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MANAGED FUNDS ASSOCIATION

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

August 7, 2000

COMMENT

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Ms. Jean A. Webb
Secretary
Commodity Futures Trading
Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Proposed Rules Concerning Intermediaries; Regulatory Reinvention; Exemption for Bilateral Transactions

Dear Ms. Webb:

The Managed Funds Association ("MFA") is a national trade association representing more than 700 alternative investment professionals. MFA's members include hedge fund managers, commodity trading advisors, commodity pool operators and fund of funds managers, as well as major end-users of the futures markets. These managers are responsible for a significant portion of nearly $400 billion invested in hedge funds and the vast majority of over $40 billion invested in managed futures funds. MFA members also include brokers, exchanges, cash managers, foreign exchange dealers, banks and other professionals who provide support services, such as accountants, lawyers, consultants and academics.

MFA appreciates this opportunity to present its comments concerning the Commodity Futures Trading Commission's ("CFTC" or "Commission") proposed rules set forth in four

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Federal Register releases entitled "A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations; Exemption for Bilateral Transactions" (the "Proposals").[1]

1. **Extending The Commission's Regulatory Reform Initiatives to Commodity Pool Operators ("CPOs") and Commodity Trading Advisors ("CTAs").** We strongly recommend that the CFTC expand its regulatory reform initiative to provide significant regulatory relief to CPOs and CTAs. In announcing its regulatory reform proposals, the Commission has declared its intention to pursue "fundamental changes to modernize Federal regulation of commodity futures and option markets." (65 FR 38985). The Commission's proposed new regulatory framework is intended to "rel[y] more heavily on disclosure rather than merit regulation," increase regulatory flexibility, and replace rigid prescriptive requirements with broad and flexible "core principles." (Id.). While MFA strongly supports providing regulatory relief for futures exchanges, we are disappointed that these proposals do not provide any meaningful relief for important sectors of the futures industry -- CPOs and CTAs and the large numbers of end-users that they represent.[2]

MFA recognizes that the Commission intends to consider rulemaking proposals "that may focus more directly upon Part 4 of the Commission's rules" at some time in the future. (65 FR 39009.) However, MFA believes that the Commission must act expeditiously to address

[1] 65 FR 38985 (June 22, 2000); 65 FR 39008 (June 22, 2000); 65 FR 39027 (June 22, 2000); and 65 FR 39033 (June 22, 2000).

[2] By Federal Register release of July 27, 2000, 65 FR 46122, the CFTC has recently proposed rule amendments designed to permit CPO's to use "profile" disclosure documents. These proposed rules will be addressed in a separate comment letter.

the regulatory framework applicable to CPOs and CTAs if its regulatory reform project is to meaningfully modernize futures regulation. There are over 2,800 CTAs and 1,500 CPOs registered with the Commission. These entities, in the aggregate, are among the futures exchanges' largest daily customers. Because CPOs and CTAs represent thousands of futures market end-users, the regulatory constraints under which these commodity professionals operate burden not just them alone but also substantial sectors of futures market participants. The regulatory constraints applicable to CPOs and CTAs necessarily impact their customers' ease of access to markets, costs of trading, and available product choices. Consequently, the ability of the new futures markets envisioned by the Commission to serve the needs of end-users depends substantially upon the ability of CPOs and CTAs to access those markets and efficiently make use of them. The regulatory restrictions applicable to CPOs and CTAs therefore must be approached with the same flexibility and willingness to change existing approaches that the Commission has shown in addressing other parts of its regulatory framework. MFA stands ready to assist the Commission and its staff in achieving these ends.

2. Expanding Access to Markets Through More Flexible Regulatory Approaches. Even as currently focused on the exchange regulatory structure, the Proposals require modification to take account of the customer interests represented by managed futures professionals. As professional trading advisors to and managers of pooled investment vehicles for the funds of end-users, MFA's members have an overriding interest in maximum access to markets and products and in the least costly, most efficient operation of markets, consistent with basic market protections. In the Proposals, the Commission has embraced the goal of moving toward disclosure standards in lieu of merit regulation -- an approach that implies a preference

for flexible criteria in permitting access to markets. However, in defining access to the proposed new futures markets, the Commission has adopted unnecessarily rigid criteria, creating barriers to market access that will likely impair their liquidity, efficiency, and utility to end-users. MFA believes that qualified CTAs -- those CTAs with at least $25 million in assets under management -- should be permitted to access all three forms of futures markets on behalf of their clients.

The Commission's Proposals would establish three new forms of futures markets, under a regulatory approach designed to reflect the level of sophistication of participating customers and the type of commodity traded. Under this new "tiered" market structure, markets operating under lighter regulatory burdens, and therefore presumably enjoying greater efficiencies and potential for innovation, would be available principally to institutional participants and individuals with at least $10 million in assets -- investor categories defined by the existing criteria for eligibility to engage in exempt swap transactions under the Commission's Part 35 regulations. As a result, the markets most able to provide innovative products, efficient operation and greatest liquidity generally will be closed to all but the wealthiest individuals and institutional traders. Only persons who are eligible swap participants would be permitted to trade on Multilateral Transaction Execution Facilities ("MTEFs"), the most lightly regulated markets. Similarly, Derivatives Transaction Facilities ("DTFs") would generally be available only to eligible swap participants. However, a DTF would be permitted to provide access to certain financial contracts to non-institutional customers trading through registered futures commission merchants ("FCMs") that are clearing members, have $20 million of adjusted net capital, and would be required to provide their non-institutional customers trading on a DTF with

additional disclosures and other protections. CTAs trading on behalf of clients generally would have access only to Registered Futures Exchanges ("RFEs"), the most highly regulated of the three market tiers.

MFA supports the Commission's recognition that customers trading through qualifying FCMs should have access to DTFs without regard to their individual financial qualifications. For analogous reasons, customers trading through registered CTAs should also have such access. MFA recommends creation of a new term, "qualified commodity trading advisor," for those CTAs with at least $25 million in assets under management. A Qualified Commodity Trading Advisor ("QCTA") would be permitted to access MTEFs and DTFs and engage in transactions on behalf of their customers in those markets. This suggestion is consistent with the Commission's proposal concerning qualifying FCMs. In addition, MFA believes the $25 million threshold for QCTAs is reasonable when considering that the CFTC proposes to permit commodity pools with only $5 million in assets access to these new forms of futures markets.

As the Commission itself has recently recognized, where a professional asset manager such as a CTA acts for a customer, the "demonstrated financial sophistication" of the professional can be relied upon, without looking to the sophistication of the individual client of the CTA. See "Exemption From Registration for Certain Foreign FCMs and IBs," 65 FR 47275, 47277 (Aug. 2, 2000).[3] Customers who have entrusted a qualified trading professional with discretion to select the products and strategies to be traded for that customer's account, the

[3] See also 64 FR 54620 (Oct. 7, 1999) ("Cantor Financial Futures Exchange's Proposal to Adopt Block Trading Procedures") approved February 11, 2000 (see CFTC Press Release No. 4362); 65 FR 18312 (April 7, 2000) ("Chicago Mercantile Exchange's Proposal to Adopt Block Trading Procedures").

market on which to trade those products and the manner of effecting transactions have determined that the CTA is best qualified to make trading decisions on their behalf. Non-institutional as well as institutional customers regularly depend upon CTAs to assess the markets, products and strategies available to them and the manner in which those strategies will be effected. The customer's decision to rely upon a CTA is made by the customer with the benefit of CFTC-required disclosures concerning the CTA and the CTA's trading program. CTAs are responsible for disclosing to customers the risks of the trading program which will be used to trade the customer's account, and the CFTC's disclosure rules already mandate that more extensive disclosures be given to non-institutional customers than to institutional customers.[4] Disclosure requirements applicable to CTAs (and CPOs) are also reflective of the nature of the market on which transactions for the account will be conducted. For example, CTAs can trade on behalf of their customers in foreign markets subject to lower levels of regulation or different forms of regulation, based upon appropriate disclosure being given to the customer.

Precluding access to markets based upon the customer's own presumed lack of expertise therefore deprives customers of their ability to elect and receive the full benefits of the professional management for which the customer has retained the CTA. Customers employ CTAs precisely to obtain the greater sophistication and expertise offered by the CTA. If CTAs' access to markets on behalf of their customers is to be constrained by the customer's individual sophistication or financial qualifications, the customer loses part of the benefit of his bargain.

4. As the Commission has proposed with respect to non-institutional customers trading through qualifying FCMs, appropriate additional disclosure could be required to be given to non-institutional customers by the CTA trading for such customers on DTFs or MTEFs.

The Commission's proposed restrictions upon access to DTFs and MTEFs also create unwarranted distinctions between customers whose funds are entrusted to a CPO as distinguished from a CTA for the purpose of trading in the futures markets. Commodity pools operated by a person subject to regulation under the Commodity Exchange Act (or a similarly situated foreign person) and having total assets exceeding $5,000,000 would have full access to MTEFs and to DTFs trading contracts set forth in § 36.2(b). CTAs would not have such access, either individually or on behalf of customers for whom they hold investment discretion. MFA submits that CTAs trading accounts which do not take the form of commodity pools should not for that reason be denied access to new futures markets. CTAs and CPOs are subject to the same or similar proficiency and fitness requirements and to parallel regulatory requirements. Moreover, the form of the trading account or vehicle, i.e., whether the customer accesses the futures markets through an individual account managed by a CTA or a commodity pool managed by a CPO, does not define its risk potential. Managed accounts, depending upon the trading program, leverage parameters, asset mix, and other factors, can have the same risk profile or even a lower level of risk exposure than a commodity pool. In most cases, CTAs are responsible for making trading decisions for commodity pools. They are equally qualified to make such trading decisions for managed account customers.

One size or form of trading vehicle does not fit all or dictate the appropriate regulatory approach. A CTA might trade a customer's account in a manner that would result in less risk than a commodity pool, depending upon the risk approach of the commodity pool. Further, the CTA managing the customer's account and the futures commission merchant through which the account is traded both have strong incentives to assure that the customer's exposure to risk will

remain within parameters appropriate to that customer's resources. Consequently, while managed accounts are not structured legally as limited liability entities, it is in the interests of CTAs and FCMs to develop appropriate risk controls, such as trading parameters, stop loss orders and margin funds, have been built into the trading program for the account to assure that the customer's risk is in fact appropriately limited.

As noted above, there are over 2,800 CTAs registered with the Commission. It is estimated that less than 10% of all registered CTAs would qualify under a $25 million in assets under management test. MFA believes that this relatively small but sophisticated class of CTAs would be an appropriate group for the CFTC to initially permit access to all 3 types of futures markets. Of course, MFA would encourage the Commission to lower the $ 25 million threshold in the future if experience shows there to be no investor protection problems.

The Commission has identified a key aspect of regulatory modernization in a preference for disclosure requirements over merit regulation. This progressive approach argues strongly for flexibility in allowing access to markets to customers who, based upon appropriate disclosure, have given investment discretion to a commodity professional operating subject to the CEA and CFTC rules. For the same reasons, MFA believes that the Commission should permit MTEFs to permit access by qualified CTAs who have been given trading authority by non-institutional as well as institutional customers.

Defining access to markets based upon the QCTA criteria discussed above should also extend to the Commission's proposed "Exemption of Bilateral Agreements," which would amend the CFTC's Part 35 swaps exemption to respond to marketplace developments and enhance legal certainty. In modernizing the swaps exemption, the Commission should recognize

the role of QCTAs exercising investment discretion on behalf of their clients to assess the costs and benefits of products and markets. As discussed above, as CTAs generally make investment decisions for commodity pools and commodity pools with total assets exceeding $5,000,000 are eligible swap participants, clients of CTAs managing at least $25,000,000 in assets should also be eligible swap participants.

3. Developing Core Principles as the Foundation for Intermediary Regulation. As we have noted above, the Commission's regulatory reform objectives must fall short of completion until the regulatory framework for CPOs and CTAs is modernized. Development of "Core Principles" to take the place of prescriptive regulatory requirements is a key aspect of modernization of the CPO and CTA regulatory structure. As the Commission has not yet proposed Core Principles for CPOs and CTAs, MFA's comments on the Commission's approach to Core Principles for intermediaries as set forth in the Proposals are necessarily general. Nonetheless, MFA believes that the proposed approach to Core Principles for certain intermediaries presents issues which warrant comment at this juncture.

As a general matter, MFA takes issue with the Commission's decision to use Core Principles merely as broad standards guiding analysis of particular rules, rather than as a more flexible alternative to and substitute for prescriptive rules. This approach differs markedly from the Commission's proposed use of Core Principles in overseeing futures markets and suggests that the Commission's approach to oversight of intermediaries will remain largely prescriptive. MFA continues to believe that the use of Core Principles as the operative standards for

intermediaries subject to Commission oversight is central to modernization of the Commission's regulation of intermediaries.

The Commission's Part 4 rules, which govern the activities of CPOs and CTAs, illustrate the potential benefits of a Core Principle approach. The Part 4 rules are among the most detailed, complex and specific of all CFTC rules. Since its original adoption twenty years ago, the Part 4 framework has been designed to provide detailed disclosures to unsophisticated customers. With the adoption of Rule 4.7 in 1992, CPO and CTA regulation has incorporated more streamlined disclosure requirements for pool offerings and managed accounts offered to highly sophisticated and accredited customers. Part 4 remains, however, a highly detailed approach to disclosure for pools and accounts that are not offered pursuant to Rule 4.7. Due in part to the dense matrix of regulation in this area, protracted efforts of the CFTC and the industry have been necessary to address a succession of technical issues, such as "notional funds" presentations, treatment of funds of funds and other matters raised by particular market innovations which do not fit neatly under the rigid requirements of Part 4. The "notional funds" issue, for example, has been the topic of CFTC and industry discussion for well over a decade -- and remains unresolved to this day. Under a Core Principle approach, the Commission could identify desired disclosure objectives and results by establishing performance standards in lieu of straitjacket rules. This approach would avoid the ultimately impossible task of attempting to anticipate in specific rule provisions all of the potential disclosure issues that will be raised as new trading strategies and vehicles develop in a dynamic marketplace. MFA strongly supports the efforts of the National Futures Association ("NFA") to develop sound Core Principles for

CPOs and CTAs. We stand ready to assist NFA and the Commission in bringing these efforts to fruition.

4. **Specific Comments.** In addition to these general comments, MFA provides the following comments concerning specific aspects of the Proposals.

New Definition: "Qualified Commodity Trading Advisor." As discussed above, MFA recommends that the Commission establish a new definition for "qualified commodity trading advisor." This term would include CTAs with at least $25 million in assets under management. This new definitional category would be used to identify those CTAs whose assets under management reflect customers' recognition of the CTA's qualifications and sophistication.

Registration: Definition of the Term "Principal." MFA supports the Commission's proposed revisions of the definition of the term "principal" in a manner that would reduce the number of persons within complex entities who are required to be registered. However, MFA suggests that the reference in the proposed rule to "any person in charge of a business unit subject to regulation by the Commission" be clarified to make clear that a principal business unit, division or function means the aggregate business unit acting in a registered capacity and not subsidiary divisions or units such as marketing, human resources, audit, and other departments within an operating entity.

Special Procedures Applicable to Firms Subject to Securities or Banking Regulation. The Commission proposes a simplified registration procedure for persons seeking registration as FCMs or IBs who will conduct transactions exclusively on DTFs for institutional customers and who are registered with the SEC as securities brokers or dealers or are banks or

other federally regulated financial depository institutions. Persons satisfying these criteria could obtain "passport" registrations by making notice filings with the NFA and providing evidence of their regulated status. The Commission's stated rationale for this new procedure is that the firms affected would be permitted to deal only with institutional customers and would be subject to oversight by other federal regulatory authorities, and the Commission anticipates "that they will conduct most of their business in the securities or banking fields, with only a minor portion of their activities involving commodity interests." (65 FR 39012). However, the rule as proposed would not limit use of this "passport" procedure to applicants whose commodity interest activities will be minor or limited in any way. As drafted, the rule would in fact permit "passport" registration of firms whose predominant business is trading or dealing in commodity interests. MFA believes that passported firms should be subject to a limitation upon their commodity interest business, such as, for example, a requirement that their commodity interest activities be incidental to their primary business as a broker-dealer or bank or that the firm's revenue from commodity interest related activity for customers represents no more than ten percent of its total revenue on an annual basis. See CFTC Rule 3.12(h)(1)(iii).

Ethics Training. MFA supports the Commission's proposal to delete the current ethics training requirements in Rule 3.34 in favor of a more flexible approach such as a Statement of Acceptable Practices.

Segregation of Customer Funds. MFA supports the ability of non-institutional customers whose funds are managed by a registered CTA to opt out of segregated funds. As noted above with respect to access to futures markets, non-institutional as well as institutional customers regularly depend upon CTAs to assess the markets, products, and strategies available

to them and the manner in which those strategies will be effected. These choices entail a weighing of risks and benefits of the same nature and complexity as will be required of customers determining whether to opt out of segregation. For all customers, the "opt out" decision will require a weighing of the relative safety of segregated funds against the greater returns on margin funds available to customers who opt out of segregation. By experience and expertise, CTAs will be far better equipped than the vast majority of customers, whether institutional or non-institutional, to assess the relative risks and rewards of opting out of segregation. Non-institutional customers should not be deprived of the ability to obtain the potential financial benefits of opting out of segregation if their decision-making is informed by a knowledgeable professional who has been entrusted with responsibility for maximizing the customer's ability to engage profitably in futures transactions. Accordingly, MFA supports the availability of opting out of segregation, both for institutional customers and for non-institutional customers whose accounts are managed by a registered CTA.

Trading Standards. The Commission notes that the supervisory procedures currently required in Rules 155.1, 155.3 and 155.4 have proven effective in curbing such practices as frontrunning, trading ahead, bucketing, taking the opposite side of customer orders, or improper disclosure of customer orders to third parties. The Commission proposes that these rules continue to apply to intermediation of trades at contract markets, RFEs and for non-institutional customers' trades at DTFs. However, for intermediation of trades by institutional customers trades on DTFs, proposed new Rule 155.6 would simply set forth a general prohibition against "misuse" of knowledge of any institutional customer's order for execution on a DTF. While the Commission states that this new provision would not "include as much detail" as the current

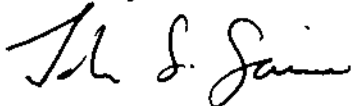
standard, "it is nevertheless intended to prescribe the same trade practice abuses as Rules 155.1-155.5." If the proposed new provision is in fact intended to subsume the same prohibitions as the more detailed standards generally applicable under Rules 155.1-155.5, MFA questions the utility of modifying the provision. MFA believes that any new standard should be designed in such a manner as to preclude any diminution in the effectiveness of prohibitions against frontrunning or other trade practice abuses and to provide sufficient clarity to facilitate compliance. Prohibitions should be clearly stated inasmuch as they carry substantial penalties and provide important protections.

Close-Out of Offsetting Positions. MFA supports the Commission's proposal to revise Rule 1.46 so that its general standard would operate as a default rule in the absence of instruction by a customer or account controller. However, MFA requests that the proposed rules be clarified to make it clear that responsibility for the instructions regarding offset should normally lie with the registrant directing trading -- generally the CTA and not the CPO. As drafted, proposed Rule 4.24(h)(2) appears to imply that the CPO chooses the manner in which positions will be offset for the pool. Where a CTA directs trading for a pool or a portion of a pool's assets, offset policies should be agreed upon by the CPO and the CTA, and the CPO should be responsible for disclosure of the agreed policies for the pool. If CPOs unilaterally exercised the right to direct FCMs as to how to offset positions, the CTA's trading could be affected without the opportunity to address or mitigate the resulting effects. The CTA might be subject to different policies for different pools, and materially different performance results could be created for otherwise similar programs.

Conclusion. MFA appreciates the opportunity to submit these comments on the Commission's Proposals. We would be pleased to discuss these issues further with the Commission or its staff and to provide any other assistance to the Commission that it would find useful.

If you have any questions concerning this letter, please do not hesitate to contact me.

Sincerely,



John G. Gaine
President

cc: Honorable William J. Rainer
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