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Via E-Mail to
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National Futures Association
300 S. Riverside Plaza, #1800
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Attention: Mary McHenry, Associate Director, Compliance
Julia Wood, Attorney

Re: Notice I-14-03: Request for Comments – CPO/CTA Capital Requirement and Customer Protection Measures (the "Notice")

Dear Ms. McHenry and Ms. Wood:

We write on behalf of the Committee on Futures and Derivatives (the "Committee") of the New York City Bar Association (the "Association") to provide our comments to the National Futures Association (the "NFA") with respect to the recently issued request for comments referenced above.

The Association is an organization of over 23,000 members. Most of its members practice in the New York City area. However, the Association also has members in nearly every state and over 50 countries. The Committee consists of attorneys knowledgeable about the trading and regulation of futures contracts and over-the-counter derivative products, and it has a practice of publishing comments on legal and regulatory developments that have a significant impact on the futures and derivatives markets.

Our comments set forth below are limited to the question of the NFA's authority to impose a capital requirement on its commodity pool operator ("CPO") and commodity trading advisor ("CTA") members. We have not commented upon other aspects of the Notice.

A. Summary

The Committee supports the goal of protecting the assets and interests of customers of CPOs and CTAs. The Committee also supports existing capital requirements for various specific types of registrants under the Commodity Exchange Act ("CEA") in cases where such requirements have been prescribed by legislative and regulatory action. However, notwithstanding the laudable goals underlying the NFA's Notice, neither the CEA nor the Commodity Futures Trading Commission's ("CFTC") designation of the NFA as a registered futures association specifically confers authority on the NFA to create capital requirements for CPOs and CTAs. Accordingly, the Committee respectfully submits that the issues raised in the Notice should be initiated with Congress and the CFTC in the first instance, and we respectfully suggest that the NFA consider the issues of legal authority and legal process before undertaking any action pursuant to the Notice.

B. Authority for Capital Requirements

Congress has specifically authorized the CFTC to impose capital requirements for only certain types of persons, including swap dealers, major swap participants, designated contract markets, swap execution facilities, derivatives clearing organizations, futures commission merchants, and introducing brokers. Capital requirements for these CFTC registrants have been adopted through formal notice and rulemaking processes based on clear statutory provisions of the CEA:

> (i) Swap dealers and major swap participants are subject to capital requirements pursuant to CEA §4s(e).
>
> (ii) Designated contract markets ("DCMs") and swap execution facilities ("SEFs") are subject to requirements to maintain financial resources to support operations pursuant to CEA §§5(d)(21) and 5h(f)(13), respectively.
>
> (iii) Derivatives clearing organizations ("DCOs") are subject to minimum financial resource requirements under CEA §5b(c)(2)(B).
>
> (iv) Futures commission merchants ("FCMs") and introducing brokers ("IB") are subject to minimum financial requirements under CEA §4f(b).[1]

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1 CFTC Regulation 1.52(a) requires each self-regulatory organization to adopt rules prescribing minimum financial and related reporting requirements for members who are registered futures commission merchants and

Congress has never imposed capital requirements for CPOs or CTAs or authorized the CFTC or any other body to impose such requirements. Similarly, the CFTC itself has not imposed capital requirements on CPOs or CTAs, and has limited its regulations imposing capital requirements to those types of entities for which the CEA specifically authorizes capital requirements (and, in the case of retail foreign exchange dealers, to those entities (1) over which the CEA confers a great deal of discretion upon the CFTC and (2) in respect of which the CEA has prescribed capital requirements when dealing with persons that are not eligible contract participants). We note that, although the CFTC did seek comment upon possible capital requirements for CPOs in 1977,[2] the CFTC never proposed specific capital requirements and decided not to propose specific capital requirements in light of general opposition thereto.[3] As a result, the NFA's approach in the Notice is not consistent with the manner in which capital requirements have been addressed in the past for other CFTC registrants and for CPOs.

Furthermore, the CEA does not confer authority on registered futures associations to create capital requirements that are not otherwise specifically provided by the CEA and CFTC rules. Consistent with this, CFTC Regulation 1.52(a) requires each self-regulatory organization to adopt rules prescribing minimum financial and related reporting requirements only for those members that are registered futures commission merchants, registered introducing brokers or registered retail foreign exchange dealers. However, this CFTC regulation does not impose similar requirements with respect to CPOs or CTAs, which is consistent with the fact that the CEA does not specifically confer authority on the CFTC to impose capital requirements for CPOs and CTAs.

The Notice explains that "the rationale that requires independent introducing brokers, which are prohibited from holding customer funds, to maintain minimum capital should apply to … CPOs … and CTAs." Whether or not such rationale applies, we believe that NFA rulemaking is an inappropriate route to impose such requirements in the absence of statutory and regulatory authority. CEA §4f(b) expressly grants the CFTC authority to impose financial requirements on introducing brokers and the CFTC has exercised such authority in CFTC Regulation 1.12. There are no comparable grounds for requiring capital requirements for CPOs or CTAs.

C. Process for Determining Advisability of Capital Requirements

A capital requirement for CPOs and CTAs would be a new and significant regulatory requirement. Imposing such a requirement implicates a host of broad and difficult legal, market, competitive and economic issues. Such a requirement may also affect the interests of persons

registered introducing brokers. CFTC Regulation 1.52(a) also specifically authorizes each self-regulatory organization to adopt rules prescribing minimum financial and related reporting requirements for members who are registered retail foreign exchange dealers, who are required to register as such under CEA §2(c)(2) and over which the CFTC is granted a great deal of discretion in promulgating rules. That regulation is consistent with CEA §2(c)(2)(B), which specifically sets forth capital requirements for retail foreign exchange dealers to the extent the same deal with persons who are not eligible contract participants. However, CFTC Regulation 1.52(a) does not impose similar requirements with respect to CPOs or CTAs.

[2] *See*, 42 F.R. 9266 at p. 9270 (February 15, 1977).

[3] *See*, 44 F.R. 1918 at p. 1923 (January 8, 1979).

other than NFA members, such as investors. As a result, the NFA may not be best situated to fully evaluate these issues or to (a) calculate the costs and benefits in imposing capital requirements, (b) determine whether or not there may be unintended consequences arising from the NFA's actions with respect to capital requirements, (c) determine whether or not participants in the commodity markets actually look to the financial wherewithal of CPOs and CTAs (in contrast to other attributes of the CPO and CTA) in determining the economic suitability of the underlying pool, (d) determine whether there are less onerous means to achieve the intended objectives of capital requirements, and (e) determine how CPO and CTA regulation harmonizes with other laws and regulations, including investment adviser regulation under the securities laws. The Committee believes that a capital requirement and associated issues are better analyzed and addressed through the legislative and regulatory process with all of the protections associated therewith (*i.e.*, (1) democratic legislative process, including the formal actions of Congress and the President; (2) formal administrative rulemaking with a notice and comment period consistent with the CEA and the Administrative Procedure Act; and (3) possible judicial review). The Committee respectfully submits that the NFA should not take action that would be inconsistent with such legal process.

D. The NFA Is a Unique Type of Association

We note that the NFA is not like a regular industry trade association, in which membership is purely voluntary. When membership in an association is voluntary, the association generally possesses a great deal of discretion in adopting membership and compliance requirements. If members disagree with the association's requirements, they can cease being members. In contrast, the NFA is a creature of statute, and membership in it for many CPOs and CTAs is compulsory as a legal prerequisite to acting as a CPO or CTA. Accordingly, the NFA should not unilaterally initiate significant and transformative actions that can affect its members and other persons without prior authorization from the CEA and the CFTC.

We appreciate the opportunity to present our views to you on this matter of importance to us as practitioners in the area of futures and derivatives and our members who constitute the working group for this letter are available to discuss any of the above at your convenience.

Respectfully yours,

Thomas D'Ambrosio, Chair
The Committee on Futures and Derivatives,
New York City Bar Association

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Thomas D'Ambrosio, Chair

§ These members of the Committee constitute the working group for this letter.

* These members of the Committee did not participate in the preparation of this comment letter.

The opinions expressed by members of the Committee in this letter are the individual opinions of the members and not necessarily the opinions of any organization with which they may be employed or affiliated.

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