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FOR THE COMMODITY FUTURES TRADING COMMISSION ROUNDTABLE ON MANAGED FUNDS ISSUES TO BE HELD ON SEPTEMBER 19, 2002

The jurisdictions of the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") overlap in relation to money managers and managed funds. Regulations are often inconsistent or duplicative. This summary highlights several problems and proposes regulatory solutions which could reduce duplicative or conflicting regulatory requirements, thereby reducing barriers to entry and the costs of conducting investment management businesses.

A. Exemptions/Exclusions for Privately Offered Funds.

Treatment of privately offered collective investment funds under SEC and CFTC rules is an example of complex, inconsistent regulation, the result of which may be that fewer managers use the regulated futures markets. Currently, in order to offer interests in a collective investment fund that trades in securities but not futures without registration with the SEC, the fund must come within an exemption or exclusion from registration under each of the Securities Act of 1933 ("1933 Act") and the Investment Company Act of 1940 ("1940 Act"). Currently, in order to offer a collective investment fund that trades securities and futures (in any amount) without registration with the SEC, the commodity pool operator ("CPO") of the fund must register or come within an exclusion under the Commodity Exchange Act ("CEA") and the fund must come within an exemption or exclusion from registration under 1933 Act and the 1940 Act.

Regulation D provides a safe harbor from registration under the 1933 Act for funds offered privately to no more than 35 "unaccredited investors". Section 3(c)(1) of the 1940 Act excludes funds offered privately to 100 or fewer persons from the definition of investment company and therefore from the requirement to register as such. Section 3(c)(7) of the 1940 Act excludes funds offered privately to any number of "qualified purchasers" from the definition of investment company and therefore from the requirement to register as such.

On the other hand, with minor exceptions for family partnerships, the staff of the CFTC defines any privately offered collective investment fund that trades any amount of futures or options on futures as a commodity pool, the CPO of which must register as such. The staff takes this position whether the futures are traded directly in the fund or indirectly by investment in another collective investment fund. There is no useful exemption from CPO registration with respect to a privately offered collective investment fund.

This problem could be rectified by coordination of the exemptions/exclusions available under the various statutes. Specifically, the CFTC should adopt one or more exclusions from the definition of CPO and/or exemptions from registration as a CPO.

1. Exclusions from the Definition of CPO.

a. *Master/Feeder*. The CFTC should exclude from the definition of a commodity pool the "master fund" in an appropriate master/feeder structure. An appropriate structure would be one in which investors invest at the feeder level. All assets of the feeder or feeders are used to

invest in a master fund. All trading is done in the master fund, which serves solely as a "joint trading account" for the feeders. A registered CPO operates the feeders consistent with CFTC regulation. Trading is controlled by the CPO or an affiliate of the CPO. This exclusion would avoid the necessity of requiring the master fund to have a CPO and then requiring that CPO to provide reporting and disclosure to itself as CPO of the feeders. This exclusion would be consistent with staff interpretations concerning joint trading accounts. This exclusion could be accomplished by an interpretation that a master fund as described above is not a commodity pool.

2. Exemptions from CPO Registration.

a. *Proposed Rule 4.9*. In order to better coordinate the CEA exemptions with those available under 3(c)(7) of the 1940 Act and Regulation D of the 1933 Act, the CFTC should adopt the Managed Funds Association's proposed Rule 4.9 which would exempt from CPO registration the CPO of a fund offered privately consistent with the 1933 Act, provided that all of the individual investors were "qualified eligible persons" and the institutional investors were "accredited investors". The CFTC would retain anti-fraud jurisdiction over the CPO and the CPO would be required to file annual financial statements with the CFTC.

b. *De Minimis* Exemption. In addition, in order to alleviate the burden of registration on hedge fund managers who use futures or options on futures only for hedging or in other very limited ways that are incidental to their securities trading, the CFTC should adopt a *de minimis* exemption from registration such as the one proposed by the National Futures Association ("NFA").

c. *Funds of Funds*. The CFTC should exempt from CPO registration the CPO of the investor fund in an appropriate fund of funds structure. An appropriate structure would be one in which (i) no futures trading occurs in the investor fund, (ii) the CPO and CTA of each investee fund that engages in futures trading are registered with the CFTC and in compliance with its rules, (iii) the CPO of the investor fund is not subject to any statutory disqualification, and (iv) each of the investee funds is primarily engaged in securities trading.

B. Publicly Offered Futures Funds.

Treatment of publicly offered futures funds is an example of complex, duplicative regulation that increases the costs of conducting investment management business and therefore raises barriers to entry. Currently, in order to offer a futures fund to the public, the prospectus must be filed with the SEC and the CFTC as well as the NASD Inc. ("NASD") and each state in which the fund will be offered. Comments are usually received from the SEC, CFTC, NASD and some of the states. In the last few years, the SEC has regularly issued 50 to 100 comments, many of which are related to plain English presentation (which is also required by the CFTC) and the investment operations of the fund (about which the CFTC is the most knowledgeable agency). Comments from states often also address investment issues. Resulting amendments and refilings are costly and time consuming. It may take four months from initial filing and several hundred thousand dollars of legal fees to launch a public fund.

In addition to 1933 Act registration, publicly offered futures funds are required to provide quarterly and annual reports to the SEC under the Securities Exchange Act of 1934 (the "1934 Act"). These 10-Q and 10-K reports impose on passive collective investment vehicles requirements applicable to operating companies. As a result, voluminous information is provided that is of dubious value to fund investors. At the same time, the CPO of the fund must provide monthly and annual reports to investors under the CEA. These reports are tailored to the operations of a futures fund.

The following suggestions could alleviate some of the complexity and duplication described above.

1. *Prospectus Review*. First, the SEC should cede substantive review of the prospectus to the CFTC as the agency most familiar with the operations of and risks entailed in futures funds. Registration statements could still be filed with the SEC and fees paid and, perhaps, the SEC could review the documents solely with respect to required financial statement presentation. In addition, the SEC should not review of the sales literature that often accompanies the prospectus of a futures fund. This review should be ceded to the NFA, as noted below.

2. *State Preemption*. Second, the states should be prohibited from substantive review of prospectuses approved via the above process. This would be consistent with the changes wrought by The National Securities Markets Improvement Act of 1996 with respect to other public companies.

3. *NASD Role*. The NASD reviews the underwriting arrangements of all public offerings as the self-regulatory agency overseeing the broker-dealer industry. It also reviews the sales literature used in connection with these offerings. Although the NASD should continue to review the underwriting arrangements with respect to futures funds, the NASD should cede its authority over sales literature for public funds to the NFA as the self-regulatory agency most familiar with the operations of and risks entailed in futures funds.

4. *Reporting*. Futures funds should be exempted from preparation of 10-Qs and 10-Ks based on compliance with the CFTC reporting requirements for CPOs. This would put futures funds in roughly the same position as registered investment companies that follow the 1940 Act regime rather than that of the 1934 Act with respect to reporting to investors.

C. Security Futures Issues.

Security futures are both securities for purposes of the 1940 Act and futures for purposes of the CEA. Use of security futures by a collective investment fund may change the determination of whether the vehicle is (i) an investment company subject to regulation under the 1940 Act, (ii) a commodity pool, the CPO of which is subject to regulation under the CEA, or (iii) both. Therefore, use of security futures by collective investment funds will exacerbate the problems of conflicting and overlapping jurisdiction addressed in A. and B. above.

In order to determine whether a collective investment fund is an investment company subject to the 1940 Act, it is necessary to determine the primary engagement of the company, unless the fund is excluded from the definition of investment company under 3(c)(1),

3(c)(7) or another exclusion in that Act. A collective investment fund primarily engaged in securities transactions is an investment company. A fund with a different primary engagement is not an investment company. The SEC staff has applied this test to collective investment funds that trade futures and hold Treasury securities as margin and determined that such funds are not investment companies subject to the registration requirements of the 1940 Act. Similarly, the staff has determined that a fund of funds in which each of the underlying funds is primarily engaged in futures trading is not an investment company subject to the registration requirements of the 1940 Act. The addition of security futures to the portfolio of a futures-only fund or an underlying fund in a futures fund of funds may change each of these results.

Similarly, the CFTC generally has viewed a collective investment fund that trades any amount of futures as a commodity pool. This is true whether the futures are traded by the fund or by the underlying fund in a fund of funds. Primary engagement is irrelevant. The addition of security futures to the portfolio of a fund that otherwise trades only securities will make the fund a commodity pool, the operator of which must register or be excluded or exempt from registration as a CPO.

In order to alleviate the potential problems that may be exacerbated by the use of security futures by collective investment funds, the solutions addressed in A. and B. above should be adopted. The solutions in A. would provide exclusions and/or exemptions from CPO registration for the CPOs of certain privately offered collective investment funds that trade in futures, including security futures. The solutions in B. would ease the regulatory burdens on CPOs of public futures funds, including those that engage in some security futures trading. In addition to the solutions in A. and B., the CFTC and SEC should jointly provide guidance on how to weigh security futures in making a determination of primary engagement. Such guidance would permit funds, CPOs and their advisors to make use of security futures with a clear understanding of the regulatory consequences of such use.

Finally, the CFTC and SEC could adopt a registration program for publicly offered funds investing only in security futures that is consistent with the program in place for broker/dealers and futures commission merchants executing or carrying security futures for customers. The fund and CPO could opt for the CFTC regime, including registration of the CPO, and then be permitted to notice register with the SEC. Alternatively, the fund and CPO could opt for the SEC regime, including registration as an investment company under the 1940 Act, and then be permitted to notice register with the CFTC.