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MANAGED FUNDS ASSOCIATION

The Association for investment professionals in futures, hedge funds and other alternative investments.

September 16, 1998

Jean A. Webb
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

COMMENT

Re: Performance Data and Disclosure for Commodity Trading Advisors and Commodity Pools

Dear Ms. Webb:

Managed Funds Association ("MFA") appreciates the opportunity to provide comments in response to the Concept Release (the "Release"), 63 Fed. Reg. 33297 (June 18, 1998) issued by the Commodity Futures Trading Commission (the "Commission") requesting comment regarding possible changes to regulatory requirements which apply to the programs offered to the public by commodity trading advisors and commodity pool operators.

MFA is a national trade association of almost 700 members. MFA's membership is made up of a diverse group of alternative investment professionals, including hedge fund and commodity trading managers, commodity pool operators and fund of funds managers. These fund managers are responsible for a significant portion of the nearly $250 billion invested in hedge funds and the vast majority of the over $35 billion invested in managed futures funds. MFA members also include brokers, exchanges, cash managers, foreign exchange dealers, banks and other professionals who provide support services, such as accountants, lawyers, consultants and academics. Accordingly, MFA and its members have a vital interest in the concepts and the NFA Proposal set forth in the Release.

Introduction

The Commission's Release addresses two major topics for Commission registered commodity trading advisors ("CTA"s) and commodity pool operators ("CPO"s):

(1) Greater regulatory requirements regarding performance reporting, disclosure and compliance issues for partially funded client accounts, and

(2) Risk and volatility measurement, disclosure and reporting for CTAs and CPOs regulated by the Commission.

Partially or Notionally Funded Accounts

With respect to the first issue, the Commission has been engaged with MFA (and its predecessor), the industry and the National Futures Association (the "NFA") in a dialogue regarding the appropriate regulatory approach for partially funded accounts for more than eleven years. As discussed in more detail below, MFA supports adoption of the NFA proposal which itself has taken more than four years of close cooperation between MFA and its members, the futures industry, NFA and the Commission to achieve. MFA believes the NFA proposal is objective and has been well-thought out, researched and discussed over the past four years. MFA believes in general that the NFA proposal represents a good balance responding to regulatory interests while providing customer protection safeguards. The Proposal takes into account the realities of trading strategies without confusing the very separate performance and compliance issues raised by partially funded accounts.

In recent years, the issue has become more acute because of the increasing utilization of notionally-funded accounts, particularly by institutional and high net worth clients.

In light of the volumes of information that have been submitted to the Commission over the years regarding the proper treatment of partially funded account reporting, the transcripts of Commission Advisory Committee meetings and NFA subcommittee meetings recording favorable support by industry leaders, accountants, lawyers and regulators alike, MFA believes the Commission should move promptly to approve the NFA proposal and not await resolution of the other, far-reaching issues and proposals raised by Commission staff which are discussed more fully below. Subject to our comments below regarding slight clarifications to the NFA proposal, MFA urges the Commission to approve the NFA proposal and to rescind

Commission Advisories 87-2 and 93-13. MFA respectfully requests that the notional funds issue be given the attention that is long overdue.

Other Disclosure and Reporting Issues

With respect to the second issue, MFA agrees that the issues of risk and volatility measurement are important topics and the regulations related to them should periodically be reviewed to ascertain their ongoing efficacy. However, MFA notes that the issues raised in the Release are not new issues they are issues that were actively considered in the 1981 amendments to the Commission's Part 4 rules and again in its 1995 amendments. Risk and volatility measurement and the disclosure of trading strategies are complex issues that are equally applicable to partially or fully funded accounts. MFA believes that having addressed these issues in rule amendments in 1995 which were adopted after several years of discussion after significant research and work by MFA, the futures industry, NFA and Commission-represented committees, the Commission should move cautiously before proposing changes of such significance as are suggested by staff's proposals in the Release. MFA is ready and able to work closely with the Commission to provide additional information and assist in an appropriate airing of these new proposed requirements.

MFA concurs with the statement of the Commission that "...requiring more data does not always result in better information for clients. It does not wish to overload clients with excessive amounts of data, nor does it wish to burden CTAs and CPOs with excessive requirements". It was in that spirit that MFA participated with the Commission and NFA (and its Special Committee for the Review of CPO/CTA Disclosure Issues at great length) during 1994 and 1995 to review and revamp completely the Part 4 disclosure rules. These efforts, which were the first major overhaul of those rules in fifteen years, resulted in comprehensive rule changes that have been in effect for just three years.

MFA respectfully requests that issues, other than that of notional funds, raised in the Release be considered as part of a longer term review of the Part 4 Rules, perhaps including the participation of the previously successful NFA Special Committee.

I. The NFA Proposal

MFA believes that the advisories and interpretations of the Commission and staff to date addressing the notional funding issue have not comprehensively resolved the problem. MFA feels the pending NFA

Proposal does just that. Accordingly, MFA fully supports the NFA Proposal. The NFA Proposal is not premised on the fact that nominal account size represents an actual investment or even a commitment of tangible funds or the existence of a commonly accepted method for determining the nominal account size. Rather, the NFA Proposal is rooted in an effort to avoid the presentation of overstated and unrealistic rates of return, such as those sometimes required under current regulations.

The NFA Proposal reflects an appropriate understanding of the distinction between the performance reporting and compliance issues raised by partially funded accounts. Commission staff appears to continue to confuse these two very separate issues.

The objective of performance reporting is to accurately convey the results from the trading which a CTA performed on behalf of a client. Notwithstanding the apparently continuing misconceptions of Commission staff that all CTAs should trade with the same amount of leverage for the same nominal account size, one of the distinguishing differences among CTAs in trading client accounts is the risk/reward determinations they make in putting on any position and the very different risk management techniques each CTA will employ even though they may be all trading the same account size. These differences are a component of what causes trading styles in CTAs to be different and permits clients to choose among the different trading styles according to the investment objectives and risk appetite of a particular client. A CTA's trading style is uniquely his own and accordingly, the performance the CTA will achieve on a particular account size will differ from other CTAs. These differences exist equally for an account that is partially funded or fully funded and the fact that one account is partially funded and the other is fully funded does not affect these differences and also does not affect the trading performance of a CTA as discussed more fully below.

A CTA's creation of a trading strategy inherently entails a determination of the number and type of contracts the CTA will trade for any given account size. While not arbitrarily determined in any sense of the word, a CTA's method for making these determinations typically is unique. We know of no successful CTA able to trade without specifically defined parameters applicable to specific account sizes. These account sizes then comprise the portfolios available to clients to choose in utilizing a CTA's strategy. NFA's requirement that this account size be agreed between the CTA and client and documented in writing prior to commencement of trading in an account eliminates the ability to after the fact "adjust" the denominator to enhance rate of returns. Communication to the FCM who, unlike the CTA, is responsible for the minimum amount of funds

a client posts as good faith margin to support the agreed trading, closes the loop and ensures that the futures commission merchant (the "FCM") will make its credit determination of the amount of margin necessary for that particular client on the basis of the same understanding of the account size being traded. It is important to note that a CTA has no control over, and no particular interest in, the amount of "actual" funds a client determines to send to an FCM - whether it be no funds, minimum margin funds or funds equal to the committed account size. The CTA's contractual agreement is to trade the account pursuant to that CTA's trading style at the portfolio size agreed to and committed by the client for trading. Anything less, and the CTA would have liability to the client.

Accordingly, the NFA Proposal requires that in determining *how a CTA performed*, NOMINAL ACCOUNT SIZE is the relevant factor and must be used in computing CTA rates of return.

The Commission staff requires an "explicit linkage to actual funds..." in order to "...have some basis in traditional financial and accounting methods." The NFA Proposal and historical industry approach have focused on how best to present the performance of similarly situated accounts - i.e., accounts where trading is identical under the umbrella of a common account size (or nominal) amount.

If a CTA agrees with each of several clients to a nominal account size and each account is traded similarly, the performance results of the CTA as they relate to these accounts should be the same. The level of funds on deposit with the client's FCM is virtually irrelevant.

Despite the argument that only the use of only funds on deposit at the FCM for the denominator in computing an advisor's rate of return is somehow consistent with generally accepted accounting principles ("GAAP"), the issue of what is the appropriate beginning net asset value, ("BNAV") or denominator in the calculation of the denominator for computation of rate of return is not a financial reporting concept as noted by Coopers & Lybrand (the "Accountant Letter") in an exhibit to a letter submitted by Robert G. Easton, Chair of the Managed Futures Subcommittee of the Regulatory Coordination Advisory Committee ("RCAC") of the Commission at the RCAC's meeting January 21, 1992 in support of use of the notional account size as the denominator. The Accountant Letter also noted that in their view, the use of actual funds as the denominator in the ROR computation for a notionally funded account would be potentially misleading. It further confirmed that for the purposes of computing a CTA's investment performance, the use of a notional account

size which has been documented in "a legally enforceable written agreement between the CTA and the investor would provide the documentation necessary for the accountant to verify the size of the notional amount and to complete the attestation procedures" by an independent certified public accountant who has been engaged to attest the information included in "notional tables".

A CTA performance table is not the same as a commodity pool performance table and is not analogous to the financial statement of a Company. A CTA's performance table is a compilation of multiple separate client accounts and a CTA has no control over the "external" leverage that a client may or may not choose to use in connection with his account. On the other hand, the pool operator has exclusive control of the pool's assets and the manner in which the pool's actual funds are allocated. The NFA proposal has an appropriate solution for a pool in which the CPO has allocated more assets to trading strategies than the pool has, or, to view it another way, the pool has leveraged the trading of the trading strategies to which its assets are allocated. GAAP is applicable to a commodity pool as its financial statement is financial reporting. However, just as in the case of a separate managed account, a CTA trading for that commodity pool has no control over and is not concerned with the actual funds that a CPO has or has not committed to the account in which the CTA trades. Rather, the CTA trades the account size and corresponding portfolio pursuant to the account size allocated and committed to the CTA by the CPO. Accordingly, the performance reporting issues for a commodity trading advisor and for a commodity pool operator differ, as is reflected by the difference in the NFA's proposed solutions for performance reporting of client managed accounts which have been partially funded and performance reporting for such commodity pools.

The NFA Proposal, in addition to putting forth a sensible performance presentation methodology, addresses related documentation, disclosure and sales practice problems that might result from notional funding.

MFA feels that the disclosures required by the NFA Proposal provide pool participants with useful information on the degree of leverage employed by the pools. This is done in a straightforward way. MFA supports the NFA disclosure rule and suggests that this issue be the subject of further study, perhaps by the NFA Special Committee.

Accordingly, the Proposal's detailed requirements, including the written account agreement between the CTA and its client as well as detailed disclosure to non-Rule 4.7 clients, fully satisfy any sales practice or disclosure concerns.

For non-Rule 4.7 clients, the NFA Proposal and other current rules require more than adequate disclosure, including disclosing "...a statement that the greater disparity between the nominal amount size and the amount deposited...the greater the likelihood, and possible size, of margin calls."

The Commission's proposal to include even more risk profile data is an example of potential data overload for investors.

II. Request for Comment

With respect to the other specific questions relating to the NFA proposal:

A. *Presentation of Data Concerning Estimated Margin Ratios*

The NFA Proposal requires (for non-Rule 4.7 clients) that the CTA must provide the client with "...an estimated range of the amount of customer equity generally devoted to margin requirements or options premiums expressed as a percentage of the nominal account size and the explanation of the effect of partially funding an account on that percentage."

Since the FCM or exchange controls the amount of funds required for margins, MFA feels that this particular disclosure may have only limited utility to clients, except perhaps to disclose in approximate terms the relationship of notional funding to margin and equity. Because margin is exclusively within the FCM's control and not a CTA's, MFA emphatically opposes any requirement that a CTA establish an absolute maximum percentage of customer equity devoted to margin as such a requirement would make it impractical for a CTA to trade its approach responsibly and would encumber a CTA's ability to adapt to extraordinary market situations.

B. *Providing the CTA/Client Agreement to the FCM*

MFA requests that the NFA Proposal be clarified regarding what is required to be supplied to the FCM. MFA supports the NFA proposal in so far as it requires disclosure to the FCM of the client's nominal

account size. However, MFA feels that this information should be provided by itself not as part of the CTA/client agreement. The client agreement frequently contains sensitive or proprietary information that need not be disclosed to the FCM. The only relevant information for the compliance purposes of the rule is the nominal account size.

C. Changes in the Presentation of Historical Data

As indicated above, proposed changes in the presentation of historical data except as provided in NFA's Proposal are questions that MFA respectfully requests be separated from the notional funding question and be the subject of further study, perhaps by the NFA Special Committee.

D. Keeping Clients Regularly Informed Regarding CTA Program Status

Each CTA client receives a confirmation of trades statement every time a trade is done in the account, a purchase and sale statement specifying the trade expenses and net profit and loss whenever a trade is liquidated, and a monthly account statement recapping all trades done in the account for that month, the realized profit (loss), the open trade equity and the account's total equity from the FCM. These statements are prepared by an independent third party subject to CFTC regulation and as such this independent reporting protects clients. While many CTAs periodically provide updates to clients (which are governed by CFTC and NFA solicitation and anti-fraud rules) MFA sees no reason for the Commission to impose a duplicate requirement on CTAs. Especially for small CTAs, this requirement could be cost prohibitative.

E. Fully Funded Subset Requirements

The Commission requests comment on whether the fully-funded subset requirement should be retained and suggests that a CTAs difficulty in obtaining a fully-funded subset may suggest a flaw in the CTAs setting of nominal account sizes. MFA endorses elimination of the fully-funded subset requirement because, as discussed more fully above, whether or not any client, all or none of a CTA's clients fully fund their accounts with the FCM is not within the CTA's control and has no impact on his trading methodology. In light of the fact that an increasing number, and to our knowledge, substantially all of the accounts that are notionally funded are institutional accounts who chose to manage any excess funds themselves, MFA has been a strong proponent since prior to the adoption of the Fully Funded Subset methodology, that the requirement for 10% of fully funded accounts be eliminated. Because a CTA does not rely on actual funds to determine the portfolio composition for the account sizes traded, the existence of this requirement serves neither a useful

compliance nor deterrence purpose. Alternatively, the possibility for manipulation and the difficulties created by computing rate of return only from a select group of accounts favors elimination of the fully funded subset requirement.

Conclusion

MFA urges the Commission to approve the NFA Proposal as soon as possible. MFA will continue to work with the Commission and staff as well as NFA and its staff to fashion disclosure rules that protect valid public interests in a workable performance presentation framework.

Sincerely yours,

John G. Gaine