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TESTIMONY OF JOHN G. GAINE ON BEHALF OF THE MANAGED FUTURES ASSOCIATION

ON H.R. 2131 - CAPITAL MARKETS DEREGULATION AND LIBERALIZATION ACT OF 1995

Mr. Chairman and members of the Subcommittee, my name is John Gaine, General Counsel and Director of Government Relations of the Managed Futures Association (MFA). MFA thanks the Subcommittee for the opportunity to present its views on H.R. 2131 - "Capital Markets Deregulation and Liberalization Act of 1995".

The Managed Futures Association is the not-for-profit national trade association representing the managed futures industry. The MFA is a membership organization of professionals who provide investment and other services to clients on a global basis. It has approximately 500 members who are responsible for the discretionary management of the vast majority of the estimated $20 billion currently invested in managed futures products, including commodity pools and managed futures accounts. MFA is governed by an elected board of directors and has offices in Washington, D.C. as well as California.

The objective of the MFA is to enhance the image and understanding of the industry, to further constructive dialogue with regulators in pursuit of regulatory reform, and to improve the communication with, and training of, the Association's members through effective conferences and communications programs.

MFA's membership is primarily composed of commodity pool operators and commodity trading advisors whose business operations are regulated under the Commodity Exchange Act by the Commodity Futures Trading Commission. The Commodity Exchange Act oversees and monitors the business activities of commodity pool operators and commodity trading advisors through registration, disclosure, record keeping, and reporting requirements, and together with the National Futures Association (the national self-regulatory body of the futures industry) is their primary regulator. However, as most commodity pools are organized as limited partnerships, the offer and sale of their interests is subject to both the Federal and state securities laws (although the operations of such pools has nothing to do with securities). I am here today on behalf of MFA and its many members to applaud the Chairman and Subcommittee for addressing the issue of the appropriate roles of the state and federal securities laws. These are issues of fundamental importance to the managed futures financial sector.

H.R. 2131 seeks to rationalize regulations applicable to our industry and to streamline the overlapping, unnecessary, internationally anti-competitive and burdensome effect of having 51 separate state and federal securities laws applicable to the offering of interests in just one entity. Public commodity pools are a significant and increasingly essential part of the U.S. financial services industry. According to Managed Account Reports, in 1983 there were approximately 32 public funds with $249 million in assets. Today there are approximately 122 public funds with $2.2 billion in assets. These investment vehicles offer important portfolio diversification and professional risk management to smaller investors who otherwise would have no access to professional management of their assets in the futures markets. The U.S.'s complex and duplicative system of regulation serves merely to increase transaction costs and discourages the creation and offering of products in response to changing market conditions. For the U.S. to remain competitive in the rapidly changing international markets and not to lose its market share of that vast business commensurate with the U.S.'s overall economic powers and financial sophistication, its complex and expensive regulatory structure must be substantially streamlined. This legislation is a major step forward.

The markets in which commodity pools invest are global and are subject to extensive federal regulation. It makes no sense to have differing substantive regulation in each of 51 states. An investor in Texas investing in the same product should receive the same offering document as an investor in New York. There is no logical rationale for distinguishing these global products according to the regional location of their investors.

My testimony today will address primarily Section 3 of H.R. 2131 - entitled "Creation of National Securities Markets". The goal of a national unified system of regulation is laudable and necessary. Then SEC Commissioner Mary Schapiro recognized this fact in a letter to Senator Dodd in April of 1991. She stated:

"The second principal reason for enactment of the exclusivity provision was to protect exchange-traded futures from interference by state regulations and the potentially adverse and costly impact of compliance with 51 different regulatory schemes. Congress recognized and repeatedly reaffirmed the value of a nationally uniform body of standards governing futures trading coupled with state antifraud enforcement."

Unfortunately, U.S. commodity pools have been a case study proving the wisdom of Ms. Schapiro's call for a uniform regulator. Few financial products have been as burdened by the state Blue Sky process as commodity pools. The history of qualification of commodity pool offerings in the various states is not happy. It has been marked by delays, inefficiencies and costs with no appreciable counter-balancing public benefits. Although trading exclusively in markets which the states are preempted from regulating and subject to the jurisdiction of two independent federal agencies, the SEC and CFTC, the pools have been compelled to focus the bulk of their start-up efforts on obtaining state registration for their securities offerings.

In a typical public offering of a commodity pool, SEC and CFTC clearance is obtained in no more than approximately six weeks. Indeed, the SEC has only recently streamlined its review process for the pools (recognizing their doubly regulated character) so that an even quicker federal review process is anticipated. In the states, on the other hand, final clearance, if obtained, can require as much as four months or longer. Furthermore, it is not just the delay which is costly and burdensome, but the uncertainty and arbitrariness of the process. Because it is impossible to predict when certain important states will "clear," it is impossible to predict when an offering can commence. This is more than simply an inconvenience. In the larger securities firms, the offerings of different products are carefully scheduled, and if a pool misses its allotted "time slot," it may be a matter of months before it can get back on the calendar.

The organizational costs - which are borne by the investing public - of a large public pool offering will typically range from approximately $500,000 to $1,000,000. Of this, perhaps $300,000 will relate to legal fees and expenses, and of that figure, $100,000 or more will be directly related to the process of responding to the often multiple rounds of questions and comments received from the merit review states -- and all this in the context of an offering which has been cleared in Washington by two different and independent agencies.

The substantial costs and uncertainty of dealing with 51 different regulatory jurisdictions is one of the principal, if not the single most important, reasons that the public pool industry has now become concentrated in a very limited group of major national firms with the capital to absorb the entry barrier created by Blue Sky costs. The merit review process of a number of states has stifled innovation and the development of new products. Smaller local and regional firms are shut out of this market. We do not suggest by any means that this situation is the fault of the state regulators. On the contrary, whatever the quality of the state regulatory personnel (which in our experience has generally been high), it is a systemic problem to require a prospectus already cleared by agencies expert both in disclosure and in the field in which the issuing pool will operate also to be reviewed by the "merit review" states of which there are approximately 25 -- adding a layer of substantive review to the stringent CFTC/SEC disclosure oriented review process. Any regulatory system which has that many "chefs in the kitchen" will inevitably result in waste, delay and industry contraction. The situation is particularly acute in the commodity pool context, as our different "chefs" have entirely different views on how to cook -- the state imposing substantive restrictions, the SEC and the CFTC focusing on disclosure.

Expense and delay are not the only negatives of multiple merit review: substantive inequities and arbitrariness also result. The NASAA Administrators spent years promulgating Guidelines relating to the substantive terms of commodity pools, but not only does the pace of change in the industry inevitably outpace the states' ability to adapt the Guidelines, but also the Guidelines are applied with widely varying degrees of strictness in different jurisdictions. For example for years, it was impossible to clear any commodity pool offering in certain major states due solely to state internal administrative policy (no statutes were involved), while at the same time other types of significantly more speculative offerings were routinely approved. Today, Minnesota and South Dakota will not admit pools which employ certain forms of incentive fees, while these fee structures (aimed at reducing routine costs payable irrespective of profitability) are otherwise universally accepted. Why should an investor in one state be denied the opportunity even to consider an investment in a pool which is available to investors in 48 other states? Furthermore, the application of the substantive provisions is not necessarily consistent. Filings using certain structures have in the past been accepted in a given state only to have substantially similar or identical offerings refused registration a few months later. Again, we do not mention this by way of criticizing the state regulators, but rather by way of pointing out the massive inconsistency and "regulatory function" which inevitably result from having more than 25 independent regulators to satisfy, in addition to those in Washington.

Even if the different states do in fact clear an offering, they frequently do so on widely different terms. Not only do different states require widely differing additional disclosures (again, after these disclosures have been exhaustively reviewed by both the SEC and the CFTC) by way of cumbersome "stickers" or supplements, but some even insist upon their idiosyncratic form of subscription agreement. When one considers that a major pool offering will not infrequently print 200,000 to 400,000 prospectuses, one can begin to appreciate the cost involved in customizing disclosures to the tastes of multiple state regulators.

Perhaps even less justifiable is the crazy quilt of suitability standards imposed by the different jurisdictions. The NASAA Guidelines stipulate a minimum suitability requirement of $150,000 net worth or $45,000 net worth and $45,000 annual gross income. In a recent public offering, 15 states applied the Guidelines standards; 10 higher standards; and the rest a lower standard. One major state has recently suggested a suitability standard of as high as $500,000 "liquid" (i.e. exclusive of home, furnishings and automobiles) net worth to invest in a pool for which the minimum investment was only $5,000.

There is little point in reciting examples of disparate treatment among different states: redemption charges, limits on management and incentive fees, interest income, limited partners' voting rights, different forms of "principal protection" structures, fund names, indemnification -- the list of issues on which the states have diverged is extensive, and the point is obvious. How can one hope to foster a national securities market when issuers must contend primarily not with the national, but with the literally dozens of autonomous and inconsistent state regulatory jurisdictions? Any system in which innumerable different jurisdictions are permitted to impose their individual substantive as well as disclosure standards on an offering represents a "balkanization of regulation" antithetical to any sort of national market.

We emphasize that we do not, and would not, suggest that states should not continue to have powers to prosecute fraud and other police activities within their borders. On the contrary, we feel that a redeployment of Blue Sky resources from the independent and duplicative review of prospectuses already twice reviewed in Washington to a focus on misconduct and violations of law would be most welcome. Our point is much narrower and simpler: if Congress continues to permit the states independently to regulate pool offerings, a significant number of states inevitably will and the Blue Sky entry barrier will continue to choke off the U.S. public pool industry. This fact is borne out quite clearly in the history of the last 20 years. The legislative history of the 1974 amendments to the Commodity Exchange Act contained language quite clearly indicating that the states were to be preempted from reviewing commodity pool offerings. As will be obvious from the above, quite the contrary was -- in the absence of an explicit provision -- the result. It is a natural fact of government in this country that that which is permitted to be regulated will be; in the case of the pools, we must either say "no" to multiple independent regulatory jurisdictions or to a national market system.

Commodity pools present a very hard case for justifying continued state jurisdiction. Under the review of two major federal agencies, with their underlying activity explicitly preempted from state jurisdiction and the subject of additional ongoing review by both the CFTC and the National Futures Association, they still must labor their way through the states. The result: most do not. Sponsors turn offshore, and many of the best American advisors provide their services exclusively to foreign investors. The "flight offshore" and proverbial "uneven playing field" are perhaps nowhere as apparent as in the case of commodity pools -- a result which is particularly ironic and disheartening as the United States is where both the futures markets and commodity pools were born and developed.

No major industrial nation has a complex two-tiered regulatory structure such as we have in the United States. In fact the EU through its Directives is going toward a system of cross-border simplification and uniformity - reflecting the global nature of these markets. The United States commodity pool industry deserves a single source of regulation over its offerings, and that source can only be the federal government -- the SEC and the CFTC. The industry cannot afford to deal with so many jurisdictions in attempting to market its products to United States investors, who simply happen to reside in different states.

MFA offers the following comments with respect to the remainder of Section 3 of the bill relating to national uniform registration provisions governing securities' industry professionals. MFA's members are primarily commodity pool operators and commodity trading advisors registered with the CFTC and the National Futures Association. CPOs and CTAs (as well as the commodity brokers through whom they execute trades) are subject to one national uniform registration system with no state involvement in the process. This regulatory scheme has been in place since 1975 and has worked efficiently and successfully in protecting the public. Any efforts to conform the securities industry registration process to a national uniform system would from our experience make sense.

In conclusion, Mr. Chairman, we thank you for the opportunity to appear, strongly support your efforts to create a national securities market and would be happy to respond to any questions you or members of the Subcommittee might have.