



MANAGED FUNDS ASSOCIATION

September 18, 2006

VIA ELECTRONIC MAIL: rule-comments@sec.gov

Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549
Attention: Nancy M. Morris, Secretary

Re: Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting; File Number S7-11-06

Ladies and Gentlemen:

Managed Funds Association ("MFA") appreciates the opportunity to make this submission of comments to the Commission's Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting.

Introduction

MFA is the leading U.S.-based membership organization dedicated to serving the needs of professionals who advise, manage and operate commodity pools, as well as hedge funds, and funds of hedge funds. Our over 1,100 members manage a significant portion of the estimated \$1.5 trillion invested in these alternative investment vehicles globally. Among the MFA membership are commodity pool operators and commodity trading advisors. As public commodity pools are subject to the requirements of Section 404 ("Section 404") of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), our members have a keen interest in the development of a prospective rule under Section 404 by the Commission.

We would like to take this opportunity to elaborate on an issue we raised in our comment letter on the Exposure Draft of the Final Report of the Advisory Committee on Smaller Public Companies concerning Section 404 and public commodity pools. MFA respectfully requests that the Commission in issuing a prospective rule under Section 404 consider the unique position that public commodity pools find themselves in as entities regulated by the Commission, the Commodity Futures Trading Commission, and the National Futures Association. For the reasons discussed below, MFA believes that public commodity pools ("Pools") should be exempt from certain of the requirements of Section 404.

Section 404 and Public Commodity Pools

Like registered investment companies, Pools are “net asset value”-based trading entities which have no operations beyond their trading activities. Registered investment companies are specifically exempted from Section 404, irrespective of size,¹ because the objectives of Section 404 are addressed otherwise by the federal securities laws;² and Pools should likewise be exempted as the Commodity Exchange Act and the regulations promulgated thereunder, as well as the rules of the National Futures Association, the self-regulatory organization of the commodity futures industry (the “NFA”), similarly address the objectives of Section 404.

Pools are subject to the reporting requirements of the Securities Exchange Act of 1934, but they are also subject to an entirely separate body of regulation under the Commodity Exchange Act. In addition to detailed disclosures with respect to a Pool’s operations,³ Pools are subject to specific recordkeeping and investor reporting requirements.⁴ These include distributing annual financial statements, audited by an independent certified public accountant,⁵ and monthly investor account statements. The monthly reports must include for the Pool, at a minimum, a statement of income (loss) and a statement of changes in net asset value for the current period as well as disclosure of any material business dealings between the Pool, the Pool’s operator, commodity trading advisor, futures commission merchant (“FCM”), introducing broker or the principals thereof not previously disclosed in the Pool’s prospectus or other monthly account statements or annual reports.⁶ Each monthly and certified annual report must be accompanied by a signed oath or affirmation of a person authorized to bind the Pool’s operator. The oath or affirmation must state that to the best of the knowledge and belief of the individual making the oath or affirmation the information contained in the document is accurate and complete. It is unlawful for the individual to make such an oath or affirmation if the individual knows or should know that any of the information in the document is not accurate and complete.⁷ It is worth noting that this oath/affirmation

¹ Section 405 of the Sarbanes-Oxley Act of 2002.

² See S. Rep. No. 107-205 (2002) Discussion of Title IV-Enhanced Financial Disclosures, Section G (“The bill exempts investment companies from certain disclosure requirements. The Committee feels that the objectives of those disclosure sections are adequately addressed by existing Federal securities laws and the rules thereunder affecting investment companies.”)

³ 17 CFR 4.24 and 17 CFR 4.25. The disclosure required of Pools under CFTC regulation, while overlapping in part, are in addition to the disclosures required in a Pool’s Registration Statement on Form S-1 or Form 10.

⁴ In addition to the detailed recordkeeping and investor reporting required of Pools and their operators, all funds received from Pool participants must be received in the Pool’s name and Pool operators are prohibited from commingling the assets of any Pool with the assets of any other person. 17 CFR 4.20 (b) and (c).

⁵ 17 CFR 4.22(c)

⁶ 17 CFR 4.22(a)

requirement predates the certification requirements of Sarbanes-Oxley by more than two decades.

Pools registered under the Securities Act of 1933 are subject to further substantive regulation by the states under Blue Sky laws.⁸ During the State registration process, approximately 15-20 States⁹ perform a substantive review of a Pool's application and largely require compliance with the North American Securities Administrators Association Statements of Policy (October 1994) "Registration of Commodity Pool Programs" ("NASAA Guidelines"), including with respect to the experience and net worth of the Pool sponsor, reporting to Pool participants and the prohibition of certain transactions including loans from a Pool to its sponsor or any other person.¹⁰

MFA also wishes to point out that the Pools and their operators are subject to regulatory audits by the NFA. NFA audits generally occur approximately every three to four years and provide oversight of the Pools' accounting processes — a form of substantive oversight that is not applicable to other public companies.

Pool operators must keep specific records relating to each Pool and its participants, all of which are subject to the Pool's independent auditor's audit as well as the audits performed by NFA. Among the records specifically required to be kept by Pool operators and routinely requested by NFA auditors are an itemized daily record of each Pool transaction containing specified information, a journal of original entry showing all receipts and disbursements of money, securities and other property, a subsidiary ledger for each participant in the Pool identifying the participant and showing all funds, securities and other property that the Pool received from or distributed to the participant, adjusting entries and any other record of original entry forming the basis of entries in any ledger, a general ledger containing details of all asset, liability, capital, income and expense accounts, a statement of financial condition as of each month-end and a statement of income (loss), prepared monthly and covering the period between the Pool's most recent fiscal year-end (or, if none, since the inception of the Pool) and the month-end income statement date, all confirmation statements, purchase and sale statements and monthly activity statements received from any FCM, cancelled checks, bank statements, invoices, computer-generated records and all other records prepared or received in connection with the Pool as well as all advertising materials.¹¹

Pool operators must also maintain, with respect to their own operations, an itemized daily record of each transaction, including the transaction date, quantity, commodity, price,

⁷ 17 CFR 4.22(h)

⁸ Other than Pools that are exchange traded funds exempt from State securities registration. *See, infra*, note 20.

⁹ Including AZ, CA, MA, OH, TX, OK, AL, IA, AK, PA, NJ and MN.

¹⁰ *See, e.g.*, NASAA Guidelines § VI.C.2.(d) (4)

¹¹ *See* 17 CFR 4.23(a)

the FCM carrying the account, any introducing broker, whether the commodity interest was purchased or sold, and the gain or loss realized, each confirmation of a trade, each purchase and sale statement and each monthly statement furnished by an FCM for the proprietary or personal account of the Pool operator and any principal and books and records of all other transactions in all other business activities of the Pool operator,¹² all of which are subject to examination during NFA audits. Moreover, a Pool must also include in its registration statement and amendments thereto an audited balance sheet of the Pool's operator prepared by an independent auditor.¹³

The internal controls employed by Pools and their operators in connection with Pool financial reporting are rigorous, effective and wholly adequate to the business operations of Pools.¹⁴ At the same time, they do not conform to the governance structure contemplated by Section 404 of Sarbanes-Oxley and, more specifically, the internal control framework published by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO Framework), which provides the fundamental model for Section 404 compliance. Pools have no directors, officers or employees, let alone independent directors, and Pool operators, many of which are smaller privately held corporations or limited liability companies, serving as the Pool's general partner or equivalent are generally managed by their ownership without independent directors. The Commission has already excluded asset-backed issuers from the rules implementing Section 404 in part due to the governance structures of those entities.¹⁵

Internal controls are, of course, crucial regulatory compliance tools to the extent they are properly applied to an issuer. However, “[t]he primary objective of internal control over financial reporting requirements should be the prevention of materially inaccurate financial statements; companies operate differently, depending on size, and internal control rules should reflect this fact; and the benefits of any regulatory burden—Section 404-related or otherwise—should outweigh the costs.”¹⁶ Due to their size and structure, Pool operators anticipate significant, if not overwhelming, challenges, both in implementing the requirements

¹² See 17 CFR 4.23(b)

¹³ See Securities and Exchange Commission Division of Corporation Finance Training Manual “Accounting Disclosure Rules And Practices” 2000 Edition at p. 2-36; NASAA Guidelines Section VI.C.4.(b) (requiring a Pool operator's fiscal year-end audited balance sheet and interim balance sheet current within 135 days be included in the Pool's prospectus).

¹⁴ Pools trade highly liquid assets in a world of daily, marked-to-market settlements, the bulk of their assets are held at banks, FCMs and securities dealers, i.e., entities subject to regulatory oversight, and their operations are fully summarized in daily brokerage and account statements. Pool operators tend to rely to a large degree on “tone at the top” and other high-level monitoring approaches to control, along with some segregation by function giving consideration to the size of the Pool operator's staff.

¹⁵ See Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release 33-8238, 68 FR 36,648 (June 18, 2003).

¹⁶ Final Report of the Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission (April, 23, 2006) p. 22.

of Section 404 and in applying the COSO Framework, which, frankly, many pool operators may simply not be able to do to the satisfaction of an independent auditor working within an Auditing Standard No. 2 environment¹⁷ without incurring great expense and adopting an unfamiliar, and otherwise unnecessary, governance structure for the Pools. Furthermore, the Pools' net asset value structure makes the burden of compliance more onerous than in the case of other public companies. If an operating company were to pay \$1 million to achieve Section 404 compliance, it is unclear how that expenditure will affect the value of such company's stock.¹⁸ In the case of a Pool, that \$1 million expenditure directly impacts the bottom line, reducing the net asset value of investors' holdings dollar for dollar.¹⁹ Layering on top of already adequate controls and oversight additional, highly costly, compliance requirements will not significantly enhance the general quality of Pool financial reporting and will serve only to weaken the competitive stance of Pools against alternatives such as commodity pools that are not, and are not required to be, Commission registrants or registered investment companies, none of which are subject to Section 404.

While accurate Pool financial reporting is relevant to Pool investors for a variety of reasons, the integrity of Pool financial reporting controls is not relevant to any "market." Pools generally issue securities that do not trade in any market²⁰ and which, accordingly, cannot be the subject of manipulation. Accordingly, and not surprisingly, Pool investors and prospective investors do not typically analyze a Pool's financial statements to assess the appropriateness of the Pool's per unit value or the future prospects of the Pool. Pool investors are much more interested in monthly and annual rates of return. Given the simplicity of the Pools' operations as "net asset value"-based entities engaged solely in trading activities, there is no meaningful investor protection benefit to be gained from insisting on the full Section 404 procedures with respect to Pools, and to require outside

¹⁷ Auditing Standard No. 2 of the Public Company Accounting Oversight Board "An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of the Financial Statements." See Final Report of the Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission (April, 23, 2006). p. 29. ("Moreover, even though auditors maintain that they are already taking a risk-based approach to the AS2 audit, we heard significant testimony from companies suggesting that implementation of AS2 has resulted in very rigid, prescriptive audits as a result of onerous AS2 requirements. Most issuer comments we received indicated that auditors applied a one-size-fits-all standard, even as auditors maintained that each audit stands on its own. As the Commission's May 2005 guidance suggests, and the input we received confirms, auditors in many instances utilize an approach that is "bottom-up" rather than "topdown." This results in audits that are not risk-based and, in particular, involve extensive testing of information technology (IT) controls. The result is an extensive focus by auditors on detailed processes, a number of which create little or no risk to the integrity of the financial statements.")

¹⁸ See CRA International Sarbanes-Oxley Section 404 Costs and Implementation Issues: Survey Update, at 1.

¹⁹ Section 2(b) of the Securities Act of 1933 mandates that whenever the SEC engages in rulemaking, it is required to consider whether the action will promote efficiency, competition and capital formation. See Peter J. Wallison, *Buried Treasure: A Court Rediscovered A Congressional Mandate the SEC Has Ignored*, AEI Online (Oct. 2005).

²⁰ Exchange traded Pools are index funds, the components of which are futures contracts the "trading" of which is completely driven by published rules. These ETFs report both the net asset value of the indices and the net asset value of the funds several times each minute.

auditors to review the internal controls of a Pool against a COSO Framework in an Accounting Standard No. 2 environment would serve no valuable purpose but would impose significant costs to be borne by Pool investors.

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MFA again thanks the Staff for the opportunity to raise concerns regarding Section 404 and its application to public commodity pools, and would welcome the opportunity to meet with Staff to discuss our comments. If you have further questions or would like to discuss our letter, please do not hesitate to contact me at (202) 367-1140.

Sincerely yours,



John G. Gain
President