COMMODITY FUTURES TRADING COMMISSION

ROUNDTABLE ON CPO AND CTA ISSUES

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Agenda Item III A. Regulatory Issues Relating to Publicly Offered CommodityPools

I. The Need to Rationalize the Regulation of Public Commodity Pools

Publicly offered commodity pools ("Public Pools") are subject to the regulatory oversight of the Securities and Exchange Commission (the "SEC"), the Commodity Futures Trading Commission (the "CFTC"), the National Association of Securities Dealers, Inc. (the "NASD"), the National Futures Association (the "NFA") and each state in which an offering is conducted.

1. The continuing burden imposed on Public Pools to comply with the rules of multiple regulatory jurisdictions is clearly contrary to the legislative policy objectives expressly advocated in NSMIA and the CFMA.

2. The multiple layers of regulation to which Public Pools are subject entail multiple layers of expense (which are generally passed along to investors) and significant delay (as much as 4 month to clear all regulatory hurdles). The combination of these two has created unjustifiably high entry barriers into the field, with the result that only the largest firms are able to offer this product in the U.S. Due to the amount of resources required, the significant regulatory delays and the high costs, many firms are offering these products to non-U.S. investors. Since many of the trading programs available through Public Pools have limited trading capacity, the very rules designed to protect investors are simply preventing U.S. investors from gaining access to these non-correlated investment products.

3. (a) The "chilling effect" on the offering of Public Pools created by excessive and inconsistent regulations is especially unfortunate at this phase in the economic cycle when smaller investors are in particular need of the potential diversification benefits offered by Public Pools.

   (b) Public Pools offer a "non-traditional investment" option in dollar amounts many times lower than can feasibly be offered in many other alternative investment products and are one of the only non-traditional investments which can be publicly offered. The alternative strategies are typically securities-based and are

prevented from making a public offering by the Investment Company Act. A typical investor does not have $250,000 (which actually is less than the standard hedge fund minimum) available to diversify into non-traditional strategies; Public Pools offer alternative investments in $5,000 minimums.

4. Public Pools enhance the liquidity of the futures market — particularly the agricultural and non-financial commodities — by providing an important source of speculative capital which tends to be traded pursuant to trend-following strategies (assisting hedgers in establishing positions needed to manage the risks of their businesses).

II. Principal Examples of Detrimental, Overlapping U.S. Regulation of Public Pools

1. <u>Required Compliance with Inconsistent and Inapplicable SEC Disclosure Requirements Designed for Operating Companies, Not Public Pools</u>

The CFTC has spent years developing disclosure rules specifically tailored to Public Pools. The SEC, on the other hand, has spent even more years developing disclosure rules specifically tailored for different types of operating companies. Instead of permitting the obviously appropriate CFTC disclosure rules to govern, current regulations require Public Pools to comply with <u>both</u> disclosure regimes. I attach to this outline a grid indicating the very few contexts in which Regulation S-K provides helpful information (in each such context, the information in question is relevant to public offerings in general, not just to Public Pools) which the CFTC does not also require, and the multiple instances in which the SEC rules require either irrelevant or even potentially misleading disclosure.

Solution: Exempt Public Pools from inappropriate S-K disclosures while otherwise subjecting them to all SEC public offering requirements. *The point is straightforward: the SEC is expert in the public offering process; Public Pools should be fully subject to SEC rules in this respect. The CFTC, on the other hand, is expert in commodity pool disclosures; Public Pools should be fully subject to CFTC rules (and <u>only</u> CFTC rules) in this respect.*

2. <u>1934 Act Registration — Designed for Issuers with Publicly-Traded Securities, not Redeemed at Net Asset Value – Should not Apply to Public Pools</u>

Open-end (*i.e.*, permitting redemptions) investment companies are not subject to 1934 Act registration; why should Public Pools be? As a disclosure matter, the 1934 Act reporting system is largely redundant of the CFTC requirements. Public Pool units are almost always offered, held and eventually redeemed by their initial purchasers. Because the units do not trade, there is no need for public information to be disseminated about them — the only persons to whom unit-related information is relevant are the investors holding such units. Under CFTC rules, all investors receive <u>directly</u> and <u>monthly</u> (not just <u>indirectly</u> and <u>periodically</u>, as in the case of the 10-Q and 10-K reports filed in Washington) as well as audited annual reports. Furthermore, 10-Q and 10-K disclosure, based on Regulation S-K, is as equally inappropriate for Public Pools as are the Reg. S-K Prospectus disclosure requirements.

Other ramifications of 1934 Act registration — for example, Section 16 reporting — are meaningless in the case of issuers whose securities do not trade, but only redeem at Net Asset Value (again, just as in the case of open-end investment companies).

Solution: Treat Public Pools in the same (logical) manner as open-end investment companies and exempt them from 1934 Act registration.

3. Blue Sky Preemption

This has been a sore point in the Public Pool industry for at least a generation. The states impose not only disclosure, but substantive, requirements on Public Pools. This is particularly ironic because the states have long been preempted from regulating the actual investment activity of the Public Pools — futures trading. Either treat the Public Pools as investment companies (in which case state review will be preempted by NSMIA) or as futures traders (in which case state review would be preempted by the Commodity Exchange Act), not as being worse off than either.

Solution: Expand the federal preemption provisions of NSMIA to include Public Pools.

4. Conform CFTC to SEC Prospectus Delivery Requirements

Pools are the only investment product in the United States which must deliver a final prospectus before any "direct or indirect solicitation of investors." This necessitates the entirely unjustifiable expense of delivering final prospectuses to persons many of whom have no interest in the product, as well as the entirely unjustifiable delay of clearing all necessary regulatory steps before being able even to test the market for an offering.

Solution: Eliminate this unique CFTC requirement — a relic from a time when commodity pools were rare, exotic and highly specialized products — and rely on the same prospectus delivery rules under the Securities Act as are applied to other offerings. *Again, the SEC is the expert on the public offering process; the SEC rules should govern in this context.*

III. Additional Agenda Items of Concern

1. Conform Private CPO and Private CTA/RIA Exemptions

This comment requires no explanation. The situation in which a manager which trades only securities can manage 14 different funds with a potentially unlimited number of clients does not have to register as an RIA, while a manager of a single privately-offered fund with only 2 investors which also trades securities but uses a single futures contract for risk management purposes needs to register with the CFTC is completely indefensible.

Solution: Conform the CFTC regulations to the SEC rules (and the statutory CTA 15 client exemption); repudiate the CFTC "lore" that managing a private pool is *per se* holding oneself out to the public (the SEC takes exactly the opposite view).

2. Make the RIA Exemption Available to CTAs also Available to CPOs

The CFMA provides that registered CTAs which primarily trade futures need not register as investment advisers and *vice versa*. However, the same exemption was not extended to CPOs. This is particularly ironic because CTAs manage unlimited liability managed accounts whereas CPOs sponsor limited liability collective investment vehicles. Given the high degree of leverage used in most futures trading, it is clearly counterproductive for regulators to favor managed accounts as opposed to limited liability vehicles, but that is the effect of failing to include CPOs within the scope of the CFMA's "primarily engaged" exemption from RIA registration.

Solution: Make the CFMA exemption available to CPOs.

3. Adopt Uniform CFTC/SEC Investor Qualification Standards

Qualified Eligible Persons, Eligible Clients, Qualified Purchasers, Accredited Investors, Qualified Institutional Buyers — these categories have accreted over time in a hodge-podge of statutory and regulatory standards. There should in concept be only 2 standards.

(a) The Lower Standard: Those investors who do not require specific disclosures (as opposed to all material information) be given to them. [Accredited Investors; Qualified Eligible Persons].

(b) The Higher Standard: Those investors who do not require substantive, not just disclosure, protections [Qualified Purchasers; Qualified Institutional Buyers]

Solution: Two simple categories would suffice and be consistent with the clear policy objectives of NSMIA and the CFMA.