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1999 SEP 29 P 2:
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1999 SEP 29 P 1:57

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99-21
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September 29, 1999

Jean A. Webb
Secretary of the Commission
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, D.C. 20581

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

Dear Ms. Webb:

I am writing on behalf of the Consumer Federation of America (CFA) to express our opposition to the proposed rules to change the way past performance information is calculated and disclosed to investors for trading programs offered to the public by commodity trading advisors (CTAs). CFA is a non-profit association of more than 250 pro-consumer groups founded in 1968 to represent the consumer interest before Congress and the federal agencies. We appreciate the opportunity to present our views to the Commission on what we believe is an important investor protection issue.

CFA has a long history of advocating improved disclosures to investors. Our policy is based on a belief that, if investors are to make informed decisions and avoid inappropriate investments, they must receive the information they need, in a form they can readily understand, at a time when it is useful to them in making their investment decisions. In short, disclosure should enhance investors' ability to make meaningful comparisons among various investment options and to select those that best suit their purposes.

The proposed rules would change the way rates of return are calculated -- and, thus, the way past performance information is disclosed to investors -- for accounts managed by CTAs. Specifically, rates of return would no longer be based on the level of cash funding provided by the client. Instead, nominal account size would be used, despite the fact that nominal account size often bears no relation to the investors' actual cash exposure. We are concerned that this proposed change represents a step in the wrong direction, and would in fact both diminish investors' ability to compare the past performance of accounts managed by CTAs to other types

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of investments and reverse the progress the Commission has made in improving risk disclosure for these accounts.[1]

The purpose of past performance disclosure

The disclosure of past performance information is particularly troublesome. Investment disclosure documents typically carry a warning that past performance is not a reliable predictor of future results. However, many investors essentially ignore this statement and make past performance one of the key factors they consider in selecting investments, on the assumption that those who produced positive results in the past will continue to do so in the future. Those who promote various types of investments also know this to be the case, and emphasize past performance, where they have positive performance to report, in the hopes that investors will make their investment selections on that basis. It is not surprising, then, to find the National Futures Association (NFA) advocating this proposed change based on a belief that the primary purpose of disclosing past performance is, or should be, to allow CTAs to showcase their past trading program results.

We reject that notion. The primary benefit of disclosing past performance to prospective investors is to elucidate the volatility that the investment has experienced in the past. Specifically, by looking at past performance data, investors can get a sense of how bumpy the road has been that produced a particular return. The Commission says much the same thing in the concept release, when it states that performance data "can be useful to clients as a way of making risk and return comparisons among investment alternatives."[2] Armed with meaningful performance information, investors can decide whether the investment has experienced a level of volatility they can comfortably withstand. To present a meaningful picture of investor experience requires a rate of return calculation that is based on actual cash funding for the account, particularly if increasing numbers of investors are participating through partially funded accounts.

For current investors, furthermore, what is relevant is not an abstract concept of how great a gain or loss they would have experienced if they had fully funded their account. What is relevant is how much of a return they got on the money they put toward the investment. To use an example from the concept release, the fact that an investor would have suffered a 30 percent loss, based on the nominal account size, is not particularly relevant to the investor who has put up just 25 percent of the nominal account size and has not only seen his initial investment wiped

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[1] Our concerns relate specifically to the retail context, in which these accounts are promoted to individual investors, who, though wealthy enough to be able to afford the investment, may nonetheless lack the sophistication to fully understand their risks. Also, we are concerned that the misleading CTA performance data resulting from this rule proposal would make its way into prospectuses of commodity pools, which are also marketed to retail investors.

[2] Commodity Futures Trading Commission, 17 CFR Chapter 1, "Concept Release: Performance Data and Disclosure for Commodity Trading Advisors and Commodity Pools," Federal Register, Vol. 63, No. 117, Thursday, June 18, 1998, p. 33297. [Hereinafter "concept release.]

out but now faces an additional deficit that must be repaid.[3] Thus, for current investors as well as potential investors, performance data must be based on actual cash funding to be meaningful.

The Commission essentially has before it a decision over whether past performance disclosure will be used to serve the interests of industry members, who wish to showcase their past trading results in promoting their services to investors, or the interests of investors, who need: 1) a clear view of the potential risks they face in order to make an informed decision about the advisability of undertaking such an investment and 2) a realistic view of the returns they have received on the money they have put up. For the Commission to act in the interests of investors, it should reject the use of notional account size in calculating rates of return.

The proposed rule would undermine the quality of risk disclosure

The Commission has made tremendous strides in recent years in improving risk disclosure based on past performance data for programs offered to the public by CTAs. The requirements that performance capsules include monthly rates of return for the most recent five calendar years and the current year to date, the worst monthly percentage drawdown during that time period, and the worst peak-to-valley percentage drawdown for the time period all work together to give potential investors a clearer picture of the volatility the account has experienced in the past. Investors should be able to use that information to help them determine the suitability of a particular investment, provided the basis for computing past performance data is not undermined.

One of the primary effects of using nominal account size to compute rates of return, however, is that it would create an appearance of lowered volatility. Thus, the primary benefit of performance disclosure -- ensuring that investors have a clear picture of the volatility that an investment in the account would have produced in the past -- would be undermined. Since the Commission issued its proposed rules, at least one member of the industry has been quoted as saying the new disclosure system would "be useful in attracting new investors."[4] Although one individual cannot be taken to speak for the entire industry, we believe these comments accurately reflect the philosophy that underlies the NFA proposal. We are very concerned, therefore, that members of the industry would use the new performance data to market their accounts to a wider array of investors, including many who would have been appropriately deterred by the clearer picture of volatility presented under the current system. It is difficult to see how the Commission could view this as a desirable result.

The proposed rule would undermine the usefulness of performance data in comparing investment options

In describing the usefulness of performance data, the Commission also emphasizes its

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[3] Concept Release, p. 33299.

[4] "CFTC Mulls New Way to Measure Advisers [sic] Performance (Update 3), Bloomberg, July 27, 1999, comments attributed to George Crapple, co-chief executive officer of fund company Millburn Ridgefield Corp. in Greenwich, Connecticut.

value in "facilitating comparisons with other investment opportunities."[5] By moving from the current system of computing rates of return, however, to one based on nominal account size, the proposed rule would decrease the comparability of performance data. As we have noted before, investors think about returns in terms of the cash they put up to make the investment. When investors weigh a decision between putting $10,000 in a mutual fund, a REIT, individual stocks, or an account managed by a CTA, the relevant performance comparison involves the return they are likely to get, and the size of the losses they could conceivably suffer, on that $10,000. While the current system may not be perfect, it clearly offers investors a better picture of likely returns on the money they put up, as well as potential losses, than a system based on nominal account size, which does not necessarily bear any relation to the amount of money the investor has actually put at risk. Furthermore, since there is no uniformity among CTAs in how they arrive at nominal account sizes, the proposed rule change would not even serve to promote meaningful comparisons among investments of the same type.

<u>Disclosure concerning draw-downs and the range of rates of return</u>

In an attempt to ameliorate the harm it would do by moving to a rate of return calculation based on nominal account size, the Commission has proposed two provisions : 1) a requirement that CTAs who accept partially funded accounts present draw-down figures computed on the basis of the actual funds committed to the CTA's program by the client with the lowest ratio of actual funds to nominal account size in the trading program and 2) a requirement for disclosure of the range of rates of return for closed accounts in the offered program. The fact that the Commission has included these provisions in its proposal demonstrates its awareness that the rate of return calculation based on nominal account size simply does not present a realistic view either of the risks of the investment to investors who partially fund their accounts or of the returns that these investors have experienced.

While we agree that inclusion of this information would be absolutely essential if the Commission adopted the proposed rule, we reject the idea that including this information is adequate to ensure that investors receive appropriate risk disclosures under the proposed system for performance disclosure. As more than one industry member noted in responding to the concept release, investors tend to become overwhelmed when faced with an excess of information. We strongly oppose their conclusion -- that this warrants omitting this information -- since this is the only information in the proposed rule that would give potential investors a realistic sense of the risks of the investment. Rather, we view this as a further argument against changing the system for computing rates of return.

Conclusion

Having made a careful reading of the concept release outlining the National Futures Association proposal, as well as the comments submitted to the Commission in response to that release, we were frankly surprised to see the Commission proposing this rule change. First, the Commission's own statements in the concept release seem to make an exceptionally strong case

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[5] Concept release, p. 33297.

against computing rates of return based on nominal account size. For example, the Commission noted that:

- Nominal account sizes are not comparable from one CTA to the next.[6]

- The fact that nominal account size does not represent an actual investment -- or even a commitment -- of tangible funds and the lack of a commonly accepted method for determining the nominal account size have been major factors in the Commission's reluctance to permit the use of the nominal account size in determining ROR, except as permitted by Advisory 93-13.[7]

Second, all those from outside the industry who commented on the concept release, including one of the Commission's own administrative law judges, strongly opposed use of nominal account size in calculating the rate of return.

In the discussion accompanying the proposed rule change, the Commission does not address either the opposition expressed by outside parties or its own past reservations in proposing this rule change. Instead, it appears to justify the proposed rule on the grounds that it will "simplify" and "clarify" disclosure and thus assist CTAs in promoting their accounts to investors. But the simplification in disclosure is a simplification for the industry only. The proposal would actually force potential and current investors to work harder to determine how reported performance figures would relate to their own investment level. And, as we have noted above, making it easier for CTAs to promote their services to investors is a questionable benefit if it rests on a less than realistic portrayal of account volatility.

While the current system of calculating rates of return may be complex for the CTA, it accurately reflects the complexity of the underlying investment vehicle. In return for easing the industry's calculations, the proposed rule would diminish the value of performance data in supplying information to investors about investment risks and in allowing investors to make meaningful comparisons among various investment options. For these reasons, we urge the Commission to rethink its decision to move forward with this proposed rule.

If you have any questions about these comments, please feel free to contact me at 719-543-9468. Thank you.

Sincerely,

Barbara L. N. Roper

Barbara L. N. Roper
Director of Investor Protection
Consumer Federation of America

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[6] Concept Release, p. 33298.

[7] Concept Release, p. 33298.