99-21
(20)

COMMENT

ARTHUR F. BELL, JR. & ASSOCIATES, L.L.C.

Certified Public Accountants

(410) 821-8000

FAX (410) 321-8359

Member:

American Institute of Certified Public Accountants

SEC Practice Section

Maryland Association of Certified Public Accountants

Suite 200

201 International Circle

Hunt Valley, Maryland 21030

1999 OCT -4 P 3:21

October 1, 1999

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

Dear Ms. Webb,

The attached letter was sent to you via email October 1, 1999. Enclosed is a signed copy of the letter for your records.

Sincerely,

Patricia A. Maitland

:pm

Enclosure

RECEIVED C.F.T.C.

1999 OCT -4 P 3:

ARTHUR F. BELL, JR. & ASSOCIATES, L.L.C.

Certified Public Accountants

(410) 821-8000

FAX (410) 321-8359

Member
American Institute of Certified Public Accountants
SEC Practice Section
Maryland Association of Certified Public Accountants

Suite 200
201 International Circle
Hunt Valley, Maryland 21030

September 30, 1999

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

Re: Performance Data and Disclosure for Commodity Trading Advisors;
64 Fed.Reg. 41843 (August 2, 1999)

Dear Ms. Webb,

Arthur F. Bell, Jr. & Associates, L.L.C. is pleased to have this opportunity to respond to the Commodity Futures Trading Commission's (CFTC's or Commission's) "Request for Comments" on proposed revisions to its rules regarding Performance Data and Disclosure for Commodity Trading Advisors.

Arthur F. Bell, Jr. & Associates, L.L.C. is a Certified Public Accounting firm serving the futures industry for approximately twenty years. The firm has over two hundred clients involved in derivative and equity trading as Commodity Trading Advisors (CTAs), Commodity Pool Operators (CPOs), Futures Commission Merchants (FCMs), Introducing Brokers (IBs), Registered Investment Advisers (RIAs) and similar capacities. Members of the firm are involved in numerous industry committees, and Mr. Bell is a member and former Director of the Managed Funds Association (MFA), a member of MFA Government Relations Committee, Futures Industry Association (FIA), National Futures Association (NFA) Special Committee, the CFTC Global Markets Advisory Committee, the UK Pension Research Accounting Group, Advisory Panel of Futures Industry Law Letter and various other similar industry groups. Mr. Bell is also on the Editorial Advisory Board of *Futures Industry* Magazine and on the Board of Editors for the *Futures and Derivatives Law Report*. The firm's experience and industry involvement are the basis for substantial interest in the proposed revisions.

We strongly support the Commission's proposal to revise its rules to require that the rate of return (ROR) be computed by dividing net performance by the beginning nominal account size. In recent years, we have seen a substantial number of accounts, particularly institutional accounts, with little or no actual cash funding due to their cash management strategies. The proposed method of ROR calculation will result in a more accurate measure of the CTA's performance and the results of its trading program. It recognizes that a CTA's trading decisions are based on the nominal account size, not the amount of actual funds.

The debate over a change from the current permitted methods anchored to actual funds to the proposed rules has been complicated by terminology and obscured by seemingly logical intuitive responses. It does seem at first impression that actual funds are the appropriate basis to measure performance and using any other calculation is an opportunity to manipulate results. The actual funds method would seem to draw support from accounting standards and the practice and standards in other investment activity reporting. The parties on either side of the argument tend to so passionately believe in their logic that the issue has been identified as "emotional funds" and the dialogue has become inflammatory with terms such as "fictional funds" and "notional nonsense" tossed around. Both sides tend to dismiss the other with some variation on the theme of "They just don't get it." We supported the actual funds approach for many years until investor demands, industry practice, NFA proposed rules, discussions with the CFTC and experience with partially funded accounts persuaded us that a change in reporting was essential to properly present performance of a CTA.

Only after careful objective analysis and understanding that commodity trading is, in fact, very different from other investments can you appreciate the reporting dilemma. Commodity trading intrinsically involves leverage, the only purchase is a futures contract (not the actual asset) and the amount of cash required is artificially determined by exchange rules, broker policies, CTA negotiated agreements and regulatory requirements and can change day by day. The investment in a $1,000,000 U.S. Treasury bill is an asset with an identifiable price requiring payment at time of purchase, whereas the purchase of a forward $1 million Treasury bill futures on the Chicago Mercantile Exchange requires only so much cash as may be determined by the above stated factors. Once the Treasury bill is purchased, the transaction is completed and no more cash is involved, contrasted with the futures position that may require additional cash or permit return of cash every trading day. Thus, cash in the first instance is a fixed relevant denominator and is a variable amount in the second with more limited function as a denominator.

A fundamental factor in assessing the proposed rule is to distinguish between calculating a particular investor's results and reporting the results of a CTA's trading program. In the case of the investor, using actual funds has merit, but combining a group on accounts funded at different levels into a composite and calculating a rate of return based on actual funds deposited for the group results in a totally meaningless rate of return for any of the investors or the CTA program. Consider a real example of a CTA with 97 accounts having a notional value of $132 million dollars. In one particular month, 37 accounts maintained a zero balance sweep account supported by cash outside the control of the CTA, 58 accounts had funding levels widely ranging from 6% to 75%, and only two accounts were fully funded. The rates of return on client accounts ranged from infinite on the zero balance accounts to 2% on the fully funded accounts. Yet, when calculated on a notional funded basis, all the accounts conformed to a common gross trading profit ratio demonstrating the CTA *program* performance.

The financial press has reported comments and contained headlines and text more typical of the *National Enquirer*, an example being "Proposed Rule Could Help Mask Commodity Trading Volatility" which appeared in the September 2, 1999 edition of the *New York Times*. This article contained words and phrases such as "smooth out past returns," "hypothetical", "duplicitous" and "manipulation." To be fair, let's consider what the proposed change really would and would not accomplish. First and most important, the industry would be required under the NFA proposal to document in clear terms with a client signed agreement, the nominal account size and reporting for the account. Thus, the client will know exactly the method of reporting, hardly a duplicitous situation. For the record, nearly all accounts we see currently use some variation of the NFA agreement. This mandated documentation will allow testing of comparability of accounts within a program to determine if the reporting fairly presents the CTA program results. If the results are misleading, the CFTC and NFA have a solid basis to commence remedial actions and successfully enforce the reporting rules. This process counters the allegations of hypothetical and self serving performance presentation. The proposed rules provide an industry wide discipline in the denominator and allows greater certainty of significance of performance results and comparability between CTAs.

Other inflammatory rhetoric alleged that the new rules would allow a CTA to increase fees and favorably alter performance. This opinion betrays a misunderstanding of the dynamics that occur when fees are negotiated with clients qualified to establish a partially funded account. The facts are that management fees have declined by nearly half in the period from issuance of CFTC Advisory No. 87-2 until today, (in some very large accounts the management fee has been eliminated altogether) primarily as a result of the bargaining power and sophistication of the large accounts eligible for partial funding. Incentive fees are entirely unrelated to account size or funding levels and thus unaffected by the proposed rule change. It should also be noted that the absolute dollar amount of performance results for both a particular account and a composite of accounts are also unaffected by the proposed rule change. It can be readily observed, and is mathematical truth, that a loss will produce a negative rate of return so long as the denominator is some positive number greater than zero. Thus, the opportunity to manipulate performance and remain in compliance is significantly reduced by the new rules.

What the proposed rule change will not do is prevent those very few scoundrels determined to commit fraud from doing so. English history includes stories of pickpockets plying their trade during public hangings of pickpockets.

<u>Comments on the Treatment of Additions and Withdrawals to Nominal Account Size</u>

It is clear from the proposed rules that the nominal account size is determined by the investor and documented in writing pursuant to a written agreement between the client and the CTA. It is unclear, however, how the ROR calculation would address the potential distortion in ROR that could result due to large additions or withdrawals to nominal account size that occur during the month. Are the alternate methods of computation outlined in the Commission's Advisory, ¶25,005, Commodity Futures Law Reporter, *"Adjustments for Additions and Withdrawals to Computation of Rate of Return in Performance Records of Commodity Pool Operators and Commodity Trading Advisors"* to be applied? Additionally, the alternate methods of computation all have an actual funds basis for ROR calculation. We encourage the Commission to clarify its position on this issue in the revised Rules.

Comments on the Disclosure of Commission Expense

Proposed Rule 4.34 (p)(2) requires that CTAs who accept partially funded accounts disclose "an estimated range of commissions generally charged to an account expressed as a percentage of the nominal account size and an explanation of the effect of partially funding an account on the commissions as a percentage of actual funds;" Commissions charged to an account are generally determined by an agreement between the client and the FCM. It can be established using a number of different methods. Most are calculated on a round turn basis, although some are based on assets and others are based on a negotiated flat fee. If the CTA does not require a specific FCM, any or all of the above methods may be present in the composite. In addition, the clients being charged on a round turn basis may have varying round turn rates. A short term trader whose volume of trading fluctuates monthly with market conditions adds another variable to establishing an accurate range. In order to assess the impact of these variables, we looked at some of our current clients and extrapolated annual commission rates by annualizing monthly data. One CTA experienced commissions that ranged from 2% to 9% of beginning nominal account size, one had a range of .06% to 6%, and another experienced a range of 9% to 48%.

We view proposed Rule 4.34 (p)(2) as unnecessary, uninformative (as reflected above) and potentially misleading. By mandating this disclosure, prospective investors could view the commission range as a vital element in their decision making process, and thus, such investors could be prone to making investment decisions based on the lowest commission range. Although commissions can have a potentially large impact on a CTA's performance, the ultimate success of the CTA is primarily a result of its gross trading activity. The prominence given to this proposed disclosure is disproportionately greater than any benefit derived. We strongly suggest eliminating proposed Rule 4.34 (p)(2).

Comments on the Inclusion of Interest Income

We agree with the Commission's position that interest on funds deposited with the FCM should be reflected as part of the CTA's performance, however, we also believe that interest earned in other accounts meeting the "Actual Funds" definition in proposed Rule 4.10 (n)(2) should also be reflected as part of the CTA's performance. We strongly recommend that proposed Rule 4.35 (a)(6)(i)(B)(iii) be revised to permit net performance to include all interest earned on "Actual Funds" as defined in proposed Rule 4.10 (n)(2). Interest income is a fundamental distinction and advantage of commodity accounts as compared to other cash intensive investments. This aspect is part of the reason a CTA attempts to obtain fully-funded accounts. Many CTAs will not accept partially funded accounts, although market forces are diminishing this position. Disallowing interest income from performance would have the effect of removing an incentive to require as much funding as possible and, perversely, encourage partial funding.

In our opinion the disparity of ROR among accounts, due to interest income, that have various levels of funding is an inherent disparity comparable to that which also occurs with commissions, incentive fee rates and management fee rates. We believe that such a disparity is inherent in presenting composite performance results, and accordingly, we suggest no revisions or modifications to the proposed Rules to address this issue.

Comments on Proposed Changes to Draw-down Calculations and Disclosures

Under the proposed Rules, draw-down calculations are based on the composite of accounts. We believe this proposal simplifies the computation of the draw-down figures without compromising accuracy and adequacy of disclosure. Accordingly, we support this proposed change. Composites that previously included significant levels of notional funds excluded RORs and draw-down figures of notionally funded accounts under CFTC Advisory No. 93-13. They would now disclose RORs and draw-down figures that are more representative of the program being traded due to the inclusion of all accounts. We are concerned, however, about the additional requirement to express the draw-down information at the lowest funding level. The number is meaningless to the prospective investor unless its funding level is that being presented and it views returns on cash deposited as the indicator of performance measurement. Multiple draw-down figures are likely to result in information overload and dilute the impact of the program-based draw-down figures. Therefore, we recommend eliminating the requirement to present draw-down information at the lowest funding level.

Comments on the Requirement to Extend the Reporting Period of Draw-down Figures

Information overload is also a real concern when considering the requirement to present the draw-down figures for the most recent five years and from inception for the offered program or programs. The Commission extended the required past performance disclosure period from three years to five years with the 1995 Revision to the Part 4 Regulations. We do not believe anyone is served by the additional disclosure of draw-down figures from inception. In the release of the 1995 Revision to the Part 4 Regulations, the Commission described among the purposes of the Revision, the simplification of past performance disclosures and the reduction of required disclosures concerning matters of secondary relevance. As mentioned earlier, the five-year reporting period was determined to be the most relevant to the investor. We believe that this remains a valid determination. The additional disclosure does not relate to the monthly rates of return presented in the performance capsule and its relevance is secondary at best. We strongly urge the Commission to limit the required reporting period for draw-down information to the current five year reporting period. Those CTAs who wish to disclose performance information and draw-down information from inception may do so under the provisions of CFTC Advisory No. 10-96.

Comments on the Additional Requirement of the Bar Graph in the Capsule

Requirements for performance disclosure for the offered program have been expanded in the proposed Rules to include monthly RORs in both a numerical table and in a bar graph. Requiring a bar graph serves only to disclose with bars what is already clearly disclosed with the tabular presentation. A bar graph is widely open to extensive manipulation of scaling and proportion. Proportions will vary with time, volatility of rates of return, axis ranges and the physical size of the graph. The wide variance in the returns experienced by CTAs would make uniform requirements an extremely complex task. In addition, the bar graph requires a lot of physical space in the capsule. As is evidenced by the example of a performance capsule in Appendix A of the proposed Rules, the capsule is now two pages long before any narrative or footnote disclosure detailing ROR calculation, fee calculations, etc. The cost of presenting information that is already included in the capsule is difficult to justify. This is especially true for the CTA that offers 10 to 20 different programs. We sincerely urge that the current requirement of presenting monthly rates of return in either a numerical table or a bar graph remain in effect.

Comments on Disclosure of Range of Lifetime Returns for Accounts Closed
We understand the Commission's intent in requiring that CTAs present the range of RORs for accounts closed with lifetime net profits and lifetime net losses during the five-year reporting period. However, we have great concern that this information may be potentially misleading. Net lifetime profits and losses are solely the result of the investor's decision making rather than a representation of a CTA's trading results. The investor, not the CTA, determines the length and time period of its investment with a CTA. This proposed rule could potentially lead prospective investors to conclude that the CTA has better or worse performance results that the RORs presented may indicate. We strongly advocate removing this requirement from the proposed rules.

Comments on Proposed Changes for Commodity Pools
Proposed changes to Rule 4.25 (a)(1)(ii)(H) focuses on pools where the CPO allocates to the CTA an amount of actual funds which is less than the nominal account size. Performance capsules for such CTAs included in the pool Disclosure Document would be required to contain additional draw-down information computed on the basis of the ratio of nominal account size to the pool's actual funds allocated to the CTA. We believe that this information is irrelevant and potentially misleading. Draw-down information presented in the CTA's capsule reflects the CTA's own five year history, not the history of its association with the pool. Draw-down information contained in the CTA's composite gives the potential investor disclosure of the performance history and draw-downs of the CTAs selected by the Trading Manager. However, by taking this information and extrapolating it to the percentage of actual funding by the pool, we are applying a percentage that, in all likelihood, is completely unrelated in timing and character to the CTA's composite draw-down percentage. Furthermore, the pool's Trading Manager is obligated to regularly evaluate its CTAs and, in its evaluation, would consider that CTA's returns. Continued concerns regarding any CTA's returns or volatility generally prompts the Trading Manager to adjust or remove the CTA's allocation. Additionally, the CTA would be required to have a separate capsule for every pool Disclosure Document that contains such CTA's capsule. The required massive additional data obscures the fact that a pool investor primarily relies on the skill of the CPO selecting the CTAs rather than the particular group of CTAs in the pool. Except for the single CTA pool, the allocation size and number of CTAs changes frequently with trading advisors added and removed from the pool. The extracted data on ever-changing advisors is useless information. Accordingly, we recommend that no modification be made to Rule 4.25 (a)(1)(ii)(H).

Comments on Proposed §4.10 Definitions
Proposed 4.10(l)(3)(i)(A) refers to "the realized gain or loss on *position* closed." We suggest changing position to *positions*. 4.10(l)(3)(i)(C) refers to "interest *accrued* on funds." The more appropriate reference would be to "interest *income*," not "interest *accrued*." Interest income earned during the month and also received in that same month would not be accrued, but would be interest income, and therefore, part of net performance. A similar recommendation is made for 4.10(l)(3)(i)(D). Other income *accrued*, should be other income *earned*. We believe that 4.10(l)(3)(i)(E)(ii) would be clearer if it read "No *interest or other* income may be imputed..." Furthermore, we recommend that 4.10(l)(4) be clarified by changing the wording to read as follows: "For purposes of § 4.25 and 4.35, a peak-to-valley draw-down which began prior to the beginning of the most recent five calendar years *and continues into or ends during the most recent five years* is deemed to have occurred during such five calendar-year period." The language as drafted deems all prior drawdowns as ending within the last five-year period, even if started and ended ten years ago.

Comments on Presenting the Percentage of Accounts that are Fully-Funded

Inclusion of the percentage of accounts that are fully-funded, pursuant to proposed Rule 4.35 (a)(1)(ix)(C), implies that this disclosure carries a meaning beyond representing the cash management strategies of the CTA's investors. The CTA does not base trading decisions on whether an account is fully or partially funded. This disclosure has no relevance to the CTA's performance history and has no place on the CTA's performance capsule.

Thank you for considering our comments. If you have any questions or would like to discuss them with us, please call Arthur F. Bell, Jr. or Ross Ellberg at (410) 821-8000.

Sincerely,

Arthur F. Bell, Jr. & Associates, L.L.C.

clients\data\1090\Sep99_Webb.doc