MANAGED FUNDS ASSOCIATION

TESTIMONY

OF

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BEFORE THE

SUBCOMMITTEE ON GENERAL FARM COMMODITIES AND
RISK MANAGEMENT

OF THE

HOUSE COMMITTEE ON AGRICULTURE
UNITED STATES HOUSE OF REPRESENTATIVES

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Testimony of John G. Gaine, President, Managed Funds Association
Before the General Farm Commodities and Risk Management
Subcommittee of the House Committee on Agriculture
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Mr. Chairman and members of this Subcommittee, my name is John G. Gaine and I am the President of Managed Funds Association ("MFA"). MFA appreciates the opportunity to provide testimony for the Subcommittee's review of the Commodity Futures Modernization Act of 2000 (the "CFMA").

MFA is a national trade association, with approximately 700 members, that represents the managed futures, hedge fund, and fund of funds industry. MFA's membership is comprised primarily of commodity trading advisors ("CTA"), commodity pool operators ("CPO"), hedge fund, and fund of funds managers who manage a majority of the estimated $600 billion invested in managed futures and hedge fund investment vehicles worldwide. Of that $600 billion, a significant portion is managed by firms that are registered as CPOs or CTAs.

Many of MFA's members act as purchasers of futures industry services and, thus, are the indirect beneficiaries of market protection provisions of and rules promulgated under the Commodity Exchange Act (the "CEA"). Those sections of the CEA and the activities of the Commodity Futures Trading Commission (the "Commission" or "CFTC") that oversee the functioning of, or participation in, futures markets have an important impact on CPOs, CTAs, and their clients. Furthermore, many aspects of the business operations of MFA's members are subject to CFTC oversight under the CEA and, pursuant to delegation of certain regulatory functions under the CEA, regulation by the National Futures Association ("NFA")—the industry's self-regulatory organization. The Commission rules regulate the business activities of CPOs and CTAs through registration, disclosure, anti-fraud, record keeping and reporting requirements. The NFA regulates the sales, promotional, registration and operational activities of these entities. Each of the exchanges also regulates trading activities on their markets.

Many of MFA's members are regulated by a host of other federal agencies as well. The public offer and sale of interests in commodity funds are subject to the Securities Act of 1933 (the "1933 Act")—requiring registration of these interests and mandating disclosure obligations, the Securities Exchange Act of 1934—requiring the filing of certain publicly-available reports, and each of the 50 states' securities laws. Moreover, hedge funds are subject to Securities and Exchange Commission ("SEC") rules governing private offerings, large position reporting, anti-fraud and anti-market manipulation. All fund managers are subject to the anti-fraud provisions of the Investment Advisers Act of 1940 ("Advisers Act"), and certain managers choose to register as investment advisers with the SEC under the Advisers Act.

MFA's members will also be subject to the requirements of the USA PATRIOT Act of 2001 in the area of anti-money laundering, due diligence, and customer

identification procedures. The U.S. Department of the Treasury has proposed regulations, pursuant to the USA PATRIOT Act, that would be applicable to CPOs, CTAs, hedge funds, commodity funds, and investment advisers and would require these individuals or entities to establish anti-money laundering programs. This is a description of just some of the significant regulatory oversight to which commodity funds, hedge funds, and their managers, are subject.

MFA, as an association, has evolved as the alternative investment industry has evolved. Until 1997, we were known as the Managed *Futures* Association. Until that time, our members were primarily CPOs and CTAs. Over the years, certain of these commodity traders began applying their futures trading strategies to other financial instruments and some of these futures funds have evolved into some of the largest "hedge funds." As our membership began to represent both managed futures funds and hedge funds, in 1997 we appropriately changed our name to Managed *Funds* Association.

Over the past year, alternative investments, particularly hedge funds, have received a great deal of attention by regulators, legislators, investors and the media. Apart from our efforts in working with the CFTC over the past few years on new rulemakings, which I will discuss below in more detail, we have been closely working with the SEC in its fact-finding mission covering the hedge fund industry that began in May 2002. Last month, I had the opportunity to participate in the SEC's "Roundtable on Hedge Funds" along with other distinguished panelists, including SEC and CFTC Commissioners and senior staff, that have an interest in this industry. The Roundtable was an excellent opportunity for the hedge fund industry to debunk many of the myths surrounding it, such as the notion that this segment of the financial world is "unregulated" or "lightly regulated." In fact, over half the managers of the world's 100 largest hedge funds are regulated by the NFA. Of those remaining, a significant number are managed by SEC-registered investment advisers. As was made clear at the Roundtable, hedge funds are subject to a host of regulatory requirements, including the anti-fraud and anti-manipulation rules of the SEC and CFTC.

In responding to the increased attention alternative investments have received in Washington, DC, MFA has been a vocal advocate for sound regulation of this important sector of the financial world—a sector that provides many benefits to the global marketplace. Hedge funds, as do commodity pools, seek to provide investors with an investment opportunity that is not highly correlated with more traditional stock and bond investments. These vehicles provide much needed liquidity to the commodity markets, particularly agricultural markets, which serves to increase the efficiency of the price discovery and hedging functions served by these markets. However, there remain barriers to entry into the futures markets created by the regulatory framework. We believe the CFTC's efforts at reducing unnecessarily burdensome regulations, as a result of the CFMA, will encourage greater use of futures products in the financial marketplace. Accordingly, we are delighted to be here today to discuss the impact of the CFMA on the managed funds industry.

MFA's Response to Industry Developments

In recent years, MFA has adapted to the changes and demands placed upon the industry through the promotion of various best practices guides for fund managers. Committee members may recall that in 1998, after the near-collapse of Long Term Capital Management ("LTCM"), both the public and private sectors focused upon ways to reduce systemic risk. In 1999, one notable public sector response was the report published by the President's Working Group on Financial Markets (consisting of the Secretary of the Treasury and the Chairpersons of the SEC, the Board of Governors of the Federal Reserve System, and the CFTC) entitled, "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management" (the "PWG Report"). The PWG Report recommended a number of measures, both public and private, designed to enhance market discipline in constraining excessive leverage, recognizing that "[a]ny resort to government regulation should have a clear purpose and should be carefully evaluated in order to avoid unintended outcomes." Rather than proposing any direct regulation of hedge funds, the PWG Report's recommendations called for "indirect regulation" of unregulated market participants. One of the responses to this recommendation was the publication of "Sound Practices for Hedge Fund Managers," in February 2000, by the hedge fund industry.

MFA believes that the public and private sector measures implemented in the aftermath of LTCM, such as those described in the "Sound Practices for Hedge Fund Managers," have successfully reduced the exposure of global financial markets to systemic risk. Consequently, MFA does not believe that new regulation to address this risk is necessary, but does believe that we have helped foster one of the goals of the CFMA, as highlighted below, of reducing systemic risk. In light of the recent growth and evolution of the hedge fund industry, MFA is currently updating the "Sound Practices" document so that it continues to provide useful and timely guidance to hedge fund managers.

After passage of the USA PATRIOT Act in October 2001, before any rules were proposed for the hedge fund or commodity futures industry, MFA worked to publish its "Preliminary Guidance for Hedge Funds and Hedge Fund Managers on Developing Anti-Money Laundering Programs" in early 2002. The "Preliminary Guidance" serves as a handbook for fund managers seeking to meet the new requirements which are to be imposed in the area of anti-money laundering. Both the "Sound Practices" update and the "Preliminary Guidance" are two clear examples of MFA's work to respond to the goals of Congress and regulatory agencies in promoting the integrity of financial markets and their participants.

The Goals of the CFMA

I testified on behalf of MFA before this Subcommittee in support of the bill that became the Commodity Futures Modernization Act. MFA continues to be a strong supporter of the goals of the CFMA. Its passage in December 2000 represented a major and very positive legislative accomplishment that set the groundwork for regulations

governing today's futures industry and which will be responsible for promoting the growth of this industry. As stated in the legislation itself, the goals of the CFMA, among others, are:

- to promote efficiency and accountability in the commodity futures industry;
- to streamline and eliminate unnecessary regulation for the commodity futures exchanges and other entities regulated under the Commodity Exchange Act;
- to reduce systemic risk and provide greater stability to markets during times of market disorder by allowing the clearing of transactions in over-the-counter derivatives through appropriately regulated clearing organizations; and
- to enhance the competitive position of United States financial institutions and financial markets.

The CFMA also mandated that the CFTC deliver its "Report on the Study of the Commodity Exchange Act and the Commission's Rules and Orders Governing the Conduct of Registrants Under the Act." Part of this report, submitted to Congress in June 2002, included a study of intermediaries—such as CPOs and CTAs. We believe that the objectives of the CFMA are in the process of being realized by the Commission, in accordance with the findings of this study, and through the CFTC's recently-adopted and proposed regulatory reforms.

CFTC's Review of Intermediaries

Today, this Subcommittee is reviewing the status of the CFMA. As part of this process, MFA would like to provide this Subcommittee with current CFTC developments in which MFA has been directly involved. As mentioned above, the CFTC submitted its report on intermediaries in June 2002. This Report primarily addressed proposed amendments to Commission rules governing futures commission merchants ("FCM") and introducing brokers as well as CPOs and CTAs. In this regulatory review, the Commission has been responsive to the competitive challenges facing the U.S. futures industry participants, while at the same time preserving important customer protections and market safeguards.

As required under the CFMA, the CFTC solicited views of the public, registrants, and the registered futures association with respect to potential regulatory reforms. Throughout this process, MFA has had the opportunity to work with the staff of the Commission to help it realize the goals set forth in the CFMA—particularly with respect to issues that are especially important to our CPO and CTA members. We have also worked closely with the Futures Industry Association, the National Futures Association, and various commodity exchanges in this process. MFA facilitated numerous meetings with CFTC staff members, provided its views on various proposed rulemakings through comment letters, participated in two roundtable panels that were part of the CFTC's study of intermediaries, and proposed a new regulation for adoption by the Commission. MFA

applauds the work of the Commission in producing the 2002 report and its subsequent progress to date on regulatory reforms.

During the last CFTC Roundtable in September 2002, I served as a panelist on behalf of MFA, along with other members of the managed funds industry, to discuss prevailing issues on the regulation of intermediaries. As part of this debate, MFA strongly advocated a number of improvements to the regulatory regime governing the futures industry. This debate included discussion of the full implementation of single stock futures trading and the need for harmonization of the regulation of public commodity pools between the SEC and the CFTC. Some other ideas that were debated included the differing definitions of "client" by the SEC versus that of the CFTC, disclosure document delivery rules for CTAs, and additional registration exemptions for CPOs and CTAs, including one proposed by MFA. These discussions have borne significant results. In March of this year, the Commission proposed, and, hopefully, seems poised to adopt, significant rule amendments concerning the registration and business practices of CPOs and CTAs. I will discuss a few now.

2002-2003 Proposed Rulemakings

Registration Exemptions for CPOs and CTAs. For over a year, MFA has been working with the Commission on a proposed exemption from registration for CPOs that is based upon the presumed sophistication of the pool's investors. Currently, there is a mandatory requirement for registration as a CPO if a pool operator trades futures and options contracts on a futures exchange—even just one contract. Hedge funds, which are required to limit their offer and sales to institutional and individual investors that meet certain minimum income and net worth standards, must register as CPOs if they utilize futures contracts. Depending on the number of investors in a hedge fund, these investors must generally be either "accredited investors" defined in Regulation D of the 1933 Act, or "qualified purchasers" as defined in section 3(c)(7) of the Investment Company Act of 1940 (the "ICA").

Last year, MFA submitted a proposal for a new exemption from CFTC registration for operators of pools offered and sold only to certain sophisticated persons in private transactions exempt from registration under the 1933 Act (the "MFA Proposal"). This rule, proposed for rulemaking by the Commission on March 17, 2003, would provide an exemption for CPOs that sell only to: (1) individuals that are "qualified eligible persons" ("QEP") under CFTC Rule 4.7(a)(2), which includes the "qualified purchaser" definition under the ICA, and (2) institutional investors that are "accredited investors" defined under Regulation D or that meet any of the Rule 4.7 definitions of a QEP. MFA believes that this new exemption, to be codified as CFTC Rule 4.13(a)(4) would do the most to advance the goals of the Commission by reducing unnecessary and burdensome regulatory requirements imposed upon managers of commodity pools comprised of highly qualified investors. If the MFA Proposal is adopted by the CFTC, and we are optimistic that it will be, we believe that this will lead to greater use of financial and commodity futures products in the financial marketplace. Many private pooled investment vehicles avoid using commodity futures in their trading strategies

because of the associated CPO registration requirement. The MFA Proposal would eliminate this requirement for certain funds and would encourage growth of the futures industry. We are pleased that the Commission has proposed this rule for adoption. The MFA Proposal has received numerous letters in support of its adoption.

Similarly, the National Futures Association has proposed a similar registration exemption for fund managers that engage in limited commodity interest trading. Historically, no such "*de minimis*" exemption has been recognized by the CFTC for operators of funds. NFA has proposed the creation of such an exemption (the "NFA Proposal"), to be codified as CFTC Rule 4.13(a)(3), to provide a CPO registration exemption for fund managers that: (1) engage in only a "de minimis" amount of futures trading, under one of two alternative quantitative constraints, and (2) sell only to accredited investors. MFA also supports the adoption of this rule.

The benefit of both of the MFA and NFA Proposals is that each is available on a pool-by-pool basis. Thus, a CPO may operate some pools on a regulated basis and other pools pursuant to either one of these exemptions. MFA is optimistic that these proposals will be adopted as final rules.

Bunched Orders. MFA has also supported and provided comments on recently-approved amendments to CFTC Rule 1.35(a-1)(5) regarding "bunched orders". This rule allows certain account managers to bunch customer orders for execution and to allocate them to individual accounts at the end of the day. The amended rule expands the eligibility of bunching to all customers and simplifies this process for account managers and FCMs. This is another area of reform on which MFA has been working with the CFTC for a number of years. MFA believes that allowing all customers to have their orders bunched will lead to better execution and pricing of their orders. We believe that this rule strikes the appropriate balance between achieving the Commission's regulatory objectives of protecting customers whose accounts are bunched, and reducing the unnecessarily burdensome regulatory demands placed upon account managers or FCMs that use bunched orders.

Definition of "Client". Another proposed CFTC rule concerns a topic that was greatly debated at the last CFTC Roundtable: the differing approaches between the SEC and CFTC in defining the term "client" for certain registration exemptions for investment advisers and CTAs, respectively. Under current CFTC rules, CTAs can generally be exempt from registration with the CFTC if they: (1) have not furnished commodity trading advice to more than 15 "persons," and (2) do not hold themselves out to the public as a CTA. The SEC has a similar exemption for investment advisers under section 203(b)(3) of the Advisers Act. SEC Rule 203(b)(3)-1 defines a single "client" to include a legal entity, such as a partnership, in meeting the "fewer than 15" limit. The SEC approach does not "look through" the entity and count individual partners or shareholders. Conversely, under the current CFTC approach , where the "person" (or client) is a legal entity, the CFTC "looks through" the entity and counts individual owners for the purposes of meeting the "15 or fewer" test. Under a proposed modification to CFTC Rule 4.14(a)(10), the Commission now seems poised to adopt the approach used

by the SEC in counting a legal entity as one person. We are pleased the Commission has proposed to adopt the SEC approach. The proposed CFTC rule change will make this CTA registration exemption available to a greater number of CTAs.

Other Proposed Rules

MFA also supports a number of other rules that we believe are important to improve the regulatory structure governing CPOs and CTAs. The first relates to the document delivery requirements for CPOs and CTAs. The CFTC is now proposing to eliminate the requirement that a disclosure document be provided to a prospective pool participant prior to soliciting that participant, by amending CFTC Rule 4.21(a). Prior to issuing this proposed rule, the Commission had amended its rules to allow CPOs to use a profile disclosure document for solicitation purposes. Under the currently-proposed Rule 4.21, CPOs only have to provide the disclosure document by the time it delivers to the prospective participant a subscription agreement for the pool, so long as any material distributed in advance of such delivery is consistent with the final disclosure document. A similar rule for CTAs has also been proposed. All solicitations to prospective clients by CPOs and CTAs would still be subject to all relevant CFTC, NFA and securities regulations.

A second proposed rule concerns the elimination of duplicative document delivery requirements for operators of master feeder funds. Under the proposed amendments to Rules 4.21 and 4.22, the CFTC is removing the needlessly burdensome requirement that these operators deliver required reports to themselves for the other pools managed by them. A third, and final, proposed CFTC rule that I will mention would expand the CPO registration exemption available for "small pool operators." The proposed rule would double the limit on pool size, from $200,000 to $400,000, for which an entity can avail itself of this exemption.

Conclusion

MFA strongly endorses the CFTC's recent undertakings to fulfill the CFMA's mandate to enhance the competitiveness of U.S. futures markets and streamline their regulation. In particular, MFA supports the various rule proposals and amendments that I have mentioned and looks forward to their adoption in the near future. In addition, MFA hopes that the CFTC will continue to implement the CFMA's goals by undertaking to harmonize the SEC and CFTC rules governing public commodity pools, and to foster the full implementation of single stock futures trading. Overall, MFA believes that the Commission has demonstrated its willingness to solicit and actively consider suggestions and proposals by industry participants that will lead to greater modernization, efficiency and innovation of the futures industry. Accordingly, I look forward to answering any questions you might have. Thank you.