

**Testimony of Patrick J. McCarty, General Counsel  
of the Commodity Futures Trading Commission  
before the U.S. Senate Committee on Banking, Housing and Urban Affairs**

**July 15, 2004**

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Thank you, Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee for the opportunity to testify before you today regarding hedge funds. I will address the Commodity Futures Trading Commission's (CFTC's) authority over hedge funds, enforcement actions against hedge funds, the CFTC's inspection and examination programs, and interagency coordination. This testimony has been reviewed and approved by the CFTC.

I will make 4 points related to hedge funds:

**First**, many large "hedge funds" are commodity pools. Well over 50% of the largest hedge fund complexes – those with over \$1 billion in assets – have commodity pool registration or reporting requirements with the CFTC.

**Second**, there has been very little fraud in the hedge fund arena. In the last 5 years, less than 3% of all enforcement actions by the CFTC and the SEC (81 out of 3,035) have been against hedge funds and/or their advisers.

**Third**, the CFTC/NFA oversight program is periodic and risk-based. CPOs, which operate commodity pools, and CTAs are inspected generally on an average of every 2.5 to 3 years for compliance with CFTC recordkeeping, disclosure and reporting requirements. 100% of all commodity pool annual reports filed with the National Futures Association (NFA), the self-regulatory organization of the futures industry, are reviewed.

**Fourth**, the CFTC has, and will continue to, work cooperatively with the SEC, the New York State Attorney General, and other regulators with respect to sharing information and investigations involving hedge funds which are sponsored, operated or advised by a CFTC-registered CPO or CTA.

**CFTC Background:**

The CFTC is an independent federal regulatory agency created in 1974. The CFTC administers the Commodity Exchange Act (CEA).<sup>1</sup> The CFTC's mission is to oversee the futures and options markets in the United States. We take very seriously our mission to ensure that these exchanges provide safe, sound and transparent markets for risk management and price discovery for a variety of commodities, including agricultural, financial, metals and energy products. We are responsible for regulating the following futures industry participants:

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<sup>1</sup> The Commodity Exchange Act is codified at 7 U.S.C. 1, et seq.

designated contract markets – futures exchanges; derivatives clearing organizations – clearing houses; futures commission merchants (FCMs); introducing brokers; and floor traders and floor brokers. In addition, we are jointly responsible for regulating security futures products (SFPs) with the SEC. SFPs are futures on individual stocks and narrow based securities indices. This new authority was part of the Commodity Futures Modernization Act of 2000 (CFMA).<sup>2</sup>

In addition to those futures industry participants mentioned above, the CFTC is also responsible – and has been since 1974 – for CPOs and the commodity pools which they sponsor, operate or advise, as well as CTAs.<sup>3</sup> CPOs and CTAs<sup>4</sup> are very similar to the investment company/mutual fund complexes and investment advisers in the securities industry, although on a significantly smaller scale.

### **CPOs and Commodity Pool Industry:**

The number of CFTC-registered CPOs at the end of FY 2003 was 2,059. See Tab 1.<sup>5</sup> These CPOs sponsored, operated or advised approximately 3,244 commodity pools<sup>6</sup> at the end of FY 2003. Based on the financial statements for 2,995 commodity pools which were filed for the calendar year ended 12/31/02, commodity pools held approximately \$424 billion in net assets.<sup>7</sup> The vast majority of commodity pools are relatively small, but there were 789 (26%) commodity pools with over \$100 million in net assets. These 789 “large” commodity pools had \$372 billion in net assets – or approximately 80% of all the net assets in commodity pools.

Two points are worth noting. First, the amount of net assets held by the commodity pool sector is quite small relative to SEC registered investment companies. SEC registered investment companies – open end mutual funds, unit investment trusts, closed end funds, and exchange traded funds - hold approximately \$7.6 trillion in assets. Commodity pools – with just \$424 billion in net assets - have only 5% of the assets which SEC registered investment companies hold. Second, the vast majority of commodity pools – approximately 98% - are private placements, which are marketed and sold almost exclusively to institutions, corporations, pension plans, endowments and other sophisticated investors. Only 43 of the 2,995 commodity pools are SEC registered public offerings. See Tab 1. This is in sharp contrast to the more than 8,000 SEC registered investment companies, which are marketed and sold to retail investors in public offerings.

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<sup>2</sup> Commodity Futures Modernization Act of 2000, Appendix E of the Consolidated Appropriations Act of 2000, Pub. L. 106-554, 114 Stat. 2763 (Dec. 17, 2000).

<sup>3</sup> The terms “commodity pool operator” and “commodity trading advisor” can be found in Section 1a of the CEA. 7 U.S.C. 1a(5), (6).

<sup>4</sup> As of September 30, 2003 there were 2,812 CTAs registered with the CFTC. See “Futures Industry Registrants by Location as of September 30, 2003” CFTC Annual Report 2003, pg. 134. [www.cftc.gov/cftc/cftcreports.htm](http://www.cftc.gov/cftc/cftcreports.htm).

<sup>5</sup> CFTC Website under “Reports and Publications.” “The CPO and Commodity Pool Industry” (June 2004). [www.cftc.gov/cftc/cftcreports.htm](http://www.cftc.gov/cftc/cftcreports.htm).

<sup>6</sup> The term “commodity pool” is defined in CFTC regulations. 17 C.F.R. 4.10(d).

<sup>7</sup> “Net assets” for purposes of this testimony consist of a commodity pool’s total owner’s equity as reported to NFA.

## **1. Large Hedge Funds are Commodity Pools**

My first point is that many large hedge funds – those with more than \$100 million in net assets – are commodity pools. A clear majority of the large hedge fund complexes – those with over \$1 billion in assets – have hedge funds/commodity pools that already are sponsored, operated or advised by CFTC-registered CPOs and/or CTAs.

While there is no official database for hedge funds, Institutional Investor Magazine publishes an annual list of the 100 largest hedge fund complexes by assets under management.<sup>8</sup> The CFTC has analyzed the 2002, 2003 and 2004 Institutional Investor's Hedge Fund 100 rankings. Based on our analysis, in each of the 3 years a clear majority of the 100 largest hedge fund complexes had hedge funds/commodity pools sponsored, operated or advised by CFTC registrants. In fact, 55 of the top 100 hedge fund complexes in 2002, 65 of the top 100 in 2003, and 63 of the top 100 in 2004, had funds that were sponsored, operated or advised by CFTC registrants.

The percentage of the 25 largest hedge fund complexes with CFTC registrants was even more striking. Based on CFTC analysis, CFTC registered CPOs and/or CTAs were in 18 of the top 25 (72%) hedge fund complexes in 2002, 17 of the top 25 (68%) in 2003, and 18 of the top 25 (72%) in 2004 – including 6 of the top 10 in 2004. I attach a list identifying which of the 25 largest hedge fund complexes, by assets under management, have CFTC-registered CPOs and/or CTAs. Tab 2.

An analysis of Institutional Investor's recent 2004 Hedge Fund 100 rankings is attached. Tab 3. To summarize, 18 of the 25 largest hedge fund complexes (72%) have funds/pools with CFTC registrants. Sixty-three (63) of the top 100 hedge fund complexes (63%) have a CFTC-registered CPO and/or CTA. These 63 CPOs/CTAs sponsor, operate, or advise 690 commodity pools – which are identified on the Tab 3 chart – and hold approximately \$173 billion in net assets out of the approximately \$450 billion managed by the 2004 Hedge Fund 100.

While there is no legal definition of what a hedge fund is, it is clear from the Institutional Investor Hedge Fund 100 rankings that many of the large commodity pools – and their CPOs – are considered to be hedge funds and hedge fund operators.

Many well-known hedge fund managers are principals of CFTC registered CPOs. For instance, George Soros of Soros Fund Management; Ken Griffin of Citadel Investment; Louis Bacon of Moore Capital; Jim Simons of Renaissance; Bruce Kovner of Caxton; Sandy Ainslie of Maverick; and Paul Tudor Jones of Tudor Investment Corporation. See Tab 3.

## **2. There Is Little Fraud in the Hedge Fund Arena**

My second point is that there has been very little fraud in the hedge fund arena. In the last 5 fiscal years (FY 1999-2003), less than 3% of all enforcement actions by the CFTC and the SEC (81 out of 3,035) have been against hedge funds and their advisers.

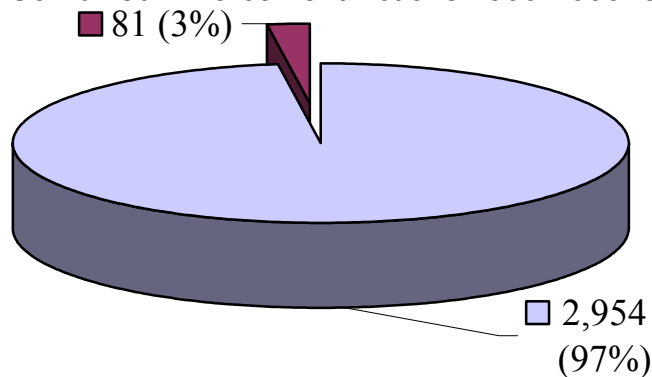
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<sup>8</sup> See Institutional Investor website. [www.institutionalinvestor.com](http://www.institutionalinvestor.com)

The CFTC and the SEC are the two primary federal agencies that have jurisdiction over hedge funds and their advisers. I testified at the SEC Hedge Fund Roundtable on May 15, 2003 on the Fraud Panel.<sup>9</sup> What follows is an update of the analysis I presented there regarding CFTC and SEC enforcement actions against entities and persons who could be considered hedge funds or hedge fund advisers.

In the aggregate, the CFTC and SEC have brought 3,035 enforcement actions in the last 5 fiscal years (FY 1999-2003). Of these, only 81 of the 3,035 enforcement actions have been against entities or persons who might be considered hedge funds or their advisers – with the CFTC bringing 43 cases and the SEC bringing 38.<sup>10</sup> This represents just 2.8% of all the enforcement actions taken by the two agencies during this 5-year period.

SEC and CFTC Hedge Fund/Commodity Pool Enforcement Actions  
Total Combined Enforcement Actions 1999-2003: **3,035\***



■ All Other Enforcement Actions   
 ■ Hedge Fund/Commodity Pool Actions

\* SEC enforcement actions during 1999-2003 totaled 2,789. CFTC enforcement actions during the same period totaled 246.

<sup>9</sup> See the SEC Website, [www.sec.gov/spotlight/hedgefunds/hedge-parts.htm](http://www.sec.gov/spotlight/hedgefunds/hedge-parts.htm). Testimony of Patrick J. McCarty, General Counsel, CFTC.

<sup>10</sup> According to the SEC Staff Report on hedge funds, the SEC brought approximately 38 hedge fund enforcement cases since 1999. See pg. 73 of “Implications of the Growth of Hedge Funds,” SEC Staff Report (September 2003) at “Staff Guidance and Studies” under [www.sec.gov/divisions/investment/guidance.shtml](http://www.sec.gov/divisions/investment/guidance.shtml).

### ***CFTC Enforcement Actions against CPOs and Commodity Pools***

The CFTC takes its oversight and enforcement responsibilities with respect to CPOs and commodity pools very seriously. In the last 12 years (FY 1993 to present) the CFTC has brought 111 enforcement actions against CPOs and commodity pools. Tab 4.<sup>11</sup> In the last 5 fiscal years (FY 1999-2003), the CFTC has brought 43 enforcement actions against CPOs and commodity pools. *Id.* The number of enforcement cases against CPOs and commodity pools averages about 10 per year. The NFA receives 10 or fewer complaints annually regarding CPOs and commodity pools.<sup>12</sup> In many instances, the CFTC works with state regulators or the SEC in bringing such actions.

The CFTC has investigated, and taken enforcement action where appropriate, in many of the most publicized hedge fund frauds in the past five years. In April 2004, for example, the CFTC sued the operator of the Shasta Fund for allegedly fraudulently soliciting at least \$5.7 million from 29 or more investors – a mere two weeks after an independent website featured Shasta as the “hedge fund of the week.”<sup>13</sup> In June 2004, a federal court in Florida ordered the operator of the Orca Funds (Donald O’Neill and affiliated entities) to pay \$12 million in restitution and civil monetary penalties totaling \$10.6 million for fraudulent solicitation and misappropriating the investments of hedge fund participants.<sup>14</sup> And the CFTC also has a pending federal injunctive action (as does the SEC) filed in early 2000 against the operator of the Maricopa Funds (David Mobley and affiliated entities) alleging a \$59 million fraud including misappropriating funds to support a lavish lifestyle for Mobley and his family and associates.<sup>15</sup>

In actions against CFTC registrants, in 2003 the CFTC filed an administrative statutory disqualification proceeding against Beacon Hill Asset Management, LLC (a registered CPO and CTA) to restrict its ability to participate in the futures and options industry based on alleged valuation and reporting misconduct regarding certain hedge funds it managed.<sup>16</sup> The NFA also has proceeded against registrants in such situations, as in 2002 when it discovered that Integral Investment Management LP (a registered CPO and CTA) and its managing partner, Conrad Seghers, engaged in false advertising and false statements to investors concerning the

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<sup>11</sup> Sanctions available to the CFTC in its enforcement cases against CPOs and commodity pools include disgorgement of management fees and ill-gotten gains, restitution, registration restrictions such as suspension or revocation, and civil monetary penalties.

<sup>12</sup> On average, 2% of all complaints received by NFA in a year relate to CPOs and commodity pools. For instance, in 2003 the NFA received 115 formal arbitration filings. Three of the 115 (2%) arbitration filings were commodity pool related. The NFA also received approximately 350 informal complaints in 2003 (emails and phone calls). Of these 350 informal complaints, 19 were with respect to commodity pools but only 5 of the complaints were against CFTC-registered CPOs. Teleconference with Patricia L. Cushing, NFA Associate Director of Compliance, July 13, 2004.

<sup>13</sup> CFTC Enforcement Press Release #4908-04, [www.cftc.gov/opa/enf04/opa4908-04.htm](http://www.cftc.gov/opa/enf04/opa4908-04.htm) (April 6, 2004).

<sup>14</sup> *CFTC v. Donald O’Neill, et al*, No. 02cv61307 (S.D. Fla. Order June 15, 2004).

<sup>15</sup> CFTC Enforcement Press Release #4368-00, [www.cftc.gov/opa/enf00/opa4368-00.htm](http://www.cftc.gov/opa/enf00/opa4368-00.htm) (Feb. 22, 2000).

<sup>16</sup> CFTC Enforcement Press Release #4734-03, [www.cftc.gov/opa/enf03/opa4734-03.htm](http://www.cftc.gov/opa/enf03/opa4734-03.htm) (Jan. 7, 2003).

performance of several hedge funds. The Art Institute of Chicago was one of the investors. NFA coordinated with government authorities to take appropriate action.<sup>17</sup> Of course, some investigations indicate that no wrongdoing has occurred. Earlier this year, both the CFTC and the SEC closed their respective investigations into Clinton Group Inc. (a registered CPO and CTA) regarding allegations of fraud in bond valuations and reporting to investors.<sup>18</sup>

One other case involving a pooled investment vehicle that is worthy of mention is the pending CFTC and SEC litigation (filed in 1999) against Martin Armstrong and Princeton Global Management, Ltd.<sup>19</sup> The CFTC alleges that Armstrong arranged for an FCM (a commodities broker) to issue over 200 letters inflating the net asset values of fund assets, and then transmitted those letters to customers in Japan. This matter has garnered public attention as the court has ordered Mr. Armstrong jailed for more than four years, held in civil contempt for continuing to refuse to turn over nearly \$15 million in corporate assets to a court-appointed receiver. As a side note to the Armstrong case, when the FCM settled criminal, CFTC, and SEC charges in 2001 based on its role, \$606 million in restitution was awarded to defrauded investors in the criminal proceeding, and the CFTC ordered the FCM to pay \$5 million as a civil money penalty.<sup>20</sup>

Based on the CFTC's 12-year experience with CPO and commodity pool fraud, I make the following observations:

1. The vast majority of cases involve unregistered commodity pools/CPOs.
2. Most cases involve outright misappropriation.
3. Typically, fewer than 50 participants or investors are involved.
4. Typically, less than \$10 million is invested.

To summarize, while there have clearly been examples of fraud in the hedge fund arena, the number of combined CFTC-SEC enforcement actions for hedge fund fraud over the last 5 years has been quite small – just under 3% of all enforcement actions. On the CFTC side, most of the fraud actions over the 12-year period have involved unregistered entities operating funds with relatively few participants and monies invested, compared to the tremendous size of the hedge fund industry. In addition, it should be noted that many of these fraud cases involved either ponzi schemes or outright stealing, as opposed to legitimate hedge fund operations.

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<sup>17</sup> NFA Business Conduct Committee, #02-BCC-003 (April 12, 2002).

<sup>18</sup> See "Clinton Group Investigation Ends," 5/11/04 Wall St. J., C5 (SEC); "CFTC Closes Probe of Clinton Group Without Action," 4/26/04 Dow Jones News Service.

<sup>19</sup> CFTC Enforcement Press Release #4312-99, [www.cftc.gov/opa/enf99/opa4312-99.htm](http://www.cftc.gov/opa/enf99/opa4312-99.htm) (Sept. 14, 1999).

<sup>20</sup> CFTC Enforcement Press Release #4590-01, [www.cftc.gov/opa/enf01/opa4590-01.htm](http://www.cftc.gov/opa/enf01/opa4590-01.htm) (Dec. 17, 2001).

### **3. CFTC/NFA Oversight of CPOs is Periodic and Risk-Based**

My third point is that the CEA and CFTC regulations applicable to CPOs and CTAs are principally designed to protect investors against fraud and overreaching by professionals managing or advising their investments. The CEA prohibits CPOs and CTAs and their associated persons from engaging in fraudulent transactions with pool participants and clients. This general prohibition applies to all CPOs and CTAs – regardless of whether they are required to register or not. Further, CFTC regulations proscribe CPOs and CTAs from accepting pool subscriptions in their own name and from commingling pool property with the property of any other person.

In addition to anti-fraud provisions, the CEA and CFTC regulations set forth registration and other substantive requirements – namely, those relating to risk disclosure, financial reporting, and recordkeeping - that are also designed to further the goal of investor protection. The CFTC has delegated to the NFA direct responsibility for registration processing and for monitoring compliance with those other requirements. Thus, the NFA, subject to CFTC oversight, receives and reviews applications for registration and grants, denies or conditionally registers CPOs and CTAs; conducts reviews of the disclosure documents that CPOs and CTAs are required to file under CFTC rules; processes claims of exemption or exclusion from various CPO or CTA requirements; and receives and reviews annual financial reports filed by CPOs. Further, the NFA conducts routine examinations of CPOs and CTAs – and of course, enforces its own rules applicable to CPOs and CTAs.

#### ***Registration***

Registration is the cornerstone of the CFTC's regulatory scheme. As a general rule, a person who intends to operate or advise commodity pools must register as a CPO or CTA unless an exclusion or exemption from registration is available.<sup>21</sup> Importantly, the operators and advisers of commodity pools – but not the pools themselves – are required to register. As noted above, as of September 30, 2003 there were 2,059 CPOs registered with the CFTC and approximately 3,244 commodity pools. See Tab 1. Each CPO and commodity pool is assigned

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<sup>21</sup> NFA has thorough and rigorous review procedures for registration of CPOs, CTAs, and their associated persons. See NFA Registration Rules 204 and 206. Sections 8a(2) and 8a(3) of the CEA specify certain disqualifications from registration, including securities and commodities laws violations, as well as violations involving fraud, embezzlement, misappropriation of funds, and other misconduct. 7 U.S.C. 12a(2) and 12a(3). NFA performs an extensive background check to determine whether a statutory disqualification exists. Three essential elements of the background check are the disciplinary information questions on the application forms that require the applicant to disclose and supply detailed information concerning possible disqualifications, a check against the National Association of Securities Dealer's CRD database, and the fingerprint cards provided by individuals. Fingerprint cards are sent to the Federal Bureau of Investigation to determine if the applicant has a criminal record. For foreign applicants, NFA may perform additional background checks such as checks with foreign regulatory and self-regulatory bodies and Interpol. NFA has the authority to deny, revoke, suspend, restrict or condition any firm's or individual's registration. See Part 500 of NFA Registrations Rules. For further information, see NFA's website, [www.nfa.futures.org](http://www.nfa.futures.org).

a unique NFA ID number. Registration is easy to confirm.<sup>22</sup> The primary purposes of registration are to ensure a person's fitness to engage in business as a futures professional and to identify those persons whose activities are subject to federal regulation.

Registration triggers other substantive requirements for CPOs and CTAs. Generally speaking, each registered CPO and CTA must provide pool participants with certain disclosures at the point of sale; report periodically on the pool's financial performance; and keep records that are available to regulators and participants.

### ***Risk Disclosures***

When soliciting prospective participants for a pool, a registered CPO must supply an offering document for such pool. This document is known as a Disclosure Document (DD) and its purpose is to provide prospective investors with information needed in order to make informed investment decisions. The DD must be filed for NFA review prior to its first use with participants and subsequently upon any material changes in it, to confirm that the document contains required information about the pool and its operator and adviser(s). Further, each participant must return a signed and dated acknowledgement that a DD has been received. This acknowledgement must be retained by the CPO or CTA and be readily available to regulators.

The DD must discuss the business background of the CPO, the trading manager, each major CTA, and the CPO of each major investee pool (as well as the principals of each of the foregoing). The DD must describe the pool's investment programs and policies and the risks associated with investing in the pool, including discussion of risks related to volatility, leverage, liquidity, counterparty creditworthiness and the pool's trading structures and expected investment activities. The DD also must disclose conflicts of interest, including actual or potential conflicts involving the CPO, the trading manager, major CTAs, CPOs of major investee pools, or any principal of these entities. Finally, it must describe the pool's policies regarding the CPO's, trading manager's, CTA's, and the principals' trading for their own accounts and the extent to which these persons have any ownership interest in the pool.

### ***Financial Reporting***

A registered CPO must provide to participants, and file with NFA, an annual report for each pool that contains the pool's net asset value (NAV), a Statement of Financial Condition, a Statement of Income (Loss), the total net gain or loss from commodity interest trading, and a breakdown of fees and expenses, among other things. In 2003, the CFTC/NFA reviewed all 2,995 commodity pool annual reports that were filed.

In addition to annual reports, the CPO must also provide to each participant an account statement at least quarterly that includes the pool's NAV, a Statement of Income (Loss), the pool's total net income or loss, and a breakdown of fees.

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<sup>22</sup> Regulators and the general public can identify 24 hours a day for free those CPOs that are registered with the CFTC and NFA, and their commodity pools, by accessing the NFA's website and using the BASIC section to search. [www.nfa.futures.org](http://www.nfa.futures.org)



## ***Recordkeeping***

A registered CPO or CTA must maintain and have available for examination certain records that support and explain its financial statements and reports, accounting journals and ledgers, detailed records of the pool's transactions, and records of personal trading by the CPO and its principals. It must also maintain copies of DDs and all promotional materials used, as well as the support for any information contained in the materials. All required books and records must be kept for five years and must be readily available for at least the first two years.

## ***Simplified Regulatory Framework For Certain CPOs/CTAs***

CFTC regulations provide a simplified regulatory framework for CPOs and CTAs under certain conditions. Specifically, a CPO or CTA may be excluded or exempt from registration because of the nature of its investors or to avoid duplicative or inconsistent regulation of funds. For instance, banks and insurance companies are all excluded from being required to register as CPOs.<sup>23</sup> In addition, the CFTC has excluded the more than 8,000 SEC registered mutual funds, which trade futures and options on futures, from being required to register with the CFTC because they are already subject to significant regulation and oversight.

This CFTC "otherwise regulated" exclusion parallels the "bank and bank holding company" exclusion from the definition of "investment adviser" under the Investment Advisers Act of 1940.<sup>24</sup> That exclusion is similar to the registration exemption for CFTC-registered CTAs that is in Section 203 of the Investment Advisers Act.<sup>25</sup> Also, the SEC proposed in May 2004 to exclude from the Investment Advisers Act certain federally chartered and regulated thrifts.<sup>26</sup> The proposed SEC exclusion would apply to the thrift's trust activities as long as it does not generally hold itself out to the public as providing investment advisory services. Further, the SEC's proposed rule would except a thrift institution from the Investment Advisers Act to the extent that its investment advice is provided to a collective trust fund. The CFTC believes that a similar type of exemption should be considered for CFTC-registered CPOs and/or CTAs that sponsor, operate or advise commodity pools/hedge funds that do not hold themselves out generally to the public as providing investment advisory services.

There are other examples of exclusions or exemptions from CPO or CTA registration: those entities that operate one or more small pools that have received less than \$400,000 in capital contributions and that have no more than 15 participants in any one pool; or entities that operate pools that are open only to certain highly-qualified investors. A CPO or CTA relying on

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<sup>23</sup> 17 C.F.R. 4.5.

<sup>24</sup> Banks are specifically excluded from the definition of "investment adviser" in the Investment Advisers Act of 1940. 15 U.S.C. 80b-202(a)(11).

<sup>25</sup> There is a specific statutory registration exclusion in the Investment Advisers Act for CFTC registered CTAs which do not advise SEC registered investment companies or SEC registered business development companies. 15 U.S.C. 80b-203(b)(6).

<sup>26</sup> The SEC proposed on May 7, 2004 to exclude certain federally-chartered and regulated thrifts engaged in trust activities from registering as Investment Advisers. See 69 Fed. Reg. 25778 (May 7, 2004).

relief from registration must nevertheless file a notice of eligibility with the NFA that includes certain identifying information and represent that it will disclose to participants that it has claimed such relief and that it will submit to special calls by the CFTC.

Relief is also available from the full disclosure, financial reporting and recordkeeping requirements for certain CPOs and CTAs, subject to notification to the NFA. For example, a CPO offering commodity pools exclusively to certain highly-qualified investors is not required to deliver DDs and is allowed to substitute abbreviated reporting and recordkeeping procedures for such pools. Similarly, a CPO offering pools which primarily trade in securities and whose commodity trading is limited, may substitute its offering memorandum for a DD and provide its participants with abbreviated financial statements.

### ***NFA Examination Cycle***

As part of its self-regulatory responsibilities, NFA conducts on-site examinations of CPOs and CTAs on a routine, periodic basis. NFA conducted 313 CPO compliance examinations in 2003.<sup>27</sup> NFA's goal is to examine all CPOs and CTAs within two years of their becoming active, and every four years thereafter; provided, however, that NFA has implemented a priority scoring approach to examination cycles that may result in accelerated exams of firms depending upon the firm's disciplinary history, customer complaints,<sup>28</sup> assets under management, or sudden changes therein. It should also be noted that CPOs that exclusively operate pools that are sold strictly to certain highly-qualified participants (and that are therefore exempt under CFTC rules from some of the normal disclosure, reporting, and recordkeeping requirements) are subject to examination on a five-year cycle. Finally, all registered CPOs and CTAs – including those that are inactive - are required to complete and submit to NFA an annual questionnaire. If, on the basis of information in the questionnaire (or any other information it obtains), NFA determines that the firm is in fact active, NFA will schedule an examination of the firm.

NFA's CPO compliance examinations have three major objectives: first, to determine whether the firm is maintaining records in accordance with NFA rules and CFTC regulations; second, to assure that the DD properly reflects material information concerning the firm and its principals; and third, to ascertain that the firm is being operated in a professional manner and that customers are protected against abusive conduct, including high-pressure sales practices.

NFA also conducts financial reviews of commodity pools. The financial review focuses on the presentation of the pool's balance sheet, income statement and account statement. The primary objective of the financial review is to determine that the financial statements are

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<sup>27</sup> The NFA completed 332 CPO compliance examinations in 1999, 364 CPO compliance examinations in 2000, 282 CPO compliance examinations in 2001, 369 CPO compliance examinations in 2002 and 313 CPO Compliance Examinations in 2003. CPO compliance examination cycle frequency for CPOs which operate commodity pools has historically been every 2.5 to 3 years as opposed to the SEC Investment Company complex and Investment Adviser examination cycle frequency of approximately every 5 years. See SEC 1999 – 2002 Annual Reports – Office of Compliance, Inspection and Examination. See “Annual Reports” at [www.sec.gov/about.shtml](http://www.sec.gov/about.shtml).

<sup>28</sup> See Note 12, *supra*.

complete, accurate and prepared in accordance with NFA and CFTC rules. While NFA's CPO examinations focus primarily on commodity futures and option activities, they can extend to the other financial instruments – including securities - held by the commodity pools.<sup>29</sup>

### ***Large Trader Reporting***

My discussion of CPO and CTA oversight would be incomplete without my mention of the CFTC's large-trader reporting system, which is an important market surveillance tool to prevent price manipulation and to enforce speculative position limits. These rules require FCMs to report to the CFTC position information of the largest futures and options traders and require the traders themselves to provide certain identifying information upon call by the CFTC. Given their size, many hedge funds and their operators hold reportable positions and thus supply the CFTC with information about their commodity interest trading on U.S. futures exchanges.

#### **4. The CFTC Cooperates with Other Regulators on Hedge Fund Investigations**

As noted above, the CFTC has available to it a significant amount of information concerning CPOs, commodity pools, and CTAs. My fourth point is that the CFTC works cooperatively with the SEC, the New York State Attorney General and other civil and criminal authorities with respect to sharing its information and investigations involving hedge funds which are sponsored, operated, or advised by CFTC-registered CPOs or CTAs. Chairman James Newsome and the other Commissioners of the CFTC have made it clear that the CFTC is to work proactively and cooperatively with other regulators on these issues and share information in its possession with respect to our registrants. Below are some examples of how the CFTC has worked cooperatively with other authorities.

The CFTC has worked closely with the members of the President's Working Group on Financial Markets (PWG) - U.S. Department of Treasury, The Board of Governors of the Federal Reserve System, and the SEC – on hedge fund issues in the past including the preparation of the 1999 PWG Report on Hedge Funds.<sup>30</sup> The CFTC has regularly provided briefings and data to the other PWG Members on hedge fund issues during the last 2 years.

The CFTC participated in the SEC's Hedge Fund Roundtable in May 2003. Two representatives of the CFTC testified at the SEC's Hedge Fund Roundtable and provided written presentations describing the CPO and commodity pool regulatory structure, identifying the large commodity pools and CPOs that are considered to be hedge fund operators, and discussing the

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<sup>29</sup> Cf. *In re Slusser*, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,701 (CFTC July 19, 1999), *aff'd as to liability, rev'd and remanded in part as to sanctions sub nom., Slusser v. CFTC*, 210 F.3d 783 (7th Cir. 2000) (CPO's undisclosed securities trading constituted fraud in violation of CEA Section 4o(1)); *In re Integral Investment Management LP, and Conrad Seghers*, NFA Business Conduct Committee, #02-BCC-003 (April 12, 2002).

<sup>30</sup> Hedge Funds, Leverage and the Lessons of Long-Term Capital Management, Report of the President's Working Group on Financial Markets (April 1999). See CFTC Website – [www.cftc.gov/cftc/cftcreports.htm](http://www.cftc.gov/cftc/cftcreports.htm).

type and amount of fraud in the CPO/hedge fund sector. These written presentations can still be found on the SEC's website.<sup>31</sup>

The CFTC has conducted educational efforts with state securities regulators regarding CPOs, commodity pools and hedge funds. CFTC staff has spoken at North American Securities Administrators Association (NASAA) enforcement conferences regarding hedge funds in 2003 and 2004 and has worked through the CFTC's Office of Cooperative Enforcement within the Division of Enforcement to provide support to state securities regulators.

The CFTC briefed SEC Senior Staff in November 2003 on the types of information the CFTC has available – both public and nonpublic – regarding hedge funds which might have CFTC-registered CPOs. As part of these briefings, the CFTC demonstrated to the SEC Staff the CPO and commodity pool information that is available in the free, 24-hour-a-day NFA registration database. The CFTC has offered to provide the same briefings to SEC Enforcement staff on the types of information which the CFTC has available regarding CPOs and commodity pools. CFTC Enforcement Staff has worked in the past, and continues to work, with the SEC, the New York State Attorney General and other regulators on hedge fund investigations which may involve CFTC-registered CPOs or CTAs.<sup>32</sup>

## **CONCLUSION**

The CFTC has seen very little fraud in the CPO and commodity pool arena relative to the number of pools, number of participants and the amount of funds invested. Again, the vast majority of commodity pools - 98% - are sold to institutional investors in private placements, and are not sold to retail investors. The number of combined CFTC-SEC enforcement actions involving hedge funds and commodity pools over the last 5 fiscal years (FY 1999-2003) is just 3% of all enforcement actions (81 out of 3,035). Most of the fraud has been committed by unregistered entities and typically involves outright misappropriation. As the record indicates, where there is fraud, the CFTC takes action.

It has been said that SEC registration of hedge funds and their advisers is necessary to afford a window for regulators into these investment vehicles in order to combat fraud. As demonstrated above, such a window already exists with respect to the segment of the hedge fund industry that is registered with the CFTC. The CFTC has a substantial amount of information available to it regarding these CPOs, commodity pools, and CTAs. This information has proved fully sufficient for the CFTC to bring enforcement actions for fraud on those relatively rare occasions when it occurs. And the CFTC stands ready to continue sharing this information with other regulatory authorities that may be in need of it.

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<sup>31</sup> See the presentations of Patrick J. McCarty, General Counsel, CFTC, and Jane Kang Thorpe, Director, Division of Clearing and Intermediary Oversight, CFTC, from May 15, 2003, at [www.sec.gov/spotlight/hedgefunds/hedge-parts.htm](http://www.sec.gov/spotlight/hedgefunds/hedge-parts.htm).

<sup>32</sup> It is the CFTC's general policy to not comment on any ongoing investigations, which would include any activity by CFTC registrants with respect to the ongoing mutual fund market timing, late trading and sticky asset scandals. The CFTC will provide private briefings to Congressional Members or Staff upon request.

In light of the foregoing, if the SEC chooses to go forward with requiring advisers to hedge funds to register, the CFTC believes it would be appropriate to consider an explicit exclusion from SEC registration for the advisers of hedge funds/commodity pools that are CFTC-registered CPOs or CTAs, similar to the one enjoyed by banks and proposed for certain thrifts.

I would be happy to answer any questions which the Committee might have.