positions traded may lead to divulgence of proprietary aspects of their trading approach. Even if such reporting to beneficial owners were possible, the Commission has not offered any guidance on how a pool's positions might be allocated to such beneficial owners. MFA believes that any such allocation might have serious negative consequences to the pool as a legal matter in addition to negating the very administrative conveniences that led to formation of such an entity. The end result of adoption of such a rule will be to guarantee that no pool has any concentration of ownership, a result that would dramatically and negatively hinder the organization and fund raising abilities of such entities and the liquidity of the markets in which they currently trade. In light of the significant expense and existing legal difficulties already inherent in the formation of such pools, MFA believes the impact of such a rule would be significant.

MFA believes proposed Rule 150.4 (c) is unnecessary and as currently drafted, is confusing. The rule is unnecessary because proposed Rule 150.1, which requires aggregation in appropriate situations of actual or implicit control as noted in the foregoing discussion is sufficient to solve the stated abuse. Such a rule is also inconsistent with the Commission's logic in adopting the exemption in Rule 150.3. It is more often the case that the affiliates of a commodity pool operator or commodity trading advisor will maintain a beneficial interest in the pool. Frequently, this structure is essential to initially form and capitalize the entity or to align the operator's interest with those of its investors, which is frequently not only beneficial to, but is demanded by, the entities investors. In many cases, the commodity pool operator is insufficiently funded to maintain such an interest and accordingly, affiliates meet the funding requirement. Where such affiliates are independent of the commodity pool operator or where the pool is traded by independent account controllers, there is no regulatory rationale for such a rule. Such a position is inconsistent with the legal theories upon which both Rule 150.3 and the Commission's Interpretative Letter No. 92-15, CCH [1992 Transfer Binder] Com. Fut. Law Report, ¶ 25831, are based.

While MFA continues to believe that the elimination of federally set speculative position limits entirely is ultimately in the best interests of the market and market participants, MFA strongly supports the Commission's proposed increase in speculative position limits.[2]

MFA extends its appreciation to the Commission for the opportunity to comment on the Commission's proposed rules and the responsiveness of the Commission to making workable rules that accomplish the purposes for which they are intended. In light of the potentially significant depletion of market liquidity and the resulting decline in the hedging and price

2 MFA reiterates its continued request that the Commission expand the exemption for spread positions which extend beyond one crop year, an item which does not appear to be addressed in the proposed rules, or leave expansion of such exemption to exchange discretion. Spread trading provides important liquidity to the markets and can be essential to the price discovery mechanism. By the nature of such trading, it is not conducive to being utilized for the type of market abuses for which speculative position limits were designed to discourage.

discovery functions of markets resulting from speculative position limits which too tightly constrain legitimate market activity, MFA joins the Commission in seeking to limit as much as possible the situations to which speculative positions limits will be applicable. MFA believes such changes will make United States markets more competitive with foreign markets which have chosen not to regulate their markets using speculative position limits without reducing public protection. With each set of revisions in the speculative position limit and aggregation rules, these markets have improved, as demonstrated by the Commission's own studies and the concerns raised by negative commentators have not come to fruition. Accordingly, MFA urges the Commission to promptly adopt its proposed rules, modified in the manner suggested above. MFA welcomes the opportunity to respond to further inquiries by the Commission or its staff in connection with this rulemaking.

Sincerely Yours,

John G. Gaine

John G. Gaine

cc: Chairperson Brooksley E. Born
The Honorable Barbara P. Holum
The Honorable James E. Newsome
The Honorable David P. Spears
The Honorable John E. Tull, Jr.
Steven Manaster, Director, Division of Economic Analysis
Paul Architzel, Chief Counsel, Division of Economic Analysis