

CFTC Letter No. 99-22

, 1999

[Exemption]**Division of Trading & Markets**

Dear:

This is in response to your letter to the Chairperson of the Commodity Futures Trading Commission (CFTC). By your letter, you request favorable consideration of proposed changes to CFTC Rule 4.35(a)(7), and you request an exemption from the requirements of Rules 4.35(a)(7) and 4.34(n). Your letter was treated as a Petition for Rulemaking pursuant to Rule 13.2 and has been referred to the Commission.

Based upon the representations made in your letter, the relevant facts are as follows. You are the sole principal of "A." During 1998, "A" had only two accounts, both of which were determined during an audit by the National Futures Association ("NFA") on February 1 and 2, 1999, to be proprietary. In one account, opened on January 12, 1998, you contributed \$\$\$,000, and your sister contributed \$\$\$,000. The other account, opened on April 13, 1998, is an Individual Retirement Account ("IRA") in which you are the sole owner. You indicate that, if these accounts are considered proprietary, it would be very disadvantageous to A because all the accounts for which the performance is disclosed in A' Disclosure Document would be considered proprietary and, as a consequence, that performance would be unusable as promotional material. You seek changes to Rule 4.35(a)(7) which would limit the definition of "proprietary" accounts in such a way as to exclude these two accounts.

The use of proprietary trading results in soliciting customer accounts is a practice which has long been of concern to the Commission. The Commission expressly addressed the issues raised by the inclusion of proprietary trading results in Disclosure Documents in extensive revisions to the disclosure requirements applicable to commodity trading advisors and commodity pool operators (the "Part 4 Revisions") which were adopted effective August 24, 1995.¹

In proposing and adopting the Part 4 Revisions, the Commission discussed a number of these concerns, noting that proprietary accounts may be traded more aggressively, with higher leverage and greater risk than customer accounts. CTAs may trade proprietary funds to test a new trading strategy before implementing it for customer funds or to establish a track record prior to trading customer funds. Proprietary accounts and customer accounts are frequently subject to different fee schedules. In a proprietary account, or in

situations where a portion of the funds in the account belong to the CTA or a relative, the CTA may elect to charge no management or incentive fee and clearing fees may be waived or reduced if the account is cleared by an affiliate. Moreover, where proprietary and customer accounts are combined for purposes of performance presentations, the amount of customer funds that the CTA has attracted is inflated. For these reasons, proprietary trading results may be of little relevance to a prospective pool participant or CTA client in many cases and may be actually misleading in others.²

As adopted, Rule 4.35(a)(7)(ii) defines proprietary trading results to include:

the performance of any account in which fifty percent or more of the beneficial interest is owned or controlled by:

* * *

(B) An affiliate or family member of the commodity trading advisor;

The Commission regulation permits the use of proprietary trading results, subject to certain safeguards to ensure that the presentation is not misleading. 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 in order to minimize the likelihood that the proprietary results will be afforded undue weight. The Commission noted that this requirement reflects the fact that such data are frequently of relatively low utility to prospective customers and the relatively high potential for confusion of proprietary and customer trading results.³

You urge that Regulation 4.35(a)(7)(ii) be "clarified" to indicate that the term "family member" is limited to the spouse or the children of the CTA. You further believe that the regulation should indicate that an IRA account is not considered to be proprietary. You point out that these changes would achieve the benefits of clarifying the term "family," and "officially recogniz[ing] that [the CTA's own] IRAs are the equivalent to client accounts."

When the current rules were adopted, concerns of the nature you present were considered by the Commission. In determining which accounts are proprietary, the test the Commission adopted focuses on issues of "ownership or control." Ownership by the CTA or a relative or affiliate creates the incentive for differential treatment, and control creates the means for such treatment. Given this rationale, a retirement account controlled by a CTA should clearly be included as proprietary. Moreover, an account the majority of which is owned and controlled by a close relative, such as a sibling, is also clearly within the intent of the rule.

In adopting the revised rules, the Commission recognized that, for many start-up CTAs, proprietary trading results are the only "track record" available to present to prospective clients. For that reason, the rule as adopted permits the presentation of these results, albeit as the last disclosure.⁴ The circumstances presented by your request, involving an IRA account and an account substantially owned by a sibling do not justify a change to or a waiver of the Commission's requirements, particularly since the Commission's rules do not preclude the presentation of proprietary trading results. Consequently, the Commission will not change the rule or grant exemptive relief to enable you to consider these accounts as non-proprietary.

If you have any questions concerning this letter, please contact Robert B. Wasserman, Associate Director, Division of Trading and Markets, at (202) 418-5092.

Very truly yours,

Jean Webb

Secretary

cc: Daniel A. Driscoll

National Futures Association

¹ 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 referred to 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).

² See 60 Fed. Reg. at 38167-38168.

³ See 60 Fed. Reg. at 38167.

⁴ 60 Fed. Reg. at 38167. See 17 C.F.R. § 4.34(n)(3)(iii).