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U.S. COMMODITY FUTURES TRADING COMMISSION

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DIVISION OF
TRADING & MARKETS

July 8, 1996

Re: Rule 4.35(a)(7) -- Request to treat as non-proprietary an account owned by the mother of the commodity trading advisor ("CTA") who directs trading of the account

Dear :

This is in response to your recent letter to the Division of Trading and Markets (the "Division") of the Commodity Futures Trading Commission (the "Commission"), as supplemented by telephone conversations with Division staff.[1/] By your correspondence, you request on behalf of "X", a registered CTA ("X"), relief from the requirements of Commission Rule 4.35(a)(7)[2/] with respect to presentation in "X's" Disclosure Document of the past performance of an account owned by your mother, "A". Absent relief, "X" would be required to place the performance data with respect to "A's" account at the end of the Disclosure Document, and prominently to label such performance as proprietary.

Based upon the representations made in your correspondence, we understand the relevant facts to be as follows. "X" began trading its "Y" Program in January 1996. From the date of inception of trading to the present, the sole account traded pursuant to the "Y" Program has been "A's" account. You represent that leveraging in the "Y" Program is moderate and that client accounts will be treated no differently from "A's" account with respect to exposure to volatility and risk. The margin to equity ratio for "A's" account averages twenty percent and approximately the same ratio will be maintained for any client accounts in the "Y" Program. Advisory fees charged to "A's" account (zero percent management fee

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1/ Your letter is undated. Division records indicate that it was received May 10, 1996. We note that you met with Division staff on June 4, 1996 to discuss the contents of your letter.

2/ Commission rules referred to herein are found at 17 C.F.R. Ch. I (1995), as amended by 60 Fed. Reg. 38146 (July 25, 1995, effective August 24, 1995).

and twenty percent incentive fee) are the same fees that "X" charges its other current account,[3] and that "X" discloses to prospective clients in its Disclosure Document.

You further represent that "A's" account is charged commissions for each round turn of fifteen dollars plus the fees charged by the National Futures Association and exchange fees. "A's" account receives no reduction in commissions by virtue of any agreement or relationship between "X" and the futures commission merchant with which the account is maintained or the introducing broker. This commission rate (which is higher than the rate charged to "X's" other existing account) will be charged each client accepted into the "Y" Program.

You state that "A" has no business interest in "X", and that she has not exerted (and will not in the future exert) "any unnatural or abnormal pressure" on you that might materially affect the manner in which her account is traded. On this basis, you argue that notwithstanding "A's" family relationship with you, her account should be treated as "outside" "X" for purposes of calculating assets under management, and for purposes of presenting past performance information.

Effective August 24, 1995 the Commission adopted extensive revisions to the disclosure requirements applicable to CTAs and commodity pool operators (the "Part 4 Revisions"), in which the Commission expressly addressed the inclusion in Disclosure Documents of proprietary trading results.[4] Acknowledging that for many start-up CTAs, proprietary trading results are the only "track record" available to present to prospective clients, the Commission decided to permit the use of proprietary trading results, subject to certain safeguards. As adopted, Rule 4.35(a)(7)(ii) defines proprietary trading results to include:

3/ "X's" other account is traded pursuant to "X's" "Z" Program.

4/ See 60 Fed. Reg. 38146 at 38167-38168 (July 25, 1995). Prior to the Part 4 Revisions, use of proprietary trading results was not specifically referenced in the Commission's rules, although Commission staff had advised registrants that any proprietary trading results presented in a Disclosure Document must be clearly labeled as such and presented in a separate table. See 59 Fed. Reg. 25351, 25360 (May 16, 1994). Staff had also required that if fees, expenses, commissions, margin-to-equity ratios, or any other item pertaining to the proprietary trading was materially different from that relevant to the pool or trading program offered to participants or clients the registrant must "pro forma" such items to correspond to those in the pool or program being offered. The Commission continues to require registrants to make such pro-forma adjustments to proprietary trading results.

> the performance of any account in which fifty percent or more of the beneficial interest is owned or controlled by:
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> * * *
>
> (B) An affiliate or family member of the commodity trading advisor; . . .

Rule 4.34(n)(3)(iii) requires that any proprietary trading results (together with any hypothetical, extracted, pro forma or simulated trading results) be placed at the end of the Disclosure Document. The Commission noted that this requirement "reflects the relatively low utility of such data and the relatively high potential for confusion of proprietary and customer trading results."[5/]

In proposing and adopting the Part 4 Revisions, the Commission discussed a number of significant concerns raised by the use of proprietary trading results, noting that proprietary accounts may be traded more aggressively, with higher leverage and greater risk than customer accounts, and that proprietary accounts and customer accounts are usually subject to different fee schedules. Moreover, where proprietary and customer accounts are combined for purposes of performance presentations, the total amount of assets under management is inflated and conceals the actual amount of customer funds being traded.[6/]

In your correspondence you argue that the reasons underlying the Commission's special treatment of proprietary trading results do not apply to "A's" account, and that you should be permitted to present the performance of that account as though it were an unaffiliated client account. In support of your position you claim that any outside client accounts that are accepted into the "Y" Program will be charged the same fees and will be traded in the same way and with the same leverage as "A's" account. You contend that because "A" has no business interest in "X", her account is "outside" "X" and cannot be used to inflate assets under management.

We do not, however, believe that these factors justify a waiver of the Commission's requirements, particularly since the Commission's rules do not preclude the presentation of proprietary trading results, but only the treatment of such results as the results of client accounts. The performance of "A's" account clearly fits the definition of a proprietary trading results. Your representations that "A's" account is effectively a "customer" account notwithstanding that "X's" "Y" Program has yet to attract unaffiliated client money do not support, in our view, recharacter-

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5/ See 60 Fed. Reg. 38146 at 38167.

6/ See 60 Fed. Reg. at 38167-38168.

ization of the account's trading results as customer account data. To the extent that a prospective client were to use "X's" Disclosure Document to evaluate the ability of "X" to attract and retain outside clients, failure to designate "A's" account as proprietary would be misleading.

Accordingly, "X" is required by Rule 4.35(a)(7) clearly to indicate that the performance of "A's" account is proprietary, and if included in "X's" Disclosure Document, such performance must be placed in accordance with Rules 4.35(a)(7) and 4.34(n).

If you have any questions concerning this correspondence, please contact me or Christopher W. Cummings, an attorney on my staff, at (202) 418-5445.

Very truly yours,

Susan C. Ervin
Chief Counsel