

September 14, 2004

(Via e-mail: rule-comments@sec.gov)

Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

Re: File No. S7-30-04; Registration Under the Advisers Act of Certain Hedge
Fund Advisers

Dear Mr. Katz:

National Futures Association (NFA) appreciates the opportunity to comment on the Securities and Exchange Commission's (Commission) proposed rule to require advisers of certain hedge funds to register under the Investment Advisers Act of 1940. Any final rules adopted by the Commission should avoid duplication of effort and conserve the Commission's valuable resources so that they can be used where they are needed most. To accomplish this goal, if the Commission goes forward with the proposed rulemaking it should provide a carve-out for commodity pool operators (CPOs) and commodity trading advisors (CTAs) registered with the Commodity Futures Trading Commission (CFTC).

NFA is a registered futures association under the Commodity Exchange Act and a self-regulatory organization for the United States futures industry, subject to CFTC oversight and review. NFA is also a limited purpose national securities association under Section 15A(k) of the Securities Exchange Act. Customer protection is our top priority. We work closely with the CFTC to provide effective and efficient regulation that protects customers without imposing undue burdens on the futures industry, and we believe that our efforts have been an extraordinary success. In the twenty-two years since NFA began operations, trading volume on U.S. futures exchanges has increased by approximately 1000% while customer complaints have actually dropped by over 70%. Furthermore, CPOs and CTAs have an even better record; although they comprise 60% of NFA's membership they are named in only 20% of NFA's enforcement actions and in only 2% of customer complaints. NFA generally

receives ten or fewer customer complaints about CPOs and commodity pools each year. These numbers are consistent with the comparatively small number of CFTC and SEC enforcement actions involving commodity pool and hedge fund activities.

As of the CFTC's fiscal year end on September 30, 2003, there were 2,059 registered CPOs. As of June 30, 2004, NFA has approximately 1600 CPO Members.¹ Of those Members, almost 1100 are currently active, and between them they operate over 3200 active commodity pools. Many of the largest hedge funds are 4.7 commodity pools operated by CPOs that are registered with the CFTC and are Members of NFA.² Eighteen of the top 25 and 63 of the top 100 hedge fund complexes are operated by NFA Member CPOs or their affiliates.³ In fact, most of the prominent names in the hedge fund business are NFA Members.

NFA has a number of programs to monitor CPOs' compliance with applicable rules and regulations. NFA's on-site examinations provide the most comprehensive review. During these examinations, NFA staff looks for and reviews transactions between the CPO and its pools, transfers between the CPO's pools, and the CPO's banking relationships. Staff performs basic testing on all the commodity pools operated by the CPO, including reviewing the pools' participant lists, solicitation materials, additions, and withdrawals. In addition, NFA uses a risk-based approach to select and test one pool in detail. In choosing this pool, NFA considers a number of factors, including the number of participants in the pool, the pool's total net asset value, exemptions held by the pool, and whether NFA conducted detailed testing on the pool in a prior exam. NFA reviews the pool's financial records, including its assets and liabilities, with an emphasis on the pool's futures transactions, and NFA confirms the existence of non-futures assets – including securities, cash, swaps, and other financial instruments – that have a material effect on the pool. NFA also reviews the pool's trading activity for consistency with its disclosure document or offering memorandum.

NFA currently examines approximately 300 CPOs every year. CPOs are generally examined within 3 years after becoming active and every 3-4 years thereafter.

¹ The number of registered CPOs is higher than the number of CPOs who are NFA Members. For the most part, the registered CPOs who are not NFA Members are inactive.

² CFTC Regulation 4.7 provides relief from most of the CFTC's recordkeeping, disclosure and reporting requirements if the pool is available only to sophisticated or high net worth participants. Regulation 4.7 does, however, require the pool to provide participants with quarterly net asset information and with an annual report containing financial information about the pool. The annual report must also be filed with NFA.

³ The pool rankings are taken from the 2004 rankings by *Institutional Investor*.

Under NFA's risk-based approach, we examine CPOs more frequently when we have reason to believe that a CPO or any of its pools poses undue risks.⁴

All pools, including 4.7 pools, must provide participants with year-end financial statements and must file those statements with NFA.⁵ NFA analyzes each one of these statements, most within 30 days of receipt. This review examines whether the financial statement adequately reflects the pool's assets and liabilities and is consistent with any disclosure document on file, and it focuses special attention on unusual balances and significant changes in the pool's net asset value. NFA looks at the pool's entire financial statement, with the greatest emphasis on the pool's futures activities. Within the last 12 months, NFA has analyzed approximately 3500 pool financial statements.

NFA also reviews each disclosure document filed with NFA. Non-exempt pools are required to provide existing and potential pool participants with a disclosure document that has been filed with and approved by NFA before its first use. NFA's review is designed to ensure that the investing public receives adequate disclosure about the investments being offered. If we have concerns regarding inadequate or misleading disclosure, we require the CPO to revise the disclosure document before using it. In the last year, NFA analyzed approximately 1000 disclosure documents for public and private pools.

The Commission's release states that hedge fund adviser registration would provide it with information about the hedge fund industry. NFA already collects a significant amount of information regarding CPOs and hedge funds through its audits; from registration forms and financial statements; and from disclosure documents or offering memoranda filed with NFA or obtained during audits. We also receive an annual questionnaire that, like audits, focuses on the CPO's futures activities. We would be happy to talk to Commission staff about sharing this and any other information, which can be accomplished without requiring CPOs and CTAs to register as investment advisers.⁶

⁴ NFA obtains information regarding CPO activity from financial statement filings, annual questionnaires, examinations, disclosure document submissions, regular monitoring of advertising in electronic and print media, and customer complaints. This information is input into NFA's database and helps us determine whether a CPO or a pool presents undue risks. It also alerts us if an inactive firm becomes active without notifying NFA.

⁵ All non-exempt pools and most 4.7 pools file certified statements.

⁶ The recent case of Integral Investment Management LP (Integral) illustrates one way that NFA already shares information with the Commission. While NFA was performing its oversight responsibilities in 2002, staff discovered that Integral and its managing partner, Conrad Seghers, had engaged in false advertising about the performance of several hedge funds and had provided false statements to investors in these funds. NFA referred this matter to and coordinated its efforts with the SEC.

Any final rules adopted by the Commission should promote efficiency by avoiding duplication of effort and conserving the Commission's valuable resources so they can be used where they are needed most. Therefore, as previously noted, NFA believes it is appropriate to provide a carve-out for CFTC-registered CPOs and CTAs. We also encourage the Commission to give significant weight to the comments filed by industry participants regarding the practical problems and burdens that Commission registration would impose.

If you have any questions or would like additional information, please contact me at 312-781-1390 or by e-mail at droth@nfa.futures.org.

Sincerely,

Daniel J. Roth
President and Chief Executive Officer

(caw:hedgefundcommentletter)

Although neither Integral nor Seghers was registered as an investment adviser, the SEC used its existing authority under the securities laws to bring an enforcement action against Seghers for fraud. See *SEC v. Seghers*, No. 3:04 CV 1320-K (N.D. Texas, filed June 16, 2004). NFA also brought its own action against Integral and Seghers under NFA rules and entered into a settlement agreement that permanently barred both respondents from the futures industry. *In re Integral Investment Management LP*, No. 02-BCC-003 (NFA BCC, Mar. 28, 2002).