Managed Funds Association
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

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Via Electronic Mail: CPOandCTAfeedback@nfa.futures.org

National Futures Association
300 S. Riverside Plaza, #1800
Chicago, IL 60606-6615
Attn: Mary McHenry, Associate Director, Compliance
Julia Wood, Attorney

Re: National Futures Association Notices to Members I-14-03 and I-14-05: Request for Comments – CPO/CTA Capital Requirement and Customer Protection Measures

Ladies and Gentlemen:

Managed Funds Association[1] ("MFA") appreciates the opportunity to provide comments to the National Futures Association ("NFA") in response to its January 23, 2014 and January 30, 2014 Notices to Members (together, the "Notice") requesting comments on the concept of imposing a capital requirement on commodity pool operator ("CPO") and commodity trading advisor ("CTA") members and other customer protection measures.[2] Some of these customer protection measures include requiring: (i) independent third party review and authorization of pool disbursements; (ii) independent third party preparation or verification of periodic account statements and pool performance; and (iii) reporting to NFA of the balances in a pool's accounts. NFA attributes its regulatory review of CPO and CTA operations to the fact that 92% of its 26 Member Responsibility Actions ("MRAs") in the past three years were against CPO and/or CTA members for fraud, malfeasance or other improper activities.[3] As discussed in

[1] Managed Funds Association represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and many other regions where MFA members are market participants.

[2] Notice to Members 1-14-03, Request for Comments – CPO/CTA Capital Requirement and Customer Protection Measures – Comments Due by April 15, 2014 (January 23, 2014), available at: http://www.nfa.futures.org/news/newsNotice.asp?ArticleID=4377; Notice to Members I-14-05, Responses to Request for Comments on CPO/CTA Capital Requirement and Customer Protection Measures not Limited to CPO/CTA Members (January 30, 2014), available at: http://www.nfa.futures.org/news/newsNotice.asp?ArticleID=4381.

[3] *Supra* note 2.

this letter, existing Commodity Futures Trading Commission ("CFTC") and NFA rules and regulations comprehensively regulate CPOs and CTAs, and already provide substantial customer protection. As explained in more detail below, we believe that a capital requirement would not address concerns about fraud in a meaningful way and would add substantial costs for CTAs and CPOs.

I. General Comments

MFA and its members strongly support the critical role that NFA plays in its oversight function of CPOs and CTAs, and its efforts to protect investors. We agree that the protection of customer funds is a paramount concern, and acknowledge the importance of NFA's role in this regard. Undisputedly, bad actors harm the entire industry. We respectfully disagree, however, that the MRAs of the last three years support a need for either capital requirements or changes in the current regulatory structure applicable to CPO and CTA operations. In reviewing the MRAs of the last three years, we make the following observations:

- The MRAs generally involved malfeasance or fraud, which we believe capital requirements are unlikely to deter. In fact, we note that one of the MRAs was against an introducing broker ("IB") subject to a capital requirement for fabricating bank statements with the deliberate intention of deceiving NFA regarding the firm's capital position.[4]

- The 26 bad actors from the MRAs represent a fraction of the industry and of NFA's membership—0.6% to be exact.[5]

Totally eliminating fraud is an impossible task, no matter how noble the effort. NFA has not demonstrated any correlation between maintaining a capital requirement and eliminating fraud. We do not believe the implementation of the measures discussed in the Notice will result in more than a negligible, if any, increase in customer protection. In any case, we are concerned that the burdensome costs associated with implementing the various measures would substantially outweigh any incremental benefits.

II. Executive Summary

MFA has carefully considered NFA's inquiries in the Notice and urges NFA to consider the following arguments against proposing the measures:

A. **Capital requirements will not ensure greater protection for customer funds.** The referenced MRAs all involve fraud, malfeasance or other improper activity. Capital requirements cannot prevent, or help NFA detect, bad actors. In addition, a lack of

[4] *See* In the Matter of IFINIX Futures Inc., NFA Case No. 11-MRA-005, August 18, 2011, available at: http://www.nfa.futures.org/basicnet/CaseDocument.aspx?seqnum=2971.

[5] According to its website, NFA had 4,174 total members as of February 28, 2014. *See* http://www.nfa.futures.org/NFA-registration/NFA-membership-and-dues.HTML.

capital, on its own, will not necessarily lead to misappropriation of customer property.

B. **Capital requirements are not necessary to prevent harm to investors following business disruptions.** Firms that meet capital requirements are not immune from business disruptions. Further, firms that experience capital shortages can liquidate in a manner prescribed by their organizational documents and any applicable laws.

C. **Substantial regulatory protections already exist.** A plethora of existing CFTC and NFA rules protect customer funds. NFA should continue to leverage information garnered in firm reports and examinations to identify bad actors. In addition, many firms are subject to protective rules as investment advisers ("RIAs") registered with the Securities and Exchange Commission ("SEC").

D. **CPOs and CTAs come in varying sizes and structures, including natural persons.** Many more non-traditional CPOs exist because of the 2012 CFTC rule changes.[6] Therefore, there is no apparent single factor upon which to base a capital requirement.

E. **Capital requirements would be costly and complicated to implement and monitor.** A capital rule that would accommodate the diversity of firms in the market would have to be extremely detailed and potentially would require constant revision. NFA and its members would need to hire and train additional staff. Such member costs might be passed through to advisory clients and pool investors.

F. **The harmful effects of imposing capital requirements would outweigh potential benefits.** The increased costs associated with maintaining capital requirements would increase the barriers to entry for emerging CPOs and CTAs. As fewer firms enter the marketplace and trade commodity interests, there would be reduced competition for advisory services and market liquidity. Instead, firms may choose to operate outside of the regulatory structure to avoid such capital requirements. Moreover, as noted, we do not believe that a capital rule would reduce fraud.

G. **Requiring independent third party authorization for disbursements of pool funds would be burdensome given the large number of pool disbursements.** Industry practices vary, but a third party agent is not a meaningful protection against fraud. Rather, the process of obtaining such consent multiple times a day may hinder the investment and other operations of the pool. Moreover, third parties may be unwilling to accept such role, and mandating such a requirement would increase service costs.

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[6] *See* Commodity Pool Operator and Commodity Trading Advisors: Amendments to Compliance Obligations, 77 Fed. Reg. 11252 (February 24, 2012) ("4.13(a)(4) Rescission Release"), rescinding the exemption from CPO registration provided in §4.13(a)(4).

H. **The costs of implementing the additional customer protection measures discussed in the Notice would overwhelmingly outweigh their benefits.** Hiring a third party to perform net asset value ("NAV") valuation and prepare monthly and quarterly reporting is unnecessary, especially for pools that trade only liquid, exchange-traded instruments. NFA reviews performance results for non-exempt pools as part of its audit process as do the pools' outside auditors. Completing daily balance reporting of pool assets would be difficult given the large number of accounts and counterparties.

I. **NFA requested comments on whether inactive members should have their memberships terminated.** We understand that NFA has an interest in ensuring that in making investment decisions, customers do not gain a false sense of security from an entity's membership status. We also believe that NFA should have a process for terminating memberships for those persons that truly have abandoned their memberships. We believe, however, that NFA should not automatically terminate memberships for the following reasons: (i) *de minimis* exemptions/exclusions are fluid and a member's ability to rely on such an exemption or exclusion may change daily; (ii) maintaining membership ensures seamless business operations; and (iii) NFA should not penalize members for being proactive about NFA membership. At the very least, NFA should allow firms to obtain waivers and/or adopt a notice and grace period before NFA cancels their memberships.

III. CPO/CTA Capital Requirement

NFA requests comments on whether CPOs and CTAs should be subject to capital requirements for purposes of ensuring: (i) greater protection for customer funds; and (ii) that such entities have sufficient funds to operate as a going concern. We do not believe that a capital requirement is either necessary or appropriate for CPOs or CTAs at this time. As mentioned above, the bad actors in the MRAs represent an extremely small fraction of NFA membership and do not evidence a systemic problem among CPOs or CTAs of misappropriating customer assets. In our view, the imposition of a capital requirement would not help to curtail the malfeasant activities identified in the MRAs. In addition, although we appreciate that part of NFA's role is to fill regulatory gaps where such gaps may exist, adequate provisions currently exist under contract and at law to govern the orderly liquidation of a CPO or CTA and minimize potential harm to investors and clients. A capital requirement would be costly for both firms and investors and may lead to a variety of unintended consequences, including decreased competition, increased fees, reduced market liquidity and incentivizing CPOs and CTAs to operate outside of the CFTC's and NFA's regulatory oversight. Any incremental benefit that might be gained from imposing a capital requirement on CPOs and CTAs to ensure that they operate as going concerns would be outweighed by these costs and consequences. Finally, current regulations provide NFA with substantial tools to protect customer funds and NFA should fully utilize such tools before imposing additional regulatory burdens on CPOs and CTAs.

A. Capital Requirements Will Not Ensure Greater Protection for Customer Funds

The Notice states that, in light of the high number of MRAs against CPOs and CTAs in recent years involving the misuse of customer funds, NFA is exploring ways to strengthen the regulatory structure applicable to CPO and CTA operations in the interest of providing greater protection for customer funds. The imposition of a capital requirement would not have prevented, nor improved NFA's ability to detect, the fraudulent and/or bad faith misuse of customer funds that were the subject of these MRAs. In our review of the MRAs, all of these actions in the last three years involved some form of fraud, malfeasance or other improper activities.[7] None of the MRAs contained any allegations that a CPO's or CTA's failure to maintain an operating reserve in and of itself resulted in a misuse of customer funds or direct harm to investors. A capital requirement would not prevent, or aid NFA in detecting, fraud. Indeed, operators of fraudulent firms may even be tempted to misappropriate client funds in order to meet capital requirements.[8]

We understand that NFA's goal is to ensure that CPOs and CTAs have sufficient capital to operate as a going concern. Part of the concern appears to be that CPOs and CTAs that do not have sufficient assets to operate their businesses will be tempted to misuse customer funds. The recent MRAs simply do not support this premise. As noted above, in almost all of the recent CPO and CTA MRAs cited by NFA that involved misappropriation of customer funds, there was also an element of malfeasance. It does not follow that a lack of capital, on its own, will lead to the misappropriation of client assets or, conversely, that sufficient capital will

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[7] *See e.g.,* In the Matter of R2 Capital Group LLC and Randell A. Vest, NFA Case No. 13-MRA-009 (Dec. 20, 2013); In the Matter of Novo Trading LLC and Thomas Henry O'Connell, Jr., NFA Case No. 13-MRA-008 (Dec. 13, 2013); In the Matter of AlphaMetrix LLC, NFA Case No. 13-MRA-007 (Oct. 21, 2013); In the Matter of Newport Private Capital LLC, Jonathan M. Hansen and David M. Giunta, NFA Case No. 13-MRA-006 (Sept. 4, 2013); In the Matter of SK Madison LLC and Michael James Seward, NFA Case No. 13-MRA-005 (June 7, 2013); In the Matter of Light Tower Investments, Inc. and Klaus P. Weyers, NFA Case No. 13-MRA-004 (May 22, 2013); In the Matter of Robert Juan Escobio, NFA Case No. 13-ARA-003 (May 1, 2013); In the Matter of James A. Shepherd, Inc., and James A Shepherd, NFA Case No. 13-MRA-002 (March 28, 2013); In the Matter of Prodigy Asset Management LLC and Ezekiel Adbel Rahman, NFA Case No. 13-MRA-001 (Jan. 31, 2013); In the Matter of KS Global Strategies and Khaled Salama, NFA Case No. 12-MRA-008 (Nov. 19, 2012); In the Matter of Peregrine Financial Group, Inc., and Peregrine Asset Management, Inc. (July 9, 2012); In the Matter of Altamont Global Partners LLC and John G. Wilkins, NFA Case No. 12-MRA-006 (June 22, 2012); In the Matter of Level III Management LLC, Level III Trading LLC, and Bruce A. Gwyn, NFA Case No. 12-MRA-005 (June 12, 2012); In the Matter of J Hansen Investments LLC and Jonathan Hansen, NFA Case No. 12-MRA-004 (Feb. 27, 2012); In the Matter of Arista LLC and Abdul Sultan Walji, NFA Case No. 12-MRA-003 (Feb. 2, 2012); In the Matter of BKT Capital Management LLC and Basil Fayadh, NFA Case No. 12-MRA-002 (Jan. 27, 2012); In the Matter of Crabapple Capital Group LLC and Robert Allen Christy, NFA Case No. 12-MRA-001 (Jan. 23, 2012); In the Matter of TS Capital Management LLC, NFA Case No. 11-MRA-008 (Oct. 26, 2011); In the Matter of Denver Difference Energy, LLC and Mukeeze Muwanga, NFA Case No. 11-MRA-007 (Oct. 20, 2011); In the Matter of SureInvestment, LLC and Crosby Wood, NFA Case No. 11-MRA-006 (Sept. 2, 2011); In the Matter of D2W Capital Management LLC, Prestige Capital Advisors LLC and Toby Hunter, NFA Case No. 11-MRA-004 (June 22, 2011); In the Matter of FIN FC LLC and Leon Lourens Wolmarans, NFA Case No. 11-MRA-003 (April 26, 2011); In the Matter of Paron Capital Management, LLC and James D. Crombie, NFA Case No. 11-MRA-002 (March 21, 2011); In the Matter of Trade Dock Capital LLC and Dominique Miguel Da'Cruz, NFA Case No. 11-MRA-001 (March 14, 2011).

[8] *Supra* note 4.

prevent misappropriation if the persons operating an entity are inclined to engage in malfeasance. Furthermore, requiring a CPO to maintain a certain capitalization will not prevent misappropriations aimed at covering shortfalls at affiliated entities. We note that the recent complaint against AlphaMetrix, LLC ("AlphaMetrix") alleges that AlphaMetrix misappropriated funds belonging to commodity pools it operated by failing to reinvest approximately $2.8 million, representing CTA fees that it had agreed to rebate, and transferring the funds to its parent company without its parent having a recognizable claim to those funds. Imposing a capital requirement on AlphaMetrix itself may not have prevented such misappropriation or business disruption because AlphaMetrix's parent was the entity that was short on capital.

Moreover, CTAs are prohibited from accepting and/or controlling customer funds and, therefore, there is theoretically no risk of misappropriation. Instead, a registered futures commission merchant ("FCM") holds all customer funds related to commodity interest trading on deposit in an account controlled by the advisory client. Advisory clients have complete transparency of positions because FCMs are required to send confirmations of all transactions to each account owner. A CTA's client has the ability to withdraw capital from its account at the FCM whenever it wishes. Most importantly, a CTA client can revoke the power of attorney given to the CTA simply by notifying its FCM. Given that it is the advisory client, and not the CTA, that has control over the client's FCM account and the fact that the client has complete transparency to such account, a capital requirement for CTAs is not necessary.

B. <u>Capital Requirements Are Not Necessary to Prevent Harm to Investors Following Business Disruptions</u>

In addition, NFA appears to assert that an undercapitalized CPO or CTA may be more susceptible to disruptions in business operations, which can harm pool participants and advisory clients. It is not clear that a firm that meets an imposed capital requirement is necessarily less susceptible to business disruptions, and NFA does not offer evidence to support that assertion. We believe that adequate protections already exist by contract and at law to protect pool investors and CTA clients in the event a CPO or CTA is unable to continue operations. If a business does not have sufficient capital to continue as a going concern, both the organizational documents of the business and the laws of its jurisdiction of organization will provide a prescribed method for liquidating the business. In the vast majority of cases, the wind-down and liquidation of a CPO or CTA, therefore, should not have a detrimental effect on pool investors or CTA clients. The pools and accounts in which they are invested will be liquidated, and all proceeds to which they are entitled returned in due course. Furthermore, if a CTA does not have sufficient funds to operate its business, and decides to terminate the advisory contract with its client, the client will not be without options. The CTA will typically assist with the liquidation of the assets, and/or the advisory client will be able to enter into an advisory contract with a new CTA. Given the protections that exist by contract and at law when a CPO or CTA terminates its operations, it is not necessary to adopt a capital requirement to protect investors.

C. Substantial Regulatory Protections Exist

We strongly believe that the existing regulatory framework provides NFA with effective tools to prevent and detect the misuse of customer funds and monitor the financial "health" of member firms. We urge NFA to consider the plethora of rules already in place that are applicable to CPOs and CTAs, many of which were designed to promote protection of customer assets. Moreover, the more recent amendments to the Commodity Exchange Act ("CEA") by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"),[9] as well as rules adopted since the passage of the Dodd-Frank Act, have greatly increased the regulatory obligations of CPOs and CTAs.

1. CFTC and NFA Regulatory Protections

a. CFTC and NFA Rules Restrict How CPOs and CTAs Handle Customer Assets

A number of CFTC and NFA rules prevent CPOs and CTAs from misusing and/or accessing customer funds. Examples of such protective rules include:

- CFTC Rule 4.20 requires a CPO to operate its pools as legal entities separate from the CPO. The rule specifically requires that all funds received from a pool participant must be received in the pool's name, and prohibits a CPO from commingling the property of any pool that it operates with the property of any other person.[10]

- CFTC Rule 4.30(a) prohibits CTAs from soliciting, accepting or receiving client funds in the CTA's name.

- NFA Rule 2-45 prohibits a CPO from lending a pool's assets to the CPO or any entity affiliated with the CPO.

b. NFA Members Are Vetted During the CFTC Registration Process

As a result of the rescission of CFTC Rule 4.13(a)(4) at the end of 2012,[11] many more CPOs are now registered with the CFTC and subject to the new CFTC and NFA reporting requirements. As part of the registration process, NFA vets principals and associated persons of CPOs and CTAs. Principals and associated persons must submit fingerprint cards to NFA and disclose both their employment and disciplinary history on Form 8-R. The enforcement of these rules by the CFTC and NFA provides a substantial level of customer protection and helps ferret

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[9] Pub. L. 111–203, 124 Stat. 1376 (July 10, 2010), available at: http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/html/PLAW-111publ203.htm.

[10] *See* CFTC Rule 4.20(b) and (c).

[11] *See supra* note 6.

out bad actors that threaten the security of customer funds. We do not believe that capital requirements would afford any greater protection against malfeasance.

c. NFA Receives Detailed Quarterly Reports and Has Broad Examination Authority

NFA also has substantial tools to monitor CPO and CTA operations on an ongoing basis. Existing reporting requirements and examination functions are critical to maintaining the integrity of the industry. No doubt, NFA recognizes the tremendous amount of resources that CPOs and CTAs commit to ensuring they remain compliant with current requirements. As noted above, in recent years the CFTC and NFA have imposed significant additional obligations upon CPOs and CTAs. Forms PF,[12] CPO-PQR, NFA-PQR, CTA-PR and NFA-PR provide the CFTC and NFA with detailed information with respect to CPOs and CTAs and their businesses.[13] Also, as discussed in more detail below in Section IV.B., a CPO is obligated to prepare and file annually with NFA audited financial statements for each non-exempt and CFTC Rule 4.7 pool it operates. NFA and CFTC should continue to analyze and review the information in these reports before either organization imposes any new requirements. By analyzing filings—which NFA now reviews with greater frequency— NFA has significantly more data to use to identify potential red flags and inconsistencies as it conducts risk-based examinations.

NFA has broad oversight and examination authority of its members. If in the course of an examination, NFA suspects that a CPO or CTA is likely to misappropriate customer assets, it may ask for more information on potential exposures, policies, and contractual arrangements regarding the disbursement of fund assets, and internal controls in place to prevent the misuse of customer assets. We believe these existing regulatory tools are more effective in protecting customers than capital requirements.

2. SEC Regulatory Protections

a. Custody Rule

In addition to the CFTC and NFA regulatory protections, the clients of many of our members already receive protection under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). Many of our members are subject to additional regulatory requirements as RIAs registered with the SEC. Advisers Act Rule 206(4)-2 (the "Custody Rule") requires an

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[12] We note that we understand that NFA may not have direct access to Form PF.

[13] Forms PF and CPO-PQR solicit various information related to CPOs and the pools they operate, including for each pool operated by a mid-sized CPO, the pool's: (i) administrators, brokers, custodians and auditor; (ii) change in NAV from the beginning of the reporting period to the end of the reporting period; (iii) monthly rates of return; (iv) subscriptions and redemptions; (v) significant creditors; (vi) credit counterparty exposure; (vii) trading and clearing mechanisms; and (viii) schedule of investments. For large pools operated by large CPOs, Forms PF and CPO-PQR also solicit information relating to risk metrics and borrowings. NFA-PQR requests some, but not all, of the foregoing information with respect to all non-exempt CPOs regardless of size. Forms CTA-PR and NFA-PR solicit information relating to the operations of CTAs, including: (i) assets directed by the CTA; (ii) key relationships (including carrying brokers); and (iii) programs traded.

RIA that has custody of a client's assets to maintain such assets with a qualified custodian and confirm that the qualified custodian is sending account statements to clients.[14] In addition, an RIA must: (i) be subject to an annual surprise audit to verify client assets; or (ii) if the RIA manages a pooled investment vehicle, the pooled vehicle must be subject to audit by an independent public accountant that is registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board, and meet other Custody Rule requirements.[15]

b. Form ADV Disclosures

RIAs, as well as advisers relying on certain exemptions from registration, are required to submit and update at least annually all or a portion of Parts 1 and 2A of Form ADV. In addition, they must promptly update their Form ADV throughout the year upon the occurrence of certain material changes. Moreover, various questions on the Form ADV address the custody of client assets, including a list of all brokers and custodians that hold private fund assets managed by the RIA. For example, Item 18(B) of Part 2A requires an RIA to disclose any financial condition that is reasonably likely to impair its ability to meet contractual commitments to clients. We would support adding a similar question to the annual questionnaires completed by CPOs and CTAs.

D. <u>CPO/CTA Business Structures and Operations Vary Widely</u>

It would be a difficult undertaking to determine what would constitute a sufficient capital level for the vast variety of CPO and CTA firm enterprises. The multitude of CPO and CTA firms vary tremendously in size, business and corporate structure and method of operation. CPOs and CTAs may be standalone businesses or part of larger complex financial institutions. Unlike in the FCM and IB context, there is no readily identifiable formula to employ for a capital requirement for CPO and CTA firms. In addition, many firms have separate CPOs for each pool that they operate and sometimes one or more CPOs per pool. Requiring multiple CPOs in a single business enterprise to maintain minimum capital would be excessively burdensome. Following the broadening of the definition of commodity interests to include swaps and the rescission of CFTC Rule 4.13(a)(4), in conjunction with the CFTC's staff's expansive interpretation of which persons or entities are CPOs,[16] many different types of business enterprises (*e.g.*, certain securitization vehicles, real estate investment trusts, etc.) have been brought within the CFTC's jurisdiction. The sponsors of such enterprises operate differently than traditional CPOs and CTAs, making it more difficult to set and enforce a uniform standard. In certain circumstances, natural persons may be considered CPOs. Requiring an individual to maintain and disclose a net worth to operate as a CPO would implicate privacy concerns and

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[14] *See* Advisers Act Rule 206(4)-2(d)(2), which deems an RIA to have custody of a client's assets if it or a related person holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them. An investment adviser that also serves as the general partner of an investment fund will be deemed to have custody of the assets of such investment fund.

[15] *See* Advisers Act Rule 206(4)-2(b)(4).

[16] *See id. See also* 4.13(a)(4) Rescission Release at 11263, where the CFTC staff took the view that absent an exemption or exclusion "one swap contract would be enough to trigger the [CPO] registration requirement".

would not be appropriate. Furthermore, in adopting CFTC Rule 4.7, the CFTC recognized that certain investors are sophisticated enough to perform their own diligence on their CPOs.[17] Given the wide variety of CPO and CTA firms and structures, there is no apparent single factor upon which to base a capital requirement.

E. Compliance Costs Will Be Significant

Capital requirements are costly to monitor for both CPO/CTA firms as well as NFA. Such requirements would be a fundamental change to the CPO and CTA business model and regulatory landscape for many reasons. For example, firms may need additional employees and systems to ensure that they maintain capital in the proper accounts at all times. Moreover, as with any new complex regulation, CPOs and CTAs likely would need to seek the guidance of legal counsel, accountants, and other advisors to help them comply, which would increase the CPO's and CTA's operating expenses. Further, if a significant portion of a firm's capital is tied up in order to meet mandatory capital levels, the firm may need to enter into costly financing arrangements to bridge the payment of firm expenses. Any increase in the operating expenses of a CPO and/or CTA will put upward pressure on the administrative and management fees charged to pool investors and advisory clients. NFA will also need to hire and train additional staff and/or develop technology solutions to investigate and confirm whether its members are maintaining capital levels. Given the current regulations available to NFA to protect customer funds, as discussed above, we do not believe that imposing increased costs on CPOs, CTAs and their customers would be justified.

F. Negative Consequences of Capital Requirements Outweigh Potential Benefits

The potential effectiveness of a minimum capital requirement in achieving NFA's goal of better protecting customer funds would be outweighed by the unintended consequences of such a requirement, including reduced competition and liquidity in the derivatives markets. Capital requirements would increase the barriers to entry and, therefore, would reduce the investment options for customers. With fewer investment options and less competition in the marketplace, advisory and administrative fees will likely increase to the detriment of advisory clients and pool investors. A capital requirement also could harm market liquidity. As CPOs weigh the costs and benefits of registration, compliance with another requirement (in addition to the many that already exist) could cause firms to decide not to register. Thus, CPOs and CTAs may limit their commodity interest trading activities so that they are eligible to rely on exemptions from registration. If CPOs and CTAs chose to limit their commodity interest trading because of a new regulation, it would lead to less liquidity in the derivatives markets. In addition, it would lead to an increased number of CPOs and CTAs legally operating outside of the current regulatory structure that offers the extensive protections described above. As a result, NFA (and the CFTC) would lose a crucial means of monitoring the activities of a significant number of CPOs and CTAs. A capital requirement, therefore, would be counterproductive to the very goals NFA is trying to achieve.

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[17] *See infra* Section IV.

G. Capital Requirement Previously Rejected by CFTC and Congress

The CFTC considered and rejected a capital requirement for CPOs during the 1970s when the federal regulatory structure for pools was implemented. Neither the CFTC nor Congress appears to believe that capital requirements are necessary for CPOs. In the 1977 proposing release for the CFTC Part 4 regulations[18] setting forth a comprehensive scheme for the regulation of CPOs, the CFTC sought comments on certain restrictions that historically state regulatory authorities had imposed.[19] One such restriction was a minimum net worth requirement for CPOs. In considering such a requirement, the CFTC identified concerns similar to those expressed in the Notice, but ultimately chose not to impose minimum capital requirements on CPOs or CTAs. Similarly, leading up to the adoption of the Dodd-Frank Act, Congress discussed the potential imposition of capital requirements on investment advisers, but ultimately decided not to enact such requirements.

IV. Other Customer Protection Measures

We have also considered the additional customer protections measures for which NFA has requested comment. As discussed in more detail below, generally, we think that the costs of implementing these measures would overwhelmingly outweigh their benefits. In addition, due to the complexity of the operations of CPOs and CTAs, certain of the measures would be extremely impractical to implement. Many CPOs and CTAs have expended significant amounts on developing bespoke accounting systems that third party service providers cannot replicate easily. Further, involving additional third parties in the functioning of the business of a CPO or CTA exposes the firm to increased potential confidentiality breaches. Even if implemented, the suggested measures do not necessarily protect against fraudulent activities that have been the subject of some recent MRAs. Finally, as noted herein, many existing regulatory protections already address such concerns.

We also note that in adopting CFTC Rule 4.7, the CFTC recognized that certain investors are sophisticated enough to protect their own interests. Sophisticated investors often demand additional information from CPOs and CTAs, perform extensive due diligence and/or negotiate individualized terms prior to investment. As such, the CFTC limited the disclosure, recordkeeping and reporting obligations of CPOs that operate funds offered solely to qualified eligible persons ("QEPs") and CTAs that advise solely QEPs. Should NFA seek to implement additional customer protection measures, we urge NFA to propose a consistent regulatory approach and exempt CPOs and CTAs relying on CFTC Rule 4.7 from compliance with such additional obligations.

A. Independent Third Party Authorization for Disbursements of Pool Funds

NFA requests comment on whether it should propose a rule that requires an independent third party to review and authorize a CPO's disbursement of pool funds. Whether

[18] Commodity Pool Operators: Proposed Comprehensive Scheme for Regulation, 42 Fed. Reg. 9265 (Feb. 15, 1977.

[19] *See id*. at 9270, note 14.

such a rule is feasible depends, in part, on the particular business operations of a CPO. As discussed above, CPOs come in varying types, sizes and structures, and the pools they operate employ a diverse number of investment strategies. A requirement that may be workable and appropriate for certain CPOs, may not be workable or appropriate for others. Industry practice varies.

Although many CPOs utilize the services of third party administrators to assist in the operation of their pools, other CPOs do not. For example, CPOs that are affiliated with larger financial institutions may choose to use expertise that they have already invested in developing internally, rather than retaining the services of a third party administrator, which could result in lower pool expenses. For CPOs without third party administrators, simply requiring them to retain and turn over specified responsibilities to such entities would be a fundamental change to their business models and could significantly increase pool operating costs. For CPOs that retain third party administrators, it still may be impractical, costly, and inefficient to require the CPO to engage that third party to review and approve every disbursement of pool assets. Disbursements of pool funds are made on a periodic basis, sometimes daily, for multiple purposes, including to: (i) pay service providers of the pools, including administrators, FCMs, brokers, custodians, research services, lawyers and accountants; (ii) make investments; (iii) meet margin calls; (iv) pay investment advisory fees; and (v) fund withdrawals and redemptions. Depending on the size of the pool and the nature of its trading, such disbursements may number in the tens of thousands over the course of a year.

Thus, requiring independent review and authorization of each disbursement could be unduly burdensome, may hinder the investment and other operations of the pool and – of critical importance – could introduce additional risk into the system. It would increase risk, for example, if imposition of such a requirement were to delay a pool in meeting a margin call. Failure of a third party to approve the transfer of pool assets to satisfy a margin call on a timely basis could result in events of default, trigger cross defaults and result in substantial losses for investors – not to mention the potential negative impact on the FCM and clearinghouse involved. We note also that, if NFA required CPOs and CTAs to have disbursements independently approved, it could considerably delay the return of capital to redeeming investors.

If, however, NFA feels that it is necessary to impose some level of review on a CPO's disbursement of pool funds, any such review should be in the nature of an after-the-fact reconciliation, and then, only with respect to funds disbursed from the pool to the CPO. While MFA's members believe that this burden would still outweigh the benefits provided, limiting the review to a post-disbursement process would mitigate the likelihood of disrupting day-to-day business operations, while still providing investors with the comfort of a periodic review of disbursements. Likewise, limiting the scope of the review to disbursements to the CPO would reduce the burden to CPOs and costs to investors.

Part of the answer to the question of whether third party approval of pool disbursements is practical also depends on what NFA means by having a third party "review and authorize" pool disbursements. Certain CPOs currently authorize their pools' outside administrators to make all disbursements on behalf of the pools. Such administrators, however, do not conduct independent diligence as to the authenticity of the evidence provided. As agents, third parties will not serve as a meaningful check on the actions of the CTA or CPO—they simply will discharge the instructions of their clients. Accordingly, imposing a third party agent requirement will not meaningfully further the goal of preventing fraud. Moreover, it is unclear whether administrators would be willing, or even able, to take on this function. With respect to the cost of such service, we have heard anecdotally that administrators would expect their fees to increase to cover such incremental service. The increased costs associated with such function, which could be substantial if administrators are subject to potential liability, could be passed on to the investors in the pool. As with capital requirements, the potential benefits created by imposing a third party disbursement approval process may be substantially outweighed by the increased costs noted above.

B. NAV Valuation and Monthly and Quarterly Reporting

NFA asks whether it would be beneficial to have an independent third party prepare or verify account statements periodically as to the value of a pool. Currently, monthly and quarterly statements may be prepared in-house or in conjunction with a third party administrator. Certain administrators also perform various valuation functions including price verification and calculation of NAV. However, whether a pool has an administrator, and the function the administrator plays in NAV valuation, depends upon a number of factors including the complexity of the trading instruments, the size of the fund and the nature of the trading strategy. In the case of complex or bespoke investments, third party administrators generally agree to confirm the valuation methodology used by the CPO rather than perform an independent valuation. Requiring all funds to have a third party administrator that verifies account statements and NAV valuation may be prohibitively costly for small pools and completely unnecessary for pools that trade only liquid, exchange-traded instruments.

In addition, pursuant to CFTC Rules 4.22 and 4.7(b), CPOs are already required to deliver to participants in their pools, and file with NFA, financial statements audited by independent accountants. Such financials include a statement of financial condition and a statement of operations. Independent accountants engaged by the CPO plan and perform an audit to obtain reasonable assurance that the financial statements are free of material misstatements. They do so by performing a review of operating effectiveness of internal control and/or substantive procedures, on a test basis, to provide evidence supporting the CPO's assertions regarding the amounts and disclosures in the financial statements for the period under audit. As part of the annual audit process, the independent accountants confirm the pool's bank and broker balances. An audit also includes assessing the accounting principles used, significant risks and significant estimates made by the CPO, as well as evaluating the overall financial statement presentation. Auditors also determine if the financial statements have been prepared using Generally Accepted Accounting Principles, and, in certain instances, International Financial Reporting Standards, and comply with relevant statutory requirements and regulations. Further, information in monthly, quarterly and annual statements delivered pursuant to CFTC Rule 4.22 or 4.7(b), as applicable, must contain an oath from an authorized representative of the CPO that the information in the statement is accurate and complete.

C. Performance Results

NFA asks whether it should require an independent third party to prepare or verify a pool's performance. As with periodic statements, pool performance results may be prepared in-house or by a third party. Subject to CFTC and NFA rules, many CPOs prefer to prepare performance statements in-house and present information in ways deemed most meaningful by the CPO and/or as requested by investors. If a CPO is required to outsource the preparation of a pool's performance statements, the CPO and its investors would lose flexibility in the manner and ways performance results are presented. Thus, such outsourcing would be highly disruptive to the CPO and its investors.

Requiring verification of a pool's performance by an independent third party would also add unnecessary cost and expense to investors, as performance results are generally reviewed as part of the annual audit process for each pool because they impact the pool's financial statements. Further, pursuant to CFTC Rule 4.27(e)(1), an authorized representative of the CPO must affirm that the information contained in Form CPO-PQR, including performance results, is accurate and complete. Thus, as existing regulatory requirements address the verification of performance results, we believe mandating the use of a third party to prepare pool performance tables would add cost but little additional value.

D. Verification of Pool Assets

NFA requests comment on whether it should require an entity holding the assets of a pool operated by a CPO member (such as a bank or FCM) to report the balance in the pool's account to NFA. The reporting of daily balances of pool assets would be extremely difficult to implement. A pool's assets generally are not maintained in a single account, but instead may be spread across different countries, among multiple accounts with multiple custodians, banks and brokers. During the financial crisis of 2008-2009, many CPOs opened additional accounts for their pools to reduce concentration and diversify pool exposure among financial institutions. In addition, depending on the pool's trading activities, accounts may be opened and closed on a frequent basis. Moreover, certain assets, such as uncertificated instruments and swaps trading off-exchange, are often not held in such accounts. Even if such information could be collected, it is unclear what NFA would be able to learn from the information. Sudden drops in pool assets would more likely be attributed to trading losses or redemptions than misappropriation of funds. As described above in Section IV.B., annual pool audits performed by independent accountants include a confirmation process regarding pool assets. The operational burden and expense of more frequent confirmations would far outweigh any incremental benefit. We note that NFA initially instituted the Form NFA-PQR filings to obtain more frequent information on pools operated by its members. We encourage NFA to continue its analysis of the Form NFA-PQR filings and use its current examination function as an opportunity to spot check pool assets, rather than creating a new process.

V. Inactive Members

NFA seeks comment on whether the membership of "inactive" CPOs and CTAs should be terminated. MFA supports allowing NFA to cancel registration if a registrant truly has abandoned its registration, with appropriate due process. However, we caution against adopting a "one size fits all" approach to the compulsory withdrawal of inactive members. We believe that there are certain valid reasons for CPOs and CTAs to become or remain members of NFA, even if they do not actively and consistently engage in commodity interest activities. Many CPOs operate funds for which they rely on the *de minimis* exemptions and exclusions found in CFTC Rule 4.13(a)(3) and CFTC Rule 4.5. The *de minimis* test is a continuous test that a fund must meet each time it establishes a new commodity interest position. Since commodities trading may fluctuate, CPOs may register and become NFA members to transition such funds seamlessly to non-exempt pools without the delay that the registration process would cause. Firms should not be discouraged from being proactive with respect to future membership obligations.

If NFA requires inactive members to withdraw their NFA memberships, it should provide an opportunity for members to obtain a waiver by providing a rationale for why continued membership is appropriate given their situation. NFA should provide notice and a grace period before terminating a firm's membership.

VI. Conclusion

As discussed, the CFTC and NFA have a robust regulatory framework in place for CPOs and CTAs. In MFA's view, imposing a capital requirement or implementing the other suggested customer protection measures on CPOs and CTAs will not address the concerns NFA identifies in its MRAs. It would, however, fundamentally change the business model of current CPOs and CTAs at great cost, and expand NFA's oversight responsibilities and financial needs to support such responsibilities. We believe the actual benefits from a capital requirement and the other customer protection measures would be insignificant and even incidental, compared to the direct and indirect costs to members and investors, and that there are more effective existing regulatory methods for protecting customers. The measures raised in the Notice would operate simply as an unnecessary barrier to entry, and would not advance NFA's objective of reducing fraud.[20]

[20] To the extent that NFA, after reviewing all industry comment letters, determines to pursue any of the measures, we ask NFA to consider whether the CFTC should lead the rulemaking process for such a substantial change to the regulatory scheme.

MFA appreciates the opportunity to offer comments and suggestions to NFA on the Notice. We would be happy to discuss our comments or any other proposals at greater length with NFA. If NFA staff has any questions, please do not hesitate to contact Jennifer Han or the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

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