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CFTC Roundtable on Managed Funds

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I appreciate the opportunity to participate in the CFTC's Roundtable on Managed Funds. Prior to joining Dechert in 1998, I served for nearly fifteen years at the Commodity Futures Trading Commission (CFTC). During most of that period, I served as Chief Counsel of the Division of Trading and Markets, with responsibility for developing and implementing CFTC regulatory requirements applicable to commodity pool operators (CPOs) and commodity trading advisors (CTAs). My current practice at Dechert involves new investment products, such as security futures products, swaps and other derivatives, and investment vehicles of all varieties (including, e.g., hedge funds, offshore funds, registered investment companies, and variable insurance products). Dechert has more than 150 lawyers specializing in investment management and other aspects of the financial services marketplace. I submit these remarks solely in my personal capacity and not on behalf of my firm or any client of my firm.

I commend the Commission for initiating this dialogue on managed funds issues. This Commission has long recognized that a sound regulatory structure is dynamic and adaptive, taking into account changing market structures and products. Designing a regulatory structure that responds to the complex and fast-changing hedge fund marketplace requires a high degree of coordination between the CFTC and the SEC. This roundtable provides a valuable forum for consideration of issues that significantly affect funds subject to the shared oversight of the CFTC and the SEC.

I would like to highlight several areas deserving of the Commission's consideration:

<u>Regulatory Relief for Managed Funds Users of Security Futures Products</u>. As the Commission is well aware, because security futures are deemed to be both futures and securities, commodity professionals who transact in these products potentially become subject to dual regulation. However, the Commodity Futures Modernization Act (CFMA) clearly was designed to provide an integrated, not a cumulative, regulatory structure for security futures products, and provides significant relief from potentially duplicative SEC and CFTC regulation in the form of notice registration procedures for FCMs and broker-dealers and expansive regulatory relief for investment advisers and commodity trading advisors. Fund managers, however, are a special case and one not addressed by the CFMA. As a consequence, security futures products provide a stark illustration of the potentially decisive impact of regulatory cost upon the investment choices of fund managers. Security futures are a logical complement to the investment strategies of many equity fund managers who have not previously given serious consideration to using futures transactions -- and who therefore have not constructed their funds with an eye to CFTC Rule 4.7 requirements for exemptive relief. Even if the managers of such funds are willing to undertake CPO registration, their funds may well include persons who are not qualified eligible persons (QEPs), rendering them ineligible for the Rule 4.7 exemption. In order to make use of security futures, such managers would not only have to become registered but also either force non-qualifying investors out of their funds or take on the task of preparing and distributing a new disclosure document that fully complies with the CFTC's Part 4 requirements. This is not an

appealing choice, and it is unfortunate that the attractiveness of an important new futures product may be so substantially affected by the regulatory status quo. I urge the Commission to exercise its authority under Section 1(a)(5) of the Commodity Exchange Act to exclude from the CPO definition the managers of privately offered funds which will limit their futures activity to security futures products.

Create Generic Exemptions and Transparent Resolutions of Inadvertent Commodity Pool Issues. The broad definition of a commodity pool historically applied by the Commission raises a number of important issues. To be sure, the concept that any futures activity renders a collective investment vehicle a commodity pool creates a simple, bright-line standard. However, it is a standard that is likely to reach many entities that are not designed to be, and do not in practice, operate as investment vehicles for futures transactions. In many instances, "inadvertent commodity pools" may arise, despite the good intentions of the parties. Moreover, the all-inclusiveness of the commodity pool definition may give rise to a perception that knowledgeable, compliance-oriented institutions who give deference to the CFTC's approach are penalized by doing so, while those who are less knowledgeable or less conscientious are likely to escape the burden of compliance with little risk of sanction. The Commission's staff provides helpful mitigation of the reach of the commodity pool definition though the issuance of no-action, exemptive and interpretive letters in appropriate cases. This is an important process but can be a taxing one for the Commission as well as the affected market participants. I suggest that the Commission encourage the staff to be proactive in this area, by maintaining a vigorous program for issuing no-action relief and other relief as warranted to address CPO definitional issues. Serious consideration should also be given to creating safe

harbors or exemptions based upon existing staff letter precedent to address in a generic way some of the prototypical situations in which CPO registration can appropriately be dispensed with. These might include, for example, funds of funds structures where the investee funds will have limited futures activity, master-feeder fund structures in which at least one CPO has responsibility for futures activities, and multi-general partner governance structures where one partner will be a registered CPO and assume responsibility for operation of the pool.

Insurance Company Separate Accounts; Funds of Funds Structures. One particular, recurrent situation that would warrant a generic exemption of the nature I have suggested would relate to variable products offered by state-regulated insurance companies. The Commission's staff has considered requests for no-action relief submitted by insurance companies proposing to offer, exclusively to QEPs, certain variable products which entail the use of separate accounts whose proceeds will be invested in one or more investee funds. These funds may include commodity pools which are operated by registered CPOs, and a registered CPO or CTA (or statutorily exempt CTA) would be responsible for selecting the investee funds and allocating separate account assets among investee funds. In these circumstances, the Commission's staff has granted no-action relief dispensing with CPO and CTA registration of the life insurance company offering the variable product, recognizing, inter alia, the applicability of state regulation and the fact that CFTC registrants will be responsible for managing the futures-related investments of the separate accounts making use of these products. The Commission would provide greater efficiency to insurance companies in constructing innovative variable insurance products if it promulgated a regulatory exemption or safe harbor to address these types of products.

Increased Flexibility for Rule 4.5 Entities. The Rule 4.5 exclusion for investment companies and other comparably regulated entities operates on the basis of a distinction between transactions for bona fide hedging and speculative positions. In the context of registered investment companies, the constraints imposed by Rule 4.5 operate, of course, in addition to the restraints imposed by the Investment Company Act of 1940's prohibition against the issuance of senior securities. This prohibition ensures that registered funds engaging in futures transactions will do so on an unleveraged basis, whether through ownership of offsetting positions or through maintaining funds in segregation to cover the risk of such positions. Given this constraint, I suggest that the Commission consider providing greater flexibility to registered investment companies and perhaps other Rule 4.5 entities in their use of futures. For example, the Commission would provide additional flexibility, while maintaining prudential limitations, by providing an alternative 10% aggregate margin test to the current "hedging plus five percent" standard, enabling funds to monitor their total futures positions against a 10% margin standard rather than separately considering hedge and non-hedge positions. Given the Investment Company Act's constraints upon leverage, this limitation would not unduly expand the permissible futures activities of registered investment companies. The CFTC and SEC in consultation may be able to devise other additional solutions with the goal of providing additional flexibility to registered funds without compromising regulatory interests.

Conclusion. I have mentioned just a few areas in which regulatory refinements would foster efficiency without reducing regulatory protections. In the past, the Commission and the SEC have improved the regulatory structure for managed funds by coordinating their regulatory programs, and this type of coordination promises to continue to provide important benefits. I

also believe that the managed funds industry would be benefited by an industry initiative to codify best practices for managed funds vehicles, and both agencies could be useful participants in that process. I very much appreciate the opportunity to present these thoughts and I would be pleased to assist the Commission and its staff in any initiatives in this area.